Credit-sensitive rates beneficial for US market, sources say

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Multiple rates should be accepted as valid replacements for USD Libor given the breadth and variety of the US market, panellists at an event reiterated this week.

Speaking at Bloomberg's latest transition series online event, the panellists argued that having the possibility to choose one's preferred alternative to Libor would, and has already benefitted the market in more than one way.

"There is a wide diversity of banks in [the US], and they have always used multiple rates," said James Lovely, consultant at FPExpert.com. "It makes perfect sense for the lending market and certain other markets to diversify the ones that they use going forward, so that – one, they're better aligned with the rate that they use, and two, there's not an overly dominant dependence on a single rate."

Alternative rates other than the secured overnight financing rate (SOFR) have come under fire in recent months, with regulators saying they emulate too many of Libor's weaknesses.

In fact, the panellists argued, credit-sensitive rates (CSRs), such as the Bloomberg short-term yield index (BSBY) and Ameribor, for instance, have had a more positive effect than some would like to admit.

"The existence of CSRs really did a service to the US lending market: as far as the Alternative Reference Rates Committee (ARRC) was concerned, in March 2021, there was not going to be a SOFR term rate," said Lovely. "It was only the existence of a competitive alternative, which is part of a healthy ecosystem, that helped to convince the ARRC that they needed to pivot and launch the SOFR term rate."

See also: FCA confirms no new Libor use after year-end

By gravitating towards Ameribor and BSBY, the market led the regulators to understand that some sectors were not satisfied with the in-arrears calculation of SOFR.

"A diverse ecosystem won't be strictly as efficient and liquid as a single-rate ecosystem, but that doesn't necessarily make it unhealthy," Lovely added. "It's worth giving up a bit of liquidity for increased diversity and improved market signalling, in this case, from credit sensitivity, market stress and liquidity stress."

In the long run, Lovely said, such dynamics should not be underestimated. “You can tackle the issue of the availability of different rates in multiple ways,” he explained. “At a philosophical level, you can talk about the fact that very few ecosystems are healthy if they're dominated by one rate or one species. The reality is that SOFR was primarily and principally designed to be a derivative replacement rate for Libor.”

Find your fit

Having multiple options to transition away from USD Libor is particularly key in the lending markets, the panellists agreed, where needs differ from other products.

“The fact that there are different bank funding costs across the board makes it clear that there's going to be different strokes for different folks with respect to benchmarks,” said Tess Virmani, associate general counsel and executive vice president for public policy at the Loan Syndications and Trading Association (LSTA). “The Fed has regularly acknowledged that, based on banks' funding costs and client needs, other benchmarks in addition to SOFR will play a role. Undoubtedly, SOFR is where the momentum of replacement for USD Libor is going, but when you look to the lending markets it is important to be cognisant of the differences between rates.”

See also: IFLR USD Libor Survey 2021

One way to address those differences is to use a credit adjustment spread– such as IHS Markit’s credit-inclusive term spread (CRITS), for instance, or SOFR Academy’s across-the-curve credit spread index (AXI) – as an add-on to SOFR.

“We're certainly seeing an adjustment included where SOFR is being used, but there can also be a more natural fit in using an all-in rate that embeds the credit premium rather than a spread adjustment – particularly for banks with higher funding costs,” said Virmani. “The heterogeneous nature of the lending markets, which are very broad, necessitates a credit-sensitive rate in some market segments where other segments may be more comfortable with SOFR.”

In lending markets, where knowing interest payment in advance is critical, having term rates available is critical to a successful transition, Virmani insisted.

“I can understand the concern that another cessation event could happen, but these rates, the ones that really dominate the CSR market –BSBY and Ameribor – are getting a lot of support,” said Edward Ivey, counsel in Moore & Van Allen’s financial services team. “People seem to forget that there are a lot of good reasons to use those rates in certain fact patterns. They may not be great for everyone, but there are markets where it makes sense to use them.”

Some are hopeful that over time and with transition progress, regulators’ perception of CSRs may change. “Lending markets were among the last ones to move, but we have seen a good amount of SOFR-based lending activity both in the investment grade and the leveraged spaces, as well as two CLO [collateralised loan obligation] tranches priced in SOFR,” said Virmani. “Now that we’re starting to see some momentum and real movement away from Libor, this would probably colour the views of anyone who was expressing concerns.

Similarly to Lovely, Ivey also agreed that having multiple rates available for use is overall safer for markets. “It is much easier to talk to regulators about why it's safer to have a book that is diversified,” he added. “What really drove the CSRs’ success in the summer was that people didn't want to use the in-arrears rate calculation. Although we’re starting to see some institutions becoming more comfortable with it, for many borrowers Ameribor and BSBY are very similar to what they are used to – and that’s what they need right now in moving away from Libor.”

Discussions around CSRs and spread adjustments will likely continue to be a hot topic right up until no-new-Libor at year-end, and beyond.

See also: BSBY Q&A with Umesh Gajria, Bloomberg