Market conventions for referencing SONIA

By Katie Kelly

Background

RFR On 18 March, the Working Group on Sterling Risk-Free Reference Rates (the "Working Group") released a discussion paper on *Conventions for Referencing SONIA in New Contracts*, which was developed with inputs from market participants across the bond, loan and derivatives markets. Largely based on the conventions which have been used in recent SONIA-referencing FRN issues in the sterling market and SOFR-referencing FRN issues in the US dollar market, the discussion paper explores those conventions which the Working Group considers to be most significant for the sterling SONIA market, and where it therefore considers that providing more information would be beneficial to the market.

Aimed at market participants who are considering how to reference SONIA in new contracts, the intention of the discussion paper is to raise market awareness of the identified conventions for referencing SONIA, with a view to supporting market participants' relevant preparations. It is hoped that raising awareness of the identified market conventions could encourage the further adoption of SONIA by a broad range of market participants and could therefore help reduce the risks of fragmented liquidity. The discussion paper is also expected to help support and inform infrastructure providers and calculation agents who may be charged with developing the necessary system and other changes to enable end-users to reference SONIA consistently across markets and products.

The discussion paper does not explore the use of term SONIA in new contracts. A term SONIA rate may develop: according to the FSB's statement, *Interest Rate Benchmark Reform – Overnight Risk-Free Rates and Term Rates,* in July 2018, "… in some cases there may be a role for term rates, including RFR-derived term rates, or term rates derived from other liquid markets". But according to the Working Group's Statement, *LIBOR Transition and Development of a Term Rate based on SONIA: Next Steps*, "The [Working Group] … encourages LIBOR users to progress their transition from LIBOR to the greatest extent possible, independently of any further progress on the development of [term SONIA rates]". Further, the discussion paper stresses that market participants are free to choose their preferred conventions, so does not provide guidance or recommendations.

The discussion paper sets out the conventions which are used in well-established SONIA-referencing markets; these include SONIA futures contracts, and the overnight indexed swaps market, in which a fixed rate cash flow is exchanged for a floating rate cash flow indexed to an overnight interest rate (SONIA). The floating rate is calculated on a compounded basis using a formula which can be found in the ISDA definitions.

Notwithstanding the fact that they reference different risk-free rates, the market conventions which have been used recently in the SONIA-referencing FRN issues in the sterling market and Secured Overnight Financing Rate (SOFR)-referencing FRN issues in the US dollar market are both pertinent to the emergence of conventions in the sterling SONIA market. Each set of conventions is explored in detail in the discussion paper. There are two main differences in the two sets of conventions used in each market; compounding or simple averaging, and a lag mechanism or lock-out mechanism, as described further below.

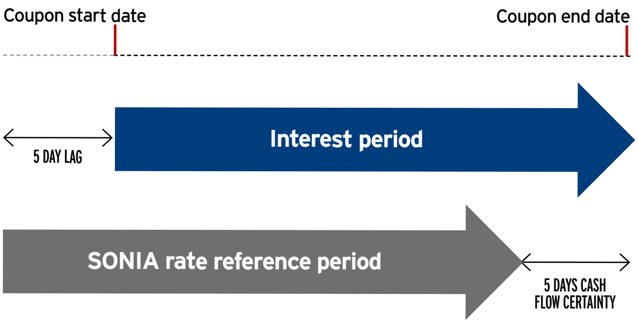
Compounding or simple averaging

Interest on FRNs is typically paid quarterly (although it can be paid monthly, semi-annually or even annually). As SONIA is an overnight rate which is published the following day, that daily SONIA rate must be aggregated in some way over the relevant period to determine the interest amount for the period. In the SONIA-referencing FRN market, the daily rates are aggregated on a compounded basis. In the SOFR-referencing FRN market, a simple arithmetic average of the daily rates, which rolls over for a Friday rate for Saturday, Sunday and public holidays, is used instead. The discussion paper sets out some of the relative advantages and disadvantages of each approach, and highlights that for either method, it would be helpful for market participants if a third party were to publish a standard SONIA rate calculator or a SONIA screen rate for a given period, which is one of the priorities of the Infrastructure and Systems Workstream.

Lag mechanism or lock-out mechanism

Given that the overnight SONIA rate is compounded (or can be averaged) over a period in order to derive the rate for a corresponding interest period, the rate for that interest period is only known at the end of the interest period. This is different to LIBOR, which acts as a forward-looking rate whereby the interest due at the end of an interest period is known at the beginning of that interest period.

But in order to achieve some degree of cash flow certainty before an interest payment is due, and to accommodate the period of time required from the operations point of view, the approach which has been used in the SONIA-referencing FRN market is to "lag" the SONIA rate reference period by five London banking days. This is illustrated in the figure below:



An alternative approach is to use a "lock-out" mechanism, which repeats one of the daily rates for the final few days of the calculation, which has been used in the SOFR-referencing FRN market. The discussion paper sets out some of the relative advantages and disadvantages of each approach, including considerations relating to varying the length of the lag period or the lock-out period.

Margin

A further issue that the discussion paper considers is whether any margin which is added to the FRN should be compounded (or averaged) as part of the daily rate calculation or added to the already calculated (compounded or averaged) rate. As before, the discussion paper highlights considerations relating to each approach.

Fallbacks

Pursuant to the EU Benchmarks Regulation (BMR), and in line with IOSCO *Statement on Matters to Consider in the Use of Financial Benchmarks*, market participants need to ensure that they have robust contractual fallbacks for SONIA. In addition, under the BMR, supervised users of all benchmarks must produce and maintain robust written plans setting out their planned course of action in the event of cessation or material change of a benchmark. The Bank of England, as administrator of SONIA, has contingency arrangements in place to enable continued SONIA publication (although these contingency mechanisms only apply to the overnight SONIA rate provided by the Bank of England (rather than any derived screen rate)). The discussion paper explains that some bond issuers have replicated the Bank of England arrangements in their fallback contractual language, but that market participants will have to consider their own needs to determine appropriate fallback contractual language.

Alignment with other markets and cross-currency

The discussion paper explains that, hopefully, with the development of cash market conventions, it may become possible for swaps using the lag or lock-out mechanism to be cleared. But meanwhile, market participants operating across cash markets and derivatives markets should consider the extent to which greater alignment between these markets is necessary. In terms of differences in conventions between currencies in certain products, while they are not considered to be overly problematic, cross-currency coordination on alignment (which is under way, for instance in the US, through the ARRC, and is likely to continue elsewhere) would reduce complexity for end-users and is likely to become more important.

Views on discussion paper

All interested market participants and infrastructure providers are encouraged to read the discussion paper and use its contents to support preparations for adopting SONIA in new products. There is an opportunity to contribute views on certain questions, which are set out in the discussion paper, by 30 April 2019.

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