

Statement on bond market conventions: Use of the SONIA Index and weighting approaches for observation periods

The Working Group on Sterling Risk-Free Reference Rates

March 2020

Statement on behalf of the Working Group on Sterling Risk-Free Reference Rates - Bond market conventions: Use of the SONIA Index and weighting approaches for observation periods

Key messages

- The Working Group on Sterling Risk-Free Reference Rates (the 'Working Group') welcomes the Bank of England discussion paper on 26 February 2020 announcing that it intends to publish a daily [SONIA Compounded Index](#) from July 2020.^{1,2} Market participants are encouraged to respond to the discussion paper by 9 April 2020.
- In the SONIA bond market, use of the SONIA Compounded Index should standardise and simplify the calculation method for SONIA-linked instruments and could be referenced in documentation. It should also reduce operational risk by facilitating reconciliation of interest amounts between market counterparties, thereby potentially encouraging scalability of the use of compounded SONIA across products, including loans.
- Use of the SONIA Compounded Index would be compatible with any financial product that uses a backward-shifted observation period which weights the SONIA rate according to the number of days that apply in the *observation period* (the "**shift approach**").³ But it should have no impact on bond issues using the "**lag approach**", which weights the SONIA rate according to the number of days that apply in the *interest period*.
- The Working Group does not make any recommendation as to whether one approach should be preferred to the other.

Explanatory background

- In the SONIA bond market, over 140 SONIA-linked floating rate notes (FRNs) and securitisations with a total nominal value of approximately £70 billion were issued by the end of January 2020, all following the same market conventions: overnight SONIA compounded daily in arrears over the interest period, with a five day lag and using the lag approach to weighting, with the margin added to the rate (but not compounded).
- Given the extensive use of the lag approach in the SONIA bond market to date, it is important to maintain confidence and stability in this format, both as regards the transactions completed and any future development using the lag approach.
- However, the announcement and proposed publication of the SONIA Compounded Index may influence an issuer's decision whether to adopt the shift approach instead of the current lag approach in the SONIA bond market. Issuers are also likely to take account of:
 - the emergence of consensus and liquidity in the SOFR market, where no particular convention has yet been used consistently enough to emerge as a clear standard, although the ARRC has expressed a preference for the shift approach;⁴
 - the loan market adopting the shift approach as the preferred approach for loans, on the basis that consistency between products and common use of the SONIA Compounded Index is considered desirable; and
 - final recommendations being released by ISDA pursuant to the results of the [ISDA Consultation on Final Parameters for the Spread and Term Adjustments](#).

¹ It is anticipated that the SONIA compounded index for a given day would first be made available that morning to licensees and to the clients of authorised redistributors. It would then be freely available the following day through the Bank's Interactive Statistical Database. See the Discussion Paper for more detail.

² The Federal Reserve Bank of New York also started publishing a freely available daily compounded [SOFR Index](#) on 2 March 2020.

³ Further information on this can be found in the [ARRC SOFR Floating Rate Notes Conventions Matrix](#) from August 2019.

⁴ The [ARRC SOFR Floating Rate Notes Conventions Matrix](#) states that: "*the observation period shift applies the correct weighting to the SOFR rates and could utilize a published compounded SOFR index.*"

- The first SONIA FRN using the shift approach was issued by the EBRD on 19 February 2020. Should there be a more widespread adoption of the shift approach in the SONIA bond market, issuers can still continue to use the lag approach for new transactions, and the economic differences in interest amounts between the two approaches is likely to be minimal.
- No changes will be required to SONIA-linked FRNs and securitisations which already use the lag approach. Development of market infrastructure will however be important to ensure easy identification of the approach taken in each transaction.
- The Working Group does not make any recommendation as to whether one approach should be preferred to the other.

The Bank of England and the FCA are each ex-officio members of the Working Group. Market participants should note that the views and considerations set out in this paper do not constitute guidance or legal advice from the Bank of England (including the PRA) or the FCA and nor are they necessarily endorsed by the Bank of England (including the PRA) or the FCA.

This paper has been prepared for the purpose of highlighting to market participants the potential use of the SONIA Compounded Index and its implications for existing market conventions. It is provided for information only and does not constitute a comprehensive outline of all relevant considerations in this regard. Market participants should therefore consider their own position and seek their own advice.