

Design Criteria for a Sterling Secured Overnight Money Market Benchmark

Working Group on Sterling Risk-Free Reference Rates

Introduction

1. The Working Group (WG) on sterling risk free reference rates has been convened to identify and implement a near-risk free reference rate (RFR) as an alternative to sterling LIBOR.
2. The Group has focused its attention on two possibilities for its preferred RFR – an unsecured overnight index or a secured overnight index. It anticipates that a decision will be made between these two options in 2016. That decision will depend both on the basic properties of the available secured and unsecured benchmarks, and the viability and likely success of implementation and transition plans in each case.
3. The WG has previously set out the selection criteria that it anticipates will guide its decision.¹ As it has previously noted, the WG does not consider that the currently available unsecured and secured sterling benchmarks (SONIA and RONIA respectively) meet its basic benchmark requirements, owing in part to the limited transaction volumes underlying those rates. The WG therefore encourages the development of robust benchmarks for sterling markets that meet its criteria.
4. Regarding the development of unsecured overnight interest rate benchmarks, the WG anticipates that the Bank of England's reformed and strengthened SONIA will meet its basic criteria, and is therefore likely to be considered a viable candidate RFR.
5. Regarding the development of secured overnight interest rate benchmarks, the WG anticipates that there is scope for robust benchmarks with broad coverage to emerge from private sector providers. Two promising proposals have already been presented to the WG, from Euroclear UK & Ireland and ICAP.
6. In order to encourage and facilitate the development of these and other proposals for secured overnight repo indices that could serve as the RFR, this document sets out the WG's views on some high-level design considerations relating specifically to secured benchmarks. Proposals which meet these specifications are more likely to be considered viable candidate secured RFRs when the WG makes its RFR determination in 2016.
7. More broadly, the development of robust secured overnight interest rate benchmarks – regardless of whether selected as the RFR – is desirable as it will support the effective functioning of sterling markets.

Design criteria for a sterling secured risk-free reference rate

8. The WG's initial selection criteria² specify basic benchmark properties which any proposed secured benchmark should be designed to satisfy, including *inter alia*:
 - Consistency with IOSCO principles,³ e.g. requirement for sufficient market data to produce a robust and reliable index

¹ See: <http://www.bankofengland.co.uk/markets/Documents/sterlingoperations/rfr/rfrselection.pdf>

² See reference in footnote 1.

³ See <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD415.pdf>

- Robustness to changes in market structure over time
- Resistance to manipulation
- Commercial sustainability for administrator and data contributors
- Appropriate controls and governance for administrator and data contributors
- Clarity of definition and calculation
- Acceptable/stable fall-back mechanisms

9. The following sections provide additional guidance to potential providers of RFRs, focusing particularly on issues that are specific to secured indices.

Coverage of the secured money market

10. The WG has agreed that the relevant secured money market to measure is overnight sterling denominated repo agreements secured against UK government securities; i.e. gilt repo.

11. The WG estimates that the gilt repo market is 90%+ of the broader sterling repo market, consistent with the findings of the Bank of England Sterling Money Market Survey;⁴ and it has estimated indicative volumes for each segment of the gilt repo market, as shown in **Figure 1**.

12. The quantity, quality and availability of underlying transaction data is a key determinant of the robustness of any RFR. As such, the WG will assess the coverage of any proposed secured index in the context of the estimates presented in Figure 1.

Figure 1 – Schematic of the overnight gilt repo market

DBV / GC	Specific	
£0-2bn	£0-2bn	Voice brokered
£1-5bn	£18-25bn	Platform brokered
	<i>Cleared</i>	
£20-30bn	£40-50bn	Bilateral
c. £5bn		Triparty

Inclusion of specific collateral repo

13. As noted in the Minutes of its 14 July 2015 meeting, the WG has agreed that a secured index should include transactions secured against General Collateral and specific collateral, since both are considered to be relevant to funding costs in secured markets.

⁴ See: <http://www.bankofengland.co.uk/publications/Documents/other/markets/mmlc/smms2015h1.PDF>

14. However, the WG is aware that the interest rate on some specific collateral gilt repo transactions may be affected by factors related to collateral supply and demand ('specialness'). Including these transactions may have the effect of skewing the distribution of interest rates in a way that does not reflect the underlying supply of, and demand for, overnight funds.

15. Accordingly, while the WG is content for specific collateral repo to be included in a secured RFR, careful consideration should be given to how best to lessen the effect of 'specialness' on the distribution of rates. The calculation methodology chosen to achieve this should, at the same time, seek to retain sufficient transparency and clarity in order that the benchmark can be broadly understood in the market.

Other points to note

16. Potential providers of secured benchmarks are strongly encouraged to develop actual or synthetic historical time series for the proposed index. This will be an essential input to the implementation plan for any candidate RFR, both to gain user acceptance and to facilitate clearing eligibility of associated derivative instruments.

17. The WG notes that it is also interested in plans for the development of markets for instruments referencing proposed indices – such as OTC interest rate derivatives or exchange traded derivative products – which would, for example, help to support the development of a term structure for a secured overnight RFR.

Timelines and next steps

18. Potential providers of overnight secured interest rate benchmarks are invited to bring their plans to the WG's attention by contacting the WG's chair, via RFRsecretariat@bankofengland.co.uk, to explore the possibility of presenting their proposal to the WG for initial feedback. The WG will, as part of its selection process, consider all candidate secured benchmark proposals received. Further details of the WG's RFR selection process will be made available to interested parties when that process commences.

19. Proposals will be most useful for the WG if they are brought to its attention before the end of the first quarter of 2016, with initial expressions of interest requested by 29 January 2016. All else equal, proposals are likely to be more attractive to the WG the more concrete and further advanced they are at the point the WG selects its preferred RFR.