The Working Group on
Sterling Risk-Free Reference Rates

From LIBOR to SONIA and what you need to know:

What is SONIA compounded in arrears and term SONIA?

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How to use SONIA in contracts?

Much new business previously using LIBOR will be able to use SONIA compounded in arrears in their contracts

- For example larger corporates and specialist lending sectors (e.g. project finance and real estate).
- Industry estimates suggest that up to 90% of lending previously on LIBOR (by value) is expected to use SONIA compounded in arrears[1]

But a smaller group of the market - by value - may prefer to use alternative rates. These rates could include Bank Rate or a Term SONIA Reference Rate.

- For example, small to medium sized enterprises (SMEs) may require greater simplicity and/or payment certainty.

[1] RFRWG Term Rate Use Case Paper

Moving to new rates…

Robust alternative benchmark rates have been established to replace LIBOR, such as SONIA in the UK

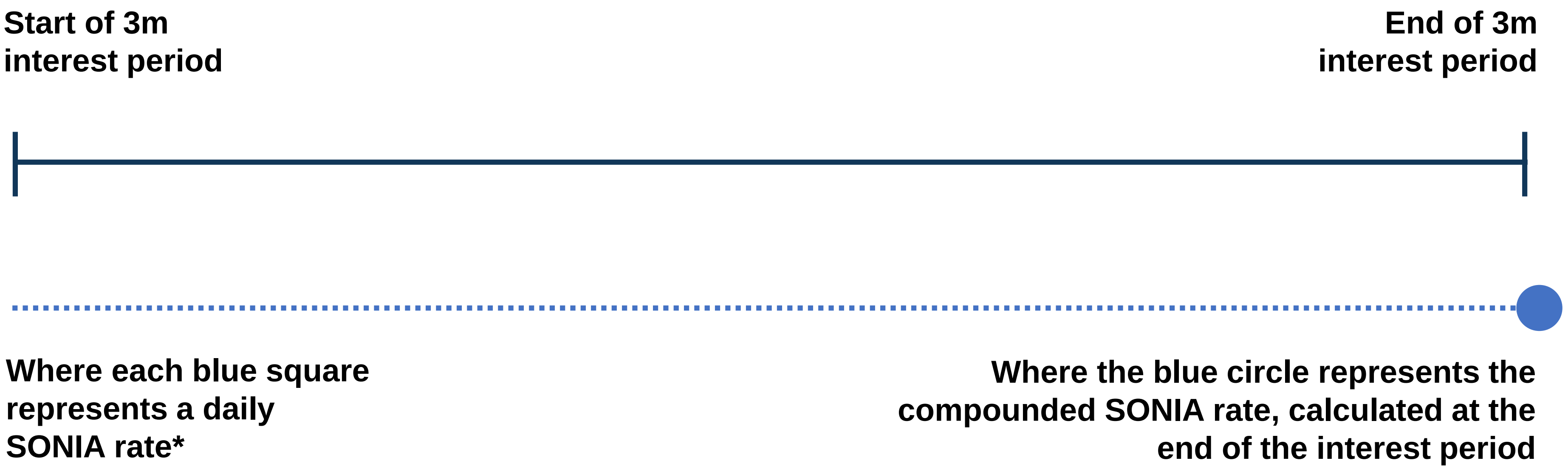
Key features of SONIA

- Deep and liquid underlying market, not based on panel bank submissions
- Overnight rate
- Published daily reflecting economic reality, and aggregated over the lending period to determine overall interest due
- Nearly risk-free rate, minimising term bank credit or liquidity premium

As an overnight rate, SONIA benefits from a far deeper underlying market than LIBOR, making it much more robust. This also brings some differences in how it is used to calculate interest payments which this video will help explain.

What is SONIA compounded in arrears?

The most established way to use SONIA to calculate interest in contracts is called ‘compounded in arrears’



This involves taking the SONIA rate for each business day over the interest period to calculate the applicable rate

*On weekends and bank holidays, the SONIA rate is held constant from the last working day

Benefits of compounded SONIA

Compounded SONIA is extremely robust:

- Overnight SONIA is underpinned by ~£60bn[1] worth of daily transactions, reported to the Bank of England
- Taking this rate every business day means there is a very large volume of transactions underpinning the final interest rate. E.g. £60bn x number of business days in interest period = significant volume

Calculating interest on a compounded basis reduces the contribution of 'one-off' volatility in interest rates, that may occur due to unusual supply and demand factors affecting a benchmark rate on a particular day

[1] Q2 2020, as reported in Bank of England Interactive Statistical Database

Conventions for compounded SONIA

- When using compounded SONIA, the interest rate payable is aggregated over the interest period and finalised at the end. The eventual rate becomes increasingly certain as the end of each period approaches and most of the SONIA observations are known.
- But we know firms need a period of certainty over their payments to operate smoothly. The market has therefore developed conventions to provide time after the last SONIA observation for the final interest to be calculated & verified before it needs to be paid.
- For example, the period for calculating interest may start (typically) five days before the actual interest period begins, so it finishes that number of days before the interest is due.

Supporting transition through the provision of compounded SONIA

You may want to verify your compounded SONIA interest payment amount, but not all firms will be familiar with how to calculate compounded SONIA so a number of tools have been created to help with this.

To support the development of calculation tools, the Bank of England launched a SONIA compounded index[1] which provides an easy way to check the SONIA rate over a given period. The index is freely available – all you need to calculate the interest is the start and end dates of the reference period, and the number of calendar days

The exact amount of your interest payment will depend on the terms of your contract, so you may need to use a specific calculation tool to match it precisely. A number of free calculators are available online, or your bank may provide one itself.

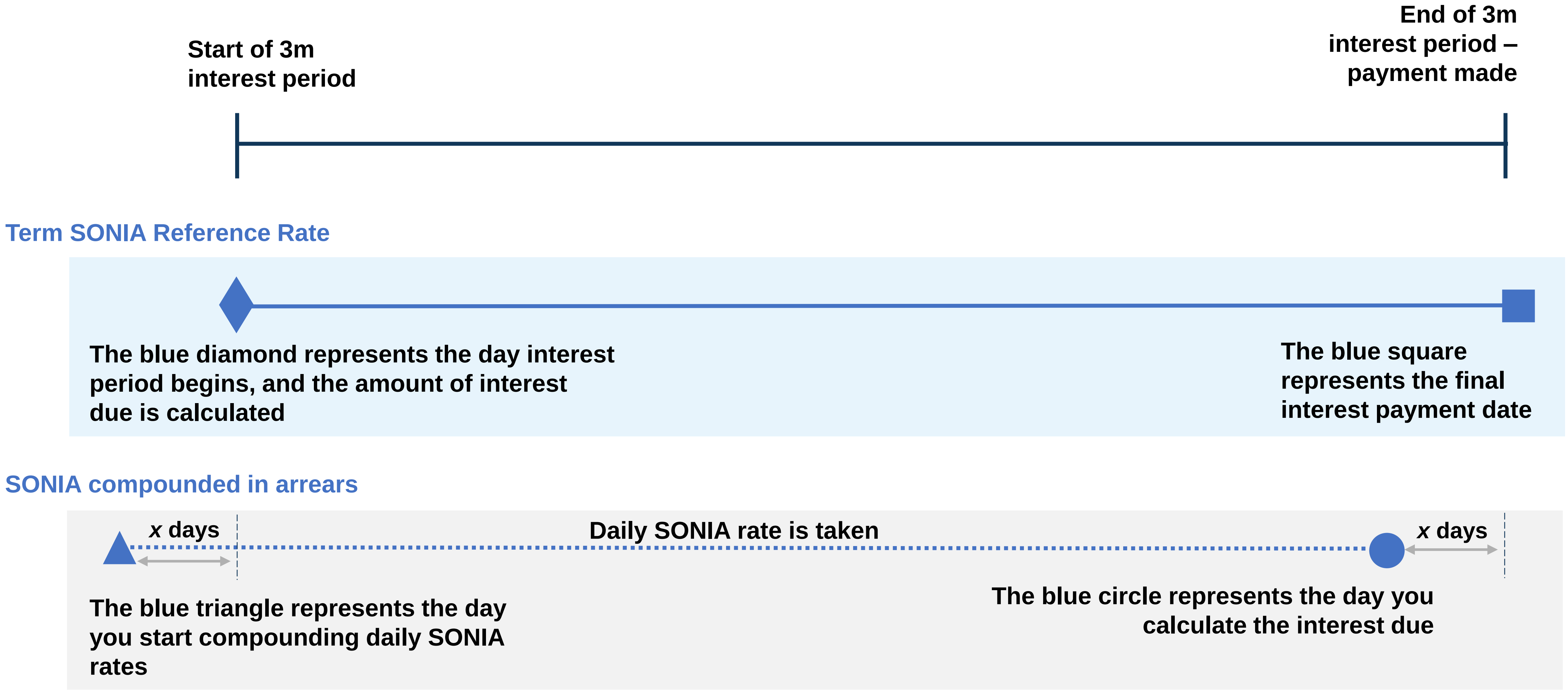
1 For more information on the SONIA compounded index please see Bank of England website

2 For a summary of freely available SONIA calculators, please see here

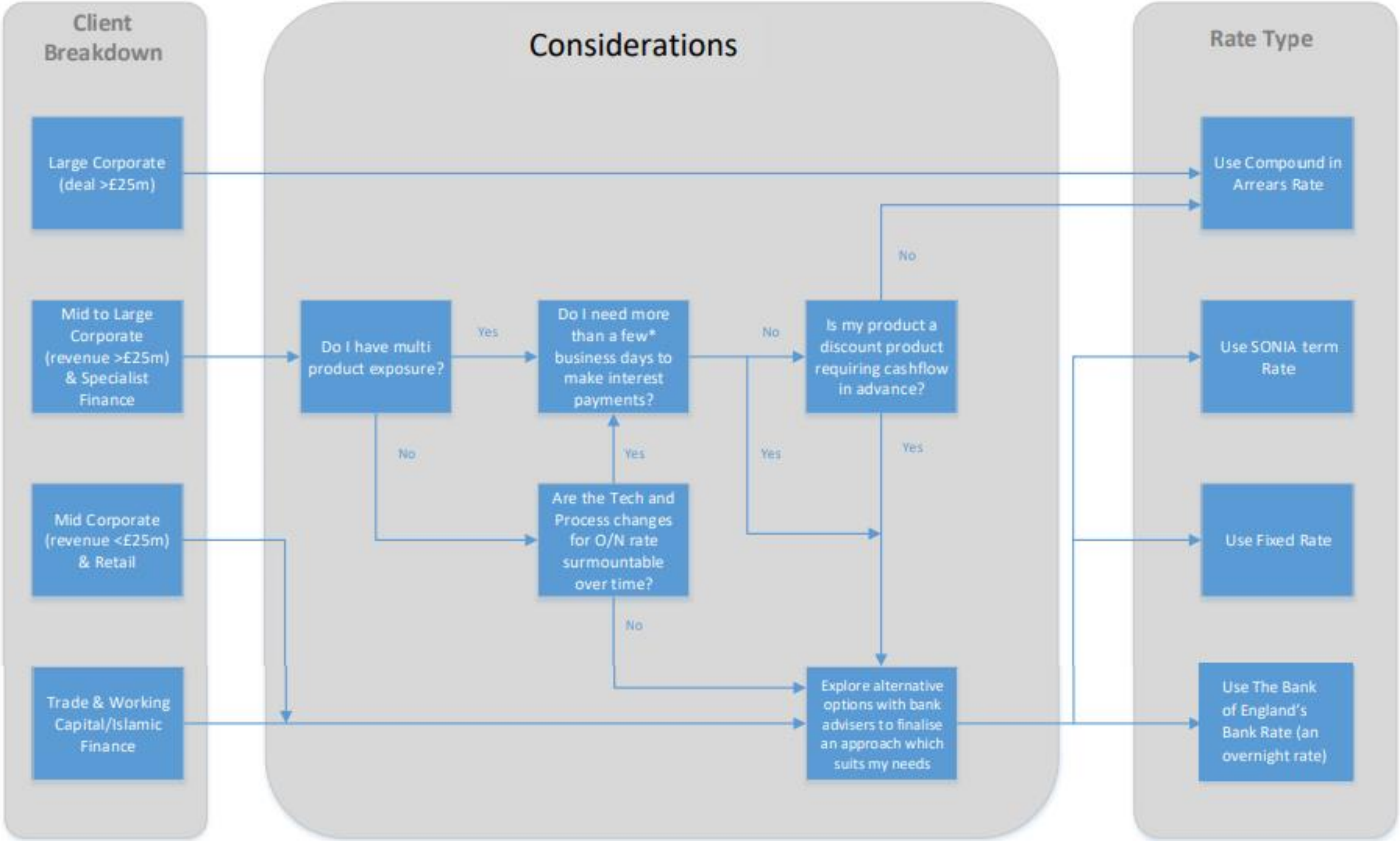
What is Term SONIA?

- A Term SONIA Reference Rate (TSRR) reflects the expected average SONIA rate over a given period. Unlike SONIA, it is not necessarily based on actual transactions.
- Term SONIA is a forward-looking rate (similar to LIBOR). The rate is fixed at the outset of the given interest period.
- Unlike LIBOR, a term SONIA rate would not reflect term bank credit risk.
- Several providers have begun to produce test versions of term SONIA from the second half of 2020, though these are not yet ready for use in contracts.

Conventions for compounded SONIA and Term SONIA



Which alternative rates to use?



RFRWG Term Rate Use Case Paper - January 2020

Which alternative rates to use?

- The need for compounded SONIA, term SONIA or alternatives will be driven by product type and demand.
- SONIA compounded in arrears is expected to be appropriate and operationally achievable for the majority of those that use LIBOR (by value). This will include large corporates and those familiar with sophisticated financial products.
- However, smaller corporates, such as those with no dedicated treasury function, may instead require simplicity or payment certainty – and it be appropriate to use term SONIA, fixed rate or Bank Rate.
- Where possible, SONIA compounded in arrears is encouraged. Firms should consult with their banks and advisors for the appropriate rate to use.

Key resources on compounded SONIA

- RFRWG Discussion paper on SONIA conventions –March 2019
- RFRWG Statement on SONIA conventions and summary of responses – August 2019
- RFRWG Term Rate Use Case Paper - January 2020
- Bank of England Discussion Paper on producing a SONIA index – Feb 2020
- Bank of England summary and response to market feedback on producing a SONIA index – June 2020
- Responses to the Bank of England Discussion Paper on producing a SONIA index – June 2020