

**Statement on behalf of the Working Group on Sterling Risk-Free Reference Rates –  
Recommendations for SONIA Loan Market Conventions<sup>1</sup>**

**Objectives**

Further to its [statement](#) of 29 April 2020, the Working Group on Sterling Risk-Free Reference Rates (the "**Working Group**") today issues recommendations on conventions to support the use of SONIA in loan markets for Sterling Bilateral and Syndicated Facilities, including Multicurrency Syndicated Facilities where there is a sterling currency option.

In recognition of the urgent need for loan market participants to commence transition away from the use of LIBOR, the Working Group, through its sub-groups including the Loan Enablers Task Force ("**LETf**") has undertaken an evaluation of the available market conventions, taking into consideration the overall needs of the Sterling market, a variety of operational and implementation considerations and the need for the maximum possible degree of consistency across currencies, products and markets. The Working Group also recognises the desire from many market participants for a close alignment of cash and derivatives markets, the need to minimise basis risk in any hedging arrangements and for international consistency wherever practicable.

Additionally, there is recognition that in cash markets there is a need for a product feature that affords parties sufficient time for notice and collection of payment. The LETf has reviewed available methodologies for doing so, including those which utilise an 'observational shift'. With multiple robust approaches available and no clear preference in sterling markets to date, identification of a standard approach in this respect was a key objective of the LETf to support rapid availability of consistent products across the loan market.

In arriving at the conclusions set out below, the Working Group was mindful and conscious of the need to effect an orderly transformation of this critical market structure change. The recommendations are based on careful consideration of potential options that are feasible or available and based on the review and challenge of Working Group members together with feedback from a survey involving its members and the members of its associated sub-groups and task forces.

Overall, the aim is clear – as previously highlighted, market participants should be ready to offer non-LIBOR loans products by end Q3 2020. SONIA compounded in arrears remains the Working Group's recommended alternative to Sterling LIBOR and the intent of these recommendations is to enable and expedite the transition away from the use of LIBOR based products for the loan market.

**Summary of Recommendations**

1. SONIA remains the Working Group's recommended alternative to Sterling LIBOR, implemented via a **compounded in arrears methodology**, and loan markets should now move consistently towards this.
2. Use of a **Five Banking Days Lookback without Observation Shift<sup>2</sup>** is recommended as the standard approach by the Working Group. This aligns with the approach recommended by the Alternative Reference Rate Committee for US dollar loan markets and in the Working Group's view is most likely to be made rapidly available. Whilst this approach is the recommendation, where lenders are also able to offer lookback with an observation shift this remains a viable and robust alternative (see the Annex below for the comparison between these two approaches).

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<sup>1</sup> The overall objective of the Working Group on Sterling Risk-Free Reference Rates (the "**Working Group**") is to enable a broad-based transition to SONIA by the end of 2021 across the sterling bond, loan and derivative markets. This will reduce the financial stability risks arising from widespread reliance on GBP LIBOR.

The Bank of England and the Financial Conduct Authority ("**FCA**") are each ex-officio members of the Working Group. The views and outputs set out herein do not constitute guidance or legal advice from the Bank of England (including the Prudential Regulation Authority ("**PRA**") or the FCA and are not necessarily endorsed by the Bank of England (including the PRA) or the FCA.

<sup>2</sup> Lookback without Observation Shift is also known as the Observation Lag convention

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3. Where an interest rate floor is used, the Working Group recognises that it may be necessary to apply the **floor to each daily interest rate before compounding**.
4. **Prepayments.** The Working Group recommends that accrued interest should be paid at the time of principal prepayment.

These recommendations are published in order to assist market participants who have been awaiting direction on the preferred methodology prior to commencing implementation and developing their standard product offerings. These recommendations are not binding and it is recognised that in certain transaction or client-specific circumstances an alternative methodology or rate may be more appropriate or convenient, and that market conventions may continue to evolve over time. Please see the Annex below for details of the recommendations.

### Explanatory background

In August 2019, the Working Group issued a [statement](#) and summary of responses to its consultation on the use of SONIA in new contracts which set out a framework for how SONIA could be implemented in loans contracts, through the use of a compounding in arrears methodology.

The Working Group, including its various sub-groups, have carefully examined how to implement compounding in arrears in loan markets, recognising the value of providing clear direction to market participants to assist in developing market practice, whilst, at the same time being mindful of alternative options or methodologies should parties deem them to be more appropriate in the circumstances. It also recognises that standards and conventions may evolve as market participants become more familiar with the pros and cons of particular conventions and product features.

A significant part of the Working Group's considerations centred around the requirement to build in product features that afford sufficient time to calculate, notify and collect interest payments based on compounded in arrears rates. Market participants will be aware that there are two primary methods by which this can be implemented in calculations; *lookback without observation shift* or *lookback with observation shift*. The Working Group carried out a survey seeking the views of its members and the members of its associated sub-groups and task forces on conventions in the loan markets in June 2020 which attracted responses from a range of market participants, including banks, corporates, trade associations, and other financial firms. Please refer to the summary of survey responses and supporting papers (found on the Working Group's webpage [here](#)) for further background on the lookback methodology outcomes and other key conventions.

Annex: RFR Compounding Conventions for the Sterling Loan Market

<b>SONIA</b>	<p>Sterling Overnight Index Average - the chosen risk-free rate for sterling markets administered by the Bank of England.</p>
<b>SONIA Compounded in Arrears</b>	<p>Calculated by compounding SONIA daily during the interest period.</p> <p>Whilst the market has shown a preference for compounding the rate rather than compounding the balance, several methods exist to calculate SONIA Compounded in arrears and implementation choice is left to individual market participants. To the extent compounding the rate is selected, the method for calculating the cumulative compounded rate should be based on ISDA's formula for Compound RFR.</p> <p>Given the need for the calculation of daily interest accruals to support distribution of interest impacted by intra-period activity such as prepayments and secondary trading, daily non-cumulative compounded rate ('NCCR') derived from the cumulative compounded rate may be an option.</p> <p>NCCR for a given day is the cumulative compounded rate for the prior day subtracted from the cumulative compounded rate for that given day.</p> <p><i>Please see associated spreadsheets with calculation methodologies to reconcile cumulative and non-cumulative compounded rates.</i></p>
<b>Holiday and weekend convention</b>	<p>Interest is compounded on banking days only; for each calendar day which is a weekend or holiday, the immediately preceding banking day's rate is applied, weighted by the number of calendar days until the next banking day.</p> <p>Holiday convention for SONIA follows London Bank Holidays. In multi-currency contracts, interest can be compounded on banking days for the drawn currency and ignore the banking/ non-banking days of other currencies.</p>
<b>Lookback</b>	<p>A Lookback period allows for payment certainty for borrowers when using an 'in arrears' rate. While a standard Lookback period of 5 Business Days is recommended, the Lookback period can vary based on borrower/lender needs.</p> <p>Lookback without Observation Shift (also known as Lag) is recommended as the standard approach by the Working Group. Here, the SONIA rate is derived from the observation period but weighted according to the days in the interest period.</p> <p>A viable and robust alternative approach is a Lookback with Business Day Observation Shift. The Observation Shift approach is where each SONIA rate is weighted according to the days in the observation period (rather than the interest period). Note the compounded rate needs to be annualised and adjusted for the actual calendar days in the interest period.</p> <p><i>Please see associated materials for explanation of Lookback without Observation Shift or Lookback with Observation Shift.</i></p>
<b>Rounding</b>	<p>The Working Group's recommendation is for SONIA to be rounded (and not truncated) to 4 decimal points and sterling amounts be rounded to two decimal points.</p> <p>To ensure the total accrued interest amount calculated using the cumulative and non-cumulative compounded rate is always the same, the Working Group's recommendation is for:</p>

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- the cumulative compounded rate to be rounded on a daily basis (based on the number of decimal points stated in the credit agreement);
- the non-cumulative compounded rate derived from the daily cumulative compounded rate not to be rounded;
- the daily compounded RFR interest component calculated using the non-cumulative compounded rate not to be rounded (so that the total accrued interest calculated as the sum of these daily compounded RFR interest components does not carry forward rounded amounts); and
- the sterling amount of total accrued interest (i.e. compounded RFR component + margin + Credit Adjustment Spread (if applicable)), whether generated using the cumulative compounded rate or the sum of daily amounts calculated using the non-cumulative compounded rate, to be rounded to two decimal places.

### Day count

The Working Group's recommendation is ACT/365 (fixed)

### Business day convention for payments

The Working Group's recommendation is "Modified Following Business Day Convention."

This means payments of interest that would fall to be made on a day that is a non-Business Day are adjusted to the next succeeding Business Day, unless that Business Day falls in the next calendar month, in which case the interest payment date is the preceding Business Day.

### Timing

SONIA for each London business day is published at 9.00 am the following London business day.

While the rate is subject to correction, the Lookback permits users to select the corrected rate were a correction to occur. The Working Group recommends that if a corrected rate is published, it is used in place of the original, uncorrected, rate.

### Margin Treatment

The Working Group's recommendation is that margin should be added after rate compounding (i.e. margin is not compounded).

### Prepayments

The Working Group's recommendation is for proportional accrued interest to be paid at the time of prepayment on any amounts of principal prepaid.

If principal is paid down without any accompanying interest being paid down at the same time, this can affect the accuracy of compounded calculations and be operationally complex.

### Floors

Market participants are free to decide whether a floor is applied and at which level.

If an interest rate floor is included in a facility agreement, it is recommended that the floor be calculated daily (rather than at the end of an interest period) because loans accrue interest daily. The floor can then be applied to the applicable daily SONIA for the relevant interest period.

For legacy contracts containing a floor, where the aggregate of SONIA plus the credit adjustment spread is less than the legacy floor value, the Working Group's recommendation is for the credit adjustment spread to remain unchanged, with SONIA adjusted to ensure that the aggregate of SONIA plus the credit adjustment spread is equal to the legacy floor value. However, the Working Group recognises that an alternative method, where the credit spread is adjusted, may be preferred by some market participants.

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### Distribution of interest

The Working Group's recommendation is that the 'pro-rata' method of distributing interest across syndicated lenders is used.

This means interest paid by a borrower for a given day (business or otherwise) would be earned by a lender based on its pro-rata share of the principal amount of the loan owned for that day.

If a lender sells out of a loan completely, they are owed interest based on the time they held part of the loan but do not earn further interest after they leave, regardless of the fact that they will not be paid until the end of the interest period.

If a new lender buys into a loan during the interest period, their interest is calculated using the compounded rate as of that day in the interest period (and will not start to compound separately from the date they buy) i.e. non cumulative compounded rate for that day can be used.

### Secondary Market Conventions

#### Delayed Compensation

The Working Group's recommendation is for the Seller to pay the Buyer the all-in rate i.e. SONIA Compounded in arrears plus Margin.

For facilities where the all-in rate may also include a credit adjustment spread (whether by reason of transition or otherwise), the all-in rate would be SONIA Compounded in arrears plus credit adjustment spread plus Margin.

#### Cost of Carry

The Working Group's recommendation on the cost of carry is for the Buyer to pay the Seller SONIA Compounded in arrears plus any credit adjustment spread, if applicable.