



RFR bond market conventions: shifts, lags and the SONIA index

By Katie Kelly

As reported in the [Q4 2019 edition](#) of this Quarterly Report, certain market conventions have developed in each of the SONIA and SOFR bond markets, including floating rate notes (FRNs) and securitisations. In the SONIA market, the conventions involve referencing SONIA compounded in arrears over an interest period, with a margin added, and a “lag” (or “lookback”, as it is commonly referred to in the US) in respect of each interest period, so that the SONIA rate used to calculate a rate for each day in an interest period is based on the SONIA rate for a prior day (typically, five days prior).

However, in February 2020, the EBRD issued a SONIA-linked FRN which used a 5 day observation period “shift” approach. This is similar to the “lag” approach described above, but the compounding formula in the “shift” approach weights the SONIA rate to account for calendar days when the SONIA rate is not published according to the number of days that apply in the *observation period*, whereas the “lag” approach weights the SONIA rate according to the number of days that apply in the *interest period*.

Also in February, the Bank of England announced that it intends to publish a [daily SONIA Compounded Index](#) (the SONIA Index), a move which has been welcomed by the Sterling Risk-Free Rate Working Group (RFR WG). The SONIA Index would provide a number representing the returns from a rolling investment earning interest each day at the SONIA rate, which is consistent with the approach taken by the Federal Reserve Bank of New York’s [SOFR Index](#). Market participants have been encouraged to respond to the discussion paper relating to the SONIA Index by 9 April 2020, with publication of the SONIA Index expected to commence by the end of July 2020.

The publication of the SONIA Index is a significant development. It would be freely available and could be referenced in documentation, thereby standardising and simplifying the calculation method. This in turn should have the effect of reducing operational risk by facilitating reconciliation of interest amounts between market counterparties. As the SONIA Index could also be used for other SONIA-referencing products, such as loans, it could thereby potentially encourage scalability of the use of compounded SONIA across products.

Importantly, the SONIA Index would also be compatible with any financial product that uses the “shift” approach, as described above. This may influence an issuer’s decision whether to use the “shift” approach over the “lag” approach in the bond

market. This not to say however that any transactions which have been issued using the “lag” approach, of which there are many, will be affected. Indeed, the RFR WG released a [statement on bond market conventions](#) in March, in which it stressed that “it is important to maintain confidence and stability in [the lag] format, both as regards the transactions completed and any future development using the lag approach”. SONIA-linked transactions which are already in issue and which use the “lag” approach can continue as they are: no changes would be required to align them with the “shift” approach, and it is considered that there is no substantive economic difference in terms of the coupon amounts for each approach.

Even if the “shift” approach were to be adopted by the market, issuers could still issue using either the “lag” approach or the “shift” approach. In other words, transactions issued using either approach can co-exist, although investors will of course need to be able to differentiate between the two different approaches in case there are any challenges associated with holding one form over the other. Market infrastructure will therefore have to evolve to ensure easy identification of each approach.

In the SOFR market, no particular market convention has yet been used consistently enough to emerge as a clear standard; as more fully described in the ARRC’s [SOFR FRNs Comparison Chart](#), some have used a “lockout” mechanism, some have used the “lag/lookback” approach and others have used a payment delay mechanism. However, in its [Conventions Matrix](#) from August 2019, the ARRC expressed a preference in the SOFR market for the lookback using the “shift” approach, on the basis that the observation period shift applies the correct weighting to the SOFR rates, and could also use the SOFR Index.

It remains to be seen whether this will drive consistency of approach in terms of conventions in the SOFR market. It is also unclear as yet whether the “shift” approach would be preferred in the loan market, and what ISDA’s recommendation will be. But needless to say, any developments with respect to these factors might further influence the outcome as to which approach is used, on the basis that consistency between products, and common use of the SONIA Index, are generally considered desirable in the transition to risk-free rates.

Contact: Katie Kelly
katie.kelly@icmagroup.org
