The SONIA Index and bond market conventions

As reported in the Q2 2020 edition of this Quarterly Report, the Bank of England announced an intention to publish a daily SONIA Compounded Index (the SONIA Index), which it did from 3 August. This is a significant development which was welcomed by the bond market. In practical terms, use of the SONIA Index is compatible with any financial product that uses a backward-shifted observation period (the "shift" approach, which weights the SONIA rate according to the number of days that apply in the observation period). The SONIA Index is also expected to standardise and simplify the calculation method for SONIA-linked instruments and should reduce operational risk by facilitating reconciliation of interest amounts between market counterparties.

In September, the EIB issued a SONIA-linked bond[1] which was the first to use the SONIA Index to calculate the interest rate for each interest period, and was closely followed by a SONIA-linked transaction by the Royal Bank of Canada[2], which also uses the SONIA Index for the same purpose. While each of these transactions consequently uses the shift approach, it is important to note that issuers can still issue using the "lag" approach (which weights the SONIA rate according to the number of days that apply in the interest period).

However, while the publication of the SONIA Index *could* lead to standardisation of conventions in the bond market, it represents a divergence from conventions in the loan market. In September, the RFRWG released *Recommendations for SONIA Loan Market Conventions,* which recommends use of a five banking days lookback without observation shift (ie the lag approach) as the standard approach for the loan market, although where lenders are also able to offer lookback with an observation shift (ie the shift approach), this remains a viable and robust alternative. Although loan market conventions are not the main area of focus for ICMA, the read across to the bond market is significant.

The ability in both the bond market and the loan market to use either the shift approach or the lag approach is encouraging and allows for greater flexibility. But any potential move in the future towards the shift approach in the bond market, and the lag approach in the loan market, means that the ambition of consistency of approach between products might not be so easy to achieve.

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1. GBP 1,000,000,000 SONIA Floating Rate Bonds due September 2025

2. GBP 250,000,000 SONIA Floating Rate Notes due September 2021