FICC MARKETS STANDARDS BOARD

Standard on use of Term SONIA reference rates

Transparency Draft

FMSB invites comments on the proposals in this Standard by Friday 28 May 2021. Please address any comments or enquiries to secretariat@fmsb.com.

I. Introduction

1. The FICC Markets Standards Board

The FICC Markets Standards Board (FMSB) was established in 2015 in response to the Fair and Effective Markets Review (FEMR) in the UK with a mandate to issue clear and practical guidance designed to improve conduct and raise standards in the wholesale fixed income, currencies and commodities (FICC) markets. FMSB is building a body of Standards and Statements of Good Practice (SoGPs) over time, prioritising those areas where FMSB member firms (Member Firms) consider there is a lack of clarity in the standards of behaviour expected of market participants, or a lack of understanding of the issues relevant to a product or transaction type, or evidence of poor conduct.

2. Applicability of FMSB Standards

FMSB members[1] agree to adopt the Standards in their business practices (where relevant) and to evidence adherence through an annual Statement of Commitment. The Member Firm confirms annually that it is committed to conduct its FICC market activities (its 'Activities') in a manner consistent with the Core Principles contained in FMSB Standards, and to have internal policies, procedures and controls reasonably designed to give effect to those Core Principles where they are applicable to its Activities, in a manner that is commensurate with the nature of its Activities in the relevant entity or jurisdiction. That confirmation is expected to apply to all FMSB Standards issued in final form in the calendar year prior to the year in which the confirmation is made.

The details of FMSB member firms are available at fmsb.com.

Standards are published on FMSB's website and non-member firms and their affiliates are encouraged to consider them. In this way, Standards are also made available to users of wholesale FICC markets (e.g. corporates, investors and other end-users) so that they may be made aware of their existence and FMSB's expectation of market conduct.

3. Relationship with law and regulation

FMSB Standards and SoGPs do not impose legal or regulatory obligations on Member Firms, nor do they take the place of regulation. In the event of any inconsistency, applicable law, rules and regulation will prevail. In developing Standards and SoGPs, certain regulators may have commented on their drafting, alongside Member Firms and other bodies, such that the Standards and SoGPs, once finalised and published, are intended to represent an authoritative statement of global good practices and processes. However, they are not normally endorsed by regulators. Where they are endorsed by a regulator, this will be made clear on the face of the Standard or SoGP in question.

4. Relationship with other industry codes ('Codes')

Other Codes already exist in relation to certain FICC markets, such as the FX Global Code, while others are in the process of being produced. There will be some overlap between FMSB's work and such other bodies and FMSB will seek to ensure it adopts a consistent approach in cases of overlap wherever possible, and will seek to avoid issuing a Standard or SoGP where the subject matter is already covered adequately by existing regulation or a Code issued by another body. It may draw attention to Member Firms of an existing code and request that Member Firms consider its applicability and act in a manner consistent with it, where appropriate.

[1] Full, Associate, and Corporate Members commit to adhere to the FMSB Standards that are relevant to their business. Information about FMSB membership is available at fmsb.com/who-we-are/

II. Use of Term SONIA and alternative interest rate reference rates

1. Background and rationale

Interest rate benchmarks play an important role in FICC markets. As the Financial Stability Board (FSB) has emphasised, it is critical that benchmarks which are used extensively are robust. In order to be robust, benchmarks need to be based on active, liquid underlying markets. Contrary to LIBOR, risk-free rates, such as SONIA, represent conditions in a deep underlying market where data inputs can evolve over time to ensure that such benchmarks adapt to future changes in money markets[2] and continue to be robust. The reliance of risk-free rates on actual transactions as opposed to expert judgement also reduces the conduct risks associated with such benchmarks.

The FCA has made clear its view that the 'overnight risk-free rates provide the most robust benchmark interest rate available, derived from markets that have remained active and reliable through times of stress'[3]. For example, a three-month compounded SONIA contract is built on overnight market transactions worth on average ~£50 billion per day. Over 60 trading days[4], this means that ~£3 trillion of transactions underpin three-month compounded SONIA.

The FSB has also stated that where the value of contracts referencing a benchmark is very significant, markets 'need to reference a robust benchmark, such as overnight RFRs to avoid systemic risk'[5]. Accordingly, in the UK, the expectation is that overnight SONIA, compounded in arrears, 'will and should become the norm in most derivatives, bonds and bilateral and syndicated loan markets given…the robust nature of overnight SONIA'[6]. This would thus reduce systemic risk.

SONIA compounded in arrears is already widely used, particularly in derivatives and bond markets. At the same time, overnight SONIA may not be the optimal rate in all cases where term LIBOR is currently used and therefore, in addition to other alternative reference rates, the development of forward-looking term rates is likely to play a role in facilitating transition to SONIA as well as on an ongoing basis for specific products and use cases.

Supervisory authorities have, however, expressed a number of concerns about a more broad-based adoption of RFR-derived term rates beyond specific use cases, with a view to preserving the most robust overall market structure and maintaining the conditions from which a robust term rate can be produced. The rationale for this is summarised below.

- Term SONIA is derived from executable quotes for SONIA-based interest rate swaps. Its robustness therefore depends on the liquidity in such swap markets, so it is in the interest of all potential users of Term SONIA for those markets to remain primarily based on overnight SONIA. If the volume of swaps data available is not consistently as large as in overnight funding markets, then Term SONIA cannot be as robust as overnight SONIA.

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[2] See for example, *Last Orders: Calling Time on LIBOR*, Dave Ramsden, Bank of England, 5 June 2019 and *Staying Connected*, Mark Carney, Bank of England, 24 May 2018
[3] *LIBOR transition – the critical tasks ahead of us in the second half of 2020*, Edwin Schooling-Latter, FCA, July 2020
[4] The number of trading days in three months
[5] *Interest rate benchmark reform – overnight risk-free rates and term rates*, Financial Stability Board, July 2018
[6] See RFR Working Group Use Cases, January 2020

- A broad-based adoption of Term SONIA may detract from liquidity in products referencing SONIA compounded in arrears, directly or indirectly reducing volumes in the SONIA-based interest rate swaps from which Term SONIA is derived.
- The methodologies used for constructing Term SONIA use SONIA interest rate swap order book data. As with other benchmarks with comparable methodologies, this could give rise to a conflict of interest where a lender / dealer is both providing prices to the relevant overnight indexed swap (OIS) order books used to construct Term SONIA and providing swaps or other products based on Term SONIA. This potential conflict could impact the willingness of banks to stream executable quotes to the relevant OIS order books which may in turn undermine the robustness of Term SONIA.

Taken together these points make clear that widespread adoption of SONIA compounded in arrears, in particular in derivatives markets, and the relatively limited use of Term SONIA in specific use cases will help to preserve the necessary conditions for a robust Term SONIA rate for the benefit of all market participants. Consistent with this, the FCA has stated that 'the use of these forward-looking term rates is meant to be limited'[7] and that 'term rates are not needed for the bulk of the derivatives market'[8]. Similarly, in the new loans market, the RFR Working Group concluded that the 'use of SONIA compounded in arrears is appropriate and operationally achievable for 90% of new loans by value'[9], a position supported by the Bank of England and FCA.

Given the financial stability and conduct considerations set out above, it is clear that regulators expect the use of Term SONIA to be limited. However, both regulators and market participants expect that Term SONIA will be sufficiently robust for selected applications where the use of a rate that is compounded in arrears is not appropriate or operationally achievable. For example, Term SONIA, as with other term rates, may be valuable where market participants need advance knowledge and certainty of their interest rate obligations or where the rate is used for discounting future cash flows such as in trade finance[10].

2. Purpose

This Standard has been developed with the aim of identifying where there may be robust rationales for using Term SONIA for transactions in the loan, bond and derivatives markets and to set out certain expected behaviours of markets participants when using or issuing Term SONIA products in light of the reduced systemic risks associated with using overnight risk free rates. Use cases for Term SONIA may evolve over time in accordance with market and regulatory developments, including in other currencies, and market participants should consider the Core Principles in this Standard in light of such developments. While it remains possible that RFR-derived term markets evolve differently in some currencies and, due to the particularities of local markets, greater reliance may be placed on term rates, this Standard does not consider such developments and is limited in its application to sterling markets.

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[7] *LIBOR: preparing for the end*, Andrew Bailey, FCA, July 2019
[8] *Interest rate benchmark reform: transition to a world without LIBOR*, Andrew Bailey, FCA, July 2018
[9] See RFR Working Group Use Cases, January 2020
[10] Conduct risk during LIBOR transition – *Questions and answers for firms about conduct risk during LIBOR transition*, FCA, November 2019; 'It is not necessary to use a forward-looking term rate to provide cash flow certainty. Other products (e.g. products based on SONIA compounded over an earlier period, fixed rates, or on 'Bank Rate' as in some existing mortgages) may be more appropriate for meeting the needs of customers who prefer cash flow certainty, are likely to be more stable than forward-looking rates compiled based on market transactions on a single day, and/or easier to explain and understand.'

3. Scope and applicability

This Standard applies to participants in the Sterling fixed income and wholesale lending markets, including Sterling legs of multi-currency products.[11]

The Standard applies to the use of Term SONIA in financial products or contracts and not to other potential use cases, including, for example, the use of Term SONIA as an input to risk/valuation modelling or cost of funds calculations.

[11] This Standard has broader applicability than other FMSB publications as it also applies to wholesale lending markets. The reason for extending the applicability of this Standard is because of the interconnectedness of lending and derivatives markets meaning that, in order to provide a comprehensive standard for market participants, it is necessary to address both markets.

4. Glossary

Term	Definition
Bank of England 'Bank Rate'	Bank Rate, sometimes called Base Rate, determines the interest rate the Bank of England pays on commercial bank deposits and influences the rates those banks charge individuals or businesses to borrow money or pay on their savings
'Benchmark Regulation'	UK version of Regulation (EU) 2016/1011, which is part of UK law by virtue of the European Union (Withdrawal) Act 2018, on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds
Dealer	Financial institution involved with the creation, promotion, analysis and sale of securities and other financial instruments
'RFR Working Group'	The Working Group on Sterling Risk-Free Reference Rates
'RFR Working Group Use Cases'	Use Cases of Benchmark Rates: Compounded in Arrears, Term Rate and Further Alternatives, RFR Working Group, January 2020. See RFR Working Group Use Cases here
'SONIA'	Sterling Overnight Index Average as published by the Bank of England
SONIA compounded in arrears	SONIA compounded during the relevant interest period
Synthetic LIBOR	Refers to the continued publication of LIBOR using a different methodology after the FCA has found the LIBOR rate using the current methodology not to be representative of the market. Synthetic LIBOR is intended to be used for 'tough legacy' contracts that cannot transition from LIBOR
'Term SONIA'	Includes any forward-looking term SONIA benchmark with a maturity of 12 months or less, published or made available to the public by any benchmark administrator
Tough legacy	Contracts that genuinely have no or inappropriate alternatives and no realistic ability to be renegotiated or amended[12]

[12] *Financial Service Regulation Statement*, Rishi Sunak, June 2020

III. Core Principles and commentary

1. Use of SONIA compounded in arrears

As outlined in Section II above, the UK authorities and RFR Working Group have made clear their expectation that the use of forward-looking term rates will be limited and that sterling fixed income and wholesale lending markets should predominantly transition to SONIA compounded in arrears. This is consistent with the FSB's view that a transition to new overnight RFRs is important to ensuring financial stability:

> *'In some markets, notably the largest part of the interest rate derivative markets, it will be important…that transition away from IBORs is to the new overnight RFRs rather than to these types of term rates. Transition will only reduce vulnerabilities if it addresses the core weakness of the IBORs – the lack of deep and liquid underlying markets. Because derivatives represent a particularly large exposure to certain IBORs, and because these prospective RFR-derived term rates can only be robustly created if derivatives markets on the overnight RFRs are actively and predominantly used, the FSB believes that transition of most derivatives to the more robust overnight RFRs is important to ensuring financial stability.'*[13]

In line with the objective of the FSB and UK authorities for the sterling fixed income and wholesale lending markets to actively and predominantly transition to SONIA compounded in arrears, Core Principles 1-3 below consider selected use cases for Term SONIA for transactions in sterling loan, bond and derivatives markets. The Principles cover loans and bonds first given that derivatives are often used to hedge these products.

2. Lending

Core Principle 1: Market participants should assess, in a manner consistent with this Standard and the RFR Working Group Use Cases, whether there is a robust rationale when deciding to use Term SONIA in lending products taking into account the reduced systemic risks associated with a broad-based adoption of overnight risk-free rates.

As outlined in the RFR Working Group Use Cases, a range of possible alternative reference rates are available for GBP lending, which may be better suited to lending products than Term SONIA. Furthermore, excessive use of Term SONIA in lending products and associated hedging instruments could lead to systemic risks due to the nature of Term SONIA reference rates (TSRRs). Market participants should therefore carefully assess, in a manner consistent with this Standard and the RFR Working Group Use Cases, whether there is a robust rationale when deciding to use Term SONIA in lending products, taking into account the reduced systemic risks associated with a broad-based adoption of overnight risk-free rates.

Examples where there is a robust rationale for using SONIA compounded in arrears or other alternative rates such as Bank Rate in lending products include where:

- The borrower may seek to hedge interest payments either at the time of borrowing or in the future; and/or
- the interest rate is not used for discounting.

[13] Ibid 5

The main circumstances where market participants may be able to identify a robust rationale for using Term SONIA in lending products, as stated in the RFR Working Group Use Cases, include:

- Trade and working capital products which require a forward-looking interest rate for discounting; and/or
- Islamic finance products which can pay variable rates of return as long as the variable element is pre-determined.

Additionally, the RFR Working Group Use Cases refer to other client segments where there may be a robust rationale for using alternatives to SONIA compounded in arrears, including mid corporate/private banking and retail and export finance/emerging markets lending. Alternatives to the use of SONIA compounded in arrears for such use cases may include Bank Rate, fixed rates or Term SONIA.

Lenders should have internal processes in place to approve any product types that reference Term SONIA and evidence the alignment of product approvals with this Standard and the rationale for any exceptions.

3. Bonds

Core Principle 2: Market participants should assess, in a manner consistent with this Standard and the RFR Working Group Use Cases, whether there is a robust rationale when deciding to use Term SONIA for bonds taking into account the reduced systemic risks associated with a broad-based adoption of overnight risk-free rates.

SONIA compounded in arrears has been adopted as the main reference rate for GBP bonds, including floating rate notes and securitisations, largely replacing GBP LIBOR[14] in new issuance on a consistent basis over a number of years. It has also been adopted as the new reference rate for use in a number of existing LIBOR-linked bonds, which have been transitioned through a variety of investor consent processes.

As outlined in the RFR Working Group Use Cases, SONIA compounded in arrears may be better suited to floating rate bonds than Term SONIA, due to the sophistication of issuers and investors and the possibility that issuers or investors may wish to hedge interest rates using derivative products.

Furthermore, excessive use of Term SONIA in floating rate bonds and associated hedging instruments could lead to systemic risks due to the nature of the TSRR.

Market participants should therefore carefully assess whether there is a robust rationale when deciding to use Term SONIA for any bonds, including floating rate notes and securitisations.

Dealers providing advice or services related to a potential new TSRR issuance should make issuers aware of the use cases for Term SONIA or alternative reference rates as set out in this Standard. Dealers should also maintain appropriate records of bonds (self-issued or third party issued) that reference Term SONIA along with a rationale as to why Term SONIA is being used for such applications.

[14] SONIA-linked floating rate note and securitisation issuance amounts to over £90bn between June 2018 and September 2020 and public issuance of LIBOR-linked FRNs and securitisations with a maturity beyond the end of 2021 has all but ceased. Source: Bloomberg

4. Derivatives

Core Principle 3: Market participants should assess, in a manner consistent with this Standard and the RFR Working Group Use Cases, whether there is a robust rationale when deciding to use Term SONIA in derivatives products. Such assessment should take into account the reduced systemic risks associated with a broad-based adoption of overnight risk-free rates as well as the potentially heightened conduct risks of excessive usage of Term SONIA.

SONIA compounded in arrears has been adopted as the main alternative reference rate to LIBOR for GBP linear derivatives products, including interest rate swaps[15]. Additionally, the majority of commonly used non-linear derivatives can potentially be structured using SONIA compounded in arrears, as outlined in the RFR Transition in Sterling Non-Linear derivatives paper[16].

Excessive use of Term SONIA in derivatives products could heighten conduct risks related to potential conflicts of interest for dealers providing swap prices that may impact Term SONIA and/or the potential manipulation of prices of short-term SONIA interest rate swaps used to set Term SONIA. Furthermore, excessive use of Term SONIA in derivatives products could lead to systemic risks due to the nature of TSRR. Notably, the FSB has made clear that it 'believes that transition of most derivatives to the more robust overnight RFRs is important to ensuring financial stability'[17].

Market participants should therefore carefully assess whether there is a robust rationale when deciding to use Term SONIA in derivatives products taking into account the reduced systemic risks associated with a broad-based adoption of overnight risk-free rates as well as the potentially heightened conduct risks of excessive usage of Term SONIA.

Examples where there is a robust rationale for using SONIA compounded in arrears or other alternative rates such as Bank Rate in GBP derivative products include where:

- The derivative is hedging an existing instrument which does not refer to Term SONIA; or
- The derivative is used by the dealer acting on its own behalf (and not in response to an end-user request) including transactions on interdealer broker venues; or
- The derivative is used by dealers or market makers for risk management of other derivatives referencing Term SONIA.

The main circumstances where market participants may be able to identify a robust rationale for using Term SONIA in derivatives transactions include:

- End-user-facing derivatives used to hedge cash products which reference Term SONIA or end-user derivatives used to manage such hedges, in line with this Standard; and
- End-user-facing derivatives used to hedge tough legacy products which reference synthetic LIBOR (if synthetic LIBOR is based on Term SONIA) or end-user derivatives used to manage such hedges.

[15] 2020 year to date (as at 26 November 2020) cleared volume of SONIA OIS traded was £82.4TN compared to £19.8TN of GBP LIBOR Interest Rate Swaps. Notional outstanding on 26 November 2020 of SONIA OIS was £15.1TN compared to £10.9TN of GBP LIBOR Interest Rate Swaps. Source: LCH

[16] For examples of products which do not have an economic equivalent version using SONIA compounded in arrears, see *Transition in Sterling Non-Linear Derivatives*, RFR Working Group, November 2020

[17] Ibid 5

Longer-dated swap rate benchmarks (1 year and over), which are in some ways similar to Term SONIA, may be appropriate for use in non-linear derivatives, including for the cash settlement of swaptions referencing SONIA compounded in arrears.

Dealers should have internal processes in place to approve any product types that reference Term SONIA and evidence the alignment of product approvals with this Standard and the rationale for any exceptions.

5. General principles for banks / dealers

Core Principle 4: Banks / dealers should track and retain appropriate records of the volume of products, used or issued by such bank / dealer, which reference Term SONIA.

Core Principle 5: Banks / dealers should ensure they have adequate policies, procedures, systems and controls in place to identify and mitigate any conflicts of interest which may arise through the use of products referencing Term SONIA.

Core Principle 6: Comprehensive risk disclosures should be provided by banks / dealers to end users who are offered products referencing Term SONIA to highlight any relevant risks associated with the use of Term SONIA.

Such risk disclosures should be clear and updated if there are material changes to the relevant risks. For the avoidance of doubt, risk disclosures do not need to be made on a trade-by-trade basis.

6. General principles for corporates and buy-side firms

Core Principle 7: Corporates and buy-side firms should assess whether there is a robust rationale for any requests made to dealers to provide products referencing Term SONIA in light of this Standard.

Steps that corporate and buy-side firms could take to promote consistency with this Core Principle include:

- Understanding the limitations of Term SONIA and the rationale for limiting its wide-spread usage;
- Exploring alternatives to Term SONIA, including SONIA compounded in arrears;
- Implementing internal processes to approve product types that are proposed to reference Term SONIA, where there is a robust rationale; and
- Maintaining appropriate records of product types referencing Term SONIA and recording a rationale as to why Term SONIA is being used for such applications where they are not identified in this Standard as specific examples where there may be a rationale for using Term SONIA.

The above steps are indicative only and will vary in accordance with the size, nature and sophistication of the relevant firm.

7. General principles for all market participants

Core Principle 8: Where market participants do use products referencing Term SONIA, taking into account this Standard, market participants should ensure that such products have robust fallback arrangements included within the contractual terms to allow orderly transition if Term SONIA were to be discontinued or declared non-representative, in accordance with the Benchmark Regulation.