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SONIA: A Primer

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As we approach the end of LIBOR, the next phase of the transition is already upon us: incorporating the new fallback rates and market conventions into our transactions. This article highlights SONIA, the Bank of England's recommended alternative for Sterling LIBOR. We explain everything you need to know about the differences between SONIA and SOFR and how they both differ from LIBOR, discuss expected variation on how SONIA will be used in the UK versus U.S. markets, and provide a cheat sheet of key terms that you'll soon start seeing in your loan documents (if you haven't already).

What is SONIA?

With the March announcements that our colleague Leah Edelboim so eloquently elucidated **here**, both the UK Financial Conduct Authority and the ICE Benchmark Administration signaled a benchmark transition event for Sterling LIBOR and the other LIBOR-quoted currencies. At the end of this year, Sterling LIBOR will permanently cease for overnight, one-week, two-month and twelve-month tenors, and will no longer be representative for one-, three- and six-month loans.

Enter SONIA, the Sterling Overnight Index Average. SONIA is the risk-free reference rate being promoted as the preferred post-LIBOR benchmark for sterling. SONIA reflects the average interest rate that banks pay to borrow sterling overnight from other lenders. It represents a robust benchmark based on a tremendous volume of roughly £45 billion in real transactions each day. As a risk-free reference rate, SONIA doesn't contain any liquidity or credit premium charged by lenders to the borrowing banks.

SONIA vs. SOFR vs. LIBOR

Like SONIA, SOFR is a risk-free overnight rate. SOFR is the Secured Overnight Financing Rate recommended by the Federal Reserve Bank to replace LIBOR for U.S. Dollar-denominated loans. Each is calculated looking backward to the prior day's deals, and so is reset on a daily basis. While SONIA is an unsecured rate determined by underlying interbank money market trades, SOFR is a secured rate underpinned by repo transactions.

Basic SONIA and SOFR differ from interbank offered rates, such as LIBOR, which are available in different tenors (one-month, three-month, six-month, etc.). LIBOR is inherently forward-looking, with the interest rate being agreed at the beginning of an interest period that lasts for a precise length of time. Because of that, LIBOR may offer greater certainty, as the interest rate is preset for a particular tenor. SONIA and SOFR are generally less predictive, as daily overnight rates determined by looking back at the prior day. LIBOR also contains credit and liquidity premiums charged to reflect bank credit and tenor risk, which are not present in risk-free rates like SONIA and SOFR. As such, SONIA and SOFR display differences in supply and demand and liquidity fluctuations compared to an interbank offered rate like LIBOR.

While SONIA and SOFR are fundamentally different than LIBOR, the goal of the benchmark administrators, the interest rate regulators and our market generally is to ensure that the economics of the risk-free rates are as close to those with LIBOR as possible. Market participants do not want a transfer of value to occur because of the transition from one reference rate to another. Loans based on SONIA and the other risk-free rates cost less because they do not contain the LIBOR risk premiums, so lenders are expected to increase the margin or add a credit adjustment spread to balance the change. Transactions based on LIBOR also contain provisions to cover breakage costs incurred by a lender if the borrower early prepays a loan period. That is inapplicable when using a daily rate like SONIA, so lenders may institute other provisions to compensate their costs for early repayment by borrowers. Lenders should also seek to adapt SONIA in a way that the amount to be paid at the end of an interest period can be determined at an earlier date.

SONIA in the UK

With the inherent disparity of LIBOR being a term rate and SONIA being a daily rate, market participants in the UK have sought to mitigate the discrepancy by formulating SONIA to function over a similarly set period of time. Based on the advice of the Bank of England, the vast majority of the UK market is expected to calculate SONIA compounded in arrears. To do so, the daily SONIA rate is compounded over a certain timeframe, such as a three-month tenor that is made up of three months' worth of daily compounded rates. To permit a borrower to know what its payment will be before the very end of the term, a "lookback" period is used. The period over which SONIA is compounded is moved, say, five business days before the beginning and end of the interest period. That makes the total interest payment known five business days prior to the interest payment date at the end of the term.

The Bank of England's Working Group on Sterling Risk-Free Rates (the "Working Group") and the Loan Market Association (the "LMA") have each endorsed certain conventions for determining SONIA. The total rate is composed of two elements: the compounded rate and a spread adjustment. For compounding methodology, they recommend using a "non-cumulative" approach. Rather than a cumulative rate being measured for the interest period as a whole, a cumulative rate is fixed for each day during the period and then is compounded. That enables a precise calculation of accrued interest for any point of time during the term. If an early prepayment ever needs to be made or a lender moves to assign its loan mid-term, the compounded rate can be ascertained.

The Working Group and the LMA also recommend a lookback "without observation shift." With that approach, SONIA is derived from the lookback period but is weighted according to the days in the interest period. This prevents a situation where the daily accrued interest could ever be negative. Alternatively, it is expected that some market participants may assess SONIA via a lookback "with observation shift." That sets the rate based on the lookback period but is weighted per the days in the observation period. As with the general convention for determining sterling interest rates, in either scenario interest is based on the actual number of days that have elapsed and a year consisting of 365 days.

The second component of the aggregate rate is the credit adjustment spread. The spread is meant to bring the final interest rate using SONIA to be as near to the LIBOR rate as practicable. Market participants should analyze the timing of when the credit adjustment spread is calculated, if they prefer to use a dynamic or static construction, whether the spread adjustment should be modified depending on the length of an interest period and the exact method for tallying the spread. Other aspects of applying SONIA compounded in arrears that transacting parties should consider are a reference rate floor, mechanics for voluntary prepayments, interest period durations and how the administrative agent or lender would notify the other parties of a change to the interest rate.

While it has been estimated that roughly 90% of the UK market will adopt SONIA compounded in arrears, certain sectors may choose to implement other forms of SONIA instead. In particular, term SONIA has already been developed as a published, usable reference rate that functions more similarly to LIBOR. As a forward-looking rate, term SONIA may offer borrowers with greater certainty as to what their interest payment will be. But the Working Group has steered market participants away from term SONIA, in part because it could potentially introduce manipulation risk implicit in forward-looking methodologies like LIBOR. Using the daily overnight SONIA rate endorsed by the Working Group would also conform to the risk-free reference rates being promulgated by administrators of other currencies. That may make it simpler to include in multicurrency credit facilities.

SONIA in the U.S.

While the UK market is anticipated to predominately utilize SONIA compounded in arrears, that is not the case for those in the United States. While a small percentage of U.S.-based fund finance transactions permit loans solely in sterling, it is far more common on this side of the pond to see sterling in multicurrency facilities that are primarily based on dollars. With SOFR replacing Dollar LIBOR, many U.S. lenders are establishing internal systems founded on the SOFR conventions. As such, they are also looking to track the replacement benchmarks for the other LIBOR-quoted currencies, like SONIA, using the same approach.

Per the recommendations of the Alternative Reference Rates Committee (the "ARRC"), most fund finance practitioners in the United States have accepted term SOFR as the initial fallback to Dollar LIBOR and daily simple SOFR as the next alternative in the replacement rate waterfall. As evidenced by the ARRC's announcement on April 20 setting forth key principles for a forward-looking SOFR term rate, it is still undetermined whether a term SOFR will ever be available. Either way, it is expected that many in the United States will conform SONIA and the other risk-free reference rates that will displace LIBOR to mirror SOFR. As such, the leading U.S. approach for SONIA is predicted to have term SONIA as the initial replacement benchmark, if it is available, and the secondary fallback as daily simple SONIA.

The market convention in the United States also differs from that in the United Kingdom for the spread adjustment. Rather than use a credit adjustment spread based on the delta between Sterling LIBOR and SONIA, it is forecast that most in America will devise a revised margin to make SONIA more economically similar to LIBOR. As SONIA is just now starting to be included in loan documentation in the United States, we have yet to see what overall approaches to SONIA will take hold.

Conclusion

The culmination of the LIBOR transition seems closer and closer with each passing day. As with Kurzweil's "Law of Accelerating Returns," the pace of the LIBOR phase-out seems to be increasing exponentially. The end of 2021 and Sterling LIBOR will be here before we know it. Now is the time to embrace SONIA.

Summary of Key Terms

The following is a list of key terms and a brief description of how they are to be used in loan documents. You can reference this list as you begin to include SONIA and the other risk-free alternative reference rates in your transactions.

"Backstop Rate Switch Date": For inclusion of a backstop date by when the rate switch from LIBOR to SONIA will occur.

"Benchmark" and related definitions: The primary terms for actualizing the change from LIBOR to the replacement reference rates.

"Central Bank Rate": For use in multicurrency facilities to distinguish between the primary fallback rates if any risk-free rate like SONIA is or becomes unavailable.

"Compounded Rate Terms": This sets out the specific terms and methodology for calculating interest at a compounded rate in any given currency.

"Compounded Reference Rate": For compounding SONIA in arrears.

"Daily Non-Cumulative Compounded RFR Rate": For non-cumulative compounding of SONIA.

"Daily Rate": If an interest rate floor is used, the parties may need to use this definition to compute the floor for each daily interest rate before SONIA is compounded.

"Daily Simple RFR": This provides the convention for calculating daily simple interest for the risk-free reference rates like SONIA and SOFR.

"Eurocurrency Rate" and related definitions: For maintaining "IBOR" rates for euros (EURIBOR) and yen (TIBOR).

"Interpolated Rate": A lender may need to use an interpolated rate to determine a eurocurrency rate if the eurocurrency rate is not available on the applicable screen page at the time of determination.

"Lookback Period": Generally used for calculating SONIA without observation shift.

"Observation Period" and related definitions: Generally used for calculating SONIA with observation shift.

"Rate Switch Trigger Event": This is meant to list objective triggers that lead to a rate switch on the applicable rate switch date, such as a public announcement from the appropriate regulatory authority.

"Rate Switch Currency": This typically is used to indicate the currencies for which a compounded reference rate would be permitted in the loan transaction.

"Rate Switch Date": This provides the mechanism for fixing a set date on which the change of benchmark rate would occur.

“RFR” and related definitions: For adopting risk-free reference rates as the fallback to LIBOR.

“Term RFR”: This provides the convention for calculating term interest for the risk-free reference rates.