CONSULTATION PAPER: THE REFORM OF SONIA

As you may know, the role of the Financial Markets Law Committee (the "FMLC" or the "Committee") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed.

The FMLC has actively and regularly engaged with the subject of financial benchmark reform since 2012. In light of its extensive work on this subject, the Committee welcomes the opportunity to respond to the consultation paper (the "Consultation Paper" or "CP") published by the Bank of England in October 2016 on the evolution of the Sterling Overnight Index Average ("SONIA"). The Consultation Paper incorporates by reference certain proposals set out in an earlier consultation by the Bank of England in July 2015 (the "2015 consultation"). Collectively, these reforms will result in a redesigned SONIA benchmark, to which the Consultation Paper refers as "reformed SONIA".

Changes to the SONIA Methodology

The Consultation Paper sets out proposals for reforming the SONIA calculation methodology. Following the 2015 consultation, the input data from which SONIA is calculated will be broadened to include bilaterally negotiated as well as brokered unsecured deposit transactions. According to the more recent proposals, SONIA, which is currently calculated as the volume-weighted mean of eligible transactions, will be calculated as the volume-weighted median. The relevant transaction window, which defines the temporal scope of the input data for SONIA and which was slightly adjusted earlier this year, will continue to run from midnight to 18.00 each London business day but, in consequence of other changes to the scope of input data, the publication time and date for SONIA will shift from same-day publication to next-day publication at 9.00.

In section 4, the Consultation Paper addresses the question of how these proposed changes can best be implemented with minimum disruption for the users of SONIA. It establishes, in section 4.1, that the Bank of England’s preferred approach to implementation of the reforms is “for a simple point-in-time switchover”. According to this approach, SONIA will be published under the current methodology, shortly after the close of the sterling money markets, on the day prior to the switchover and the next day no level will be published. On the third day, reformed SONIA will be published via existing publication venues at 9.00.

The question of implementation pathways has previously been addressed, in abstract, as part of a report by a Market Participants Group (the "MPG Report") supporting work by the Financial Stability Board on Reforming Major Interest Rate Benchmarks (the "FSB Report"). Broadly, the MPG Report considers four alternative transition
pathways: (i) a "seamless transition" from one methodology to another; (ii) a "successor rate" pathway whereby one benchmark is withdrawn and replaced by another with a different but similar identity; (iii) a "market-led" transition, involving the voluntary adoption of a different benchmark published in parallel to the legacy benchmark; and (iv) a "cut over" transition whereby adoption of a new benchmark is encouraged by notice to users that the legacy benchmark will be withdrawn at a future date. By the time the FSB Report was published, the first of these pathways was commonly referred to as "evolution" rather than "transition", because it involves no material shift in the identity of the benchmark.

Notwithstanding the Consultation Paper refers to the preferred implementation pathway at section 4.1 as a "switchover transition", the proposal arguably has more in common with the evolutionary or seamless approach than with any of the other pathways identified in the MPG Report. This is apparent from the fact that many of the core characteristics of SONIA—including the name, the publication venues, the administrator and, crucially, the broad, underlying economic reality the benchmark is trying to measure—will remain the same after the switchover. Projected values for reformed SONIA and for SONIA as it is currently calculated are also expected to be very similar, to within a maximum spread of one to two basis points.6

Legal risk and financial contracts (CP Questions 10 and 11)

It is sometimes said that benchmark transition gives rise to legal risk. Those who raise this concern are usually referring to frustration risk in relation to existing financial contracts which reference the benchmark.7 The FMLC has observed elsewhere that it would be highly unusual for a commercial contract to be frustrated,8 particularly where the parties have incorporated fallback provisions dealing with the eventuality of benchmark withdrawal.9 Even where the parties have made no express provision for changes to a benchmark, an agreement may be found, at common law, to incorporate an implied term which covers the eventuality: for example, by recognising the parties' obvious, if implicit, intention that a new methodology is to apply in substitution for the original methodology where the latter has been superseded.

The majority of sterling interest rate contracts are likely to be governed by English law and the risk of these contracts being frustrated following a change to the methodology by which the rate is calculated is, in the view of the FMLC, remote.10 Moreover, although it is true to say that the risks of disruptive litigation will not always be as remote as the risks of contract frustration in cases of benchmark transition,11 history suggests that there are also grounds to be sanguine in this regard,12 particularly where the projected spread in values between the two methodologies is low, as here.

The legal and operational risks associated with benchmark reform are minimised where the proposed implementation can properly be characterised as evolutionary rather than transitional (i.e. from one rate to another). For this reason, the MPG report describes evolutionary change as "the most efficient possible transition".13 In light of this, the FMLC agrees with the approach set out at section 4.1 of the Consultation Paper on the grounds that reformed SONIA will be materially similar to current SONIA.

Contractual definitions and next day publication (CP Questions 9 and 12)

Although it is not possible definitively to answer the question in abstract whether a contract will be disrupted by benchmark reform, it is useful to review market standard terms and see how these might accommodate benchmark evolution.
The Consultation Paper correctly observes, at section 3.4, that the standard definition for SONIA ("GBP-WMBA-SONIA-COMPOUND") published by the International Swaps and Derivatives Association ("ISDA") is commonly referenced in interest rate derivatives and Credit Support Annexes which constitute collateral agreements for the purpose of interest rate derivatives. This definition has no internal fallback and refers to a rate calculated by the Wholesale Markets Brokers Association ("WMBA"). The WMBA has transferred the administration of SONIA to the Bank of England and, while it remains the calculation agent for SONIA for the time being, the plan is for the Bank of England to assume this role eventually. ISDA has said it will address these developments by making changes to the definition, according to the Consultation Paper at paragraph 24.

Since SONIA is calculated as a volume-weighted average and does not reflect a snapshot of the market for sterling overnight deposits at any particular hour, the ISDA definition for SONIA does not refer to a publication time nor does it use the familiar "as of" drafting technique commonly associated with the contractual definitions of, say, the time-sensitive Interbank Offered Rate benchmarks. In that regard, the FMLC does not anticipate that the change to the publication day will cause significant legal issues for contracts which rely on the definition.

Other market standard terms, however, may possibly be affected by the change in publication day. In particular, a number of SONIA swap rate definitions published by ISDA in supplements to the 2006 ISDA Definitions refer to swap prices that are fixed in a time-sensitive manner, typically by taking a snapshot of real-time prices for SONIA swaps published on brokers' screens "as of" either 11.00 or 16.15. The Committee wishes to draw to your attention the possibility that there may be a shift in the economics of the underlying market for SONIA swap deals around these times which occurs as a result of changing the publication times for SONIA and, in consequence, a possible change in the levels of the swap rates, as defined.

Benchmark concepts (CP Question 5)

As a final brief point, the Committee would like to express its support for the way in which the Consultation Paper, in section 3, aligns the analysis of SONIA with the conceptual schema now widely adopted in international regulation. Drawing a careful distinction between: (i) input data, (ii) the benchmark methodology and (iii) the economic reality or underlying market the benchmark is attempting to measure, is essential not only to ensure the correct application of law, regulation and best practice guidelines but also to promote a shared understanding of the risks associated with reform and an accurate analysis of its impact.

I and Members of the Committee would be delighted to meet you to discuss the issues raised in this letter. Please do not hesitate to contact me to arrange such a meeting or should you require further information or assistance.

Yours sincerely,

Joanna Perkins
FMLC Chief Executive

cc. Ed Ocampo, Tim Taylor
The FMLC has published multiple letters and papers on benchmark reform (which can be accessed at www.fmlc.org). Members of the FMLC Secretariat also contributed to the work of a Market Participants Group (the "MPG"), established by the Financial Stability Board (the "FSB") and to the MPG's Final Report of the Market Participants Group on Reforming Interest Rate Benchmarks, dated 22 July 2014. The report is available at: http://www.fsb.org/wp-content/uploads/r_140722b.pdf. The findings of the MPG Report were considered by the Official Sector Steering Group (the "OSSG") of the FSB. Accordingly, the FSB published its own recommendations on Reforming Major Interest Rate Benchmarks, in a report dated 22 July 2014. The FSB Report is available at: http://www.fsb.org/wp-content/uploads/r_140722.pdf.


That is, it will be published under licence on screens maintained by, inter alios, Bloomberg and Thomson Reuters and also made freely available, with a time lag, via the Bank of England's Interactive Statistical Database.

Supra n.1.

See the Consultation Paper, page 7.

Frustration risk materialises at common law when the subject matter of a contract has been destroyed, or has otherwise become unavailable, and as a result performance by one or both of the parties to the contract is rendered impossible. It is often said that benchmark withdrawal would represent a frustration risk for financial contracts and occasionally the same thing is said of benchmark transition or evolution on the premise that the evolved benchmark no longer shares the identity of the original benchmark.

A similar issue, which is perhaps more prevalent in civil law systems, is the risk of force majeure, whereby a party is excused performance under a contract because performance has become impossible or impracticable owing to the intervention of an unpredictable and overwhelming supervening event. In common law systems, although there is no free-standing doctrine of force majeure, contracts sometimes include force majeure clauses contemplating events that may render performance impossible or impracticable and make provision for the parties to be excused further performance. When a force majeure clause is triggered it will normally bring an end to the contract.


Frustration will only occur where the parties to the contracts can be said to have wholly failed to allocate the risks of benchmark withdrawal. The parties may be taken to have allocated these risks in a number of different ways. (See FMLC report ibid, p.24 to 27, for more detail on the doctrines of frustration and implied terms.)

The precise risks will, however, depend on the terms of the parties' contract and their circumstances as a whole. Parties should consult their lawyers on the implications of benchmark transition for their contracts referencing the benchmark. The views of the FMLC do not constitute legal advice to any person.


At page 42.

See, for example, "GBP-SONIA-OIS-11:00-ICAP" in Supplement no.13 and "GBP-SONIA-OIS-11:00-TRADITION" and "GBP-SONIA-OIS-4:15-TRADITION" in Supplement no.20.

In view of the fact that this letter responds to a consultation issued by the Bank of England, Sinead Meany took no part in the preparation or drafting of this letter.