

STERLING OVERNIGHT INDEX

Reviving the Benchmark Resilience



Associates in
Capital Markets

Recap

It is no more surprising to the industry participants and to the public in general to acknowledge the need for a coordinated response from international regulators, post the attempted market manipulation of key reference rates. The wave of reforms and regulatory recommendations, from Wheatley Review way back in 2012 to the currently brewing European Benchmark Regulation, point out to just this - restoring public confidence in financial system at large.

The Bank of England's (BoE) special interest in monitoring the overnight money market, in order to assess the effectiveness of monetary policy implementation, was a step in that direction. Following an extensive consultation (in Q3-Q4 2015), the BoE unveiled its plans to revive the Sterling Overnight Index (SONIA), which is widely used by wholesale market participants including as a reference rate for the sterling OIS market.

With the timelines for the proposed reforms now coming into force, it is imperative that we recap the key features of the plan to get a better understanding of what can be expected in the coming months and to better prepare for compliance.



Quick Facts:

Sterling Overnight Index (SONIA) tracks actual market overnight funding rates. It is the weighted average rate to four decimal places of all unsecured sterling overnight cash transactions brokered in London by contributing WMBA member firms between 00:00 hrs and 16:15 hrs UK time with all counterparties in a minimum deal size of £25 million.

Plan of Action

SONIA, which tracks the actual market overnight funding rates, is a key interest rate benchmark with the underlying notional value running into trillions of pounds. A study conducted by the BoE showed that the volume of transactions underpinning the rate had fallen significantly in the recent years. This is the main area of concern as a low volume would put the longevity of the benchmark at risk thereby affecting the size and liquidity of the underlying market. With this in focus, the BoE proposed the following:

- ▶ **Broader Transaction Base** - Since the market for brokered deposits is limited, there is a strong case for the BoE to broaden the transactions underpinning the benchmark. Therefore, the proposal is to expand the eligible transactions criteria to include *brokered as well as bilaterally negotiated* overnight unsecured deposit transactions. This would ensure the robustness of the benchmark.
- ▶ **Data Collection Exercise** - Broadening the scope of transactions for the determination of SONIA as stated above would involve a deeper understanding of the current functioning of the short-term interest rate activity which is a data dependent exercise. The BoE, therefore, proposed a plan to collect transaction level data from banks, building societies and major investment firms on their secured and unsecured sterling money market borrowing activity. This data, the BOE believes, would enable it to not only giving a better picture of the benchmark and the underlying market but also in providing important inputs for its decisions regarding monetary and fiscal policies. This data collection would require data submission on an annual basis from all the aforementioned market participants and on a daily basis from those firms which are most active in sterling market. The list of the latter would be determined separately by the BoE, although it is expected to have overlap between the two groups. This necessarily means certain players in the market would have to submit data on a daily as well as annual basis.

The data to be collected therefore, is dependent on the following criteria:

- Transactions only if the party is the borrower of sterling cash
- Transaction size is at least £1 million; and
- Transaction original maturity is no more than 1 year - Forward Starting Transactions are included.

The transaction data to be collected is broader than what is required for the computation of reformed SONIA. However, the BoE clarified that the reformed rate will consider only unsecured overnight transactions settled same day as is the case now while the additional data would be used to assess the monetary conditions and the functioning of sterling market.



Plan of Action



- ▶ **Transition from WMBA as Administrator** - The data collection exercise from deposit takers by BoE would be possible based on the power derived from the Bank of England Act of 1998. This, in turn, would mean that the BoE would take over as the administrator of reformed SONIA from Wholesale Market Brokers' Association (WMBA) - the current administrator by the year 2017. The BoE is also expected to consider whether any other methodological enhancements are warranted in the computation of the benchmark as part of this transition.
- ▶ **Change of Publication Time** - In order to address the need to process anticipated higher volume of data for the computation of the benchmark, the BoE proposed moving the publication time to 9:00 am on the business day following that to which the rate pertains as against the current practice of publishing forty minutes after the close of markets (i.e., 17:00 London Time). The proposal also stems from the fact that the anticipated higher volume of data combined with the extension of current RTGS hours (from 14:20 to 18:00 London time) from mid-2016 and the need for validation and plausibility checks would mean that it is unlikely that the BoE would be able to publish the rate on the same day. However, it is worth noting that the revised publication time is consistent with the current approach of utilising the rate to enter into and settle the trades on the same day.



What Next?

The timeline for the first leg of the reforms i.e., the data collection exercise is to start in Feb-2016 for the early adopters with the transition to daily submission by full set due from Jun-2016. The public consultation for the revising the methodology for computation of SONIA is expected to be conducted in Q3-2016 with the revised SONIA anticipated to come into force by Q2-2017.

Our Take

The Sterling Overnight Index is a major short-term interest rate benchmark supporting sterling OIS contracts with notional outstanding value exceeding £10 trillion and major sterling swaps notional outstanding value of £35 trillion⁺. The efforts undertaken by the Bank of England are essential and hold the key for ensuring a robust benchmark and thereby an efficient financial system. With the legacy of manipulation allegations of major benchmarks looming over the financial world, the efforts to reform the SONIA are crucial for restoring investor confidence.

The upward shift of benchmark regulations with tighter control exerted by the regulators on various aspects of rate determination from data submission to oversight, governance, audit and control would necessarily mean increased pressure for the participating financial institutions. Banks and financial institutions should therefore, focus on building a comprehensive strategy to address the anticipated changes and compliance for all the benchmarks to which it is a party rather than acting in silos and “as-it-comes” basis. This would not only provide process and system efficiencies but also compliance on time.

“...Key is to build a comprehensive strategy... rather than acting in silos”



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