CAPITAL MARKETS - JAPAN

Public consultation on appropriate choice and use of Japanese yen interest rate benchmarks

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Introduction

In July 2014 the Financial Stability Board published a report in which it recommended the strengthening of existing major interest reference rates (IBORs) and the development of alternative risk-free rates (RFRs) to replace IBORs. In December 2016 – in response to this report – the Study Group on Risk-Free Reference Rates, which was established by market participants, identified the uncollateralised overnight call rate (the so-called 'Tokyo overnight average rate' (TONA)) as the Japanese yen RFR. In July 2017 the Japanese Bankers Association TIBOR Administration, which is the administrator of the Tokyo Interbank Offered Rate (TIBOR), implemented a TIBOR reform. Further, to address the risk that the London Interbank Offered Rate (LIBOR) may be discontinued after 2021, the Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks was established in August 2018 to:

- recommend the appropriate choice and use of Japanese yen interest rate benchmarks depending on the type of financial transaction involved (eg, loans, bonds and derivatives); and
- develop transition plans for a new framework enabling the use of Japanese yen interest rate benchmarks.

In July 2019 the committee published a paper entitled "Public Consultation on the Appropriate Choice and Usage of Japanese Yen Interest Rate Benchmarks". This article provides a brief explanation of the public consultation.

Alternative benchmark options

The TONA, which was identified as the RFR for Japanese yen, is an overnight rate calculated and published on a daily basis by the Bank of Japan using market information provided by selected market brokers based on transaction data. On the other hand, LIBORs are rates with various terms (eg, the three-month LIBOR and the six-month LIBOR). In order to use TONA as an alternative benchmark for Japanese yen LIBOR, term rates which reference TONA must be developed. In this respect, the public consultation proposes the following options:

- TONAs compounded and fixed in advance;
- TONAs compounded and fixed in arrears;
- term rates based on a Japanese yen overnight index swap;
- term rates based on overnight call rate futures; and
- TIBORs.

The first and second options are both compounded averages of the daily TONA for the calculation period corresponding to the term of the LIBOR that they are replacing (eg, three or six months). Under option one, the rate is determined at the beginning of the calculation period by referencing the daily TONA for the period preceding the calculation period. Therefore, while the rate is determined in advance, as with LIBOR, the reference period does not match the calculation period as it references the period preceding the calculation period. Under option two, the rate is calculated approximately at the end of the calculation period and references the daily TONA for such calculation period. Because it is practically necessary under option two to secure a certain number of business days from the date of calculation until the payment date, the public consultation proposes three additional options:

- the 'lock-out' methodology (ie, the rate is calculated a certain number of business days before the end of the calculation period and the TONA determined on such calculation date is used for each of the remaining business days in the calculation period);
- the 'reset days prior' methodology (ie, the rate is calculated by shifting the reference period back by a certain number of business days); and
- the 'delay' methodology (ie, the payment date is delayed until a certain number of business days after the end of the calculation period).

By contrast, options three and four above (ie, term rates based on a Japanese yen overnight index swap and term rates based on overnight call rate futures) are both forward-looking term rates that are determined in advance at the beginning of the calculation period. However, neither option exists at present. With regard to option three, the public consultation states that it is appropriate to calculate the term rate by adopting the 'waterfall method', under which the use of transaction data is prioritised and quote data is used only if there is insufficient transaction data. Such term rate is expected to be established by mid-2021 at the latest. In August 2019 the Task Force on Term Reference Rates was established to discuss the overall scheme for the calculation and publication of term rates and the detailed methodology for calculating those rates. With regard to option four, trade in overnight call rate futures that are listed on the Tokyo Financial Exchange has been suspended and the resumption of such trade is under discussion.

According to the public consultation, in the case of bonds, because options three and four provide for cash flow certainty in advance, they are considered to be highly compatible with current bond practices. Accordingly, the committee believes that these options should be used once they have been established. Until then, another option (eg, option two) would need to be used temporarily.

In the case of loans, the public consultation states that because loans are indirect finance provided via the balance sheets of banks, there is rationale for selecting option five (TIBORs) for the lending rate. It also states that it would be reasonable to use options three and four in the future, using another option temporarily until option three is established in mid-2021.

Options for spread adjustments

LIBOR and TONA are different types of rate; LIBOR incorporates a bank credit risk premium, whereas TONA is a near risk-free rate. Therefore, a spread adjustment is necessary to replace LIBOR with TONA. In this regard, the public consultation proposes the following methodologies:

- a forward approach;
- a historical mean/median approach; and
- a spot-spread approach.

Under a forward approach, the spread adjustment is based on the forward spread between LIBOR and TONA in the relevant tenor when the fallback is triggered. For this option, market data that is necessary for the calculation may not be readily available or may be vulnerable to manipulation and distortion in the market.

In the case of a historical mean or median approach, the adjustment is based on the mean or median spot spread between LIBOR and TONA that is calculated over a certain lookback period (eg, five or 10 years) before the relevant announcement or publication triggering the fallback provisions. The adjustment is based on readily available market data, requires only simple implementation and verification processes and diminishes the effects of market distortion and potential manipulation. However, it may be impossible to obtain the amount of historical data required for calculations when using the term rate as a replacement benchmark because it has yet to be developed and no such data currently exists.

Under a spot-spread approach, the adjustment is based on the spot spread between LIBOR and TONA on the day preceding the relevant announcement or publication triggering the fallback provisions. Although this is a simple approach which is easy to implement and understand, it is vulnerable to manipulation and distortion in the market.

Other elements of fallback provisions

In response to the risk of LIBOR's discontinuation, the public consultation suggests that contracts referencing LIBOR should contain fallback provisions under which the parties agree in advance that LIBOR be replaced with TONA on the former's discontinuation. In this regard, in addition to the abovementioned alternative rate and spread adjustment options, the public consultation requests the public's input on two other elements of the fallback provisions:

- the trigger events; and
- the procedures under which the fallback provisions will be introduced.

With regard to the trigger events, in addition to the 'permanent cessation trigger' (ie, the announcement of the permanent cessation of LIBOR's publication), the public consultation also seeks responses on:

- the 'pre-cessation trigger' (ie, the regulatory authority's announcement that LIBOR is no longer representative); and
- the early 'opt-in trigger' (ie, when parties elect to adopt a trigger that takes place before LIBOR is permanently discontinued or becomes no longer representative. This mainly applies with regard to loans).

With regard to the procedures under which the fallback provisions will be introduced, in respect of loans, the proposed approaches are:

- the 'hardwired approach', under which the replacement benchmark is determined at the time of introducing the fallback provision; and
- the amendment approach, under which the replacement benchmark is decided by mutual agreement of the parties in the future.

These are similar to the fallback provisions recommended by the Alternative Reference Rates Committee in the United States.

In respect of bonds, only the hardwired approach is proposed because, under Japanese law, the amendment approach would require bondholders' meetings to pass resolutions regarding the amendments to be made to the bonds' terms. The passing of resolutions at bondholders' meetings would also be required to amend the terms of the outstanding floating rate bonds in order to introduce the fallback provisions.

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