

## Road to Risk-Free Rates in Japan

In response to the UK Financial Conduct Authority's proposed discontinuation of LIBOR, Japan, like other countries that rely on LIBOR as the preferred reference rate, has had to consider alternatives for its reference rate that uses USD LIBOR as a component.

In 2018, the Cross Industry Committee on Japanese Yen Interest Rate Benchmarks (the "Committee"), consisting of financial and institutional investors and non-financial corporates, was established. Its purpose is to conduct necessary deliberations to facilitate and guide Japanese yen interest rate benchmark reform.

In 2019, the Committee, together with the Bank of Japan, held a public consultation on the choice of alternative benchmarks to JPY LIBOR, the results of which revealed an industry preference for two alternatives: the Tokyo Interbank Offered Rate ("TIBOR") and the Tokyo Overnight Average Rate ("TONAR").

The two alternative rates are compared as follows:

- (i) TIBOR is a forward looking interest rate benchmark that reflects local market conditions. First published by the Japanese Bankers Association ("JBA") in November 1995, TIBOR is now published by *Ippan Shadan Hojin JBA TIBOR Administration*, following reform aimed at making TIBOR more standardised and transparent. TIBOR is subject to regulations of the Japan Financial Services Agency as a Specified Financial Benchmark under the Financial Instruments and Exchange Act; and
- (ii) TONAR is a risk-free rate ("RFR") based on the uncollateralized overnight call rate.<sup>1</sup> TONAR was identified in 2016 by the Study Group on Risk-Free Reference Rates, which was established by market participants to develop risk-free rates in response to a recommendation by the Financial Stability Board. In February 2020, the Committee appointed QUICK Corp as the calculation and publication agent for a term reference rate, and in May 2020, QUICK Corp began to publish daily prototype term rates of different tenors. These prototype rates, however are not intended to be used in actual transactions. QUICK Corp anticipates that it will begin publishing production rates for use in transactions no later than mid-2021.

The Committee and JBA have stated that parties are free to choose which of the two alternatives to JPY LIBOR they wish to use. This multi-rate approach, coupled with the lack of underlying liquidity in TONAR hedging and funding instruments, has led to a delay in the uptake of TONAR. According to a recent newsletter produced by the International Swaps and Derivatives Association ("ISDA"), entities still are choosing to continue to use JPY LIBOR, although there is "widespread support in bond and loan markets" for a term version of TONAR.<sup>2</sup>

---

<sup>1</sup> TONAR will be based on JPY OIS, which is a type of interest rate swap in which a floating rate calculated as the (compounded) weighted average of the uncollateralized overnight call rate for a certain period is exchanged for a fixed rate.

<sup>2</sup> [ISDA® Quarterly – Asian Options](#), September 2020, pp 16-17.

### *Fallback Provisions for Loan Agreements*

In March 2020, the JBA published sample fallback provisions for bilateral and syndicated business loans (available in Japanese only)<sup>3</sup> following communication with a wide range of market participants including Committee members. The JBA stipulated that the fallback clause chosen must be fully discussed between the contracting parties and established by mutual agreement. As a result, the fallback language does not specify which alternative benchmark rate should be used.

In August 2020, noting that both borrowers and lenders had asked for further discussion of replacement benchmarks, the Committee launched a second public consultation.<sup>4</sup> Among the issues considered were the Committee's proposals for the replacement benchmarks and spread adjustment methodologies for fallbacks in loans referencing JPY LIBOR, which take into account global consultations on RFRs, such as the recommendations by the U.S. national working group, the Alternative Reference Rates Committee (“ARRC”).

The Committee's proposed waterfall structure for the replacement benchmark for loans is as follows:

1st priority	Term Reference Rates
2nd priority	O/N RFR Compounding (Fixing in Arrears)
3rd priority	The alternate rate of interest that has been selected by the Lender [giving due consideration to (i) any selection or recommendation of a replacement rate or the mechanism for determining such a rate by the Relevant Governmental Body or (ii) any evolving or then-prevailing market convention]

The proposed waterfall does not include TIBOR; however, the Committee confirmed that it would not preclude contracting parties from selecting other waterfall structures, including those using TIBOR or a single replacement benchmark. With respect to the spread adjustment methodology, the Committee recommended a methodology similar to that adopted by the ARRC and ISDA, to ensure consistency and to prevent “administrative work from becoming complicated.” A spread adjustment for TIBOR has not been determined by the Committee, which notes that such a spread adjustment should be determined by the contracting parties.<sup>5</sup>

<sup>3</sup> 相対貸出のフォールバック条項の参考例（サンプル）の補訂について。The fallback clause was updated in June 2020, and a comparison table showing the changes between the March and June versions (in Japanese only) is available at [https://www.zenginkyo.or.jp/fileadmin/res/news/news320341\\_4.pdf](https://www.zenginkyo.or.jp/fileadmin/res/news/news320341_4.pdf).

<sup>4</sup> [Second Public Consultation on the Appropriate Choice and Usage of Japanese Yen Interest Rate Benchmarks - Considering the developments since the publication of the final report on the results of the last public consultation](#), 7 August 2020.

<sup>5</sup> Contracting parties that choose to use TIBOR may utilise, for example, the [methodology published by the Bank of Japan's Sub-Group on Loans](#) on 5 November 2020.

On 30 November, the Committee published a report with the results of the second public consultation,<sup>6</sup> which concluded that almost all respondents generally supported the Committee's recommendations.

### *Timetable*

In April 2020, it was reported that Japanese dealers were calling for an extension of the target LIBOR cessation date due to the effect of COVID-19, which had led to delays in, among other things, the implementation of system upgrades by banks and financial institutions required to operationalize the transition. The Bank of Japan, while acknowledging the delays caused by COVID-19, noted that overall available information indicates that these delays do not pose specific concern about meeting the 2021 year-end deadline for the discontinuance of LIBOR.<sup>7</sup>

This position was supported by the draft timetable for transition from JPY LIBOR included in the August 2020 second public consultation, which proposed, among other things, the cessation of the issuance of new loans and bonds referencing LIBOR benchmark by the end of Q2 2021 and the publication of TONAR term rates for use in contracts by the beginning of Q2 2021. The timeline is comparable to the targets announced by the UK's Working Group on Sterling Risk-Free Reference Rates for the cessation of new issuances of sterling LIBOR loans (end of Q1 2021) and the ARRC's target for the cessation of new issuances of USD LIBOR loans (end of Q2 2021).<sup>8</sup>

Further support for a firm 2021 deadline came in November 2020, when it was announced that ICE Benchmark Administration ("IBA") would consult on plans to cease publication of all tenors of a number of LIBORs, including JPY LIBOR, after December 31, 2021.<sup>9</sup> It was announced subsequently that IBA proposed to consult on ceasing publication of select tenors of USD LIBOR 18 months later, after June 30, 2023,<sup>10</sup> but this announcement is not expected to affect the timeline for JPY LIBOR cessation.

---

<sup>6</sup> [Final Report on the Results of the Second Public Consultation on the Appropriate Choice and Usage of Japanese Yen Interest Rate Benchmarks](#), 30 November 2020.

<sup>7</sup> Bank of Japan Review: [Financial Institutions' Preparedness for LIBOR Cessation and Future Actions with a Focus on the Results of the Joint Survey by the Financial Services Agency and the Bank of Japan](#), August 2020.

<sup>8</sup> [Further statement from the RFRWG on the impact of Coronavirus on the timeline for firms' LIBOR transition plans](#), 29 April 2020; and [ARRC Recommended Best Practices for Completing the Transition from LIBOR](#), 3 September 2020.

<sup>9</sup> [ICE Benchmark Administration to Consult On Its Intention to Cease the Publication of GBP, EUR, CHF and JPY LIBOR](#), 18 November 2020.

<sup>10</sup> [ICE Benchmark Administration to Consult on Its Intention to Cease the Publication of One Week and Two Month USD LIBOR Settings at End-December 2021, and the Remaining USD LIBOR Settings at End-June 2023](#), 30 November 2020.