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Financial Conduct Authority
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FCA ref: CP17/15

Comments on the Consultation Paper, "Powers in relation to LIBOR contributions" issued by the Financial Conduct Authority

Dear Mr. Grafen:

We, the Japanese Bankers Association (JBA), would like to express our gratitude for this opportunity to comment on the Consultation Paper: Powers in relation to LIBOR contributions, issued by the Financial Conduct Authority (FCA) on June 12, 2017. We respectfully expect that the following comments will be sufficiently reflected in your further discussion.

[General comments]

JBA has approximately 190 members comprising of banks and bank holding companies operating in and outside Japan. Some member banks have operations and conduct their business activities in the UK and other foreign jurisdictions.

Member banks widely use LIBOR in their lending/hedging activities and derivatives transactions particularly when such transactions are denominated in currencies other than Japanese yen. Also, they constantly enter into a number of loan agreements under which LIBOR is referenced for U.S. dollars or British pounds. Therefore, LIBOR is a critical benchmark for Japanese banks' activities. Furthermore, some member banks serve as a LIBOR panel bank and submit rates for the LIBOR calculation.

Having looked at international developments, we understand that regulators intend

to maintain and enhance the quality of IBOR while at the same time to consider risk-free rates (RFR), based on a multiple-rate approach (which moves away from a reliance on a single reference rate and allows users to choose amongst a range of reference rates) proposed by the Financial Stability Board (FSB).

Meanwhile, we appreciate the FCA's initiatives for maintaining, and enhancing the quality of, LIBOR.

However, regarding the FCA's recent Consultation Paper, there are some points that we would like to ask the FCA to consider in order to minimise impact on loan transactions and realize a sustainable framework from viewpoints of LIBOR users and panel banks (including potential panel banks). In this respect, our comments on Questions 1 to 6 in the Consultation Paper are provided below for your future consideration.

[Individual comments]

Question 1:

What time and costs do you think would be required for a new bank to prepare itself for contributing to LIBOR for transactions-based submissions and for expert judgment based submissions?

(Our comment)

Given that the business size and model and the development of information systems vary across banks, it is difficult to pre-estimate the degree of difficulties in establishing a relevant framework and time and cost that would be required for a new panel bank. Nonetheless, a considerable amount of time and cost would be needed.

It would be difficult for potential panel banks, in particular, to estimate required time and cost as they have less knowledge about developments of LIBOR reforms and a sense of the required internal management framework level compared to existing panel banks. Whilst potential panel banks are expected to require more time than existing panel banks to develop systems and establish an internal management framework, we believe, this is more achievable for the potential panel banks to implement appropriate initiatives, within a sufficient period of time for consideration, appropriate support by competent authorities, consideration to minimize or remove disincentives (e.g. risk), as well as incentives to the extent practical.

When currencies are added or in other cases, the same initiatives, such as system development, would need to be implemented by the existing panel banks as well, albeit within a shorter timeframe. Therefore, a sufficient consideration should be given in this respect.

Question 2:

Do you have any comments on our general approach to use of compulsion powers in relation to LIBOR?

(Our comment)
Our view, as an organization with a number of member banks using LIBOR in their transactions, is that it is necessary to ensure continuation of LIBOR given its importance as LIBOR is being used in all types of transactions around the world. From this viewpoint, we would like to request the FCA to sufficiently consider (i) minimising an impact on transactions, such as loans, and (ii) establishing a sustainable regime, in implementing its initiatives, with a view to maintaining and enhancing the quality of LIBOR. We believe that there would be a situation where the exercise of compulsion powers would be acceptable in order to ensure continuation of LIBOR provided that the policy is to allow such powers to be exercised only for necessary and limited cases. In light of the objective to secure an adequate number of panel banks for stable and continued submission of high-quality benchmarks, the exercise of such compulsion powers should be limited to the minimal extent and means.

Firstly, with respect to the above (i), it is necessary to carefully identify the availability of alternative rates in loan transactions. The Consultation Paper indicates that a key consideration in whether and for how long the use of powers to compel contributions to LIBOR is essential for market integrity will depend on the availability of alternative interest rate benchmarks (i.e. RFR). However, the FCA should recognise that banks may have considerable difficulty in using the RFR for loan transactions.

In executing loan transactions, not only customers' credit risk but also funding cost associated with fund transactions (for example, liquidity premiums in interbank transactions and credit cost) needs to be taken into consideration. Where the RFR is used in loan transactions, the portion of such funding cost (i.e. the spread between LIBOR and RFR) needs to be taken into account. Since this spread may lead to a significant difference in fair valuation and thus will have a

significant impact from the perspectives of risk management (valuation model) and hedge accounting (effectiveness), banks would need to change their models or develop systems. In addition, in cases of credit default swaps (CDS), etc., it is difficult to measure funding cost embedded in the spread and therefore it would be extremely difficult to calculate a highly convincing and objective funding cost in a stable manner. Moreover, as derivatives executed to hedge deposits/lending refer to the RFR, it is also difficult for banks to hedge the portion of funding cost. Given this, there is a high risk that the core functions (i.e. deposits and lending) of banks serving as a financial intermediary will be undermined.

Furthermore, where LIBOR is referred to for the portion of floating rates in fixed rate swaps, the spread between LIBOR and RFR will be updated because LIBOR at the time of each fixing will be used. Since, however, the spread specified in the contract is fixed, consideration on how to transfer to customers those changes in credit risk occurred over a long loan term would need to be reflected in the form of modification of contracts with each customer. It is assumed that banks will require a significant amount of time and burden for the negotiation of such a contractual modification because many end users (e.g. corporates) are not well-versed in the RFR. The significance of the use of financial benchmarks is to enable an efficient execution of transactions by avoiding such individual negotiations. If such a benefit of benchmarks is undermined due to benchmark transition, this would contradict the original objective of the use of benchmarks. It is our understanding that, from the above viewpoint, the FSB recommended a multiple-rate approach (which establishes multiple financial benchmarks) in its report: Reforming Major Interest Rate Benchmarks, published in July 2014 with a view to providing financial benchmark options that better meet the purpose of a transaction.

Secondly, in order to realise a sustainable regime, it is necessary for the FCA to give consideration to reducing risk, cost and workload associated with being a panel bank and thereby to mitigate disincentives for being a panel bank.

The main reason for discouraging banks from the benchmark submission is that risks inherent in the benchmark submission, such as legal risk (e.g. risk of being subjected to a huge amount of payment of damages and legal risk to individual employees), are considerably high and unbalanced relative to benefits of becoming a panel bank. In this view, if banks are to be required to continue submission by the FCA's exercise of the compulsion powers, it is necessary to introduce a frameworks to eliminate legal risk (e.g. to take a measure to prevent banks from being sued in the class action simply because of being a panel bank so long as they

make the submissions in accordance with predetermined rules). Moreover, for purposes of leveling the costs, a framework where gaps in burden between panel and non-panel banks are eliminated, each financial institution, etc. bears the costs equally or authorities partially bear the costs should be considered as well.

Furthermore, where the use of compulsion powers affects those financial institutions which are located in different jurisdictions and are supervised by overseas authorities other than the FCA, the FCA should avoid imposing excessive burdens that would disincentivise banks to continue the panel bank status, such as requiring submission of group-level data. In addition, a framework should be established for sufficient exchange of opinions and coordination between relevant authorities.

We believe that if the above initiatives are taken to ensure continued submission of LIBOR in a stable environment without imposing excessive burdens, the integration of markets will be promoted, which as a result would ultimately lead to benefits for both panel and non-panel banks. This should secure the number of LIBOR panel banks and enable continuation of highly reliable LIBOR that is anchored in a wide range of applicable actual transactions.

Question 3&4:

Do you have any comments on the description of the market we would propose to use for the BMR participation test in relation to LIBOR?

Do you agree with the criteria we propose to use to identify banks to include in our population and the measures we propose to assess actual and potential participation in the market LIBOR intends to measure? Are there other criteria or measures that you would recommend using?

(Our comment)
It is our understanding that panel banks (including potential panel banks) might be required to submit data on an ongoing basis for the participation test purposes. In establishing criteria for data collection and selection, the FCA is requested to establish a feasible framework in consideration of burdens, business characteristics (e.g. the size of exposures by currency) and other relevant factors of each bank.

The Consultation Paper requires all covered banks to submit each region’s data on

a global basis, which is an extremely difficult requirement to comply with for those banks not carrying out global book management. This may give rise to an issue of jurisdiction and other issues. Also, it is required to stably ensure the data quality in data submission through appropriate testing, internal approval processes and governance procedures, etc. As discussed above, however, a sufficient consideration should be given to the point that due to differences in business characteristics, etc., it would not be easy to capture and supervise global-level or affiliates' transaction data depending on the location or the size of exposures by currency and also that a compliance burden would be significantly heavy. In this respect, in consideration of data availability and visualization of transactions, the ICE Benchmark Administration (IBA) allows the use of data to the extent agreed beforehand. This necessitates an approach that is consistent with existing agreements concerning the data scope, etc. Banks may be subjected to a heavy compliance burden particularly in extracting and aggregating historical transaction data, and may also face system-related challenges and may incur excessive costs if they are to capture affiliates' transactions. The FCA needs to take this into account and give a sufficient consideration to feasibility.

Furthermore, if it is apparent that a bank will continue acting as a panel bank for coming several years given its size, transaction volumes or other factors, such an existing panel bank for which sufficient information is captured should be excluded from the scope of data collection in light of the intent of the Consultation Paper. In this way, the FCA is requested to consider minimising banks' burden in data submission to the extent practical.

From the business characteristics perspectives, the principal location of business and the currencies transacted in large volume differ across banks. Therefore, the proposed criteria for selecting panel banks could be operated in an appropriate and stable manner if explicit, fair, convincing and reasonable rules (e.g. the volume of actual transactions are considered for respective currencies for which rates are submitted and those banks exceeding a certain threshold become a panel bank, in principle) are developed.

Question 5:

Do you have any comments on the draft Rule in the appendix?

(Our comment)

Given that financial institutions may have some currencies for which transactions

referring LIBOR hardly exist, requiring panel banks to submit rates for such currencies may affect the reliability of the benchmark of the currencies, and thus should be avoided (see our comment to Q1).

Question 6:

Do you have any comments on our proposal to use the approach described above if necessary to require firms specifically under the BMR powers?

(Our comment)
To our understanding, the maximum period in which the BMR compulsion powers to require submissions for the LIBOR calculation remain effective is twenty four months. However, please note that it is difficult to prepare alternative rates for LIBOR within the 24-month period since there are various challenges as mentioned in our comment on Q2.
Furthermore, consistency between the power under the UK acts and the BMR power should be ensured if such powers are to be exercised.