



October 22, 2018

International Swaps and Derivatives Association, Inc.  
(via Email: FallbackConsult@isda.org)

**Comments on the Consultation on *Interbank Offered Rate (IBOR)*  
*Fallbacks for 2006 ISDA Definitions***

Dear Sirs/Madams:

We, the Japanese Bankers Association (JBA), would like to express our gratitude for this opportunity to comment on the consultation on *Interbank Offered Rate (IBOR) Fallbacks for 2006 ISDA Definitions* (the Consultation) published on July 12, 2018 by the International Swaps and Derivatives Association (ISDA).

The JBA is an organization whose members consist of approximately 200 banks operating in Japan and abroad.

We respectfully expect that the following comments will contribute to your further discussion.

**1. General Comments**

**(1) Impact of developing forward-looking term rates**

Working groups in U.K. and other jurisdictions have initiated discussion on term rates for respective currencies. Once robust forward-looking term rates are established, they may be referenced in various products and it is expected that the hedging needs will arise.

Although we recognize it is the intention of the Financial Stability Board (FSB) Official Sector Steering Group (OSSG) that the fallbacks could work without the development of forward-looking term rates, we believe that ISDA should carefully consider how the development of forward-looking term rates will have impacts on the fallbacks for derivatives.

**(2) Retention of economic value**

It is preferable to retain economic value of an existing transaction after triggering a fallback. Under the spread adjustment methodologies other than the forward approach proposed in the Consultation, the present value of a transaction will change when the fallback rate is applied to the transaction instead of the original reference rate. This would cause an

impact on profits and losses. In addition, there is an issue that subsequent changes after applying the fallback in the market condition would not be reflected in the fallback rate.

### **(3) Consideration to cash products hedged by derivatives**

While derivatives are independent financial transactions, many of them are used for the purpose of hedging cash products and are managed together with those cash products. The users of those derivatives include many non-financial institutions (i.e. end users) that have relatively limited measures. From the perspective of ensuring the soundness of derivatives markets, these hedgers that have actual demand for derivatives are essential market participants.

Therefore, although the Consultation excludes the fallbacks in non-derivatives products from its scope, the fallbacks' compatibility with cash products should be taken into account. Specifically, ISDA should consider the documentation that takes into account compatibility with cash products in addition to the language related to interbank derivatives transactions. The Consultation regarding fallbacks for syndicated business loans published by the Alternative Reference Rates Committee (ARRC) on September 24, 2018, also indicates that cash product fallbacks may differ in some respects from derivative fallback provisions<sup>1</sup>.

As for the proposed approaches for adjusted risk-free rates (RFR), the hedge effectiveness could not be ensured other than in the compounded setting in arrears rate approach. In particular, it would be difficult to convince end users of the appropriateness of the fallback rate unless the hedge effectiveness, etc. is ensured for existing transactions even after the fallbacks are applied.

### **(4) Timing of finalization and implementation**

According to ISDA's FAQ, the 2006 ISDA Definitions will be amended in the latter half of 2019. Given a situation where there is a concern over the permanent discontinuation of LIBOR, we understand that ISDA sets this schedule to provide clarity and certainty to market participants in the event of permanent IBOR discontinuation. However, the following two viewpoints are important from practical standpoints, and we expect that in finalizing this amendment ISDA will carefully consider these as well as the timeline regarding the potential cessation of LIBOR.

#### **a. Development of term rates**

If this amendment is finalized as is proposed, it means that the fallback rate for

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<sup>1</sup> See "C. Differences between Proposed Fallback Provisions for Cash Products and Derivatives" of ARRC CONSULTATION REGARDING MORE ROBUST LIBOR FALLBACK CONTRACT LANGUAGE FOR NEW ORIGINATIONS OF LIBOR SYNDICATED BUSINESS LOANS. (<https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Syndicated-Business-Loans-Consultation.pdf>)

derivatives may be different from a fallback rate for other products, which can be a forward-looking term rate. In that case, the hedge effectiveness cannot be ensured between such derivatives and cash products when the fallbacks are triggered. This can have an adverse effect on the liquidity of the derivatives market.

#### **b. Preparation of infrastructures for including fallback provisions into contracts**

When including fallback provisions by amending contracts, it is preferable that the following conditions are satisfied. To fulfill these conditions, it is necessary to have an appropriate preparation time.

- The market of derivatives referencing a fallback rate such as Overnight Index Swap (OIS) is as liquid as that of the interest rate swaps referencing existing IBORs.
- End users understand and recognize the fallback rates sufficiently.
- Financial institutions have in place an appropriate framework for revenue management and risk management.

## **2. Answers to the Questions**

### **(1) Preferred Approach**

- Please rank the combinations listed above with 1 as your preferred approach, 2 as your second preferred approach, and so forth.
  - Please explain your rankings. Please specifically comment on the characteristics of the combinations you ranked the highest that most influenced your decision.

(Answer)

In conclusion, we have decided not to rank the pairs of adjusted RFR and spread adjustment because we are aware of many concerns to be solved.

(Rationale)

It is important to take into account the following three points when discussing the fallbacks.

- i) The fallbacks should be compatible with current practices given that many derivatives are used as hedge instrument for cash products.
- ii) Adjustments should be made to reflect actual market conditions.
- iii) The fallbacks should retain the present economic value of transactions.

The JBA's member banks have discussed the approaches proposed in the Consultation and many concerns were expressed from the viewpoints written above. If we were to choose an approach for adjusted RFR and spread adjustment, we would be forced to choose one in a negative manner. Therefore, we concluded that it is not possible to rank the combinations listed in the Consultation.

- Indicate whether your preferences apply universally to GBP LIBOR/SONIA; JPY LIBOR/TONA; TIBOR/TONA; Euroyen TIBOR/TONA; CHF LIBOR/SARON and BBSW/RBA cash rate.
- If your preferences apply universally, please indicate whether you would also expect your preferences to apply to USD LIBOR/SOFR, EUR LIBOR/[the identified EUR RFR] and EURIBOR/[the identified EUR RFR].

(Answers)

#### **[Multi-currency transactions]**

The fallback approach in transactions involving multiple currencies, in particular, should be consistent across currencies, including USD and EUR (differences in the timing of consultation should not result in different treatment of the fallbacks for USD and EUR).

It is not realistic to change the adjustment approach according to currencies because it would multiply the workload to prepare for fallbacks.

Furthermore, in the case of currency swaps referencing the IBORs of two currencies, applying different approaches for the fallback will impact the valuation and pricing.

Price comparison between currencies is currently relatively easy because the portion of the yield curve relying on current IBORs is built upon common concepts and on/off-balance sheet transactions are priced based on such a yield curve. If the concepts vary between currencies, price comparison will become difficult, which may undermine or distort the market's pricing function.

#### **[Single-currency transactions]**

The footnote to the Consultation states that “however, this consultation does not exclude the possibility of a market participant electing to use TIBOR as the fallback for JPY LIBOR.” Based on the statement, we believe that TIBOR may be selected as the fallback rate for JPY LIBOR through bilateral negotiations.

From a practical viewpoint, however, there are some issues to be solved for the adjustment of differences between IBORs. We therefore expect ISDA to discuss technical measures for adjusting such differences. Similar issues may arise for EUR, which is not in the scope of the Consultation.

#### **[Other requests concerning currency]**

While the Bank Bill Swap Rate (BBSW) is frequently used for AUD-denominated

transactions in market practice, the Bank Bill Swap Bid Rate (BBSY) is frequently used in Sydney as a benchmark rate for loans. We request ISDA to consider a fallback rate for BBSY as well, because currently BBSY is defined only by referencing the screen.

- Please indicate whether you would not be able to transact using definitions that incorporate fallbacks based on any of the approaches to adjusted RFRs or spread adjustments. If you would not be able to transact, please give specific examples of the types of derivatives for which the fallbacks would be problematic and explain why.

(Answers)

**[Major concerns for transactions applying the compounded setting in arrears rate approach]**

Given that many transactions are currently executed based on forward looking fixing of rates, applying the compounded in arrears rate approach will require accumulation of interest rates during the compounding period, and result in changing interest rate receipt/payment operations significantly, which is expected to impose significant burdens on operation and systems.

**[Specific examples of transactions]**

- There may be some cases (for example, in LIBOR in arrears swap) where it is unable to complete the fixing in time for floating rates payment.
- Trust banks as trustee for investment trust funds currently reconcile with the investment management company the amount of accrued interest that is accumulated on a daily basis at the time when calculating accrued interest on the first day of the interest rate swap, and then transfer journal entry data from the executed trade management system to the accounting system. If the compounded in arrears rate approach is applied, they will need to consider fundamentally modifying their current flow or making operational changes.

- Please provide separate comments on the general appropriateness and effectiveness of each of the four approaches to adjusted RFRs and three methodologies for the spread adjustments. Please specifically comment on anticipated operational challenges, economic impacts, implications for hedging, feasibility of implementation and any other complexities. Indicate whether your comments apply to all contracts, new contracts only or legacy contracts only. With respect to any operational challenges, please explain how long it would take to overcome such challenges.

(Answer)

As previously mentioned, it is preferable that the followings are met: (1) the fallbacks should be compatible with current practices given that many derivatives are used as hedge instrument for cash products; (2) adjustments should be made to reflect actual market conditions; and (3) the fallbacks should retain present economic value of transactions. The table below summarizes our analysis on the RFR adjustment and the spread adjustment from these three viewpoints.

In conclusion, with respect to the RFR adjustment, the compounded setting in arrears rate is the preferable approach as it reflects actual market conditions. With respect to spread adjustment, the forward approach would be the preferable approach so long as data are available. However, from a realistic viewpoint, the historical mean/median approach could be an option as well. Nonetheless, each approach has issues to be addressed as below, and this conclusion is reached only in a negative manner.

**[RFR adjustment]**

	(1) Compatibility with current practices	(2) Adjustments reflecting actual market conditions	(3) Retention of present economic value of transactions	(4) Others
Spot Overnight Rate	<p><b>Compatible</b></p> <ul style="list-style-type: none"> <li>- The interest rate is set in advance at the beginning of</li> </ul>	<p><b>Not accurately reflect</b> actual market conditions.</p> <ul style="list-style-type: none"> <li>- This approach would mean</li> </ul>	<p><b>There are gaps</b> in the present value of transactions referring existing IBORs and that of</p>	<p>The fixing <b>risk is elevated</b> and <b>adverse effects</b> on the market are expected due to reliance on the</p>

	(1) Compatibility with current practices	(2) Adjustments reflecting actual market conditions	(3) Retention of present economic value of transactions	(4) Others
	the term of the interest rate.	that an overnight rate that does not have term structure will be applied to every term.	transactions referring fallback rates. - An overnight rate that does not have a term structure will be applied to every term.	interest rate on a specific date.  <b>The hedge effectiveness could be undermined</b> if the term for referencing interest rate differs between the hedged item and the hedging instrument.
Convexity-adjusted Overnight Rate	<b>Compatible</b> - The interest rate is set in advance at the beginning of the term of the interest rate. - However, due to the complicated formula, this rate could only be used as a fallback and is not expected to be widely used as a base rate for new contracts. As a result, this will give rise to market bifurcation.	<b>Not accurately reflect</b> actual market conditions despite convexity adjustments. - This approach would mean that an overnight rate that does not have term structure will be applied to every term. - Furthermore, convexity is not necessarily calculated appropriately as the formula does not rely on interest rate volatility. Therefore, this approach does not produce enough benefits to justify the	<b>There are gaps</b> in the present value of transactions referring existing IBORs and that of transactions referring fallback rates. - An overnight rate that does not have a term structure will be applied to every term.	<b>Difficult to earn end users' understanding</b> due to complexity.  <b>The hedge effectiveness could be undermined</b> if the term for referencing the interest rate differs between the hedged item and the hedging instrument.

	(1) Compatibility with current practices	(2) Adjustments reflecting actual market conditions	(3) Retention of present economic value of transactions	(4) Others
		complexity of the calculation method.		
Compounded Setting in Arrears Rate	<p><b>Not compatible</b></p> <ul style="list-style-type: none"> <li>- Shifting from the interest rate set in advance to the interest rate set in arrears is expected to impose significant burdens on a wide-range of users, and have significant effects in practice, such as necessity to unify terms and conditions in contracts entered into with customers.</li> </ul>	<p>The <b>most preferable option</b> among the four approaches from the perspective of reflecting actual market conditions.</p>	<p><b>Not possible to completely retain</b> the present value of transactions because the timing of fixings differs from that of IBORs.</p>	-
Compounded Setting in Advance Rate	<p><b>Compatible</b></p> <ul style="list-style-type: none"> <li>- The interest rate is set in advance at the beginning of the term of the interest rate.</li> </ul>	<p><b>Historical rates may deviate</b> from actual market conditions if market conditions are highly volatile due to such events as interest rate hikes.</p>	<p><b>There are significant gaps</b> in the present value between transactions referring existing IBORs and that of transactions referring fallback rates as historical interest rates are referenced.</p>	<p><b>The hedge effectiveness could be undermined</b> because historical interest rates are referenced.</p>



**[Spread adjustment]**

	(1) Compatibility with current practices	(2) Adjustments reflecting actual market conditions	(3) Retention of present economic value of transactions	(4) Others
Forward Approach	-	This approach is <b>vulnerable to manipulations and distortions</b> in the market and the availability of appropriate data is uncertain. Furthermore, this approach is dependent on model selection, etc. as data used are not directly observable in the market.	<b>Minimization of value transfer can be expected</b> at the time when fallbacks are triggered since this approach reflects expected market prices. This however <b>could not retain the economic value</b> of the transactions before triggering the fallback because subsequent changes in the markets are not reflected.	<b>Vulnerability to manipulations and distortions in the market could be mitigated</b> to a certain extent by collecting historical data of respective tenors and using their average, etc. However, this is unrealistic because it requires additional tremendous amount of market data.
Historical Mean/Median Approach	-	It is <b>relatively insusceptible</b> to recent market manipulations, depending on the determination of an appropriate period.	<b>Value transfer will occur.</b> - This approach does not necessarily reflect actual market conditions at the time when fallbacks are triggered appropriately as it makes adjustments using the average of historical prevailing market rates.	This approach <b>can avoid cliff effects</b> and thus stable spreads can be expected.

	(1) Compatibility with current practices	(2) Adjustments reflecting actual market conditions	(3) Retention of present economic value of transactions	(4) Others
			<ul style="list-style-type: none"> <li>- Furthermore, this could not retain the economic value of the transactions before triggering the fallback because subsequent changes in the markets are not reflected.</li> </ul>	
Spot-Spread Approach	-	This approach is highly <b>vulnerable to market manipulations</b> before the fallback triggered.	<p><b>Value transfer is significantly susceptible</b> to changes in market conditions at the time when the fallback is applied</p> <ul style="list-style-type: none"> <li>- This approach only reflects recent market prices.</li> <li>- Furthermore, this could not retain the economic value of the transactions before triggering the fallback because subsequent changes in the markets are not reflected.</li> </ul>	Other than a benefit of data availability, we do not see any advantages over the historical mean/median approach.

## (2) General

- How important or unimportant is it for the fallbacks to be approximately present-value neutral at the time of trigger? Please explain why.

(Answer)

It is important for the fallbacks to be present-value neutral from the perspective of retaining the economic value of contracts.

(Rationale)

When applying the fallbacks, it is important that pre-fallback economic value is unchanged after the fallback is triggered. However, every approach proposed in the Consultation is not capable of retaining economic value as noted in this letter. The final document should specify this point.

- How important or unimportant is it for the fallback rates to be available in advance of the accrual period. Alternative, is setting in arrears acceptable? Please explain why or why not.

(Answer)

Taking into account the compatibility with current practice, it is important for the fallback rates to be available in advance of the accrual period. The setting in arrears might be acceptable, though it is necessary to give particular consideration to end users for the reasons written in the “Rationale” below.

(Rationale)

As mentioned above, the users of derivatives transactions for hedging purpose include many non-financial institutions (end users) that have relatively limited measures. If it is difficult for such users to select the setting in arrears as the fallback rate for hedged assets, it is possible that they will not select the setting in arrears as a fallback rate in order to ensure the correlation between the reference rate of a hedged asset and that of a hedging instrument.

- How important or unimportant is it for the fallback rates to be wholly (or mostly) convexity free? Please explain why or why not.

(Answer)

It is important from the perspective of appropriately capturing actual market conditions.