



July 12, 2019

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

***Comments on Consultation on Pre-Cessation Issues for LIBOR
and Certain Other Interbank Offered Rates (IBORs)***

Dear Sirs/Madams:

We, the Japanese Bankers Association (JBA), would like to express our gratitude for this opportunity to comment on *Consultation on Pre-Cessation Issues for LIBOR and Certain Other Interbank Offered Rates (IBORs)* published on May 16, 2019 by the International Swaps and Derivatives Association, Inc. (ISDA).

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

1. General Comments

We understand that the proposal for pre-cessation issues has been made to address a request from the Official Sector Steering Group (OSSG) and the speech by an official of the UK Financial Conduct Authority (FCA) and to ensure a consistency with the fallback provisions for cash products established by the Alternative Reference Rates Committee (ARRC).

In our process of discussions on and preparation for the fallbacks, great concerns have been expressed on the risk that the timing for implementing fallbacks and related procedures may concentrate upon the permanent cessation of IBOR. There is also a growing concern over how to ensure the consistency with fallbacks for derivative transactions, which are used for the purpose of hedging cash products and are managed together with those cash products, as we commented on the consultation on Interbank Offered Rate (IBOR) Fallbacks for 2006 ISDA Definitions published in July 2018.¹

We support the proposal this time as we believe that the ISDA has given due consideration on these concerns.

Nonetheless, given that the pre-cessation triggers will have significant impacts on market participants, we respectfully request the ISDA to clarify and further discuss the issue described below to facilitate a smooth preparation process for transition away from LIBOR.

¹<https://www.zenginkyo.or.jp/fileadmin/res/en/news/news181022.pdf>

(1) Clarifying the definition of a “statement” corresponding to the pre-cessation triggers

This consultation assumes that a regulatory supervisor of a benchmark administrator publishes “a statement that the relevant Covered IBOR is no longer representative” as a pre-cessation trigger. If this definition is ambiguous, market disruption may result from varying interpretations across market participants or from the occurrence of a trigger event at unexpected timing.

We understand that whether an event is considered to be a trigger is up to the judgement of parties to a transaction. Nonetheless, by defining the “statement” corresponding to the pre-cessation triggers in light of the objectivity, publicity and simultaneousness as much as possible, we believe that common understanding can be further developed and confusion can be minimized across market participants.

As a way to further clarify the definition, we would like to suggest options to provide a template illustrating language in the case where an event is considered to be a pre-cessation trigger by the evaluation of relevant regulators of benchmark administrators under the EU Benchmarks Regulation, or to provide contents of the statement in a form of limited enumeration, thereby enhancing the predictability of market participants.

(2) Period until implementation of a fallback (replacement to a new interest rate) after the occurrence of a pre-cessation trigger

In the case of permanent cessation triggers, we expect that a certain preparation period can be ensured from the time of the occurrence of a trigger event since a spread adjustment is fixed at the time of the event² and the fallback is actually implemented at the time of the cessation. However, the timing of the fallback for the pre-cessation trigger is not specified in this consultation.

If a fallback is implemented in an extremely short period after the occurrence of a pre-cessation trigger, market participants may not be fully prepared for the fallback, which may lead to significant market disruptions not only for financial institutions but also for end users. On the other hand, if market environment changes significantly during the period between the pre-cessation trigger and the fallback, there is a growing concern that the value transfer will not be minimized.

² For example, see page 3 of this consultation.

“Note that the fallbacks will not apply until the actual discontinuation of the relevant IBOR (if that is after the announcement date).”

We therefore request the ISDA to set an appropriate preparation period from the time of the occurrence of a trigger event to the implementation of a fallback, by taking into account feedback from market participants on this consultation in addition to the issues we pointed out above.

(3) Including pre-cessation triggers in the 2006 ISDA Definitions and the protocols

To avoid confusion among market participants, it is important to promote standardization of procedures and reduce exceptional treatment so that they can take actions under the same conditions. Moreover, it is advisable to reduce practical burdens and to take efficient actions from practical perspectives. We, therefore, support the proposal to include pre-cessation triggers in the amendments to the 2006 ISDA Definitions and in the protocol, and take steps for developing fallbacks. However, we request the ISDA to consider exceptional treatment that allows not to include pre-cessation triggers for certain limited transactions to ensure the consistency relating to hedge as including fallback provisions into cash products may be difficult compared to derivative transactions.

(4) Consideration to cash products

We understand that this consultation takes into account ARRC's discussions on fallbacks for cash products. Various discussion bodies in jurisdictions other than U.S. are also considering fallback provisions and issues for cash products. In finalizing the proposal, the ISDA should pay close attention to considerations made on cash products other than those that reference USD LIBOR. ISDA should also engage in coordination and considerations to ensure consistency across currencies and products as much as possible with a view to preventing mismatch of hedging between cash products and derivatives.

Of the issues discussed above, we would like to emphasize the issue of mismatch in fallback rates. The recommendations on fallbacks for various cash products published by the ARRC in April and May 2019 explicitly specify the use of forward-looking term RFRs as primary fallback rates with support by a large majority. On the other hand, in the case of interbank derivatives, the Final Results of Benchmark Fallbacks Consultation published in December 2018 shows that the compounded setting in arrears rate is supported and hence it is expected that the use of such a rate will be facilitated. However, that ISDA consultation was undertaken prior to the publication of ARRC's consultation on the recommendations above and forward-looking term RFRs were not included in the options of adjusted RFRs. If robust forward-looking term RFRs that can be used for transactions are developed, there may be needs to use such term RFRs as fallback rates for IBOR. Given this and also taking into account the

consistency with cash products as discussed above and the convenience for corporate borrowers which have difficulty in using compounded setting in arrears rates and have limited hedging instruments, we request the ISDA to consider using such forward-looking term RFRs as potential fallback rates at least for derivatives used as hedging instruments.

(5) Approach to smoothly implement a preparation process for fallbacks

We understand that the ISDA has been closely collaborating with the OSSG and various discussion bodies to implement measures that facilitate market participants' preparation processes in a timely manner. We request the ISDA to continue taking appropriate measures in line with the specified timeline in finalizing the proposal.

Moreover, since the nature of fallbacks is complex and its concept is still not widely understood, we request the ISDA to develop and disseminate convention necessary for market participants to use alternative reference rates, as is the case with the Financial Stability Board (FSB) and other discussion bodies in respective jurisdictions. As part of this effort, certain measures should also be taken to facilitate understanding, such as providing an explanation in an easy-to-understand manner in relation to consultation on the final parameters for the term and spread adjustment which ISDA intends to publish.

In the following section, we are responding to the questions based on our general comments above.

2. Answers to the Questions

(1) Would you be content to have any contracts that continue to reference the Covered IBOR after the supervisor of the Covered IBOR's administrator makes a statement that the Covered IBOR is no longer representative? If so, why and under what circumstances?

(Answer)

We generally do not expect that financial institutions enter into a new contract referencing the Covered IBOR. However, the Covered IBOR may still be used in the following cases.

(a) New contracts

- Temporary use of the Covered IBOR when convention for using alternative reference rates is not fully developed;
- Use of the Covered IBOR when customers wish to use the Covered IBOR and its use is permitted under the regulation (for example, cases where both parties to the transaction are not subject to the EU Benchmarks Regulation).

(b) Legacy contracts

- Temporary use of the Covered IBOR until the transition to alternative reference rates is completed;
- Temporary use of the Covered IBOR during the period between a trigger event and the time to use alternative reference rates;
- Use of the Covered IBOR for contracts with only a short remaining maturity.

(Rationale)

Since a statement by a regulator that “the Covered IBOR is no longer representative” may have significant impacts on the quality of the benchmark and the liquidity of transactions referencing the Covered IBOR, it is natural for both financial institutions and customers to use alternative reference rates instead of the Covered IBOR for new contracts.

On the other hand, forcing market participants to replace IBORs with alternative reference rates may cause a confusion under circumstances where a market of transactions referencing alternative rates are not liquid enough, or system development by related parties to transactions is not completed. Furthermore, for contracts with only a short remaining maturity, replacing IBORs with alternative reference rates may result in excessive operational burdens relative to the necessity of implementing this for such contracts. However, we expect that only a few contracts would continue to reference the Covered IBOR, because the transition to alternative reference rates will be facilitated with necessary measures taken by national authorities and the ISDA.

(3) Do you expect to amend or close out your derivative contracts referencing Covered IBORs prior to the possibility of a statement that a Covered IBOR is no longer representative? Please specifically comment on whether you expect to have exposure to LIBOR post-2021.

(Answer)

We expect to amend or renew contracts as much as possible with consent of counterparties.

(Rationale)

Early amendment or renewal of contracts are recommended as indicated in the speech by regulatory supervisors, and may contribute to the smooth transition and to avoiding the concentration of transition-related operations. To achieve this, understanding of, and cooperation by, counterparties are essential, and it is important for market participants to be prepared for referencing alternative rates (e.g., ensuring liquidity in the market of transactions referencing alternative rates and permeation of a certain convention).

(4) Do you expect any impediments to taking the steps you would want to take? How could ISDA mitigate these impediments? What other entities could mitigate these impediments and how could they do so?

(Answer)

We request the ISDA to promote discussions on the following issues in order to smoothly implement a preparation process for fallbacks.

(a) Convention

Currently, convention for using alternative reference rates are not harmonized across products, and this may impede market participants for taking specific actions, such as reviewing requirements for system. Accordingly, we request the ISDA to collaborate with national authorities to standardize convention for alternative reference rates across products as much as possible.

(b) Developing necessary measures for hedge accounting

The development of necessary measures for hedge accounting to address cases where triggers and other elements differ between derivatives and cash products, has yet to be completed. Therefore, it is advisable that the ISDA closely monitors the progress of discussions among accounting standard setters and provides necessary support to them.

(c) Regulatory treatment

There are uncertainties in regulatory treatment such as whether reporting obligations apply to amending contracts, for which the private sector has made a request for clarification. It is desirable that the ISDA identify and clarify these issues and consult with relevant bodies to reduce burdens of financial institutions arising from the uncertainties as necessary.

(d) Promoting standardization

With regard to amending contracts, standardized approaches with low operational burdens will facilitate negotiations with end users. Therefore, we request the ISDA to continue its work for standardization, such as inclusion into the 2006 ISDA Definitions and the protocols as suggested in this consultation, while giving due consideration to ensure the consistency across products.

(5) Would it be appropriate to include a pre-cessation trigger regarding 'representativeness' with the triggers for permanent cessation in the amendments to the 2006 ISDA Definitions and in the protocol that ISDA intends to publish to introduce the IBOR fallbacks? Please explain your answer.

(Answer)

We believe that it is appropriate to include pre-cessation triggers in the amendments to the 2006 ISDA Definitions and in the protocol. However, in order to do so, the clarification of the definition of a “statement” corresponding to the pre-cessation triggers and the timing of a

fallback after a pre-cessation event occurs should continue to be discussed.

(Rationale)

From a viewpoint of facilitating preparation of market participants, it is advisable to include pre-cessation triggers in the amendments to the 2006 ISDA Definitions and in the protocol so that necessary actions for the pre-cessation triggers can be taken using the standardized approaches by all participants.

(6) Is inclusion of the trigger necessary to enhance existing controls and mechanisms already in place contractually and/or under existing law or are these controls and mechanisms sufficient?

(Answer)

We believe that it is necessary as inclusion of the trigger would enhance existing controls and mechanisms.

(Rationale)

We expect that the robustness of contracts would be enhanced and the transition to alternative reference rates would be facilitated at an early stage by including the trigger.

(7) What problems could arise if such a trigger were not included in amendments to the 2006 ISDA Definitions and in the protocol that ISDA intends to publish to introduce the IBOR Fallbacks? Please specifically consider and comment on

(7-a) the potential for a CCP to exercise its discretion to change a reference rate if it determines that a Covered IBOR is no longer sufficiently robust or no longer fit for purpose

(Answer)

If pre-cessation triggers were not included in amendments to the 2006 ISDA Definitions and in the protocol and a reference rate were changed at the discretion of a CCP, centrally cleared transactions and non-centrally cleared transactions would not ensure the consistency, giving rise to basis risk or to undue burdens for amending individual contracts to avoid basis risk.

(7-b) management of a legacy portfolio of derivatives referencing an IBOR if use in new contracts is also prohibited by regulation (at least for entities in certain jurisdictions)

(Answer)

Reference rates may differ between legacy transactions and new transactions, and therefore portfolios may not be appropriately managed. At the same time, basis risk would arise or undue burdens would occur to amend individual contracts to avoid basis risk.

(7-c) derivatives that hedge cash products that may have pre-cessation triggers and fallbacks

(Answer)

A hedging relationship may not be maintained due to differences in the nature of triggers between a hedged item and a hedging instrument. Alternatively, market participants may incur burdens to include pre-cessation triggers in individual derivative contracts to maintain the hedging relationship.

(8) What problems could arise if such a trigger were included? Please also consider derivatives that hedge cash products that do not have pre-cessation triggers and fallbacks. Please consider the implications of linking the fallbacks for the permanent cessation of a Covered IBOR with the agreement to convert the Covered IBOR to the corresponding adjusted RFR plus a spread upon a pre-cessation trigger.

(Answer)

Problems include a possibility that market disruption may be caused by the unclear definition of the “statement”, that an adequate preparation period for a fallback may not be secured, and that a hedging relationships with cash products may not be maintained. Therefore, we expect the ISDA to have further considerations on these issues. In particular, there is a concern about the timing of a fallback after the occurrence of a pre-cessation trigger, from the perspective of ensuring the consistency with cash products or operational burdens, as discussed in the “1. General Comments”. We request the ISDA to communicate these issues to other related regulatory agencies, such as the FCA.

(9) Do you think inclusion of a pre-cessation trigger would positively or negatively affect industry take up of the permanent cessation fallbacks? Please specifically comment on adherence to the protocol to amend legacy derivative contracts.

(Answer)

We believe that inclusion of a pre-cessation trigger would have positive effects.

(Rationale)

Market participants are expected to avoid the concentration of operations including the fallback procedures. If pre-cessation triggers were to be included in the protocol, it is likely that market participants will adhere to the protocol containing permanent cessation triggers as well.

Therefore, in terms of adherence to the protocol among market participants, inclusion of pre-cessation triggers would have positive effects.

(11) Would such a protocol be helpful to address concerns regarding 'non-representative' benchmarks? If so, which of the approaches listed above (and/or variations of these approaches) do you prefer?

(Answer)

We are not able to respond to this question because no details are provided regarding (a)-

(d), including the nature of a “matching” function. While it is desirable that pre-cessation triggers should be applied to all legacy contracts in principle, there may be cases where inclusion of pre-cessations triggers is undesirable in the limited circumstances, such as cash products whose contracts are difficult to amend. A solution to address this would be to allow flexibility to exclude certain transactions (for example, (a) and (d) of the proposed approaches) for limited cases to the extent possible.

(12) Please comment on the relative disadvantages and advantages of such a protocol as compared to inclusion of a pre-cessation trigger in the 2006 ISDA Definitions and the protocol that ISDA intends to publish to implement the IBOR Fallbacks without any ability to elect for or against inclusion of such a pre-cessation trigger.

(Answer)

Advantages include allowing market participants to take flexible approaches according to their actual practice because such a protocol includes multiple options. On the other hand, inclusion of such a protocol may hinder the introduction of fallback languages and transition to alternative reference rates will not proceed smoothly at the market-wide level due to increasing exceptional treatments.

(13) Would you prefer using such a protocol as opposed to template language for bilateral incorporation in derivative contracts to address concerns regarding 'non-representative' benchmarks, and other pre-cessation concerns you may have?

(Answer)

We prefer using the protocol that allows adherents to (a) and (d).

(Rationale)

According to the fallback provisions established by the ARRC, it is assumed that new contracts for cash products referencing USD LIBOR will contain pre-cessation triggers. Therefore, the protocol allowing adherents to (a) and (d) incurs less operational burdens as it is also necessary to include pre-cessation triggers for derivatives used as hedging instruments.

(15) Would it be appropriate to use the adjusted RFR plus a spread under these circumstances or could it be problematic? Please explain.

(Answer)

We consider it would be appropriate.

(Rationale)

To ensure that simple and standardized approaches are taken in the market, it is advisable to use replacement rates that are calculated based on the adjusted RFR plus spreads, consistent with fallbacks for cessation triggers.

It is also advisable to use values calculated at the time of the pre-cessation trigger for spread adjustments (please also see our response to the Question18).

(18) In this scenario, should the spread adjustment following permanent discontinuation of the Covered IBOR automatically change to the 'permanent cessation' spread (i.e., a spread calculated by reference to historical data at the time the announcement is made in respect of permanent cessation)? Alternatively, should it remain at the spread adjustment for the 'pre-cessation' event?

(Answer)

We consider that spread adjustments calculated at the time of a pre-cessation event should be maintained.

(Rationale)

Calculating spread adjustments for multiple times may cause heavy operational burdens and it is difficult to gain an understanding of counterparties.

Since the timing of a trigger is an important element defined in a contract, it is natural that values of spread adjustments differ accordingly.