June 30, 2016

Study Group on Risk-Free Reference Rates

Feedback Statement on the Public Consultation of a Japanese Yen Risk-Free Rate

1. Background

Since April 2015, the Study Group on Risk-Free Reference Rates (hereinafter the Study Group), in accordance with recommendations laid out in the report published by the Financial Stability Board (FSB) in July 2014[1], has examined various issues to develop an alternative Japanese yen (JPY) risk-free interest rate benchmark that would not include bank credit risk. In March 2016, the Study Group released a public consultation paper which summarized the findings from the Study Group's works and invited comments from a wide range of interested parties.

In the public consultation paper, the Study Group considered the uncollateralized overnight call rate (Tokyo Overnight Average Rate, TONAR) as the primary candidate for the JPY risk-free rate, and the GC repo rate as the secondary candidate. At the same time, the Study Group envisaged the scope of use of the risk-free rate in derivatives transactions and proposed some revisions of the existing OIS market conventions to improve convenience of JPY OIS referencing TONAR, the primary candidate.

The Study Group planned to examine remaining issues taking into account the comments received through this public consultation, and to publish a report on the identification and use of the JPY risk-free rate by the end of June 2016, as recommended in the FSB report.

2. Feedback on the Public Consultation Paper

The Study Group received comments from three market participants in writing and through an outreach meeting in which eleven organizations had participated. The Study Group is deeply grateful for this as it is valuable for the development of the JPY risk-free rate.

[1] Financial Stability Board, "Reforming Major Interest Benchmarks", July 2014.

The Study Group recognizes that the feedback mostly supports the public consultation paper, with some suggesting additional points for discussions. What follows are the summary of the feedback received.

(On the identification of the risk-free rate)

- To the extent that there exists an interest rate benchmark which is backed by sufficient amount of transaction, it is desirable to use it as a risk-free rate. Thus, TONAR is suitable for the JPY risk-free rate.
- It is worth further assessing developments in the uncollateralized call market since the introduction of the negative interest rate policy by the Bank of Japan. Thus, the Study Group should consider postponing the decision on the identification of the risk-free rate. Besides, the GC repo rate has advantages to some extent.

(On the scope of the use of the risk-free rate)

- Demand for OIS transactions is expected to increase as OIS discounting methods in derivatives valuations become popular. On the other hand, there is concern that the introduction of the risk-free rate might cause liquidity in interest rate swap markets to be fragmented into interest rate swaps referencing an interest rate benchmark with bank credit risk (hereinafter IBORs) and the risk-free rate.
- The scope of the use could be expanded if term reference rates are available like IBORs.

(On the revisions of the existing OIS market conventions)

- In terms of revising interest rate payment frequency, six months is preferred to a year as it would facilitate hedging of the Japanese government bond portfolio. Such revision will make the payment frequency of OIS consistent with that of other JPY interest rate swaps and would thus improve convenience of transactions.

(Other feedback)

- The Study Group should discuss reforms not only of OIS but also of interest rate futures to enhance the use of TONAR. We [The party which submitted this comment] are willing to engage in the discussions with a view to reviewing the contract details and nature of the product.
- The importance to introduce a risk-free rate should be stressed, because the current situation where the size of the derivatives market enormously outweighs the market that underlies IBORs means that there is an incentive to manipulate the IBORs.

3. Next Steps

The Study Group discussed the next steps based on the feedback to the public consultation and the progress of discussions on risk-free rates in other currencies. The Study Group decided to further assess the relationship of the JPY risk-free rate with risk-free rates in other currencies, and the developments in the Japanese money market aiming to identify the JPY risk free rate by the end of this year. Thereafter, the Study Group would publish a report on the identification and use of the JPY risk-free rate.

The Study Group will further discuss the consistency of JPY risk-free rates with risk-free rates of other currencies, including the judgment of its importance, and will conduct a preliminary study on developing the GC repo benchmark which could be available as the JPY risk-free rate. The Study Group will also further investigate the use of the Japanese risk-free rate based on the feedback to the public consultation.