(Tentative translation)

[I] Report from the Sub-Group on Loans

- The Sub-Group on Loans reported at the fifteenth meeting of the Committee (July 16, 2020) that a large majority of the sub-group members had agreed to continue examining appropriate spread adjustment methodologies applicable to TIBOR as the replacement benchmark, in response to issues raised by some members concerning the adoption of the "historical median approach over a 5-year lookback period" for TIBOR, including the issue of the resulting impact of the approach on the economic value transfer between parties involved. The same issue was also pointed out in the second public consultation by the Committee.

- Accordingly, the sub-group continued examining appropriate spread adjustment methodologies applicable to TIBOR as the replacement benchmark, mainly focusing on the "historical median approach over a 5-year lookback period."[1] Subsequently, the sub-group consulted with its members on the following specific issues: (i) whether it would be necessary to publish the results of the sub-group's deliberations and to issue a recommendation with regard to the "historical median approach over a 5-year lookback period," and (ii) whether it would be necessary to establish and publish a methodology based on the approach on the premise that there were no publishing entities at the time of the consultation. The results of the consultation are shown below in (2).

- Regarding the point indicated above in (i), the sub-group decided to ask the Committee to publish the results of the sub-group's deliberations, although it would not to request for a recommendation by the Committee because the use of the "historical median approach over a 5-year lookback period" may not necessarily minimize the variation in the economic value of rates.[2] As for the point indicated in (ii), the sub-group decided to ask the Committee to publish an overview of the methodology, in order to establish the minimum standards for using TIBOR as the replacement benchmark.

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[1] In the discussions by the sub-group, it was pointed out that the lack of spread adjustment methodologies applicable to TIBOR as the replacement benchmark would force entities that attach particular importance to the compatibility with the current administration and systems and to the consideration for developing administrative systems for parties involved to choose a fallback based on a single, unpublished rate (Term Reference Rates). In other words, the lack of spread adjustment methodologies for TIBOR would narrow the range of options for those entities by making it difficult for them to choose the waterfall structure with Term Reference Rates in the first priority and TIBOR in the second priority.

[2] The sub-group expects that the results of its deliberations will be published in the final report on the results of the second public consultation. It will also ask for the same treatment with regard to the publication of the spread adjustment methodology for TIBOR.

(1) Issues related to spread adjustment methodologies for TIBOR as the replacement benchmark[3]

- ✓ The sub-group confirmed that there were no significant problems, at least from the perspective of the level of the rate, about the use of the "historical median approach over a 5-year lookback period" for TIBOR as the replacement benchmark. Then, the sub-group discussed the issues of economic value transfer between parties involved that could arise from the use of the spread adjustment methodologies for TIBOR, as they had been pointed out by the Committee and in the second public consultation.
- ✓ As a result of the deliberations of the sub-group based on actual market developments and case studies, progress was made to some extent for the issues arising from the use of the spread adjustment methodologies for TIBOR.[4,5] Also, the members of the sub-group shared the view that the approach might pose conduct risk if the lender did not sufficiently explain the issues to the borrower.
- ✓ The members agreed that it was necessary to deliberate and publish an outline of the methodology with a view to avoiding the situation in which the calculated spread adjustments would vary among financial institutions, although it would not be realistic to have a separate publishing entity for the spread adjustments for TIBOR based on the "historical median approach over a 5-year lookback period."

(2) Results of the Consultation in the Sub-Group on Loans

A. Results of the consultation with regard to the use of the "historical median approach over a 5-year lookback period"

- ✓ While the issues associated with the economic value transfer were pointed out once again, some respondents expressed the view that it would be desirable to publish the results of the sub-group's deliberations in such a way to support the use of the approach based on an agreement between contracting parties, taking into account both demand for TIBOR as the replacement benchmark and consideration for a wider range of benchmark options. It was also noted that such publication should include the point regarding the Committee not

[3] Moreover, some members shared the view that the Committee should publish a statement to encourage transition to TIBOR, as TIBOR -- an existing interest rate benchmark -- was already available for the transition from LIBOR.

[4] The sub-group also deliberated the use of forward approach. Then it deemed the adoption of the approach as difficult due mainly to the lack of consistency with global discussions, complexity of the calculation associated with the approach, and uncertainty over future developments.

[5] The following are the issues that were mainly deliberated: (i) it was difficult to expect the spread calculated based on the forward curves in the LIBOR/TIBOR basis swap market to be the same with the spread calculated by the "historical median approach over a 5-year lookback period"; (ii) based on the latest market developments, the difference between the spread calculated by the "historical median approach over a 5-year lookback period" and the spread calculated based on the forward curves might arise, about plus or minus 10 basis points at the greatest for shorter tenors. Such difference might widen as the maturities would become longer; and (iii) there could be two different prices, for example, in the case of derivative transactions to hedge the loans after the fallback to TIBOR.

recommending the approach and the reason behind it. A large majority of respondents agreed with these views.

- ✓ Many respondents agreed to the Committee publishing the issues associated with the economic value transfer as points to note for contracts, which both the lender and the borrower should recognize (see Appendix), with a view to avoiding conduct risk.

B. Results of the consultation with regard to the methodology for the "historical median approach over a 5-year lookback period"

- ✓ In terms of the spread adjustments for TIBOR, many respondents agreed that it was desirable to deliberate and publish an outline of the methodology based on the approach, with a view to establishing the minimum standards for using TIBOR as the replacement benchmark.[6]

■ In addition to the points mentioned above, the sub-group consulted with its members on conventions related to using TONA in arrears for loans.

[6] A small number of members supported the use of "forward approach" and the publication of the methodology in the same way as the "historical median approach over a 5-year lookback period," with reference to the discussions on the transition held by the U.K. Working Group on Sterling Risk-Free Reference Rates (RFRWG).

(Appendix) Points to note for contracts in the case of using the "historical median approach over a 5-year lookback period" as the spread adjustment methodology for TIBOR as the replacement benchmark

- The Committee shall not preclude contracting parties from selecting waterfall structures using TIBOR as long as the parties concerned agree, although TIBOR is not included in the waterfall structure for loans recommended by the Committee. In the case of using the "historical median approach over a 5-year lookback period" as the spread adjustment methodology for TIBOR as the replacement benchmark, there may be conduct risk if the lender does not at least explain the following issues to the borrower sufficiently. Specific examples of the points concerned that both the lender and the borrower should understand and confirm are provided below.

  - In the case of calculating the spread adjustment applicable to TIBOR as the replacement benchmark, there could be difference between the "historical median over a 5-year lookback period" and forward curves that incorporate market conditions. The difference between the spread calculated by the "historical median approach over a 5-year lookback period" and the spread calculated based on the forward curves may especially widen (it would be more disadvantageous for the borrower) as the maturities become longer. Both the lender and the borrower need to understand and confirm this risk when they introduce a fallback provision for contracts for loans, which is especially the case with contracts with longer maturities.

  - In a case where the borrower has a need for derivative transactions either currently or in the future for the purpose of hedging interest rate risk, both the lender and the borrower should understand and confirm the following points when they enter into contracts using the spread adjustment applicable to TIBOR as the replacement benchmark:

    (1) Even if the "historical median approach over a 5-year lookback period" for TIBOR as the replacement benchmark is adopted for loans, a different fallback methodology that utilizes spreads based on the pricing reflecting current market conditions (e.g., TIBOR + spread adjustment reflecting current market conditions) may be applied for derivative transactions,

    (2) On the other hand, in the case of adopting the "historical median approach over a 5-year lookback period" for the pricing of both loans and derivative transactions, either the lender or the borrower would have to bear the additional cost to adopt such approach.

    — In addition, there are differences in the accounting treatment between loans and derivative transactions. In particular, in the case of considering the use of TIBOR as the replacement benchmark, the lender needs to inform the borrower of those accounting differences appropriately within the scope of their businesses by, for example, encouraging the borrower to confirm the accounting standards beforehand, together with the points to note described above. Subsequently, the lender and the borrower need to discuss and negotiate on the issue of economic value transfer (such as the spread between JPY LIBOR and the replacement benchmark as well as that between JPY LIBOR and the replacement rate).

In the case of choosing TIBOR as the replacement benchmark, it should be noted that publishing entities of the spread adjustments have not been determined by the Committee. Both the lender and the borrower should understand and confirm the fact that the spread adjustments would be determined by the contracting parties' agreements, utilizing, for example, the methodology deliberated by the Sub-Group on Loans.