(Tentative translation)

[IV] Reports from the Sub-Group on Bonds

I. Additional Issues in the Sub-Group on Bonds and Approaches to Them

■ After considering developments overseas, and following extensive deliberation by each member, the Sub-Group on Bonds discussed potential additional issues regarding bonds. The following are the main views of the members and approaches to them.

(1) Practical issues of adopting "O/N RFR Compounding (Fixing in Arrears)"

✓ Many members reported that "O/N RFR Compounding (Fixing in Arrears)" involves considerably high cost in launching new operations and systems which are compatible with fixing in arrears. In addition, from a practical perspective, some expressed concerns including those over the feasibility of interest payments in the case where the interest rate is fixed 2 or 5 business days before the payment date and those over the determination of prices and accrued interest in the secondary market.

⇒ The sub-group has discussed that "O/N RFR Compounding (Fixing in Arrears)" can be used temporarily until the development of risk-free term reference rates is completed. Taking the above views into account, the sub-group conducted an internal survey about the present evaluation of reference rate options and the practicability of using fixing in arrears (see II. below for further details).

(2) Approach to bonds other than corporate bonds such as structured bonds, capital securities, and securitizations

✓ So far, the sub-group has mainly discussed corporate bonds with a large outstanding volume and which entail complicated procedures to amend contracts. However, some members reported that it is important that specific issues regarding structured bonds, capital securities, and securitizations are identified in a future public consultation in order to facilitate deliberation after the consultation, because they are also expected to generate a considerably large practical burden.

⇒ In the public consultation, although the Committee will not consult on specific issues focusing on structured bonds, capital securities, and securitizations, it will mention that the specific issues should be deliberated in the near future and invite concerns about them.

II. Reorganization of the Evaluation of the Reference Rate Options for Bonds

■ As described above, the sub-group conducted an internal survey about the present evaluation of the reference rate options and the practicability of using fixing in arrears, because many members reported that “O/N RFR Compounding (Fixing in Arrears)” involves considerably high cost in launching new operations and systems which are compatible with fixing in arrears. The following is the outline of the survey results.

(1) Evaluation of reference rate options for bonds

- ✓ At this moment, many members viewed that it would be desirable to use risk-free term reference rates.
- ✓ On this point, those who estimated no need to revise their systems for using “O/N RFR Compounding (Fixing in Arrears)” until mid-2021, when risk-free term reference rates are planned to be developed, responded that it is possible to use fixing in arrears temporarily. On the other hand, of those who estimated the need to revise their systems, some -- mainly securities companies -- preferred “O/N RFR Compounding (Fixing in Arrears)” for temporary use while others -- mainly banks and non-financial corporates --preferred “O/N RFR Compounding (Fixing in Advance)” and “JPY TIBOR.”
  - ✧ Many members considered that it would be difficult to use “O/N RFR Compounding (Fixing in Arrears)” with a slight revision of systems or standardization of procedures, not only because it can affect a wide range of systems such as for contract & settlement, market valuation, risk management and finance & taxation, but also because their companies are expected to have a considerable number of transactions of bonds referencing JPY LIBOR.
  - ✧ Members’ preferred using “O/N RFR Compounding (Fixing in Arrears)” mainly for consistency with ISDA derivatives and in light of examples of usage overseas.
- ✓ In addition, because it requires revisions of systems, some -- mainly securities companies and non-financial corporate -- favored the idea that they revise their systems at first and continuously use “O/N RFR Compounding (Fixing in Arrears),” instead of risk-free term reference rates.

⇒ In conclusion, because “O/N RFR Compounding (Fixing in Arrears)” involves considerably high cost from a practical perspective, depending on the current state of operations and systems in each company, its temporary use may not be cost-effective. Therefore, in adopting “O/N RFR Compounding (Fixing in Arrears),” it could be pragmatic to revise systems at first and use it permanently, instead of risk-free term reference rates.

(Tentative translation)

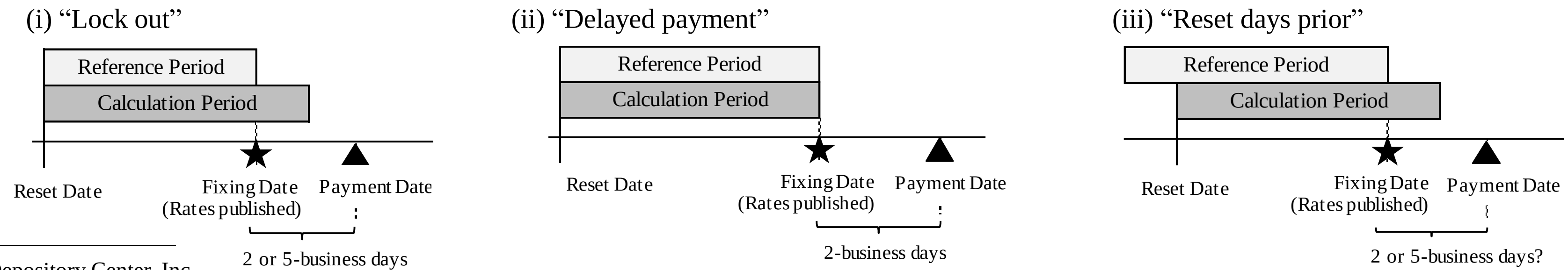
(2) Practical issues regarding interest payments in using “O/N RFR Compounding (Fixing in Arrears)”

- ✓ Some members reported that it is practically difficult to set the fixing date 2 or 5 business days before the payment date as a requirement for “O/N RFR Compounding (Fixing in Arrears),” because calculation agents or fiscal agents must notify interest rates to the JASDEC[1] 7 days before the payment date under the JASDEC’s current system.
- ✓ On the other hand, some members reported that if the fixing date is moved ahead of payment date, which means shortening the reference period, it could cause the interest rate to deviate more from the market rate and possibly increase risk of interest rate volatility (this is evident especially for transactions across quarter-ends or in the event of monetary policy change). In addition, some members indicated that if the interest rate deviates from the current OIS market convention, this could generate basis risks with interest rate swaps.

⇒ Meanwhile, the following has been deliberated internationally as calculation methodologies for “O/N RFR Compounding (Fixing in Arrears)”: (i) “lock out,” where the reference period is shortened (see charts below); (ii) “delayed payment,” where the reference period is identical to the calculation period, only with a delay in the payment date; and (iii) “reset days prior,” where the reference period starts before the calculation period, with the number of business days in both periods being equal.[2]

If responses to the public consultation support the idea to set the fixing date 2 or 5 business days before the payment date as a requirement for “O/N RFR Compounding (Fixing in Arrears)” on the basis that the interest rates are made publically accessible, it is necessary to deliberate on concrete approaches for interest payments for bonds, considering developments overseas[3] and discussions about other financial instruments and products.

▽ Main calculation methodologies for “O/N RFR Compounding (Fixing in Arrears)” discussed overseas



1 Japan Securities Depository Center, Inc.
2 An overnight index swap (OIS) adopts the “delayed payment” methodology. At this moment, FRNs referencing RFR issued in the United States and the United Kingdom adopt the “lock out” and “reset days prior” methodologies, respectively.
3 There are some cases overseas where interest rates are calculated not only by “O/N RFR compounding” but also “O/N RFR simple averaging.”