(Tentative translation)

[III] Reports from the Sub-Group on Loans

1. Additional issues in the Sub-Group on Loans and Approaches to Them

(1) Contractual issues

- The key issues regarding loan contracts are agreements between contracting parties. No specific issues concerning the interpretation of statutory provisions were identified in the discussions of the Sub-Group on Loans.
- Even if LIBOR were to be permanently discontinued, contracts that reference LIBOR and mature after its discontinuation would not immediately become void. However, many pointed out that it would be beneficial to provide for a fallback at this time, given that the contracting parties would need to negotiate on a replacement rate in due course.
- Meanwhile, regarding the amendment process of existing contracts, careful steps will have to be taken when adopting a streamlined process including negative consent, considering that both lenders and borrowers expressed concern about litigation risk.

(2) Contracts with fallback provisions

- Fallback arrangements can be divided into a “hardwired approach,” in which the specifics of a replacement rate (e.g., how a waterfall structure that uses a term RFR as a replacement rate will be adopted) are set out when fallbacks are introduced and an “amendment approach,” which provides contractual provisions with flexibility that allows for the replacement rate to be decided later.
- The advantages of the amendment approach include the following.
  - ✓ Compared to the hardwired approach, borrowers and lenders will find it easier to reach an agreement to introduce contractual provisions that gives flexibility to existing contracts (amid uncertainty about the future).
  - ✓ If such provisions are agreed upon by contracting parties, it will enhance the stability of the contract. If an early opt-in trigger is incorporated, it will be easier than in contracts without the trigger to amend contracts* or to review and transition to a new reference rate prior to pre-cessation trigger events or permanent cessation trigger events. *This may include setting out the detailed terms in a clause.
  - ✓ In the event of future negotiations, it will allow the parties to base their considerations on the then-prevailing market conditions.
- It should be noted that in cases where contractual provisions that offer flexibility are already incorporated in existing contracts, those provisions may substitute for the amendment approach.
- As for syndicated loans, the LMA published a template clause which provides more flexibility in contractual amendments than under the existing process to transition to a new reference rate upon the permanent discontinuation of LIBOR. This could be useful as reference.
- The specifics of the “hardwired approach” and the “amendment approach” in the template clause for syndicated loans are expected to be considered by the JSLA and other practitioners concerned. Although there is no template clause available for bilateral loans, each firm may wish to undertake studies by drawing on the JSLA’s efforts.

(Tentative translation)

2. Concept of transition and fallback

- Based on the deliberations thus far, the concept of transition and fallback could be classified as follows.

<table>
<tr><th></th><th>Item</th><th>Explanation</th><th>Triggers (Classification in the US ARRC consultation)</th><th colspan="2">Alternative reference rates / Replacement rates & Spread adjustments</th></tr>
<tr><td rowspan="2">Transition</td><td>(1) New contracts (including the rollover of contracts maturing before end-2021)</td><td>Reference an alternative interest rate benchmark when entering into new transactions</td><td>-</td><td colspan="2">Individually negotiated when making new contracts</td></tr>
<tr><td>(2) Renewal of existing contracts</td><td>Replace the reference rate with an alternative interest rate benchmark by renewing existing contracts</td><td>-</td><td colspan="2">Individually negotiated when renewing existing contracts</td></tr>
<tr><td rowspan="3">Fallback</td><td>(3) Early opt-in fallback</td><td>Replace the reference rate upon the occurrence of a trigger event which is determined by contracting parties based on the then-current market environment</td><td>(a) Early opt-in trigger</td><td rowspan="3">[Hardwired Approach]
Determined in advance (when making new contracts or adding fallback provisions)
(i) Single rate
(ii) Waterfall approach</td><td rowspan="3">[Amendment Approach]
Determined based on the then-current market environment
(In the US ARRC consultation, the lender has a right to choose a rate, which could be subject to negative consent by the borrower)</td></tr>
<tr><td>(4) Fallback before cessation</td><td>Replace the reference rate upon the occurrence of a trigger event based on objective conditions</td><td>(b) Pre-cessation triggers</td></tr>
<tr><td>(5) Fallback upon cessation</td><td>Replace the reference rate upon the occurrence of an ISDA trigger event</td><td>(c) ISDA triggers</td></tr>
<tr><td>(Ex-post response)</td><td>((6) Ex-post response)</td><td>(Address the cessation of LIBOR without fallback provisions)</td><td>-</td><td colspan="2">(Will be individually negotiated, taking into consideration the market practices, etc. at the time when cessation is announced.)</td></tr>
</table>

- As for loan contracts, “(6) ex-post response” should be avoided at all cost. The triggers, at least, should include “(c) ISDA triggers” and a workable “(5) fallback upon cessation” should be put in place. However, (4) and (5) entail a risk that the benchmark replacements would take place all at once, and to mitigate such risk, it is important to consider transition ((1) and (2)) and “(3) early opt-in fallback.”

(Tentative translation)

3. Review of options for loans

- The sub-group sought members' views about how they rank the options regarding (a) benchmarks in new contracts and (b) the combination of replacement benchmarks and spread adjustments.

[(a) Benchmarks in new contracts]

✓ Whereas products referencing O/N RFR Compounding will become available once necessary preparations including on the administrative and operational fronts are completed, the provision of products referencing Term Reference Rates will take a certain amount of time. In light of this, the following two paths and choices of interest rates ((i) to (vi)) were presented to the members.

(1) Tentatively use O/N RFR Compounding or TIBOR for the time being, and permanently use Term Reference Rates after their development

	Tentative use before the development of Term Reference Rates	Permanent use after the development of Term Reference Rates
(i)	O/N RFR Compounding (Fixing in Advance)	Term Reference Rates (Swaps/ Futures)
(ii)	O/N RFR Compounding (Fixing in Arrears)	Term Reference Rates (Swaps/ Futures)
(iii)	TIBOR	Term Reference Rates (Swaps/ Futures)

(2) Permanently use an existing benchmark from the beginning (not use Term Reference Rates)

	Permanent use regardless of the development of Term Reference Rates
(iv)	O/N RFR Compounding (Fixing in Advance)
(v)	O/N RFR Compounding (Fixing in Arrears)
(vi)	TIBOR

✓ The overview of the responses is as follows.

○ At this point, (I) the most common view was that the future use of risk-free term reference rates is preferable, followed by (II) the view that preferred the permanent use of TIBOR from now.

[Permanent use of Term Reference Rates in the future and interest rates tentatively used until the development of Term Reference Rates]

○ The tentative use of (iii) TIBOR gained broadest support because of the relatively low administrative burden in light of existing operations and systems (as pointed out by non-financial corporates, securities companies, insurance companies, and banks).

○ Some members viewed that (ii) O/N RFR Compounding (Fixing in Arrears) could be tentatively used because they (mostly non-financial corporates) intend to opt for it to ensure consistency with derivative contracts given that it will become a replacement rate for ISDA derivatives.

○ Other than the above, a few members (non-financial corporates) preferred (i) O/N RFR Compounding (Fixing in Advance) out of concern about the administrative burden.

[Permanent use of an existing benchmark from the beginning]

○ (vi) TIBOR received a certain degree of support for reasons, including that it has the highest compatibility with current operations, that interest rates that reflect risk premiums associated with interbank funding are suitable as general base rates applied to funds provided through loans, and that it is useful in cases which do not involve ISDA derivatives to which hedge accounting is applied (all of which were pointed out by banks).

○ On the other hand, members preferred the permanent use of (v) O/N RFR Compounding (Fixing in Arrears) only on conditions such that Term Reference Rates are not developed, and there was no support for (iv) O/N RFR Compounding (Fixing in Advance).

(Tentative translation)

[(b) Combination of replacement benchmarks and spread adjustments]

✓ Based on the discussions to date, the possible combinations of replacement rates and spread adjustments are shown in the left table. The responses drawn from the members are summarized in the right table.

	Spread adjustments	Replacement benchmarks
X	Forward approach	(i) O/N RFR Compounding (Fixing in Advance)
		(ii) O/N RFR Compounding (Fixing in Arrears)
		(iii) Term Reference Rates
		(iv) TIBOR
		(v) TIBOR (using L/T spread)
Y	Historical mean/median approach	(i) O/N RFR Compounding (Fixing in Advance)
		(ii) O/N RFR Compounding (Fixing in Arrears)
		(iii) Term Reference Rates
		(iv) TIBOR
Z	Spot-spread approach	(i) O/N RFR Compounding (Fixing in Advance)
		(ii) O/N RFR Compounding (Fixing in Arrears) *Not Available*
		(iii) Term Reference Rates
		(iv) TIBOR

＊ A waterfall structure could be adopted when using a term RFR as a replacement rate given that it is uncertain whether the rate will be developed before the fallback.

○ Regarding spread adjustments, the majority preferred the (Y) historical mean/median approach (on the premise that the spreads will be published), pointing out, for instance, that it is consistent with ISDA derivatives and that it is difficult to manipulate because a wide range of actual transactions will be referenced, and it is easy to calculate and transparent in terms of calculation results.

○ Meanwhile, a few members preferred the (X) forward approach and the (Z) spot-spread approach considering, for example, that it is easily understandable by borrowers.

○ Regarding replacement benchmarks, when evaluated in combination with spread adjustments, many members preferred, as is the case with [(a) benchmarks in new contracts], "Y-(iii) Term Reference Rates" and "Y-(iv) TIBOR" due to concerns including those over the administrative burden. About the same number of members preferred "Y-(ii) O/N RFR Compounding (Fixing in Arrears)" considering that publication by a vendor selected by ISDA is planned.

○ Other than the above, very few members preferred "Y-(i) O/N RFR Compounding (Fixing in Advance), "X-(iv) TIBOR," "X-(v) TIBOR (using L/T spread)," and "Z-(iv) TIBOR."

○ In any case, it was pointed out anew that value transfer will occur regardless of the choice of the combination.