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Bank of Japan

Toward a More Robust and Developed Financial Market: Two "Transitions" and the Bank of Japan's Initiatives

Keynote Address at the International Swaps and Derivatives Association (ISDA) 38th Annual General Meeting

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I. Introduction

It is a great honor to deliver a keynote address at the Annual General Meeting of the International Swaps and Derivatives Association (ISDA) in Tokyo.

ISDA was established in 1985 in response to increased demand for standardized transactions in growing derivatives markets. Since then, ISDA has taken various initiatives to foster safer and more efficient derivatives markets and to facilitate effective risk management for users of derivatives products. I would like to express my respect to ISDA's endeavors and my appreciation for ISDA Japan's cooperation in the Bank's activities.

Financial markets have changed dramatically over the past four decades since ISDA's establishment. During that period, financial markets have enhanced their price discovery function and played an increasingly pivotal role in bolstering economic activities. This has been facilitated by financial deregulation, the advancement of globalization, and the development of financial technology, including ICT. However, risk management systems have struggled to keep pace with the mounting complexity of financial transactions. This led to vulnerability in the financial system, which resulted in a number of financial crises, notably the global financial crisis in 2008.

Drawing on these experiences, both the public and private sectors have invested substantial resources to enhancing the robustness of financial markets by strengthening financial regulations and refining risk management practices. Interest rate benchmark reform, including the LIBOR transition, constitutes an integral part of these efforts. On this front, initiatives for a more robust interest benchmark have steadily advanced as evidenced by the fact that the cessation of the US dollar LIBOR, the last remaining milestone, passed at the end of June 2023 without major disruptions. Meanwhile, financial markets have also strived to enhance their contributions by, for example, addressing the transition to a net-zero society through climate finance. With the launch of various new initiatives, financial markets have seen rapid growth in this area in both infrastructure and market size.

Today, I would like to discuss the efforts toward establishing a more robust and developed financial market by focusing on two "transitions," namely the LIBOR transition and the transition toward achieving a net-zero society. I would also like to touch upon the actions taken by the Bank in these fields.

II. LIBOR Transition: Interest Rate Benchmark Reform

Let me start with interest rate benchmark reform, specifically the LIBOR transition, as a pivotal effort by financial markets to enhance their robustness.

Interest rate benchmarks are indicators of major money market rates. They play important roles not only by facilitating effective price discovery in money markets, but also by serving as a base rate for a wide range of financial instruments in and outside of money markets. Although LIBOR had long been a leading interest rate benchmark, concerns about its credibility were raised after attempted manipulation. Since then, international efforts have been underway to identify alternative benchmarks and consider transition plans.

In 2013, the International Organization of Securities Commissions (IOSCO) issued a report articulating desirable features of interest rate benchmarks. The report identified conflicts of interest as a root cause of attempted manipulation, and suggested that this might have been amplified by expert judgement. To address these challenges, the report proposed 19 principles for financial benchmarks, highlighting the importance of establishing credible and transparent governance and of calculating benchmark rates based on actual transaction data rather than by expert judgement.

In identifying alternative benchmarks, the Financial Stability Board (FSB), in its 2014 report, recommended reforming existing IBORs and identifying risk-free rates. As for transition plans, the report advocated a multiple-rate approach that enables the use of different benchmarks depending on the circumstances in each jurisdiction and the nature of the transaction. It argued that while some transactions might be better suited to a rate representing the bank's borrowing rate, derivatives transactions, where such specifications are not always required, should preferably reference a risk-free rate.

The reform of the Japanese Yen interest rate benchmark has proceeded in alignment with the FSB's recommendations. The reform involved the identification of the Japanese Uncollateralized Overnight Call Rate, known as TONA, as a risk-free rate, the reform of TIBOR to enhance its robustness, and the establishment of the Tokyo Term Risk Free Rate

(TORF). These new benchmarks have supplanted the role previously held by LIBOR. In particular, most existing interest rate swaps now refer to TONA. Prior to the transition, a majority of those swaps were based on LIBOR.

Due to its widespread use, the smooth transition from LIBOR presented a significant challenge for a wide range of entities in both the financial and non-financial sectors. I believe that the smooth transition was achieved with the support of international initiatives. These efforts included identifying challenges, analyzing desirable outcomes, developing viable transition plans, and tracking and sharing progress in the transition. I would like to add that ISDA's initiatives, including developing measures for fallbacks, were crucial in ensuring a seamless transition for derivatives transactions, which accounted for a considerable portion of LIBOR-referenced contracts. In Japan, several national working groups were established to address relevant issues. These working groups, primarily consisting of market participants, played an important role in the smooth transition by identifying challenges, coordinating opinions, and proposing transition plans, while also being open for public consultation. The Bank supported the market participants' efforts by serving as the secretariat for the working groups. Interest rate benchmark reform has been of genuine interest to the Bank, as it closely aligns to the Bank's responsibility as a central bank for monetary policy and financial stability, as pointed out in the 2013 report by the Bank for International Settlements (BIS).

The LIBOR transition was largely completed with the cessation of the US dollar LIBOR publication at the end of last June, which passed without major disruption. However, there are still several outstanding issues. The foremost priority is to establish the sustainable usage of alternative benchmarks. With regard to TIBOR, the transition from Euroyen TIBOR is underway, and its publication is set to cease at the end of this year as an initiative to comply with the IOSCO principles. This decision comes as the rate refers to offshore market rates, where turnover has significantly declined. The Bank will continue to monitor and encourage the appropriate selection and use of interest rate benchmarks.

III. Transition to a Net-Zero Society: Climate Finance

Let me turn to climate finance, which represents efforts by financial markets to enhance their roles by facilitating the transition to a net-zero society.

The difficulties posed by climate change stem from "externalities" associated with greenhouse gas emissions. It is therefore crucial to "internalize" challenges related to climate change into a market mechanism aiming at the reduction of emissions. Reflecting climate-related risk and opportunities to market prices by reducing information asymmetry, thereby improving price discovery mechanisms, is vital to a seamless transition to a net-zero society. To this end, financial markets have undertaken various initiatives.

An example of this is enhanced disclosure of climate-related information in compliance with financial disclosure frameworks. Recommendations by the Task Force on Climate-related Financial Disclosures (TCFD) have made tremendous contributions to encouraging voluntary disclosure. As the significance of such disclosure came to be widely recognized, the International Sustainability Standards Board (ISSB) finalized new standards following a series of international discussions. In light of this, climate-related disclosure will become a legal requirement in many jurisdictions, including Japan, marking a new phase in disclosure practices.

Climate-related financial products and markets have also seen continuous growth. The outstanding amount of green and other ESG bonds has significantly increased over the past decade both in Japan and internationally. Carbon credit markets have expanded globally. In Japan, the Tokyo Stock Exchange began trading carbon credits last October. New markets are also emerging for derivatives globally, such as futures for ESG stock indices and carbon credits, and there are growing expectations for derivatives to provide risk management and price discovery functions.

In addition, climate finance has evolved alongside progress in discussions about economic activities aimed at reducing greenhouse gas emissions. For example, recognizing the heightened importance of practical transition plans, both public and private sectors have been actively addressing transition finance. In this context, the Japanese government issued the world's first sovereign climate transition bonds in February.

Against this background, the Bank has taken various actions from a central bank's perspective to support the climate-related efforts in the market. First, the Bank conducts funds-supplying operations to support financing for climate change responses. Through those operations, financial institutions can borrow funds specifically for climate-related investments and loans. The outstanding amount of these operations has reached 8.2 trillion yen (55 billion dollars), after five disbursements during a period of two and a half years. Second, the Bank has conducted an annual survey on the functioning of climate-related markets to gauge the progress and identify the issues within the market. The Bank is currently conducting its third survey, with a special emphasis on recent market developments such as transition finance, alongside regular monitoring points like the pricing of climate-related factors and the development of ESG bond markets. There are few comparable surveys even on a global basis that consistently monitor market developments from the perspectives of both issuers and investors, and I trust that the findings of this survey will continue to be utilized for the advancement of climate finance. In any process of a transition, it is imperative to identify the status of the transition and disseminate information to the relevant stakeholders, as exemplified by the lessons learned from the LIBOR transition.

Transitioning to a net-zero society is also integral for the Bank to carry out its mandate of maintaining price and financial system stability. The Bank will continue to support market initiatives in this regard.

IV. Conclusion

Lastly, let me touch upon the new challenges arising amid the latest financial developments. At the Monetary Policy Meeting held last month, the Bank changed its monetary policy framework, including the termination of the policy framework of Quantitative and Qualitative Monetary Easing with Yield Curve Control and the negative interest rate policy. It is crucial for the financial market to adapt smoothly to the changing environment and to function appropriately. We aim to figure out market developments through dialogue with market participants and to support their initiatives for better market functioning. Taking these matters into consideration, the Bank will keep contributing to building a more robust and developed financial market from the perspective of a central bank.

Thank you.