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Financial Institutions' Preparedness for LIBOR Cessation and Future Actions with a Focus on the Results of the Joint Survey by the Financial Services Agency and the Bank of Japan

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London Interbank Offered Rate (LIBOR) is used in a broad range of financial transactions, but it will likely cease at end-2021. All LIBOR users, including financial institutions and their corporate clients, need to make necessary preparations while being aware of the limited time available as only a year and a half remains until end-2021. The survey on the use of LIBOR jointly conducted by the Financial Services Agency and the Bank of Japan aims to (1) accurately ascertain financial institutions' outstanding balances of financial instruments and transactions that reference LIBOR, the adoption of alternative benchmarks to LIBOR, and the status of establishing a managerial framework and allocating staff to prepare for LIBOR cessation at financial institutions, as well as (2) further encourage financial institutions to ensure a smooth transition. This paper highlights the results of the first round of the joint survey conducted in October-December 2019.

Introduction

At present, London Interbank Offered Rate (LIBOR) is the most globally used benchmark for a broad range of financial transactions, such as those involving loans, bonds, and derivatives. However, as international efforts to reform interest rate benchmarks move ahead, LIBOR will likely cease permanently at end-2021. LIBOR is calculated and published based on rates submitted by multiple banks selected as panel banks. The U.K. authority, considering requests from panel banks, has made it clear that those banks will no longer be obliged to submit to LIBOR after 2021, in which case it will be practically impossible to calculate and publish LIBOR.[1]

Given that LIBOR is widely used, it is necessary to prepare for its cessation to ensure the smooth functioning of financial intermediation through financial institutions and markets even immediately before and after LIBOR cessation. Among these preparations, tasks requiring efforts by the market as a whole, such as the construction of alternative benchmarks to JPY LIBOR, are being steadily addressed based on deliberations by, for example, the Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks (hereinafter "the Committee"), for which the Bank of Japan (BOJ) acts as the secretariat. In parallel to these market-wide initiatives, it is of utmost importance for individual LIBOR users such as financial institutions, institutional investors, and non-financial corporates to press ahead with their own preparations. Given both the wide range of issues that need to be addressed and the limited time available until end-2021, it is necessary for all LIBOR users to make a strong commitment at the management level and push ahead with efforts in a well-planned and steady manner, although the extent to which LIBOR is used varies among entities.

In response to the spread of COVID-19, financial institutions have recently been preferentially allocating their management resources to the provision of financing support for corporates and households. In addition, due to the pandemic, both financial institutions and their corporate clients have inevitably scaled back some operations. Accordingly, their preparations for LIBOR cessation have been affected in some areas, such as the implementation of IT system upgrades and discussion with customers on LIBOR transition. The U.K. authority, however, continues to urge LIBOR users to prepare for the cessation after 2021, and insufficient preparedness could cause a profound negative impact at the time of cessation. Therefore, LIBOR users in Japan also need to push ahead with necessary preparations in a timely manner.[2]

Against this background, the Financial Services Agency (FSA) and the BOJ have been jointly working on various initiatives to encourage private-sector efforts to prepare for LIBOR cessation. One such example is the first round of the joint survey of a wide range of financial institutions regarding their use of

LIBOR, which was conducted in late 2019 (Chart 1). The aim of this survey was to (1) accurately ascertain the status of establishing a managerial framework and allocating staff to prepare for LIBOR cessation, the outstanding balances of financial instruments and transactions that reference LIBOR (hereinafter "LIBOR exposure"), and the adoption of alternative benchmarks to LIBOR at financial institutions operating in Japan, as well as (2) encourage these institutions to ensure a smooth transition. The survey period was October-December 2019, with the reference date of LIBOR exposure as of end-June 2019. The survey covered a total of 278 entities, including banks, securities companies, insurance companies, and central organizations of financial cooperatives. The following is a detailed description of the findings.[3]

[Chart 1] Overview of the 1st survey on the use of LIBOR

Survey coverage	278 entities: 9 major banks, 104 regional banks, 15 foreign bank branches, 32 securities companies, 95 insurance companies, 23 central organizations of financial cooperatives and other banks
Survey period	October-December 2019
Major survey items	The status of establishing a framework for deliberations for LIBOR cessation; the status of preparedness of business operations; and the scale of LIBOR exposure of five currencies (yen, U.S. dollar, euro, pound sterling, and Swiss franc) with the reference date as of end-June 2019.

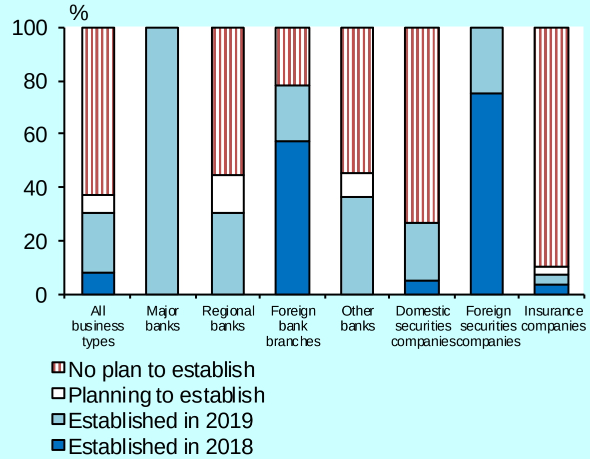
Note: The 9 major banks comprise Mizuho Bank, MUFG Bank, Sumitomo Mitsui Banking Corporation, Resona Bank, Mitsubishi UFJ Trust and Banking Corporation, Mizuho Trust and Banking Company, Sumitomo Mitsui Trust Bank, Shinsei Bank, and Aozora Bank. The 104 regional banks comprise member banks of the Regional Banks Association of Japan and of the Second Association of Regional Banks and Saitama Resona Bank.

Overview of the First Round of Survey Results on the Use of LIBOR

The survey comprises two parts. The first covers qualitative information, such as the managerial framework and allocation of staff to prepare for LIBOR cessation and the status of preparedness of business operations in the individual divisions of financial institutions. The second covers quantitative information, such as the scale of LIBOR exposure by currency and product.

This section first explores survey findings from the qualitative part. As of December 2019, about 30 percent of respondents had established specialized project teams or working groups that address the permanent cessation of LIBOR (Chart 2). By type of

[Chart 2] Proportion of entities that have established specialized project teams, working groups, etc. for LIBOR transition

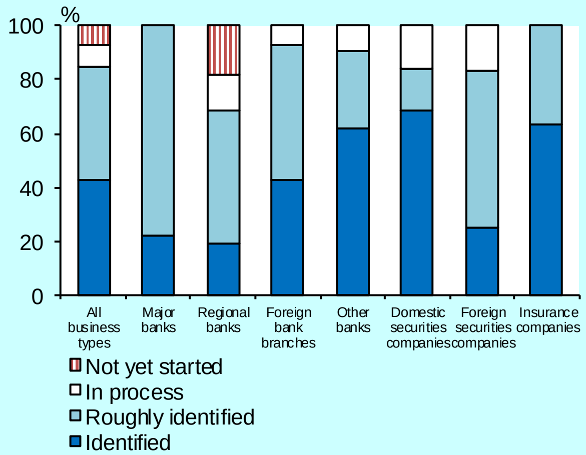


Note: Data are as of December 2019.

financial institution, while all major banks and foreign securities companies have set up such groups, there were many insurance companies, domestic securities companies, and regional banks that have no plans to establish the same. This difference between types of financial institutions likely reflects a difference in the volume of LIBOR exposure, as will be detailed below. Cross-divisional project teams and working groups are not equally necessary for all the financial institutions.[4]

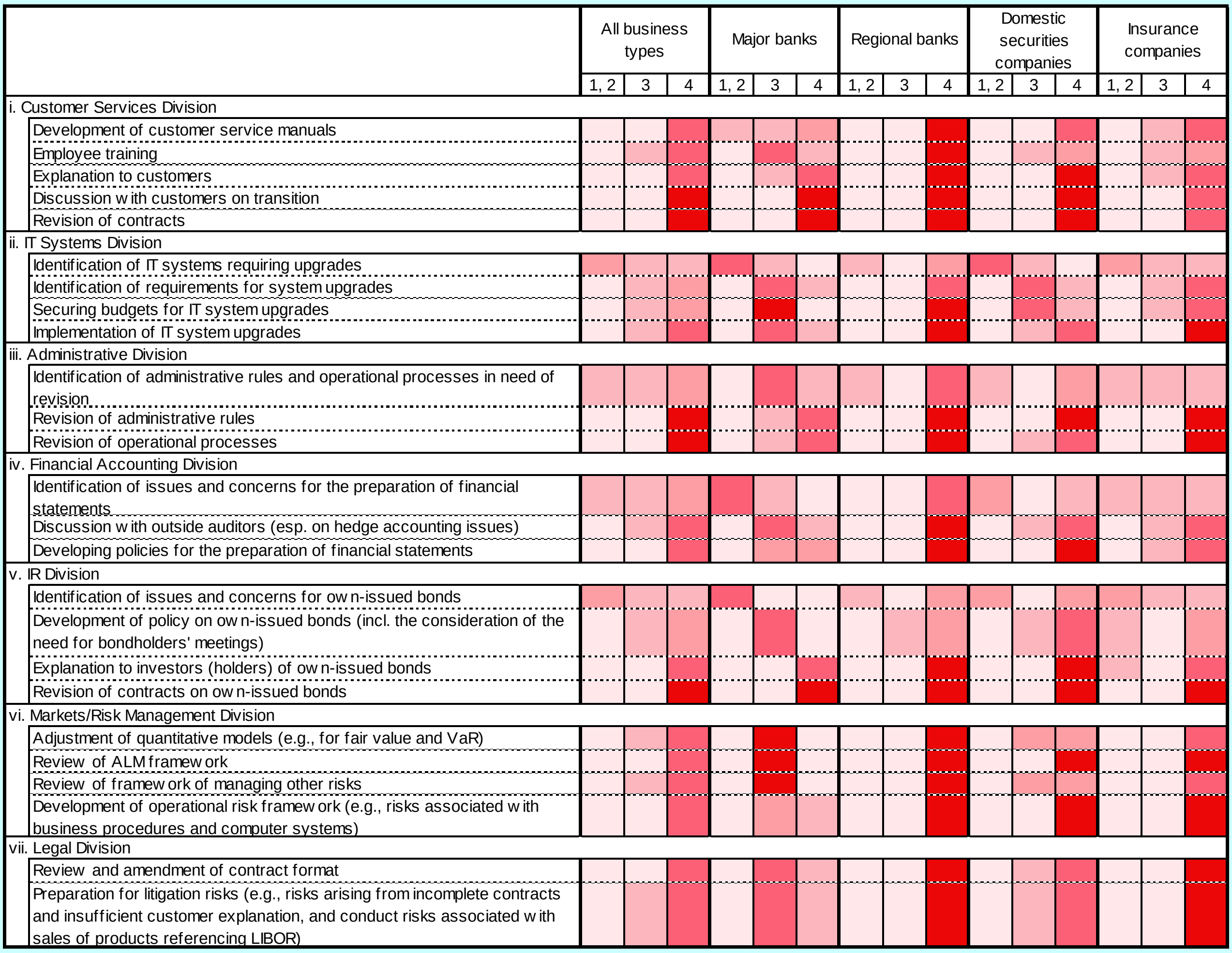
80-90 percent of respondents have at least generally identified business operations that reference LIBOR (Chart 3). However, the survey also shows that concrete actions with respect to the individual tasks identified have only just begun. Chart 4 indicates their status of preparedness regarding the specific examples of business operations that need to be addressed in

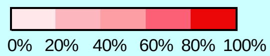
[Chart 3] Proportion of entities that have identified business operations affected by LIBOR transition



Note: Data are as of December 2019. Examples of business operations affected by LIBOR transition are shown in Chart 4.

[Chart 4] Preparedness of business operations for LIBOR transition in Japan

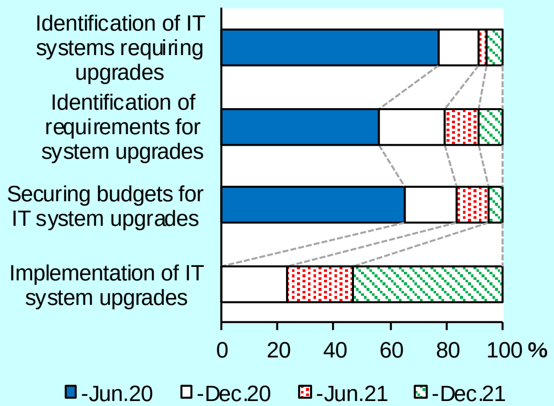




Note: Data are as of December 2019. The response options were as follows: 1 = action completed; 2 = action almost completed; 3 = action in process; 4 = action not yet started; and 5 = not applicable. Different shades in the table represent the percentage shares of responses 1 to 4. The table does not include data for foreign bank branches, other Japanese banks, and foreign securities companies. For details, see Financial Services Agency and Bank of Japan, "Summary of Survey Results on the Use of LIBOR and Main Actions Needed," March 2020.

divisions of domestic business bases, such as customer services, IT systems, and administrative divisions. Taking the IT systems divisions as an example, some progress was observed for the early stage of preparations, such as identification of IT systems requiring upgrades. However, a large proportion of respondents indicated that subsequent operations -- such as identification of requirements for IT system upgrades, securing budgets for such upgrades, and implementation of the upgrades -- were still in process or had not yet started. When asked about the anticipated completion period for the implementation of IT system upgrades, nearly 80 percent of the respondents who indicated that the implementation was still in process responded during 2021; in particular, a little more than 50 percent stated the latter half of 2021 (Chart 5). This suggests that many financial institutions anticipate that preparations will continue through the end of next year. It should be noted that, although some financial

[Chart 5] Scheduled date of completion of IT system upgrades



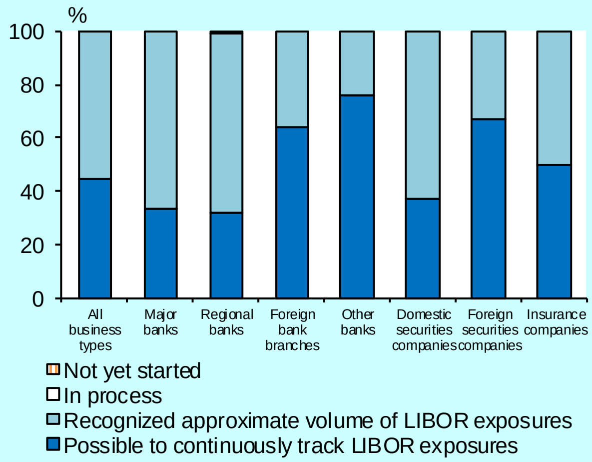
Note: Data are as of December 2019. The data in the chart above cover financial institutions that selected "action in process" in the response options. The horizontal axis represents the percentage shares of responses.

institutions have delayed the implementation of IT system upgrades longer than initially planned due to the

COVID-19 pandemic, thus far, the information available from financial institutions does not suggest specific concern over the completion of such upgrades by end-2021.

Hereafter in this section, the quantitative part, or the scale of LIBOR exposure, will be examined. As a background to this, almost all the responding financial institutions indicated that they had at least recognized the approximate volume of their LIBOR exposure (Chart 6). On this basis, a simple aggregation of LIBOR exposure as of end-June 2019 suggests that assets (e.g., loans) amounted to about 164 trillion yen, liabilities (e.g., deposits and bonds issued) amounted to about 35 trillion yen, and derivatives amounted to about 6,300 trillion yen in terms of their notional value (Chart 7). By currency, the dollar made up the largest share, followed by the yen, while the shares of other currencies -- the euro, the pound sterling, and the Swiss franc -- were small. The reason behind the smaller exposure of JPY LIBOR than USD LIBOR is likely the large volume of transactions referencing Tokyo Interbank Offered Rate (TIBOR). Contracts with a term extending beyond end-2021 accounted for about 97 trillion yen of assets, about 17 trillion yen of liabilities, and about 3,200 trillion yen of derivatives in terms of their notional value, thus accounting for 50-60 percent of all LIBOR exposure.

[Chart 6] Proportion of entities that have recognized LIBOR exposure

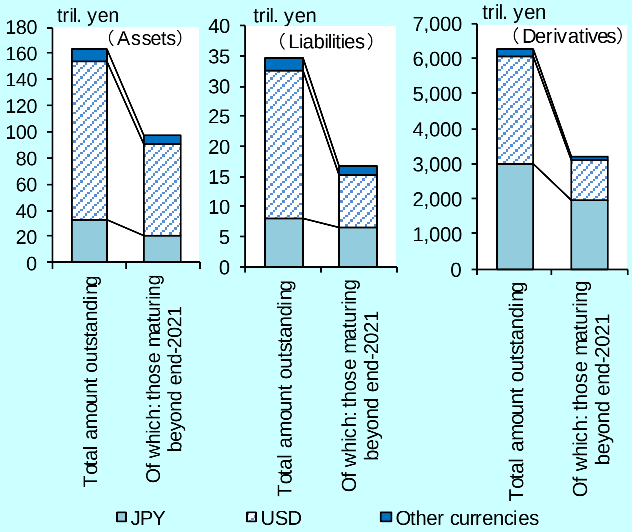


Note: Data are as of December 2019.

A breakdown of LIBOR exposure by type of financial institution shows that major banks accounted for a large share of assets, liabilities, and derivatives, although domestic and foreign securities companies also accounted for substantial shares of derivatives (Chart 8).

A more detailed breakdown by type of financial product shows that loans accounted for the largest share

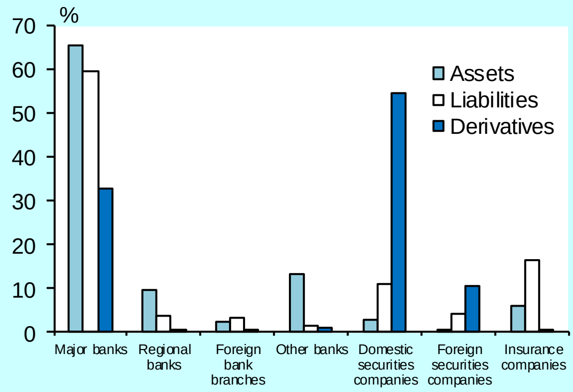
[Chart 7] Overview of the scale of LIBOR exposure



Note: Data are as of end-June 2019 with some exceptions. Data other than JPY LIBOR are converted into yen based on foreign exchange rates as of end-June 2019. Derivatives contracts are based on notional amounts. The same applies to Charts 8 and 9.

of assets both in terms of the value and the number of contracts (Chart 9). Regarding liabilities, borrowings accounted for a large share on a value basis, but in terms of the number of contracts, insurance products and deposits made up large shares. Finally, derivatives mostly consisted of over-the-counter interest rate swaps both in terms of the value and the number of contracts.

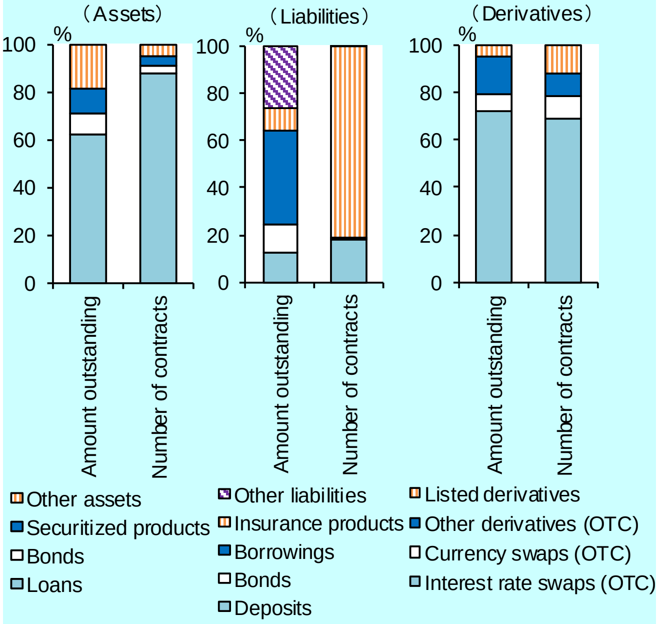
[Chart 8] Proportion of LIBOR exposure by type of financial institution



Note: Based on amount outstanding.

As a preparation for LIBOR cessation, contracts referencing LIBOR should either (1) be shifted to new contracts referencing alternative benchmarks to LIBOR at an appropriate timing, such as the expiration of existing contracts, or (2) include fallback provisions in advance to stipulate alternative benchmarks applicable after LIBOR cessation. Regarding the latter, the survey findings show that only a small share of contracts referencing LIBOR have included fallback provisions

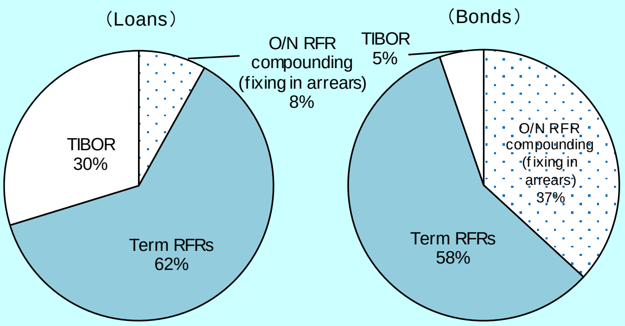
[Chart 9] Proportion of LIBOR exposure by type of financial product



thus far, all in terms of assets, liabilities, and derivatives.

While this survey describes the situation as of end-June 2019 for the quantitative part, subsequent consultation in Japan with market participants conducted by the Committee showed that term risk-free reference rates (RFRs) received the strongest support as alternative benchmarks to JPY LIBOR for both loans and bonds (Chart 10).[5] Regarding the term RFRs, in February 2020, it was determined that QUICK Corp. would be the entity responsible for calculating and publishing "prototype rates," which are not intended for use in actual transactions, and it began publishing such rates on May 26.[6] As for derivatives, the International Swaps and Derivatives Association (ISDA) is proceeding with amending the 2006 ISDA Definitions to include fallback provisions and publishing a protocol to apply these fallback provisions to derivative contracts entered into prior to the date of the amendment.

[Chart 10] Results of public consultations on the alternative benchmarks to JPY LIBOR



Note: Multiple answers allowed.
Source: Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks.

Accounting issues regarding interest rate hedging derivatives are also being addressed: the Accounting Standards Board of Japan (ASBJ) released the Exposure Draft of Practical Solution on the Treatment of Hedge Accounting for Financial Instruments that Reference LIBOR on June 3. Furthermore, the Committee is making progress in formulating the roadmap for LIBOR transition. Going forward, it is expected that there will be steady progress in the inclusion of fallback provisions through vigorous negotiations between contracting parties in view of these recent developments in the LIBOR transition.[7]

Future Actions

The results of the survey suggest that although there has been progress in financial institutions' preparations overall, such as in terms of their awareness of challenges posed by LIBOR cessation and their identification of contracts referencing LIBOR, there remains some room for further efforts on their part. They include taking concrete actions in individual divisions and inserting fallback provisions in existing contracts. Assuming that LIBOR will cease at end-2021, financial institutions need to be aware of the limited time available and continue with their preparations while involving their corporate clients.

The FSA and the BOJ will continue to support market-wide initiatives, including the early establishment of term RFRs. At the same time, the two entities will continue the efforts to identify the degree of preparedness of individual financial institutions and, as necessary, individually encourage them to accelerate their preparations. Such efforts include the joint survey on the use of LIBOR and dialogue with financial institutions with large LIBOR exposure.[8] On June 1, 2020, the FSA and the BOJ jointly sent the representatives of major financial institutions a notification, the "Dear CEO" letter, and also made the same available on the FSA's and the BOJ's websites. In the letter, the two entities, as the country's financial authorities, highlighted the importance for CEOs of financial institutions to address LIBOR cessation. It is expected that compiling the related materials requested in the letter with the active involvement of management officials will encourage these financial institutions to push ahead with preparations. Those financial institutions that are not addressed in the letter are also expected to make necessary preparations by referring to the published letter.

Preparations for LIBOR cessation cannot be completed by the efforts of financial institutions alone.

The FSA and the BOJ will raise public awareness of LIBOR cessation through multiple opportunities and channels and gain the understanding that it will be necessary to have cooperation among a wide range of entities other than financial institutions, such as corporates. Meanwhile, it is expected that continually showing the progress in the adoption of alternative benchmarks to LIBOR through the survey will make it easier for LIBOR users to select alternative benchmarks and encourage their transition efforts.

Only less than a year and a half remains until end-2021 and the issues that need to be addressed by financial institutions are diverse. The FSA and the BOJ will continue to work closely to provide support for efforts by financial institutions and other relevant parties toward the reform of interest rate benchmarks, while taking into account the impact of the spread of COVID-19.

[1] For details on the reform of interest rate benchmarks and market-wide initiatives, see Box 1 in the April 2019 issue of the BOJ's *Financial System Report* as well as the website of the Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks.

[2] On June 23, 2020, the U.K. government announced its intent to enact legislation to give enhanced powers to the Financial Conduct Authority (FCA), which supervises LIBOR. The new regulatory powers will enable the FCA to direct the ICE Benchmark Administration (IBA), an administrator of LIBOR, to change the methodology for a critical benchmark, in circumstances where the regulator has found that the benchmark's representativeness will not be restored and where action is necessary to ensure market integrity. However, the government emphasized the importance for LIBOR users to continue to focus on active transition, given that the use of LIBOR with changed methodology will be limited to some existing contracts that genuinely have no ability to transition from LIBOR or include fallbacks, such as due to a large number of contracting parties.

[3] For an official summary of the survey results, see Financial Services Agency and Bank of Japan, "Summary of Survey Results on the Use of LIBOR and Main Actions Needed," March 2020.

[4] For example, a particularly large proportion of insurance companies responded that they had "no plan to establish" specialized project teams or working groups, and more than 50 percent of these companies had no LIBOR exposure.

[5] See Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks, "Final Report on the Results of the Public Consultation on the Appropriate Choice and Usage of Japanese Yen Interest Rate Benchmarks," November 2019.

[6] See Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks, "Determination of the Calculating and Publishing Entity of Prototype Rates for Term Reference Rates," February 2020, and "Statement regarding Calculation and Publication of Prototype Rates for Term Reference Rates," May 2020. Prototype rates for term RFRs are available at https://moneyworld.jp/page/qtrf001.html.

[7] If LIBOR-linked derivatives conform to the 2006 ISDA Definitions, the ratification of the protocol will automatically introduce fallback provisions. For contracts that do not conform to the 2006 ISDA Definitions, the contracting parties need to agree to alternative benchmarks for each contract.

[8] At present, the second round of the survey on the use of LIBOR is scheduled to be sent out during the January-March quarter of 2021, with the reference date of LIBOR exposure as of end-December 2020.

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