In July 2017, Andrew Bailey, Chief Executive of the UK Financial Conduct Authority, declared that the authority would no longer persuade or compel panel banks to make LIBOR (London Interbank Offered Rate) submissions after 2021. As submissions are necessary for the creation of LIBOR, which is widely referenced to determine applicable interest rates in financial transactions, concern has increased among market participants that LIBOR itself would not exist after 2021. This concern has been addressed globally through various means. In this newsletter, we discuss the Japanese response by presenting the main points of a relevant committee’s recently-published consultation paper and consider the legal issues anticipated to derive from their suggestions.

1. Commencement of the Public Consultation Concerning the JPY Interest Rate Benchmark

The response in Japan to potential LIBOR discontinuation involved establishment of the Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks (the “Committee”) in August 2018. Through practical and robust discussions in and among its three sub-groups (based on Loans, Bonds, and Development of Term Reference Rates), relative proposals were put forth and the Public Consultation on the Appropriate Choice and Usage of Japanese Yen Interest Rate Benchmarks (the “Consultation Paper”) was published on 2 July 2019. The deadline for public comments on the Consultation Paper’s treatment of proposed interest rate benchmark reform is September 30, 2019.

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1. Outstanding volume of transactions: USD 30 trillion for JPY LIBOR, USD 150 trillion for USD LIBOR, and USD 30 trillion for GBP LIBOR. For reference, USD 150 trillion for EURIBOR, USD 5 trillion for TIBOR (see Appendix 1-a of the Consultation Paper).
2. Secretariat: the Bank of Japan
3. We refer to the page numbers in the English translation of the Consultation Paper: https://www.boj.or.jp/en/paym/market/jpy_cmte/data/cmt190702b.pdf
2. Summary of the Consultation Paper

The Consultation Paper is lengthy (with the main body alone approaching 50 pages). Below, we will introduce its major points organized by keywords.

(1) Multiple-Rate Approach, IBORs, and RFR (pp. 2 & 3)

In *Reforming Major Interest Rate Benchmarks*, the Financial Stability Board (FSB) advocated a multiple-rate approach by which different appropriate interest rate benchmarks are used depending on the financial instruments or nature of transactions. This is to be accomplished by (i) enhancing the reliability and robustness of existing interbank offered rates (IBORs), such as the LIBOR and TIBOR (Tokyo Interbank Offered Rate), and (ii) identifying a nearly risk-free rate (RFR) that should not reflect the credit risks of banks; the assumption is that IBORs would be used for loans, etc., and RFRs would be used in many derivatives transactions.

In Japan, TIBOR reform has been implemented by the JBA TIBOR Administration, and a Tokyo Overnight Average Rate (the “TONA”) was selected to serve as an RFR. On the other hand, in the U.S.A., U.K., and Switzerland, since their existing major interest rate benchmarks are LIBOR based, transitions to RFRs (U.S.A.: SOFR, U.K.: SONIA, Switzerland: SARON) are progressing.

(2) “Transition” and “Fallback” (pp. 5 & 6)

The Consultation Paper proposes “Transition” and “Fallback” as two approaches to prepare for the discontinuation of the LIBOR (Table 1).

<table>
<thead>
<tr>
<th>Transition</th>
<th>Fallback</th>
</tr>
</thead>
<tbody>
<tr>
<td>Newly executed financial instruments and transactions use alternative benchmarks (such as RFR and TIBOR), as a reference rate, instead of the JPY LIBOR.</td>
<td>Parties to existing contracts using the JPY LIBOR as a reference rate and the terms of which continue beyond the LIBOR cessation agree on a fallback provision identifying a replacement rate to be referred to in lieu of the JPY LIBOR after the LIBOR is discontinued.</td>
</tr>
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</table>

The “Transition” approach suggests the use of alternative benchmarks in new contracts begin prior to the LIBOR cessation. The “Fallback” approach suggests provisions identifying replacement rates designed to succeed the JPY LIBOR be agreed upon prior to, but implemented after, the cessation; specifically, for contracts utilizing the JPY LIBOR, it will continue to apply but be replaced with a replacement rate under certain triggering conditions, such as cessation of the JPY LIBOR.

(3) Term Reference Rates and Options (1) to (5) for Alternative Benchmarks (pp. 7 - 17)

Regardless of the choice to use a Transition or Fallback approach, an interest rate benchmark is required to succeed the JPY LIBOR. On this point, the Consultation Paper notes five options (Table 2).

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5 In relation to the status of other countries, for example, see Appendix A to the *Reforming major interest rate benchmarks: Progress report* dated November 14, 2018, published by the FSB.

6 For the background information of proposing each option and technical details, see the main body of the Consultation Paper and applicable appendices.
Table 2: Five JPY LIBOR Interest Rate Successors Proposed in the Consultation Paper

<table>
<thead>
<tr>
<th>Underlying Rate</th>
<th>(1) O/N RFR Compounding (Advance)</th>
<th>(2) O/N RFR Compounding (Arrears)</th>
<th>(3) Term Reference RFR (Swap)</th>
<th>(4) Term Reference RFR (Futures)</th>
<th>(5) TIBOR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Timing of Interest Rates</td>
<td>Setting in advance</td>
<td>Setting in arrears</td>
<td>Setting in advance</td>
<td>Setting in advance</td>
<td>Setting in advance</td>
</tr>
<tr>
<td>Reference Period</td>
<td>A certain period prior to reset date</td>
<td>A future certain period, commencing from the spot day based on the reset date</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reference and Calculation Periods</td>
<td>Inconsistent</td>
<td>Almost consistent (reference period limitations)</td>
<td>Generally consistent</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

O/N RFR – Overnight Risk Free Rate; TIBOR – Tokyo Interbank Offered Rate; OIS – Overnight Index Swap

With reference to Table 2, options (1) and (2) develop term reference rates by compounding the actual figures of the TONA every business day. This is seen as a means of counteracting the potential problems of using an RFR as an alternative benchmark, such as in the case of the TONA, where it is merely an overnight rate, and there is no term reference rate with tenors of three months or six months, as with the JPY LIBOR or TIBOR. The difference in options (1) and (2) is as to whether the actual figures are compounded from the preceding or following interest rate setting period. The former is referred to as “setting in advance” because the interest rate is already determined at the beginning of the period to which it will be applied, and the latter is referred to as “setting in arrears” because the applicable interest rate is set close to the end day of the interest rate calculation period.

The method for calculating term reference rates in option (3) of Table 2 proposes basing them upon derivatives transactions deemed to indicate the future outlook of the TONA, such as JPY Overnight Index Swaps.7 Option (4) is a method of developing rates based on the prices of futures on unsecured overnight call rates listed on the Tokyo Financial Exchange (for which trading is currently suspended). Both options (3) and (4) are classified as “setting in advance.” Furthermore, a method using the existing TIBOR also has been proposed as Option (5).

(4) Fallback Provisions and “Value Transfer” (pp. 17 - 30)

Implementation of the Fallback approach requires provisions in contracts stipulating a replacement rate to be referenced in lieu of the JPY LIBOR. For such provisions, three issues were acknowledged as in need of further clarification: (i) provision of “triggers,” (ii) determination of the replacement rate, and (iii) identification of introduction procedures. In relation to (iii), we introduce and analyze legal issues pertaining to loans and bonds in part 3 (below).

For (i), in addition to the cessation being set as a trigger, certain events prior to the cessation could be set as triggers, for example when the reliability of the LIBOR is beginning to falter due to its anticipated demise. Further, mainly in relation to loans, early “opt-in” triggers to activate fallbacks at a stage prior to the cessation of the LIBOR can also be discussed by the parties. In any case, such efforts have little meaning unless the trigger works, so it is important to identify specific and clear triggers that are likely to be considered acceptable by market participants.

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7 Principles for Financial Benchmarks Final Report (July 2013) by the International Organization of Securities Commissions was also considered (p. 15 of Consultation Paper).
In relation to (ii), if the JPY LIBOR is supplanted by a replacement rate, the difference between the two (i.e. the “spread”) may result in a “value transfer” in which one party to the transaction receives benefits and the other party incurs losses. This potential leads to concerns that accounting or tax issues or litigation risks will arise; as such, adjustments to minimize such potential are also discussed in the Consultation Paper. Therein, considering options (1) to (5) will primarily utilize RFR as a fallback rate, three spread adjustment processes are discussed, based on the following formula:

Replacement rate of fallback provisions = Fallback rate + Spread adjustment

(5) Treatment of Derivatives Transactions

In the Consultation Paper, cash instruments, such as loans and bonds, are discussed in detail. In relation to derivatives transactions, however, in a letter dated July 2016 from the FSB to the International Swaps and Derivatives Association (the “ISDA”), the FSB requested that the ISDA coordinate (internationally) to enhance the contractual robustness of derivatives transactions denominated in major currencies (including Japanese yen) in preparation for the cessation of the IBORs; therefore, it was deemed unnecessary to include derivatives transactions within the scope of the Consultation Paper.

However, the Consultation Paper reiterates results of the ISDA public consultation at multiple points, especially concerning the relationship between alternative benchmarks and fallback provisions, highlighting the fact that consistency between cash instruments and derivatives transactions was considered.

3. Legal Considerations for Arising Issues

Given the discussion in part 2 (above), we now turn to points worthy of note from the viewpoint of Japanese law concerning the loans and bonds referencing the JPY LIBOR discussed in the Consultation Paper. Our discussion aims to provide general considerations on expected major legal issues caused by the LIBOR discontinuation with respect to loans and bonds that are governed by Japanese law and lent or issued under general conditions in the current practice in Japan. Therefore, please note that readers may need to separately review the issues relating to individual loan contracts or bonds, following the cessation.

(1) Legal Issues with Loans

(a) Loan Contracts to be Executed in the Future

For loan agreements that are to be executed in the future and continue to be in effect after the end of 2021 (i.e. when the JPY LIBOR is expected to cease), from the perspective of preventing any confusion in practice or any dispute between the parties in relation to interest calculation methods at or after such time, it is recommended, depending on the timing of the execution, either:

(i) to agree in advance on an alternative benchmark for the entire term (“transition”); or
(ii) to include a fallback provision for future transition to a replacement rate.

8 A waterfall structure which decides the priority of application of options (1) to (5) is also discussed.
9 Forward Approach: based on the spread of each “forward rate” between JPY LIBOR and the fallback rate observed in the market at the time of triggering.
Historical Mean/Median Approach: based on the mean or median of the spread between the past JPY LIBOR and the fallback rates for a certain period.
Spot-Spread Approach: based on the spread between the JPY LIBOR and the fallback rate on the business day immediately before triggering.
We recommend that currently in force loan contracts that will continue to be in force after 2021 and which have a base rate tied to the JPY LIBOR should be amended to include fallback provisions. In relation to this point, the following matters should be taken into consideration:

✓ Availability of the Existing Contract Terms

Some loan contracts referencing the JPY LIBOR set forth methods to determine an alternative rate in cases of a JPY LIBOR cessation (the “Existing Fallback Provisions”), including where lenders may reasonably decide the successor rate. With respect to these loan contracts, some argue that it may be unnecessary to amend them to incorporate fallback provisions, since the Existing Fallback Provisions can be considered as covering a LIBOR cessation. However, it is not necessarily the case that all parties to a contract agree that the Existing Fallback Provision should apply to a permanent discontinuation of the initial base rate benchmark. Some parties maintain that it should apply only where the initial base rate benchmark is temporarily unavailable. Therefore, it would be desirable to amend contracts to incorporate fallback provisions in order to mitigate the risk that the referenced interest rates become unclear after the JPY LIBOR ceases to exist.

✓ Practical Burdens and Possible Methods Concerning Contract Amendments

Incorporating fallback provisions in concluded loan contracts anticipating LIBOR discontinuation would impose practical burdens on the parties.

Amendments to an existing loan contract are, in principle, achieved by the agreement of all parties to the contract and through the procedures for amendments provided in the agreement, if any. Therefore, when a fallback provision is to be newly added to an agreement, it is necessary to negotiate with the other party(ies) and to follow the procedures prescribed therein. Those tasks could become burdensome, particularly for financial institutions party to an enormous number of loan contracts.

One method to reduce such burdens would be to adopt a “negative consent” approach, wherein (i) a lender notifies the borrower that if there is no objection from the borrower within [xx] days, it is deemed that the borrower agrees to the contract amendment proposed by the lender (the details of which must be clearly explained), and (ii) if there is no objection from the borrower within the period, the lender deems that the borrower has agreed to the proposed amendment (which therefore becomes effective). In general, this is a valid means of amending loan contracts, so long as the borrower is deemed to have agreed impliedly to the proposed amendment. However, when deciding whether this method should be utilized, lenders must note that:

10 While it is possible that a certain interest rate benchmark will prevail as a replacement benchmark for the JPY LIBOR, this does not mean that every party to an existing loan contract referencing the JPY LIBOR intends to adopt such common benchmark as a successor. Therefore, it is desirable to provide fallback provisions in advance, in order to clarify the parties’ intentions and prevent possible disputes.

11 Similar provisions are included in the definition of “Base Rate” in the commitment line (2019, Art. 1.10) and term loan (2019, Art. 1.6) agreements published by the Japan Syndication and Loan-trading Association, which are widely referred to by loan market participants in Japan (although the initial base rates they reference are TIBOR). The forms essentially provide that if the initial base rates (JPY TIBOR or Euro-Yen TIBOR) are not published for some reason, the base rates will be reasonably decided upon by the agent in consideration of the offered rate applicable for interbank lending and borrowing transactions in the Tokyo interbank market (in Japanese Yen) for a term equivalent to the interest calculation term of the relevant agreement on the same day as the initial base rate would have been set if published.

12 Possibilities and problems of “negative consent” are introduced on page 25 of the Consultation Paper. However, the “negative consent” discussed therein differs from that discussed above; the former appears to require that such option already be embedded in a loan contract, while the latter does not.
(i) even if there are no objections from the borrower during the prescribed timeframe, it is possible that the borrower may later claim to have not agreed with the proposed contract amendment, leading to the development of a dispute concerning the fact that there is no clear evidence showing such implied consent;

(ii) no new written agreement between the borrower and the lender is entered into and, therefore, if the relevant contract requires written agreement for any amendments, it is necessary to examine in advance any possible negative impacts of conducting a contract amendment without complying with such procedure; and

(iii) it is necessary for the lender to make the details of the proposed amendment reasonable, as well as to have the borrower recognize, and fully understand, the details of the proposed amendment through appropriate means (which differ depending on the type of borrower), including by explaining such details to the borrower.

(2) Legal Issues with Bonds

Below, we discuss legal issues concerning bonds issued under the Companies Act of Japan (the “CAJ”).

If there are no provisions addressing JPY LIBOR cessation in a bond which references the JPY LIBOR, problems may occur in determining the applicable interest rate post-cessation. As such, offerors of bonds scheduled to exist after the end of 2021 are urged to consider providing fallback provisions. Likewise, for new bonds referencing the JPY LIBOR intended to exist after the end of 2021, it is desirable to consider setting an alternative benchmark as the referencing interest rate (“transition”), or to provide fallback provisions for a future transition to a replacement rate. Moreover, bonds referencing the JPY LIBOR already in existence, and scheduled to remain so after the end of 2021, should also consider providing fallback provisions. Procedural issues related to these points are described below.

Procedures of Bondholders’ Meetings

One procedure for adding fallback provisions to existing bonds is to make changes to the terms and conditions of the bonds by way of a bondholders’ meeting resolution. Relatedly, the Consultation Paper notes that procedures to amend the terms and conditions of bonds are provided by the CAJ: given that bondholders’ meetings, in principle, are required for certain determinations, it is assumed that a bondholders’ meeting resolution is required to add fallback provisions to existing bonds.

In principle, a matter for resolution is approved at a bondholders’ meeting if consent is obtained from more than half of the total number of those holding voting rights present at the bondholders’ meeting. A bondholders’ meeting resolution is effective against all bondholders who hold bonds of the relevant class (CAJ Art. 734, para. 2); therefore, fallback provisions resolved at a bondholders’ meeting by majority decision may be applied without obtaining agreement from every bondholder. However, bondholders’ meetings are subject to the following CAJ rules:

(i) Bondholders’ meetings for each class of bonds are to be constituted by the relevant bondholders, and, in principle, a separate bondholders’ meeting is required for each series of bonds (CAJ Art. 715). Accordingly,

13 Page 27 of the Consultation Paper.
14 Under the CAJ (Art. 716), matters in relation to the interests of bondholders, such as adding fallback provisions, may be resolved at bondholders’ meetings.
15 No provisions exist to the effect that a resolution of a bondholders’ meeting may be substituted by the approval of all bondholders under the CAJ, and the effect of such approval is not clear (in the “Outline of re-examination of company legislation (relating to corporate governance, etc.)” (kaisha housui (kigyou touchi tou kankei) no minasuhi ni kansuru youkou) adopted at the Legislative Council of the Ministry of Justice of Japan held on February 14, 2019, it was proposed that a provision be added to the CAJ to the effect that if all voting right holders of a bondholders’ meeting indicate their agreement in writing or by electronic records, it is deemed that there was a resolution of the bondholders’ meeting to the effect that the proposal was approved).

However, bearing in mind cases where there are a limited number of bondholders, discussion concerning the validity of adding fallback provisions may involve approval of all bondholders (see footnote 52 on page 27 of the Consultation Paper), in a form other than face-to-face meetings.
for issuers of multiple bond series considering introduction of fallback provisions, the burdens of holding bondholders’ meetings cannot be ignored.

(ii) Bondholders’ meetings have no provisions equivalent to shareholders’ meetings’ “omission of calling procedures” and “omission of resolutions” (see CAJ Arts. 300 & 319). Accordingly, bondholders’ meetings must be held in person, notably increasing procedural burdens if there are many bondholders or bond series.

(iii) Approval of a court is required to make a bondholders’ meeting resolution effective (CAJ Art. 734, para. 1), and if a ruling has been given approving or rejecting a bondholders’ meeting resolution, the bond issuer must give public notice to that effect without delay (CAJ Art. 735). As such, procedures of the bondholders’ meeting are required to be carried out in a manner that ensures sufficient time to obtain the approval of a court. Accordingly, even if a bondholders’ meeting resolution is obtained, theoretically, court approval may not be obtained, rendering the amendment invalid; therefore, there is potential for both the procedural burden associated with holding a bondholders’ meeting as described in (i) and (ii) above and the procedural burden associated with obtaining the approval of a court even after a bondholders’ meeting resolution.

✓ Considerations of Bondholders’ Meetings for Introducing Fallback Provisions

Given the potentially heavy procedural burdens issuers may incur concerning bondholders’ meetings, the Consultation Paper states that an approach that requires bondholders’ meeting resolutions at the time of adding fallback provisions and at the time of determining a replacement rate would not be practical. Thus, the Consultation Paper recommends a “hardwired” approach, which seeks simultaneous determination of a replacement rate when making the decision to add a fallback provision. Recognizing that the practical burdens on issuers are considerable, and bondholders’ meetings take a certain amount of time, it is further recommended to hold the necessary bondholders’ meetings to add fallback provisions as quickly as possible prior to discontinuation of the JPY LIBOR.16

4. Developments Going Forward

Based on the premise of a pending permanent discontinuation of the LIBOR, we have discussed legal issues under Japanese law pertaining to loans and bonds; however, several issues regarding interest rate benchmark reform remain, such as:

(i) acknowledgement and handling by not only financial institutions but also various market participants, such as institutional investors and corporations;

(ii) consistency of the structures of fallback provisions, etc., with overseas trends and derivatives transactions;

(iii) accounting issues, such as whether hedge accounting may be applied when fallbacks are triggered; and

(iv) confirming the sufficient liquidity of alternative benchmarks (by the end of 2021), including OIS and futures.17

Finally, attention should be paid to addressing LIBOR discontinuation related problems from a management perspective, such as: structuring of governance systems; identifying instruments, transactions, and business using the LIBOR; and considering the relevance of such tasks to each department, such as client services, IT systems, risk management, and legal.18 Considering year-end 2021 is not far off, each problem will need to be considered carefully and promptly.

16 Regarding the above, see pages 27 to 28 of the Consultation Paper.

17 On July 30, 2019, the Bank of Japan released that the “Task Force on Term Reference Rates” will be established to facilitate practical support of establishing the alternative benchmarks. See https://www.boj.or.jp/en/announcements/release_2019/no190730b.pdf

18 Appendix 4-b of the Consultation Paper.
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