The New Reference Rate Framework

On 2 January 2015, the Base Rate (BR) replaced the Base Lending Rate (BLR) as the main reference rate for new retail floating-rate loans and financing facilities. This article discusses the general role of a reference rate, the motivation for the replacement of the BLR, the key features and benefits of the new BR framework and the transition from the BLR to the BR. The article concludes by providing an overview of the current reference rate landscape under the BR.

(i) Roles of a reference rate

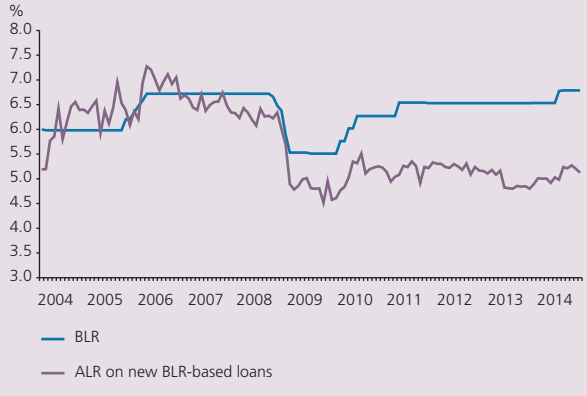
A reference rate constitutes a key component of the lending rate on a floating-rate loan. In general, a reference rate serves three important roles. First, as a reference rate is typically linked to the bank's cost of funds, it forms the basis for the pricing of loans. Second, it allows banks to vary floating lending rates to reflect changes in their funding costs that could arise from changes in central bank policies and general market funding conditions. Third, it ensures that changes in monetary policy are transmitted to borrowers and thereby influence decisions related to consumption, investment and debt.

(ii) Motivation for a new reference rate

Since its introduction in 1983, the BLR served as the main reference rate on floating-rate loans in Malaysia. In recent times, however, the BLR appeared to have become less meaningful as a basis for pricing, as retail lending rates on new loans were being offered at substantial discounts to the BLR (Chart 1). A survey of housing loan rates across major commercial banks in 2013 indicated that these loans were offered at between 2.0% and 2.5% below the BLR[1]. In addition to the cost of funds and the Statutory Reserve Requirement (SRR), the BLR also included the cost of managing liquidity risk, profit margins and operating costs (Chart 2). The inclusion of these components had made changes in the BLR less transparent. This contributed to an asymmetry in BLR adjustments to changes in the monetary policy and resulted in instances of the BLR not fully adjusting to reductions in the Overnight Policy Rate (OPR). For example, following the cumulative 150 basis points OPR reduction in 2008 and 2009, the BLR adjusted downwards by only 121 basis points. In contrast, when the OPR was subsequently increased by 100 basis points, the BLR adjusted fully. The incomplete pass-through to repayments of existing borrowers reduced the effectiveness of a key channel of monetary policy transmission to the economy. Uneven monetary policy pass-through was also observed between new and existing loans when the OPR was increased, as the competition among banks for new loans ensured that these loans were more competitively priced. The BLR also appeared less sensitive to changes in funding costs arising from factors such as market conditions that were unrelated

Chart 1

Commercial Banks: BLR and ALR on New BLR-based Loans



Source: Bank Negara Malaysia

[1] This observation of negative spread is not unique to Malaysia, and in recent years appears to be a common occurrence in countries with a base lending rate framework.

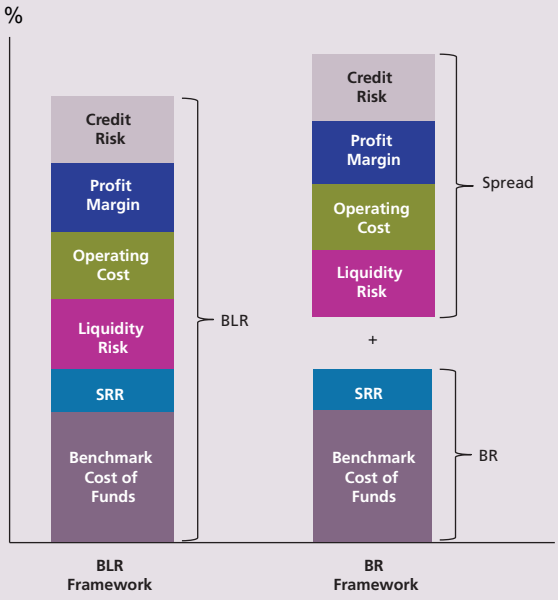
to changes in monetary policy. These shortcomings have motivated the need for a new reference rate framework that would allow banks to effectively manage interest rate risk, that is fair and transparent to borrowers, and that facilitates effective monetary policy transmission.

(iii) Key features and benefits of the Base Rate framework

The BR replaced the BLR as a basis for the pricing of new retail loans tied to a reference rate. Unlike the BLR, the BR is a cost of funds based reference rate[2]. Accordingly, the BR is determined only by the SRR and a financial institution's funding costs (Chart 2). In terms of the latter, financial institutions have been given the flexibility in choosing the appropriate benchmark money market or financial market rate to reflect the funding costs associated with making the loan. Other components of loan pricing such as borrower credit risk, liquidity risk premiums, operating costs and profit margins are reflected in the spread above the reference rate, which will remain fixed throughout the life of the loan[3].

Chart 2

Comparison of the BLR and the BR Frameworks



Source: Bank Negara Malaysia

The new BR is expected to benefit borrowers and financial institutions, while facilitating a more effective transmission of monetary policy changes to the economy. A key aspect of the BR is that it is more transparent and fair to borrowers. Unlike the BLR which allowed changes in factors other than those related to the funding costs to be reflected in the lending rate after the loan has been contracted, the lending rate of a BR-based loan will vary only in response to changes in funding costs. As the funding costs are referenced off money and financial market rates that are readily visible[4] to borrowers, there will be an increase in the transparency of changes to the BR.

[2] A cross-country survey of loan pricing practices indicates that the use of reference rates is common practice. In general, there are two types of reference rates – base lending rate and cost of funds based reference rate. Both share a strong link to the cost of funds. A base lending rate, however, allows for other elements such as the profit margin and operating costs to be included in the reference rate, while with the cost of funds framework, the reference rate comprises only the cost of funds – all other components are included in the spread on top of the reference rate.

[3] The pricing of the spread can only change if the loan is restructured due to a severe deterioration of borrower credit risk which impairs the ability to meet the repayment obligation.

[4] For example, the Kuala Lumpur Interbank Offered Rate (KLIBOR) is published in most major local newspapers, as well as on Reuters and Bloomberg.

For financial institutions, the BR enables the lending rate on existing loans to adjust to changes in market funding conditions. This would support their management of market interest rate exposures. The BR is also expected to provide financial institutions with a meaningful basis for pricing floating-rate loans, as it reflects the relevant benchmark cost of funds for making the loan. An important consequence of this is that financial institutions will not have the incentive to price loans below the BR as it will not be profitable to contract the loan below their benchmark cost of funds, while all other non-cost components are priced as a positive spread over the BR. The introduction of a new reference rate framework will also promote greater discipline in banks' pricing practices. Under the BR, all non-cost factors in loan pricing, including the risk premiums, are fixed throughout the life of the loan. As such, the new framework incentivises banks to effectively price and manage these risks.

For most financial institutions, floating-rate loans are benchmarked off a short-term money market rate. Changes in these rates in response to monetary policy adjustments have typically been symmetric, regardless of the direction of policy. Thus, unlike the BLR which did not always adjust equally to increases and reductions in the OPR, changes in the OPR will be reflected symmetrically in the BR. In addition, the BR is also likely to facilitate a more even transmission of changes in market funding conditions to both new and existing loans. This will enhance the effectiveness of monetary policy changes in influencing spending and borrowing decisions, and consequently, better influence the economy in the intended direction.

As the new framework entails a shift towards benchmarking retail lending rates against rates that are driven by market forces, the risk of transmitting financial market volatilities to the borrower during a crisis period may also increase. To mitigate this, banks can price such a risk into the liquidity spread. Additionally, under such circumstances, Bank Negara Malaysia would also conduct its monetary operations to manage volatility in domestic money markets. These mitigating factors will ensure that there will not be an excessive transfer of bank funding cost risk to borrowers during periods of high financial market stress.

(iv) Transition from the Base Lending Rate to the Base Rate

Existing floating-rate loans which were granted prior to 2 January 2015 will continue to remain priced against the BLR. To ensure that borrowers with existing BLR-based loans are not worse off than new borrowers with loans referenced to the BR, any future adjustments to the BLR shall be tied directly to the changes in the BR. As such, financial institutions are required to display both their BRs and BLRs at all branches and websites.

It is important to note that the implementation of the BR does not represent a change in the monetary policy stance. As such, the proposed changes should not affect the overall level of lending rates for retail loans in the economy[5], as the quoted BR and borrower-specific spread reflect the financial institutions' existing loan pricing practices. The shift to the new framework is to strengthen the link between retail lending rates and the reference rates that financial institutions use to manage the risk of future changes to funding costs incurred in providing the loans (Chart 3).

(v) Reference rate landscape under the Base Rate

Under the new BR, financial institutions are given the flexibility in choosing the appropriate benchmark money market or financial market rate to appropriately reflect the cost associated with making the loan. As at 2 January 2015, floating-rate loans for most financial institutions are benchmarked off the 3-month Kuala Lumpur Interbank Offered Rate (KLIBOR)[6]. Besides the KLIBOR, a few banks opted to use a composite funding cost approach as the benchmark to determine the BR. The composite funding cost

[5] Notwithstanding any changes in monetary policy and market funding conditions, new floating retail lending rates under the BR should not differ from current effective lending rates under the BLR framework, under the assumption that all risks associated with the loan are appropriately accounted for.

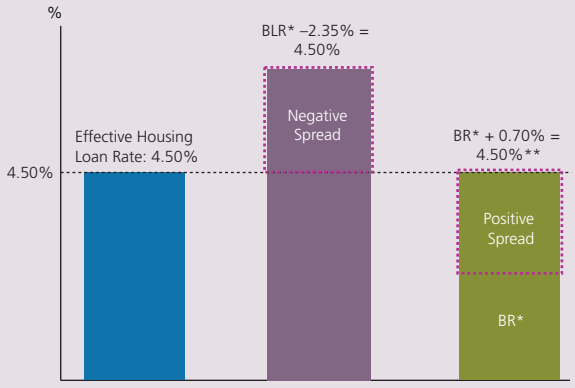
[6] The reason for choosing the KLIBOR reflects a number of factors. When presented with a lending opportunity, the 3-month KLIBOR is the marginal cost of raising new funds in the wholesale market through interbank borrowing or corporate deposits. The 3-month KLIBOR is also the standard reference for financial contracts and the settlement of hedging instruments such as the interest rate swaps and KLIBOR futures, which are used by banks to manage interest rate risks. The choice of the KLIBOR will also increase the transparency in the movements of the BR, as the KLIBOR is an observable market rate that is published on a daily basis.

reflects the average cost of raising new funds through a variety of instruments including retail deposits and wholesale funding. The difference in BR methodologies has several implications for borrowers.

First, compared to the BLRs that were relatively uniform across banks, it is likely that there would now be some divergence in BRs across financial institutions. Upon introduction, the BRs of banks ranged between 3.20% - 4.25%. At the onset, this disparity may appear to favour banks offering lower BRs as their loans could be perceived as being less costly by borrowers. Nevertheless, it is important for borrowers to compare the effective lending rate, which also includes risk premiums, operating costs and profit margins, rather than just the level of the BR alone. In this regard, a survey of the effective lending rates on housing loans across the banking system following the implementation of the BR framework suggests that the effective rates charged by various banks remain highly competitive despite the differences in the BRs. To facilitate comparison and assist borrowers in making an informed financial decision, Bank Negara Malaysia requires banks to publish the effective lending rate of a standard housing loan product[7] offered to the most credit-worthy customer.

Chart 3

Comparison of Quoted Lending Rates under the Base Lending Rate (BLR) Framework and Base Rate (BR) Framework



* For illustrative purposes, the BLR is assumed to be 6.85%, while the BR is assumed to be 3.80%.
**Effective lending rate under both the BLR framework and the BR Framework is assumed to be similar, under the assumption that all risks are appropriately accounted for.

Source: Bank Negara Malaysia

Second, two BRs derived using different methodologies can be expected to respond with varying degrees to OPR changes. While KLIBOR-based loans are likely to change almost completely, the composite funding cost approach is expected to adjust by a lesser extent due to the insensitivity of savings and current account deposits which pay minimal or no interest. This diversity in BR computation can cater to borrowers with varying needs and risk appetites. BR loans tied to the composite funding cost will provide borrowers with greater stability of repayments even when the OPR changes. On the other hand, borrowers of BR loans tied to the KLIBOR are likely to experience greater variability in repayments, but would benefit from a larger decrease in repayments should the OPR be reduced.

As the BR reflects changes in market funding conditions, it may entail more frequent changes compared to the BLR. Consequently, to reduce the volatility of the BR to small changes in market funding conditions, most banks are adopting a buffer, whereby only permanent increases or reductions in funding costs beyond a certain threshold would trigger a revision of the BR. For most banks, this threshold ranges between 5 – 10 basis points. Nevertheless, any adjustment to the stance of monetary policy will warrant an immediate review of the BR to ensure swift transmission to borrowers.

[7] A standard housing loan product is defined as a 30-year loan with a principle value of RM350,000 and without a lock-in period.

In conclusion, the new reference rate is a further step towards a more mature financial landscape in the country. Going forward, the inherent flexibility of the framework allows reference rates to evolve as borrowers become more sophisticated in choosing products that suit their individual appetite for risk. Financial institutions will be able to offer a range of products based on different reference rates to manage changes in their funding composition and strategies, as well as the different elements of risks. Bank Negara Malaysia will closely monitor the implementation of the BR mechanism to ensure that it achieves its intended objectives of increasing the transparency of loan pricing and improving the efficiency of monetary policy transmission.