1 Feature Article

Outcomes of the Reference Rate Framework: Moving Towards More Efficient and Transparent Practices

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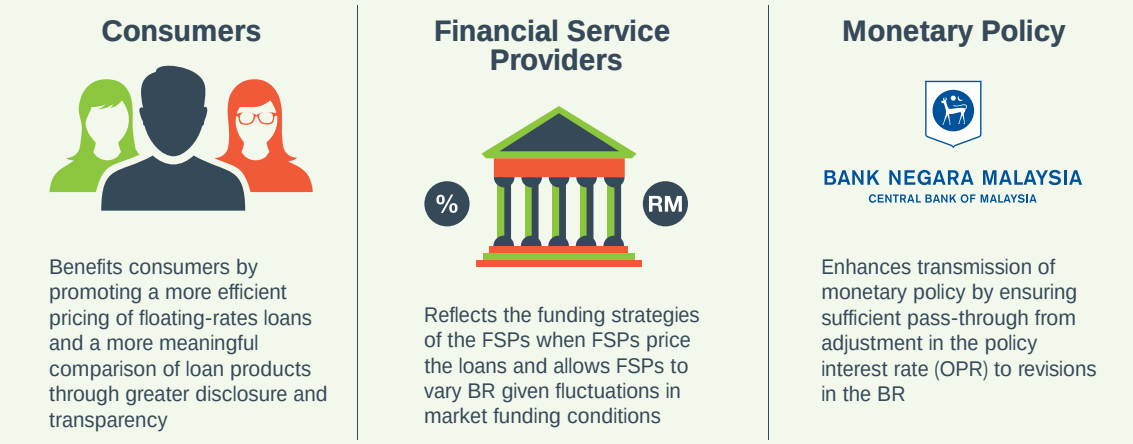
HIGHLIGHTS

- The Reference Rate Framework introduced in January 2015 replaced the Base Lending Rate with the Base Rate as the reference rate for retail floating-rate loans and financing facilities.
- Implementation of the Reference Rate Framework is driven by three outcomes:
  - benefit consumers with more efficient pricing and greater transparency;
  - reflect funding strategies of financial service providers; and
  - enhance transmission of monetary policy.
- The results observed thus far indicate that the Reference Rate Framework is on-track to achieve its intended outcomes.

Introduction

The Reference Rate Framework (RRF) was introduced in January 2015 to replace the Base Lending Rate (BLR) with the Base Rate (BR) as the main reference rate for the pricing of new retail floating-rate loans and financing facilities[1]. The RRF aims to achieve three key outcomes: to benefit consumers by providing more efficient pricing and transparency; to better reflect funding strategies of financial service providers (FSPs) while encouraging greater discipline in the pricing of retail financing products; and to effectively transmit monetary policy (Figure 1). This article discusses how the three objectives have driven the implementation of the RRF and the revisions made to the framework in August 2016. It also highlights the extent to which the intended outcomes have been achieved.

Figure 1: Three Outcomes Drive the Implementation of the Reference Rate Framework



Source: Bank Negara Malaysia

[1] Further details in the Bank Negara Malaysia Annual Report 2014 Box Article: The New Reference Rate Framework.

i) Benefits consumers with more efficient pricing and greater transparency

The BR is an important consideration for consumers when taking a floating-rate loan as changes in this rate will affect monthly loan repayments (Figure 2). Specifically, consumers need to be aware of what constitutes the benchmark cost of funds used to calculate the BR and how this can affect movements of the BR. The characteristics of the benchmark cost will determine the pass-through from changing funding conditions of FSPs to BR[2,3].

The shift to the BR regime serves to benefit consumers given the more efficient and transparent features of the framework. The components of the BR are clearly defined and determined only by the FSPs' relevant benchmark cost of funds and the Statutory Reserve Requirement (SRR). As such, the adjustment mechanism of the BR is more efficient as it only reflects movements in funding costs of FSPs that are either driven by changes to monetary policy, market conditions or SRR adjustments.

Another aspect of an efficient pricing practice is that only sustained changes in funding costs are allowed to be passed on to the BR. This requirement under the RRF serves to safeguard consumers from excessive BR fluctuations. The revision of the RRF in August 2016 further mitigates BR fluctuations by only allowing FSPs to revise their respective BRs at quarterly intervals.

Implementation of the RRF creates greater transparency to borrowers through several ways. First, FSPs are required to publish their BR, by prominently displaying the BR on their websites and at all their branches, and disclose the indicative effective lending rate for a standard housing loan[4]. These disclosure requirements are intended to facilitate a meaningful comparison by the consumers amid the varying BR offered by FSPs. Second, following the revision of the RRF in August 2016, FSPs are now required to disclose the benchmark cost of funds used to compute the BR, factors that would result in movements of the BR and to notify borrowers of a change in the benchmark cost of funds. These requirements are intended to make the movements of the BR more transparent and help consumers better anticipate movements of the BR. Third, FSPs are required to provide advance notice to borrowers prior to a change in the monthly loan repayments, to ensure that consumers are aware of the changes.

Close to three years after the implementation of the RRF, consumers are increasingly more responsive to the greater transparency of the RRF. From April 2017 to June 2017, the number of views received on the BR comparison table provided on the Bank's website[5] has increased more than three-fold compared to that in the first year after the implementation of the RRF. The transparency in the RRF has empowered consumers to make well-informed comparisons and decisions when choosing from a variety of loan products offered.

ii) More efficient and transparent practices by Financial Service Providers (FSPs)

For FSPs, the implementation of the RRF incentivises banks to efficiently manage their funding risks and pricing of floating-rate loans. The RRF ensures that FSPs compute their BR using only benchmark funding costs that reflect their funding strategies. This way, the framework ensures that only relevant costs are used in the pricing of loans and in future adjustments to the consumers' monthly loan repayments. Furthermore, as the lending rates on BR-based loans adjust to changes

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[2] For example, a more volatile benchmark cost of funds may result in larger and more frequent fluctuations in the BR and monthly instalments, while a more transparent benchmark cost would let borrowers anticipate future BR movements.

[3] The effective lending rate, which is the BR plus a fixed spread charged by FSPs, is another key consideration for consumers. The spread reflects other loan pricing components, including credit risk, liquidity risk, operational costs and profit margins of the FSPs. Therefore, the spread can be considered as a comparable measure of efficiency across FSPs, which in turn facilitates a more informed decision making by consumers.

[4] Refers to a housing loan with financing amount of RM350,000 for a tenure of 30 years with no lock-in period.

[5] A comparison table for the BR, BLR and indicative effective lending rate of 24 FSPs is published on the Bank's website: *http://www.bnm.gov.my/index.php?ch=en_announcement&pg=en_announcement&ac=19*

in market funding conditions, the RRF better facilitates FSPs' management of interest rate risk. Under the RRF, other risk premia and non-cost factors are now captured in the fixed spread above the BR. Once a loan is contracted, the spread remains fixed and can only change over the life of the loan if there are substantial changes to the creditworthiness of the borrower. This requirement encourages greater discipline in managing funding risks by FSPs when determining the pricing of their loans.

To ensure effective implementation of the RRF, FSPs are required to select the benchmark cost of funds that is most reflective of their funding strategies. Initially, when the RRF was introduced in early 2015, the 3-month Kuala Lumpur Interbank Offered Rate (KLIBOR) was a popular choice for the benchmark cost among FSPs due to its simplicity. However, towards the end of 2015, the BR began to diverge from developments in the 3-month KLIBOR. Competition for more stable sources of funding during the period had led to higher wholesale and retail cost of funds for FSPs. While market conditions began to stabilise by early 2016, deposit costs remained elevated before gradually moderating. This led to some upward revisions in the BR between January and May 2016 despite the decline in the 3-month KLIBOR. Following this temporary divergence between the 3-month KLIBOR and the BR, some FSPs began to review and adopt a new benchmark cost to better reflect funding strategies. As a result some FSPs began to compute their BR using a composite rate that comprised the 3-month KLIBOR and their internal funding costs such as deposit rates.

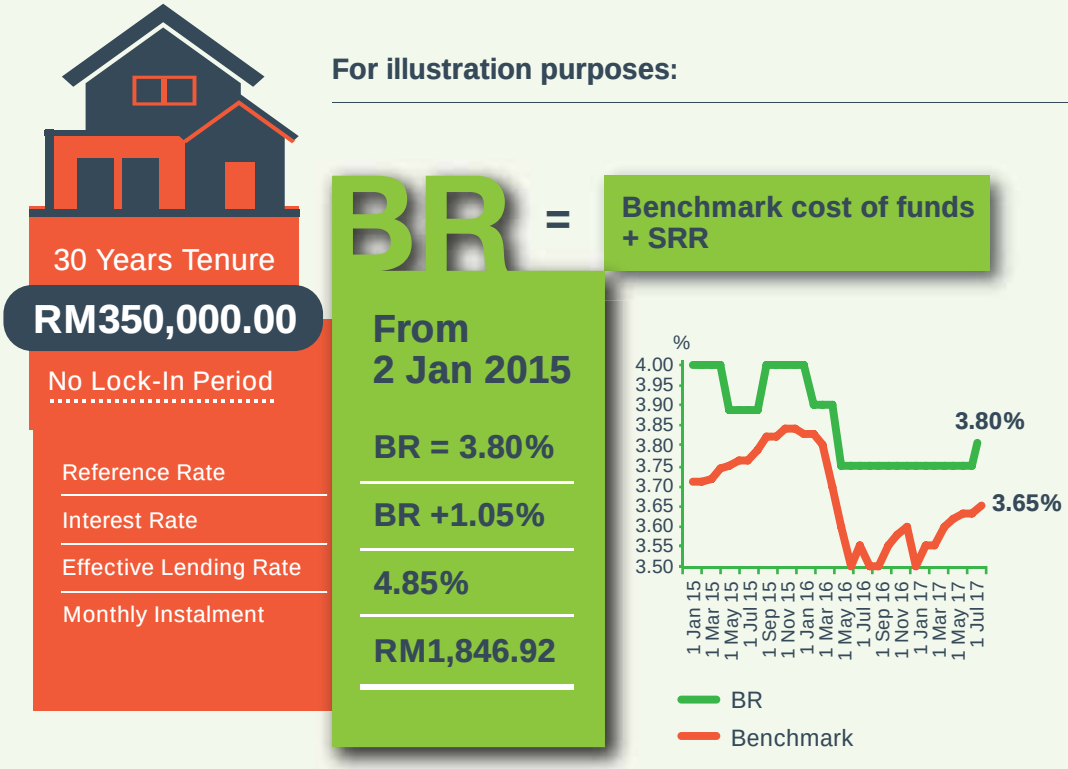
iii) Enhances monetary policy transmission

The BR is intended to vary with fluctuations in the cost of funds stemming from both changes in market funding conditions and adjustments in the OPR. The latter provides a transmission channel from OPR adjustments to lending rates on both new and existing retail loans, and consequently influence the domestic economy (Figure 3).

Following the latest OPR reduction of 25 basis points in July 2016, a higher pass-through from monetary policy to the reference rate was observed. Specifically, the weighted average BR of commercial banks declined by 21 basis points, equivalent to an 84% pass-through, within two weeks of the OPR reduction. In comparison, the pass-through to the BLR was historically lower at around 70%.

The improved transmission, with most FSPs reviewing a shift in their benchmark cost of funds from the 3-month KLIBOR towards a composite of the 3-month KLIBOR and internal funding, there was a concern that the strength of future monetary transmission might diminish over time. The choice of the benchmark cost of funds used to calculate the BR is important as it will influence the strength of the pass-through of monetary policy. A KLIBOR-based benchmark cost for example, will have a strong pass-through since the KLIBOR tends to be very responsive to changes in OPR. With FSPs increasingly referencing their internal funding costs, there was a concern that these funding sources may not necessarily be as responsive to the changes in the OPR. To address this concern, the revision of the RRF in August 2016 requires the computation of the BR to be based on the FSPs' marginal cost of funds of the benchmark cost chosen. The marginal cost of funds refers to the incremental cost that would be incurred by the FSPs to obtain new funding. This requirement would ensure that the transmission of monetary policy to lending rates remains strong. Furthermore, FSPs are also required to revise their respective BR within seven working days of the OPR change to facilitate relatively quicker monetary transmission to lending rates.

Figure 2: Considerations For Consumers When Taking a Floating-rate Loan

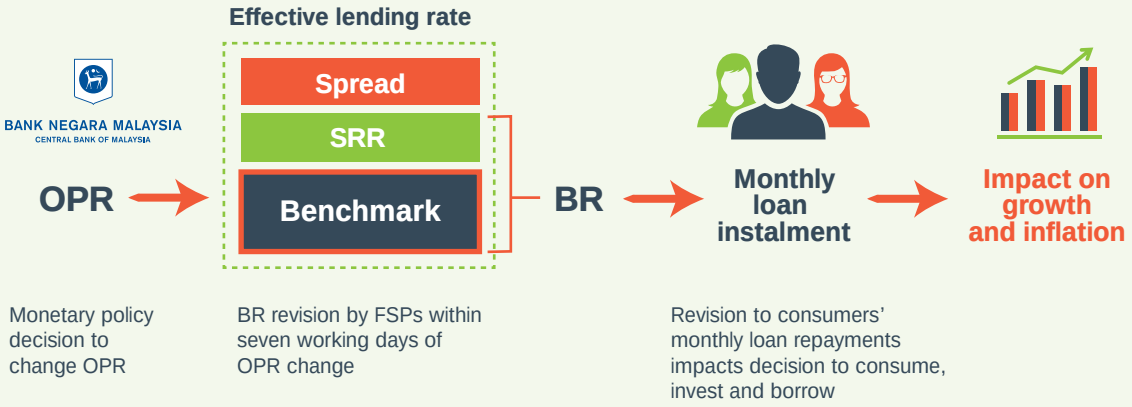


What should you do as a borrower?

1. Compare the effective lending rates quoted by different financial institutions before taking a new floating-rate loan.
2. Ask for a Product Disclosure Sheet (PDS) that constitutes the effective lending rate and total repayment amounts for the loan.
3. Ask the financial institution to explain what constitutes the benchmark cost of funds used to compute the Base Rate and the factors that may lead to a change in the benchmark cost and the Base Rate. The Base Rate should reflect the movements of the benchmark cost of funds.
4. The amount of monthly repayments will increase or decrease or the financing tenure may change when there is a change in the Base Rate.
5. Compare the different Base Rates and benchmarks offered by different financial institutions. A comparison table is provided on Bank Negara Malaysia's website. *http://www.bnm.gov.my/index.php?ch+en_announcement&pg=en_announcement&ac=19*
6. Borrowers should assess the affordability of loan repayments if the effective lending rate increases in the future.
7. Borrowers should receive notifications from the financial institution when there is a revision to the Base Rate and monthly repayments, and if the financial institution changes the definition of the benchmark cost of funds.

Source: Bank Negara Malaysia

Figure 3: Monetary Policy Transmission (OPR Pass-through to BR)



Source: Bank Negara Malaysia

With revisions made to the RRF, movements of the BR are expected to be more responsive to changes in monetary policy. The intention is to build a stronger relationship across the OPR, BR and market interest rates, which would facilitate a more complete adjustment from monetary policy to consumers and real economic activity.

Going forward, the Bank will continue to monitor closely the implementation of the RRF to ensure that the intended outcomes achieved continue to improve further, marking a step towards more efficient and transparent practices as the financial landscape develops further.