1 Feature Article

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

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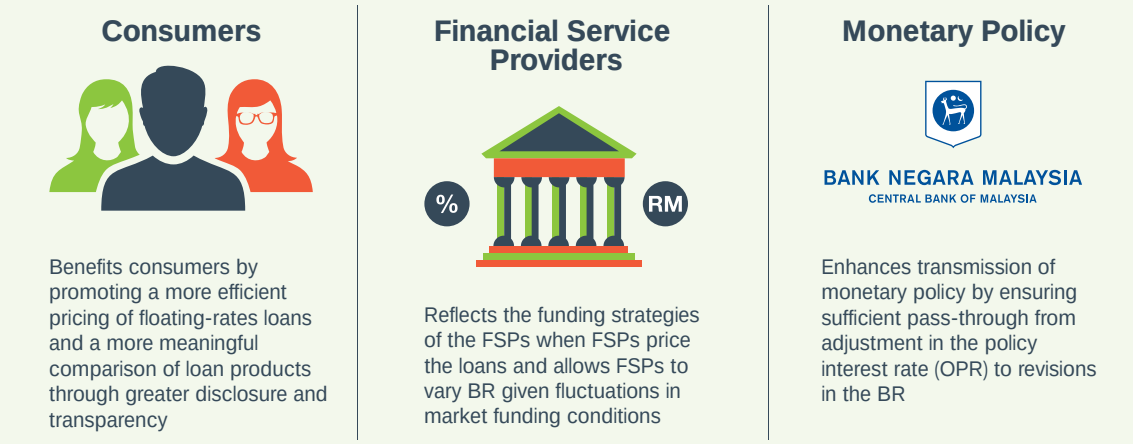
HIGHLIGHTS

- 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.

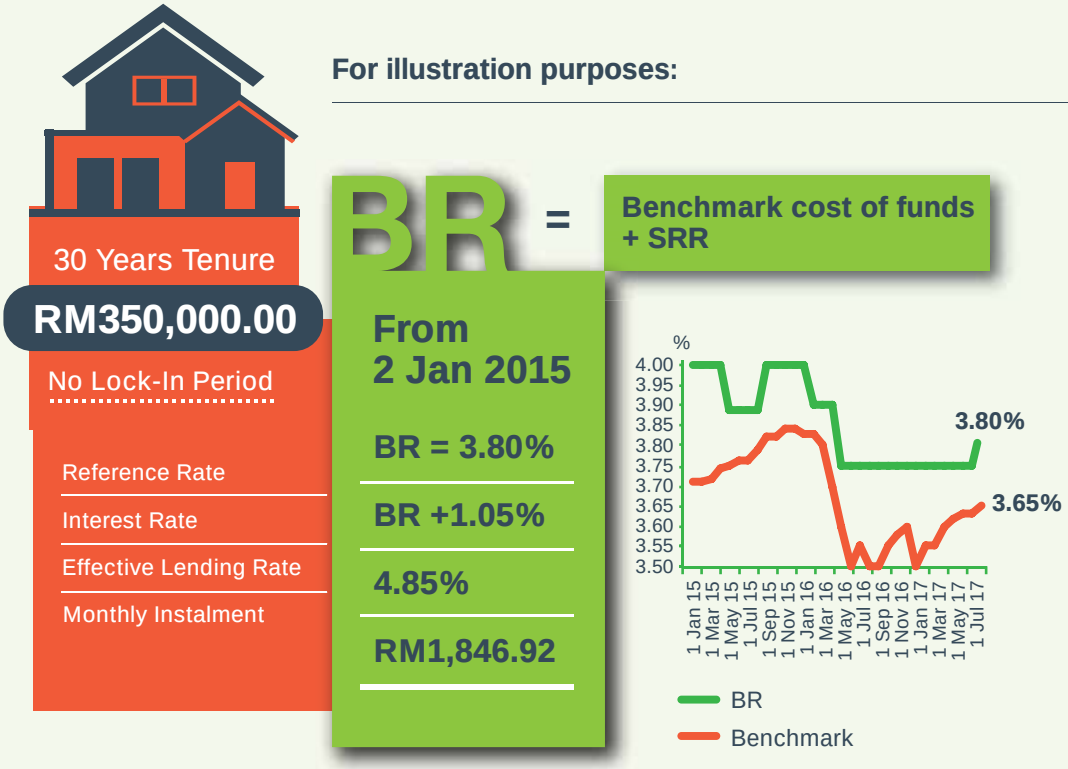
iii) Enhances monetary policy transmission

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

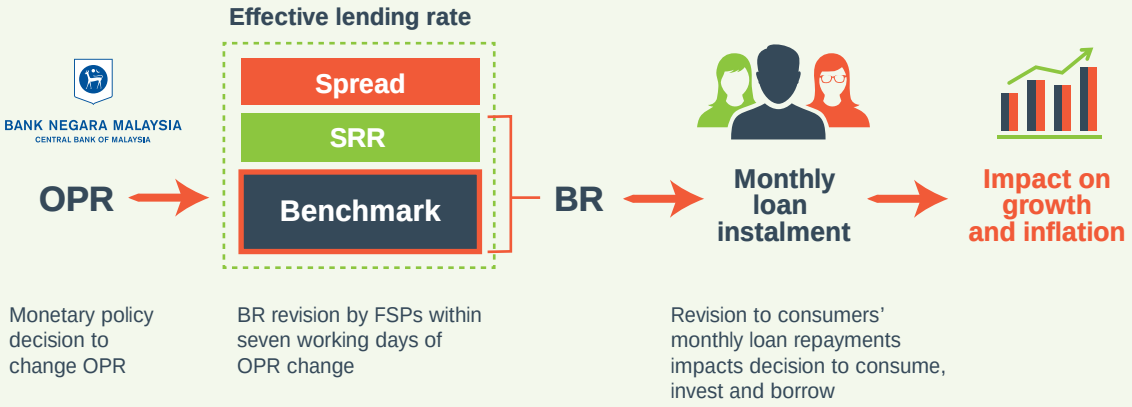


What should you do as a borrower?

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.

2 Feature Article

Liberalisation of Motor Insurance Business: Rewarding Good Risk Management

Authors: Izian Sherwani Mansor and Afiza Abdullah

HIGHLIGHTS

- **The liberalisation of motor insurance achieves more equitable pricing which reflects the underlying risks and appropriately differentiates good and bad risks.**
- **Broader rating factors will be taken into account in determining fairer premiums for consumers.**
- **Consumers will benefit from healthy competition which will lead to improvements in service quality, expanded range of products and continued access to motor insurance cover at competitive prices.**

What is motor insurance liberalisation?

Liberalisation of motor insurance means that the price, scope of coverage and terms and conditions of motor insurance products will no longer be dictated by the Motor Tariff which until 2012, was last reviewed in 1978. Under the new environment, the pricing of motor insurance products will be determined by individual insurers based on risk factors and competitive forces. Products and pricing will no longer be standardised and may vary from one insurer to another. This allows motor insurance providers to be more responsive to consumer preferences and market conditions. It also achieves more equitable pricing which better reflects the underlying risks and appropriately differentiates between good and bad risks. Consumers with good risk profiles should expect better pricing for their insurance premiums.

The liberalisation process is carried out in two phases. Phase 1 which was implemented on 1 July 2016 saw some insurers introducing new motor insurance products with non-tariff features, at market rates. Under Phase 2, which began on 1 July 2017, two existing motor insurance products covered by the tariff were liberalised. These are:

(i) products that provide coverage for third party losses and loss or damage to an insured's own vehicle due to fire or theft only; and

(ii) products that provide comprehensive coverage, comprising coverage as per (i) above as well as damage to an insured's own vehicle from any accident.

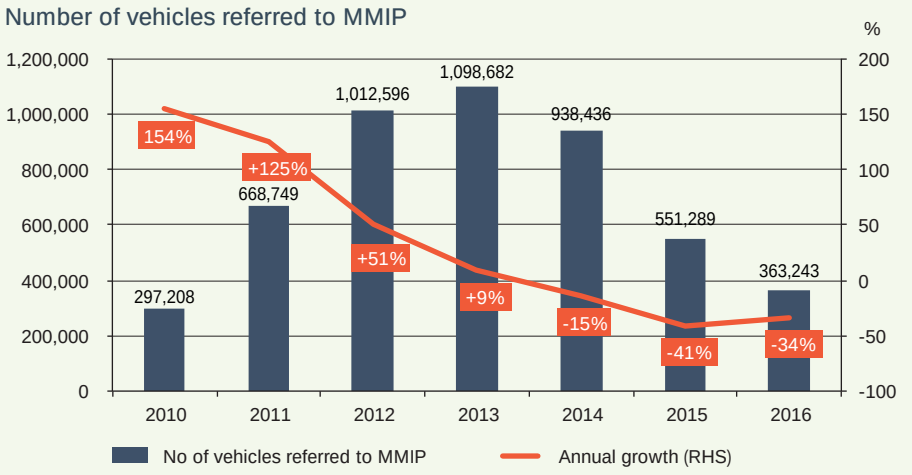
Compulsory third party insurance required under the Road Transport Act will remain controlled under the tariff. This aims to ensure continued affordable access to compulsory motor insurance during the transition and facilitate gradual and orderly market adjustments. Further liberalisation will be subject to a review by Bank Negara Malaysia in 2019 to assess the readiness of the market to support subsequent phases of liberalisation.

Addressing pricing inequity and incentive problems under a tariff environment

Under the tariff arrangement, significant cross-subsidies exist between risk segments resulting in some policyholders paying more premiums than they should, compared to relatively riskier drivers and vehicles. Beyond a certain point, broad-based adjustments to tariff rates which increase the extent of cross subsidies would lead to sub-optimal outcomes. Insurance would become economically inefficient for good risks, resulting in adverse selection and reduced capacity for motor insurance among insurance providers.

Evidence of this was observed in 2012 when over a million private vehicles had to turn to the Malaysian Motor Insurance Pool (MMIP) to obtain motor insurance cover following actions by several insurers to decline motor (especially third party) risks due to prolonged and sustained losses. Risks in the pool were subjected to significant premium increases at the time. Underwriting conditions subsequently eased with gradual tariff premium adjustments introduced under the New Motor Cover Framework in 2012. The adjustments fully anticipated an eventual transition to a more sustainable, market-based pricing environment in order to reduce the distortions mentioned earlier.

Chart 1: The Small Premium Adjustments had Partially Resulted in Some Insurers Accepting Motor Risks Previously Declined Due to Misaligned Pricing



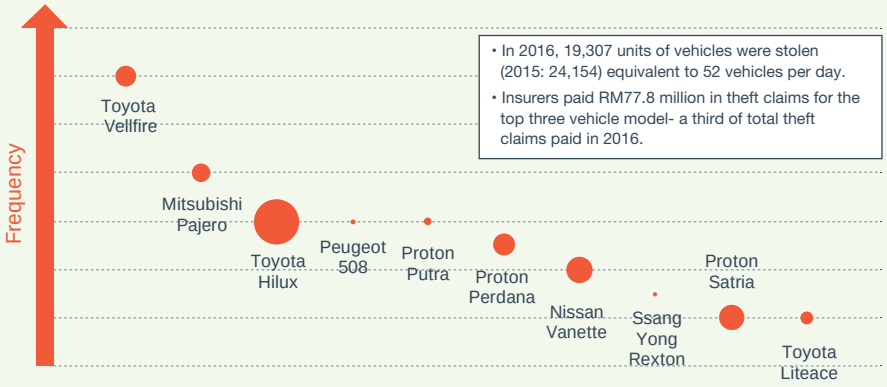
Source: Malaysian Motor Insurance Pool (MMIP)

Between 2011 and 2016, the insurance industry also paid out more than RM2.8 billion in claims for losses from vehicle theft. Despite a disproportionately higher incidence of theft observed for specific vehicle models, insurers were unable to differentiate pricing accordingly under a tariff environment and this led to increased pressure on overall premiums.

These developments illustrate the problems associated with a tariff system in which weak incentives exist for vehicle owners, manufacturers and drivers to manage risks. This in turn leads to higher premiums over time which are not properly attributed to and borne by those risks that contribute most to losses. The lack of competition between insurers also weakens the functioning of market mechanisms that allow optimal prices to emerge, and impedes innovation and service quality improvements which ultimately benefit consumers.

Chart 2: Higher Incidence of Theft is Observed for Specific Vehicle Models in Malaysia

Top 10 frequently stolen vehicles in 2016



Note:
1. The size of the bubble represents the number of theft count for each vehicle model
2. Frequency is calculated by dividing the number of theft count by total policy count

Source: Vehicle Theft Reduction Council

How premiums are calculated and early observations of premium trends in the liberalised environment

Insurance is based on a pooling concept where similar risks are pooled together. In a liberalised environment, similar risks can be grouped together in more granular pools, thus allowing prices to more accurately reflect the risks presented.

More factors will also be taken into account in determining premiums. Under the tariff, premiums were largely driven by sum insured, cubic capacity of the vehicle engine, age of driver and age of vehicle. While these factors remain relevant in the liberalised environment, premiums may also be further differentiated based on other additional factors such as vehicle make and model, security features in the vehicle, driving experience and behaviour, duration the vehicle is on the road, location of a vehicle when not in use and record of traffic offences. The factors that drive pricing will vary between insurers.

Based on pricing models of 11 out of 26 insurers sampled by Bank Negara Malaysia as at end July 2017:

- Both premium increases and decreases within a range of +/-10% were observed across all risk pools. This suggests insurers are appropriately differentiating between lower and higher risks consistent with more equitable pricing.
- A reasonable dispersion of premium adjustments that were less than +10% was observed, suggestive of more refined pricing models by some insurers.
- Premiums generally decline with age, reflecting higher risks associated with younger and less experienced drivers, in particular below the age of 25 years. Some policyholders within the age band of 40 and 50 years old may experience marginally higher premiums, which is partly attributed to the use of their vehicles by young adult children of driving age.
- Downward adjustments in premiums were more prevalent for newer cars compared to older cars.
- No significant differences were observed across vehicle makes and models which may indicate a more cautious approach taken by insurers before fully reflecting risk factors in price adjustments. In the initial phase of liberalisation, this is likely to tamper the effects of premium adjustments across risk groups. An exception, however, was observed for high theft-prone vehicles which are likely to attract higher premiums.
- Higher premiums were observed for vehicles in West Malaysia than those in Sabah and Sarawak. This is mainly due to differences in risk levels and risk exposure arising from traffic density and road conditions.

These observations do not take into account more specific individual risk factors that insurers may apply in calculating premiums for individual policies. An insurer can apply such additional factors (for example, how often a vehicle is used or security features installed by a vehicle owner) to adjust premiums either higher or lower than that indicated by their pricing models.

Consumers should therefore make comparisons of products in terms of features, premium rates and scope of protection, to select the product that best suits their needs. Consumers should also be mindful that price should not be the only determining factor when purchasing coverage. Insurers' customer service standards and claims handling are other important considerations in deciding which product to buy and which insurer to buy from.

More choice and control for consumers

With liberalisation, a wider range of product options is being offered by insurers to suit different needs. Telematics insurance is one such product. It takes into account the extent of use of vehicles and driving behaviour in determining premiums, where drivers can enjoy premium discounts for vehicles that are used less often or if safer driving behaviour is observed.

With greater flexibility in product design, policyholders can also choose different levels of coverage for the perils that best suit their risk exposure instead of standardised perils under the tariff, thus having more control over the extent of coverage and hence, premiums that they will ultimately pay. Consumers can also take practical measures to influence the premiums that they pay, for example parking in secure facilities when not in use, installing anti-theft devices or considering vehicle specifications that can reduce insurance risk when buying a car.

As insurers will offer different product options and flexibilities, it is important that consumers shop around. Information on motor insurance and takaful providers, product options, and convenient on-line channels to obtain premium quotations from insurers is available through the 'product selector' provided at Persatuan Insurans Am Malaysia's (PIAM) and Malaysian Takaful Association's (MTA) websites. Alternatively, consumers can go to the websites of individual insurers directly, or through Bank Negara Malaysia's website, for information and quotes.