Box Article

Standardised Base Rate

Introduction

As announced by Bank Negara Malaysia (BNM) on 11 August 2021, the Standardised Base Rate (SBR) replaced the Base Rate (BR) as the main reference rate for new retail floating-rate loans and financing facilities with effect from 1 August 2022. For the purpose of this box article, 'loans' include Shariah-compliant financing facilities. Prior to this, banks adopted different methodologies to set their respective BRs. The SBR will serve as the common reference rate for all banks and is linked solely to BNM's Overnight Policy Rate (OPR). This article discusses the background and motivation behind the introduction of the SBR, the key features and benefits of the SBR, the transition from the BR to the SBR, and the way forward.

A) Background and motivation behind the introduction of the Standardised Base Rate

Reference rates are publicly accessible interest rates used by banks as a basis for the pricing of loans. This is particularly relevant for floating-rate loans, as changes in the reference rates lead to changes in the lending rates over the tenure of the loans. The way in which reference rates are determined and used, therefore, have implications on consumers' repayments of their loans, banks' practices in the pricing of loans and the effectiveness of monetary policy transmission.

The Reference Rate Framework was introduced in January 2015. It introduced the BR, which replaced the Base Lending Rate (BLR) as the reference rate for retail floating-rate loans in Malaysia.[1] The introduction of this framework served to improve transparency and discipline in the pricing of retail loans, while enhancing the transmission of monetary policy. Unlike the BLR, which could change due to factors such as banks' operating costs and profit margins, the BR would vary only in response to changes in banks' funding costs. The framework allowed banks to adopt bank-specific BR methodologies that were reflective of their funding strategies, while encouraging greater discipline in banks' pricing practices as banks could not change the lending rates during the tenure of a loan except where there were changes in the credit risk of the borrower or funding costs of the bank (and not for example, to recoup additional operating costs). Over time, banks' BR methodologies became increasingly complex. Initially, the 3-month Kuala Lumpur Interbank Offered Rate (KLIBOR), which was a market-determined external benchmark, was a popular choice for the benchmark rate among banks due to its simplicity. It was also easily comparable across banks. Since then, advancements in banks' BR methodologies had led to the wider adoption of internal benchmarks that were individually determined by the respective banks. This included BRs that were based on a composite of the 3-month KLIBOR and internal funding components, or solely based on banks' internally-determined benchmarks. These developments were also reflective of broader types of funding instruments used by banks to fund loans. The evolution of BR methodologies in turn had reduced the transparency and comparability of BRs across different banks, making it more difficult for consumers to compare the retail loan products and understand the reasons behind changes in their loan repayments. In addition, the variability of BR methodologies across banks also had the effect of dampening monetary policy transmission, due to uneven responses by banks to changes in the OPR.

[1] For more information, please refer to the box article titled 'The New Reference Rate Framework' in the BNM Annual Report 2014, as well as the box article titled 'Outcomes of the Reference Rate Framework: Moving Towards More Efficient and Transparent Practices' in the Quarterly Bulletin on Economic and Financial Developments in the Malaysian Economy in the Second Quarter of 2017.

As part of BNM's periodic review of its policies, further revisions, which came into effect on 1 August 2022, were therefore made to the Reference Rate Framework to ensure that the requirements remain relevant and fit-for-purpose in achieving its intended outcomes, which are to-

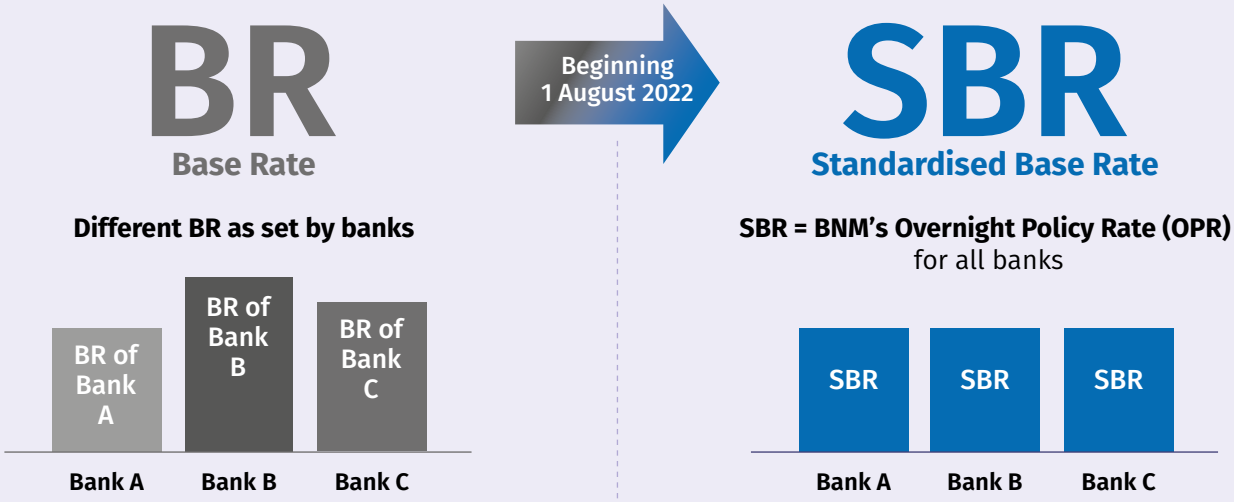
a) promote a transparent reference rate that facilitates meaningful comparisons of loans across banks to allow consumers to make informed decisions;
b) reinforce sound practices in the pricing of retail floating-rate loans by banks; and
c) preserve the effective transmission of monetary policy decisions.

These revisions are encapsulated in the introduction of the SBR to replace the BR for all banks.

B) Key features and benefits of the Standardised Base Rate

The main feature of the SBR is in its standardisation as the common reference rate for all banks. Unlike the BR, which differs for each bank, the SBR is the same across banks.[2]

C1 What is new in the revised Reference Rate Framework?



Another key aspect of the SBR is that it is linked solely to the OPR. This is a further simplification compared to the BR, which was previously determined by both the banks' individual benchmark cost of funds, as well as the cost of holding non-interest bearing statutory reserves with BNM.[3] All other components of loan pricing, such as borrowers' credit risk, liquidity risk premiums, Statutory Reserve Requirement (SRR) cost, operating costs and profit margins, are reflected in the spread above the SBR, which will remain fixed throughout the life of the loan, except in cases where there is a change in the credit risk profiles of borrowers (Chart 2).[4]

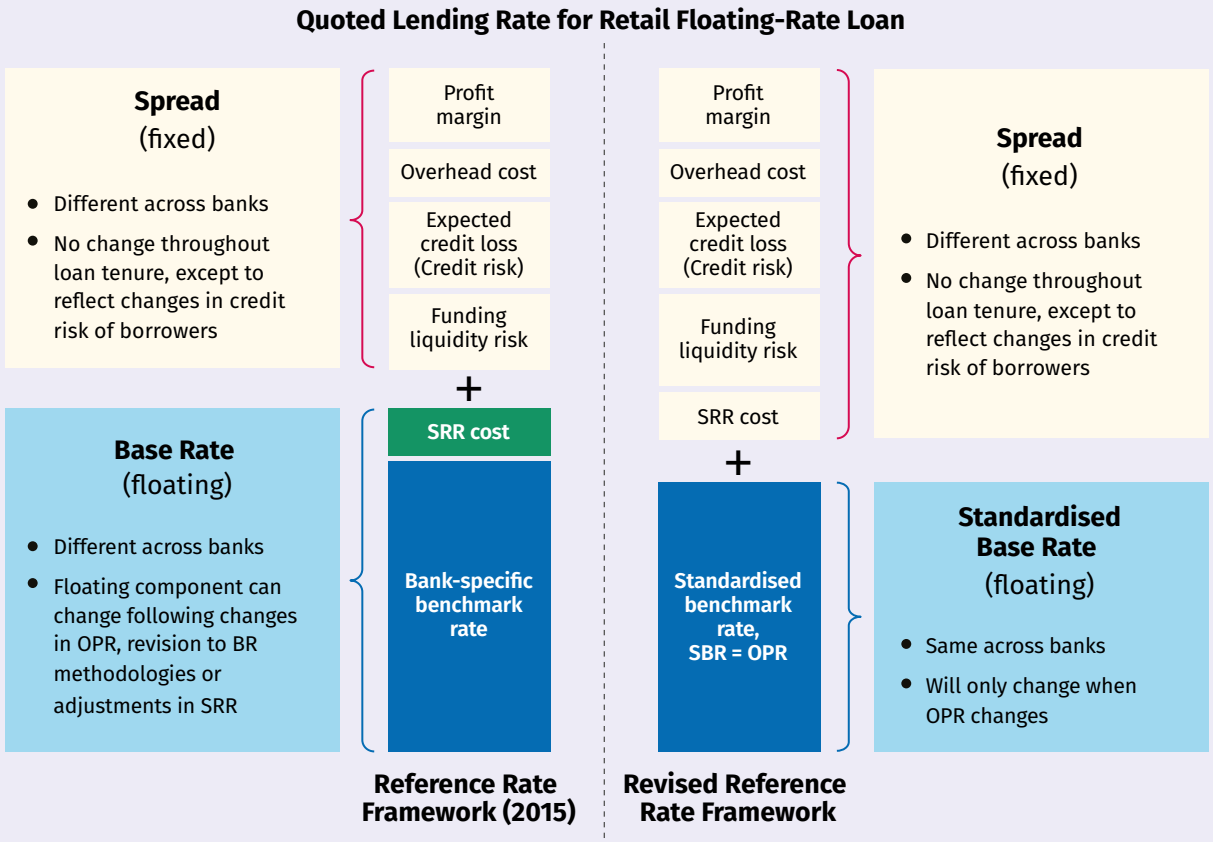
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[2] For more details on the revised Reference Rate Framework guidelines, please refer to the Reference Rate Framework policy document published on 11 August 2021.

[3] Statutory reserves are held by all banks pursuant to the Statutory Reserve Requirement (SRR) set by BNM. The SRR cost component has been excluded from the SBR for simplicity and ease of understanding for consumers. The exclusion also avoids the complexities and additional compliance costs for banks that are associated with operationalising the changes to the SBR arising from changes in the SRR. In addition, this was in consideration of the relatively small quantum of the change in the SRR cost component compared to changes in banks' overall cost of funds. The SRR component is incorporated in the overall pricing of the loans, as part of the spread that is fixed over the SBR.

[4] The pricing of the spread can only be adjusted to reflect changes in the credit risk profile of the customer throughout the tenure of the loan, and cannot be increased to reflect changes in banks' operating costs, funding management strategies or the overall portfolio default experience. Such repricing or revision to the lending rates would be subject to BNM's Responsible Financing policy document issued in 2019, as well as the Credit Risk policy document issued in 2019. The guidelines protect customers' interest by ensuring that lending rates would not be repriced in cases of one or two missed repayments, unless such missed repayment has resulted in a change in the credit risk profile or creditworthiness of the customer. The quantum of repricing should also be reasonable, such that it is not excessive and does not exceed the reasonable estimated costs incurred by the banks in connection with the defaulted financing facility.

C2 Comparison of the Reference Rate Framework (2015) and the Revised Reference Rate Framework

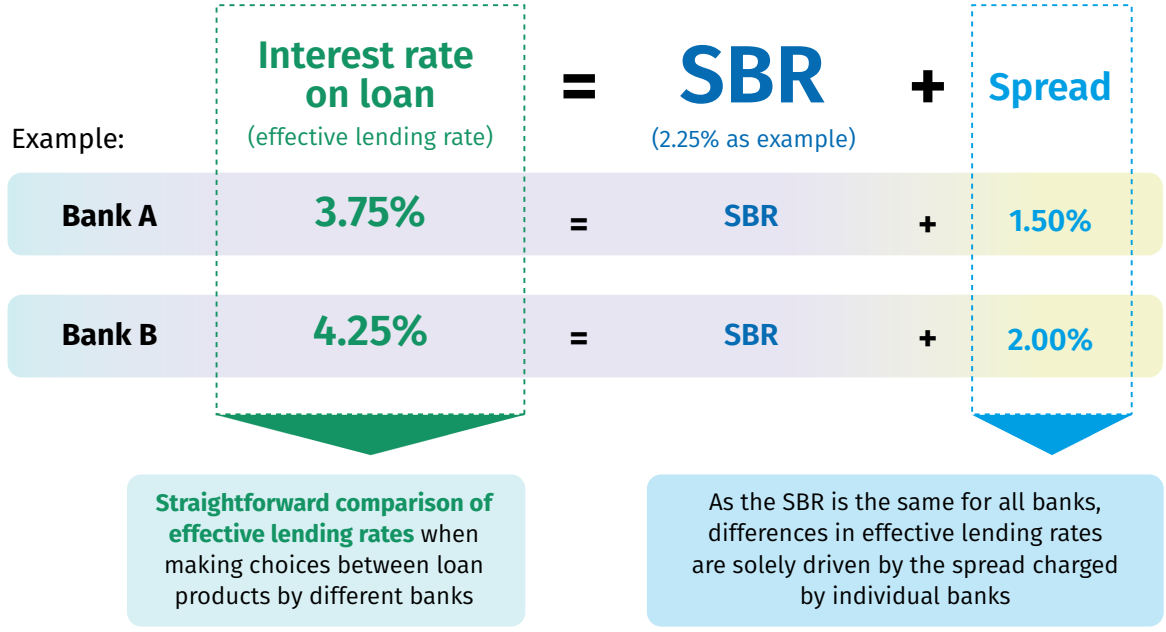


With this revision, changes to the SBR would therefore only occur following changes in the OPR, which is determined by the Monetary Policy Committee (MPC) of BNM. The OPR was selected as the benchmark rate as it is best suited in achieving the intended outcomes of the Reference Rate Framework. The OPR is simple and transparent to consumers. Compared to other external benchmark rates such as KLIBOR, the OPR as the benchmark rate would also ensure greater robustness, integrity and resilience of the benchmark during both normal and stressed market conditions.

The standardisation of the reference rate will make it easier for consumers to compare floating-rate loan products across banks by focusing on the spread above the SBR. It also helps consumers better understand the factors causing changes in their loan repayments during the life of a loan. This is important given the relatively high refinancing costs including legal costs, which increase barriers for borrowers to refinance their existing loans. The SBR therefore will also contribute towards preserving a competitive retail loan market by encouraging more informed borrowing decisions by consumers.

The SBR applies to retail floating-rate loan applications from 1 August 2022. This includes new loans, refinancing of existing loans, and renewal of existing revolving facilities after 31 July 2022. For consumers, this would be applicable to floating-rate loans, such as housing loans and personal loans. Given that the main feature of the SBR is in its standardisation of reference rate, consumers can more easily compare the all-in, effective lending rate across banks, which captures the different spread charged by individual banks.[5]

C3 How should you compare lending rates across banks?



Consumers may also find more information to help with their borrowing decisions from the Consumer Guide on the Revised Reference Rate Framework, which is available on the BNM website*.

* https://www.bnm.gov.my/documents/20124/938039/Consumer+Guide_RRF_EN.pdf

The introduction of the SBR itself would have no impact on the effective lending rates of existing retail loans at the point of transition. Existing BR- and BLR-based loans which were granted prior to 1 August 2022 will continue to remain priced against the BR and BLR until the maturity of these loans.[6] With the revised Reference Rate Framework, changes to the reference rate for existing loans earlier priced against the BR and BLR would also move exclusively in tandem with the OPR, changing by the same quantum as changes in the OPR. Changes in borrowers' loan repayments would therefore be more predictable and transparent to borrowers, as future movements in the loan repayment amounts for borrowers who service their loans on time will only happen due to changes in the OPR.[7] Previously, changes in the BR and BLR could vary due to individual bank-specific factors, which were not completely visible to borrowers.

[5] The effective lending rate refers to the all-in annual interest rate charged on the outstanding loan amount. Differences in the effective lending rates would affect the monthly loan repayment amount.

[6] Banks will continue to display their BRs and BLRs, in addition to the SBR, at all branches and websites after the effective date, for customers' reference.

[7] With the revised Reference Rate Framework, beyond OPR movements, changes in borrowers' loan repayment amount after the initiation of loans would only occur following changes in the credit risk profiles of borrowers. The potential for lending rates on existing loans to be repriced to reflect changes in the credit risk profiles of borrowers is similar to the practice under the previous regimes.

The revised Reference Rate Framework also reinforces sound pricing practices by banks. While the reference rate will be standardised, banks will retain the flexibility to determine the lending rates on new loans based on various factors, including a borrower's credit risk, liquidity risk premiums, operating costs, profit margin and other costs, which would continue to be reflected in the spread above the SBR. As the spread remains generally fixed throughout the lifetime of a loan, the revised framework further strengthens incentives for banks to appropriately price and manage these risks and costs. Improved comparability in the spread above the SBR between banks would also drive greater efficiency in banks, ultimately benefitting consumers. Existing regulations, such as the Risk-Informed Pricing standards issued by BNM would also mitigate against the competitive underpricing of risks that may impact financial stability.

As movements in the SBR, BR and BLR will exactly mirror changes in the OPR, the revised Reference Rate Framework further facilitates an effective and even transmission of monetary policy, given the more direct and equivalent pass-through of OPR adjustments to retail interest rates. Accordingly, changes in lending rates for retail floating-rate loans would better reflect changes in OPR, both in cases of OPR increases and reductions. The enhanced transmission of monetary policy following the revised framework is crucial, as the financing of the economy remains predominantly bank-based even as market-based financing has been increasing over the years,[8] and the majority of banking system financing consists of floating-rate loans.[9]

C) The way forward

Going forward, BNM will continue to closely monitor the implementation of the revised Reference Rate Framework to ensure that it achieves its intended outcomes. At the same time, efforts will continue to further develop a more mature loan market, supported by appropriate market infrastructure and increased financial literacy among consumers.

Some of the desirable features of such a market include the availability of a broader range of loan products, including hybrid loans[10] or convertible loans[11] that can better cater to the different needs of consumers. This would entail a more needs-based and personalised approach for consumers, underpinned by minimal regulatory friction and costs, greater transparency, and healthy market competition. The further development of market infrastructure, including more active securitisation and derivatives markets, would also provide a more conducive environment for banks to enhance their risk management and offer differentiated loan products. Measures to reduce the refinancing and legal costs of loans, alongside ongoing initiatives to increase the financial capability of consumers are equally important to improve the dynamism of the loan market.

Given continued developments in the loan market, the Reference Rate Framework will continue to be periodically reviewed to ensure that the framework remains effective in supporting financial intermediation activities.

References:

Bank Negara Malaysia. 2021. "Reference Rate Framework" Bank Negara Malaysia's 11 August 2021 Policy Document.

Bank Negara Malaysia. 2021. "Consumer Guide on the Revised Reference Rate Framework" https://www.bnm.gov.my/documents/20124/938039/Consumer+Guide_RRF_EN.pdf

Bank Negara Malaysia. 2017. Box Article on "Outcomes of the Reference Rate Framework: Moving Towards More Efficient and Transparent Practices" Bank Negara Malaysia's 2Q 2017 Quarterly Bulletin on Economic and Financial Developments in the Malaysian Economy.

Bank Negara Malaysia. 2015. Box Article on "The New Reference Rate Framework." Bank Negara Malaysia's 2014 Annual Report.

[8] Private sector financing by the banking system and in the corporate bond market accounted for 72% and 28% of total net financing, respectively, as at end-2021 (2010: 77% and 23%, respectively).

[9] Around 78% of total banking system loans are floating-rate loans, as at May 2022.

[10] A typical feature of this type of loan involves the pricing of the loan against a fixed interest rate during the initial periods, which then changes into floating-rate pricing at the later periods.

[11] A form of a hybrid loan where borrowers hold the option to convert from fixed to floating-rate pricing during the tenure of the loan.