BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

Concept Paper

New Reference Rate Framework

Issued on: 16 January 2014

BNM/RH/CP 008-13	Consumer and Market Conduct Department	Concept Paper on New Reference Rate Framework

Issued on: 16 January 2014

PART A OVERVIEW

1. BACKGROUND

1.1 Reference rates are employed in loan and financing contracts to reflect and manage the risk of future changes in the funding costs of financial institutions. The pass-through of changes in funding costs from the money market to retail lending rates constitutes a key part of monetary policy transmission, especially in countries like Malaysia, where financial institutions play a major role in providing financing to households and businesses. A reference rate also serves to capture the transmission of changes in monetary policy to financing costs which in turn affects spending in the economy. The way in which reference rates are determined and used is therefore relevant in supporting effective monetary policy transmission and efficient financial intermediation.

1.2 The base lending rate (BLR) framework was introduced in 1983. Over time, financial service providers (FSPs) have been given greater flexibility to set their own BLR based on cost structures and business strategies and to determine their own lending rates for all credit facilities and loan products based on internal and commercial considerations. The prescribed limit on the maximum spread of 2.5 percentage points above the BLR was also correspondingly removed in 2004.

1.3 With the liberalisation of interest rates, retail lending rates in the financial system have been observed to move in tandem with the costs of lending and the risks assumed by FSPs. However, while the BLRs have moved in response to changes in Bank Negara Malaysia's (the Bank) Overnight Policy Rate (OPR), retail lending rates have typically adjusted by less. This suggests that the link between the BLR and retail lending rates has weakened. In addition, the increasing level of competition in the retail segment in an environment of excess liquidity has spurred the offering of retail loans at a substantial discount to the BLR over the past few years. This has also resulted in an uneven transmission of changes in monetary policy to the cost of financing observed between existing and new borrowers. The observation that most financial institutions have similar levels of BLR further suggests the lack of sensitivity in the BLRs to changes in the cost of funds for FSPs. These developments indicate that BLR has become less relevant as a meaningful reference rate in the pricing of retail financing products. The lack of transparency and comparability in how BLRs are set by FSPs has also increased the challenges of assessing and communicating the effectiveness of monetary policy transmission to retail lending rates.

2. OBJECTIVE

2.1 This policy document outlines a proposed new reference rate framework which aims to:

(a) Enhance the efficiency of monetary policy transmission to retail lending rates;

(b) Ensure a reference rate that is relevant and consistent with prudent pricing of retail financing products; and

(c) Promote a transparent reference rate that allows meaningful comparison for informed decision making by consumers.

2.2 The policy document sets out requirements that FSPs must comply with in relation to the pricing of retail financing facilities against a reference rate.

3. APPLICABILITY AND SCOPE

3.1 This policy document is applicable to FSPs as defined in paragraph 6.2.

3.2 This policy document is applicable to all loan/financing facilities, including Shariah-compliant financing, priced against the reference rate as defined in this document.

4. LEGAL PROVISIONS

4.1 The requirements in this policy document are specified pursuant to:

(i) sections 47(1) and 123(1) of the Financial Services Act 2013(FSA);

(ii) sections 57(1) and 135(1) of the Islamic Financial Services Act 2013 (IFSA); and

(iii) sections 41 and 126 of the Development Financial Institutions Act 2002 (DFIA).

5. EFFECTIVE DATE

5.1 FSPs shall fully comply with the requirements of this policy document on a date to be specified, which will include a transition period of at least six months from the issuance date of this document.

6. INTERPRETATION

6.1 The terms and expressions used in this policy document shall have the same meanings assigned to them in the FSA and IFSA, as the case may be, unless otherwise defined in this policy document.

6.2 For the purpose of this policy document:-

"S" denotes a standard, requirement or specification that must be complied with. Failure to comply may result in one or more enforcement actions;

"G" denotes guidance which may consist of such information, advice or recommendation intended to promote common understanding and sound industry practices which are encouraged to be adopted; and

"Base lending rate" includes Base Financing Rate (BFR) in the context of Islamic financing products;

"Deposit rate" includes profit rate paid on Islamic deposit products;

"Financial service provider" or **"FSP"** means -

(a) a licensed bank under the FSA;

(b) a licensed Islamic bank under the IFSA; and

(c) a prescribed institution under the DFIA.

"Retail lending rates" refer to both lending rates for conventional loan products and financing rates for Islamic financing products.

7. GUIDELINES SUPERSEDED

7.1 With the coming into effect of this policy document, the Guidelines on Reference Rates, Lending Rates and Deposit Rates of Banking Institutions are superseded.

PART B POLICY REQUIREMENTS

8. REFERENCE RATE AND FINANCING RATES

S 8.1 With effect from the effective date, FSPs shall replace the BLR with the Prime Financing Rate (PFR) for the pricing of new retail loans/financing tied to a reference rate.

S 8.2 The PFR shall be determined by the FSP's benchmark cost of funds and statutory reserve requirement (SRR). The benchmark cost of funds shall reflect the FSP's specific funding structures and strategies.

S 8.3 The basis for determining the benchmark cost of funds shall be documented and made available for the Bank's supervisory review as and when required.

S 8.4 Other components of pricing such as administrative or operating costs, credit risk premium, liquidity risk premium and profit margin shall be excluded from the computation of the PFR.

G 8.5 The use of benchmark cost of funds for pricing retail financing products would ensure a more effective monetary policy transmission from OPR adjustments to retail lending rates on retail financing contracts. The PFR reflects the cost of managing interest rate risk and liquidity that is directly influenced by monetary policy changes, market funding conditions and regulatory changes.

S 8.6 Where the pricing for a retail financing product is tied to the PFR, the lending rates charged to the borrower shall be the PFR plus a spread. FSPs shall observe the requirements in the policy document on Risk-Informed Pricing in determining the retail lending rates levied on borrowers.

S 8.7 The PFR only applies to new retail loan/financing facilities offered from the effective date and for the refinancing of existing credit facilities. Floating rate loan/financing facilities granted prior to the effective date shall continue to remain priced against the BLR**.** In addition to disclosing the PFR, FSPs shall continue to display their BLRs at all branches and websites.

S 8.8 Under this reference rate framework, FSPs shall not offer any retail loan/financing facilities at a rate below the FSP's quoted PFR.

S 8.9 From the effective date, any changes made to the PFR shall result in a corresponding adjustment to all new and outstanding loan/financing facilities priced against the PFR.

S 8.10 Once a loan/financing is contracted, any revision to the spread above the PFR during the tenure of financing shall only be made to reflect changes in the credit risk profile or creditworthiness of the borrower. FSPs shall not increase the spread on outstanding loan/financing contracts to reflect changes in operating costs, funding management strategies, or portfolio default experience. Further, FSPs shall not increase the spread to gain a higher profit margin during the financing tenure.

S 8.11 FSPs shall review the PFR periodically or when market conditions require a review and make appropriate adjustments with the approval of the Board or the Asset Liability Management Committee. FSPs are allowed to adjust the PFR to reflect changes to the benchmark cost of funds due to changes in market funding conditions and the SRR.

S 8.12 When FSPs adjust the PFR, the FSPs shall make a corresponding adjustment to the BLR to reflect changes in the FSPs' cost of funds. This is to ensure that changes in monetary policy are effectively transmitted to the retail lending rates of both outstanding loan/financing contracts tied to the BLR as well as new retail loan/financing priced against the PFR.

S 8.13 For any upward or downward revision to the PFR and the BLR, FSPs shall adjust the monthly instalments of loan/financing priced against the PFR or the BLR. PFR or BLR changes shall not generally alter the contracted financing tenure. FSPs shall provide the borrowers with particulars of the revised monthly instalment amount at least <u>seven</u> calendar days prior to the effective date of the revision.

G 8.14 The requirement in paragraph 8.13 does not apply to restructured/ rescheduled loans for borrowers in financial difficulty or upon request by the borrower to retain the monthly instalment when the PFR or the BLR is revised downwards. FSPs may lengthen the financing tenure for borrowers who are unable to meet higher monthly instalments as part of a debt restructuring/rescheduling exercise. In such an event, FSPs should communicate clearly to the borrowers on the implications of restructuring/rescheduling their loans including among others, any new terms and additional interest/profit charges.

G 8.15 For the pricing of corporate loans, FSPs continue to have the flexibility to determine the choice of reference rates other than the PFR, in accordance with their cost structures, business and portfolio management strategies.

G 8.16 Pricing for the following loan/financing facilities is excluded from the scope of this policy document:

(a) Credit cards which are subject to the maximum financing rate of 18% per annum as stipulated in the Credit Card Guidelines;

(b) Financing facilities where the retail lending rates are governed by legislation or prescribed by the Bank:

a. Hire purchase financing as prescribed by the Hire Purchase Act 1967; and
b. Mortgage financing for low income group as stipulated in the Guidelines on Lending to Priority Sectors.

9. DEPOSIT RATES

The proposed new reference rate framework will not affect current requirements with regard to deposit rates (as stipulated in the Guidelines on Reference Rates, Lending Rates and Deposit Rates of Banking Institutions) and these requirements are reproduced below.

G 9.1 FSPs are free to determine the rates payable on deposits accepted based on their funding requirements and strategies, subject to the conditions stipulated in paragraphs 9.2 to 9.4 below.

S 9.2 For savings deposit accounts:

(a) FSPs shall offer a basic savings account, which should earn interest or profit irrespective of the account balance. The minimum level of interest or profit rate to be offered on basic savings accounts shall not be lower than 0.25% per annum.

(b) Deposit rates payable on children accounts with balances of up to RM50,000 shall not be lower than the 1-month fixed deposit rate of the respective FSPs.

S 9.3 Housing Development Accounts

(a) The rate payable on a Housing Development Account shall be computed on the daily balance and is set at:

1 month fixed deposit account rate – 1%

G 9.4 FSPs are allowed to give hibah/dividend on Islamic current accounts subject to the following conditions:

(a) For Federal Government, State Government and statutory bodies, the hibah/dividend payment shall not exceed the return on investment for 1-month maturity of the FSP;

(b) For current account held by individuals, clubs, societies, schools, religious associations, the hibah/dividend payment shall not exceed the return on investment for 1-month maturity of the FSP;

(c) For current account held by companies, the hibah/dividend payment shall not exceed 2 percentage points per annum.

10. NOTIFICATION REQUIREMENT

S 10.1 FSPs shall submit the basis and methodology used to set the PFR to the Bank (i.e. Financial Conglomerates Supervision Department or the Banking Supervision Department) at least two weeks prior to the effective date of this policy document. In addition, FSPs shall notify the Bank prior to the introduction of other reference rates for the pricing of non-retail loans/financing facilities. The notification which shall include the methodology used in determining the reference rate, shall reach the Financial Conglomerates Supervision Department or the Banking Supervision Department at least seven working days prior to the introduction of the reference rate.

S 10.2 For revisions to the PFR and the BLR that are made in response to a change in the Bank's OPR, FSPs shall notify the Financial Conglomerates Supervision Department or the Banking Supervision Department at least <u>one</u> working day prior to the effective date of the revision.

S 10.3 For changes due to other factors, FSPs shall notify the Bank on the revision to the PFR and the BLR at least <u>two</u> working days prior to the effective date of the revision. Any proposed revision must be supported by proper justifications. The advance notification to existing borrowers on the revised monthly instalment as required under paragraph 8.13 shall take place only after the lapse of the two working days' notice to the Bank.

11. DISCLOSURE REQUIREMENT

S 11.1 FSPs shall ensure that the reference rates and deposit rates, including the effective dates of these rates, are prominently displayed at the FSP's business premises and website.

S 11.2 FSPs shall display changes to the PFR, including those made in response to a change in the Bank's OPR, at the FSP's business premises and website no later than the effective date of the revision.

12. SUBMISSION OF INFORMATION

S 12.1 FSPs shall submit to the Bank the information as specified in the following returns at a regular interval:

(a) Weekly Interest and Islamic Deposit/Financing Rates (ISS);

(b) Monthly Interest and Islamic Deposit/Financing Rates (ISS); and

(c) Financing rates on new loans approved during the month (submission to Financial Surveillance Department).

Feedback required:

1. *Please provide comments on the proposal for the PFR to be based solely on the FSP's benchmark cost of funds and SRR.*

2. *Do you foresee the need to set and quote different PFRs for different types of retail loan/financing products?*

3. *Please provide comments on the proposal for liquidity risk premium to be part of the spread above the PFR?*

4. *Please comment on any transitioning issues and challenges, including arrangements that need to be considered to ensure that the proposed changes do not interfere with financing contracts entered into with borrowers before the effective date.*

5. *Please highlight any significant implementation issues that may arise in complying with the requirements of the policy document, including any implications that may arise for institutions considering the adoption of a fund-transfer-pricing (FTP) system for credit pricing.*

6. *Please comment on any other considerations that are relevant to the proposed new reference rate framework.*

The Bank invites constructive feedback on this concept paper. To facilitate the Bank's assessment, please support each comment with a clear rationale, accompanying evidence or illustration and proposed alternative. Please respond to the Bank by **14 February 2014** addressed to:

Pengarah
Jabatan Konsumer dan Amalan Pasaran
Bank Negara Malaysia
Jalan Dato' Onn
50480 Kuala Lumpur

Should you require further clarification, please contact any of the following officers:-

1. Sharon Lim 2698 8044 ext 7386/ sharon@bnm.gov.my
2. Nor Haliza Jaafar 2698 8044 ext 7266/ norhaliza@bnm.gov.my