INTRODUCTION TO BNM BASE RATE

Pengenalan kepada “BNM Base Rate”

Liqa’ ASAS Peringkat Kebangsaan 2015

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Key Extract from the Reference Rate Framework

2. OBJECTIVE

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

(a) promote a transparent reference rate that allows meaningful comparison to be made for informed decision making by consumers;

(b) better reflect changes in the cost of funds arising from monetary policy or market funding conditions; and

(c) encourage more disciplined and efficient practices by FSPs in the pricing of retail loans/financing facilities.

8. REFERENCE RATE AND FINANCING RATES

8.1 FSPs shall use the Base Rate (BR) as the reference rate for the pricing of retail loans/financing facilities. This requirement applies to applications received for new retail loans/financing facilities and refinancing of existing retail loans/financing facilities, and the renewal of existing revolving retail loans/financing facilities, on or after the effective date.

8.2 FSPs shall determine the BR based on the FSP's benchmark cost of funds and statutory reserve requirement (SRR). The benchmark cost of funds shall reflect the FSP's specific funding strategies.

8.4 FSPs shall adjust the BR to reflect changes to the benchmark cost of funds due to changes in the OPR and the SRR.

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Reference Rate Framework

8.7 FSPs shall exclude other components of pricing from the computation of the BR such as credit and liquidity risk premiums, operating costs, profit margins and others. FSPs shall reflect these components in the spread over the BR.

8.9 Where there are any changes made to the BR, FSPs shall effect a corresponding adjustment to all new and outstanding retail loans/financing facilities which are priced against the BR.

8.10 Once a contract for a retail loan/financing facility is concluded, any revision to the spread above the BR during the tenure of the retail loan/financing facility shall only be made to reflect changes in the credit risk profile or creditworthiness of the borrower over the life of the loan/financing facility.

8.14 For any upward or downward adjustment to the BR and the BLR, FSPs shall revise the monthly instalments of retail loans/financing facilities which are priced against the BR or the BLR as the default option. FSPs shall provide borrowers with particulars of the revised monthly instalment amount at least <u>seven</u> calendar days prior to the date the revised monthly instalment comes into effect.

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Summary Points for Base Rate

1 **BR TO REPLACE BFR**

Base Rate is meant to be more **transparent** and meaningful to Clients

2 **CLEAR COMPONENTS**

Only Bank's benchmark **Cost of Funds** and **Statutory Reserve Requirement** are the allowed components to BR. No hidden costs

3 **COMPETITIVE**

Banks can offer a **lower BR** if they have cheaper Cost of Funds and/or more efficient in their fund management or risk management. Banks have full **control** of pricing

4 **RISK INFORMED PRICING**

The Bank's Spread (margin) can cater for customers with **different risk profile**, with higher pricing for higher risks. All risk related pricing is agreed up-front

5 **RISK ADJUSTED PORTFOLIO**

Throughout the course of financing, Bank can **adjust the Bank's margin** to meet increased risk from the customer (change in creditworthiness – defined as default).

6 **IMMEDIATE CHANGE**

Instalments are **immediately adjusted** to cater for pricing change (default option)

Base Rate Methodology – Saadiq Malaysia

Approach

1. The Bank will not calculate "Actual" cost of funds (usually combination of low-cost deposits, interbank borrowings and capital).

Base Rate

1. Base Rate to be determined by each Bank, and can only be revised if there is an OPR (Overnight Placement Rate) movement.

2. Benchmark Base Rate is proposed to be the 3M KLIBOR rates. Rationale – the 3M KLIBOR closely tracks the OPR on a 1-2 months lag basis.

3. Proposed SRR costs is based on average 12 months KLIBOR (12 months / 2)

Spread over Base Rate (Margin)

1. The Spread over BR is the Bank's expected operating costs, risk costs and margin. The minimum AVERAGE Spread over BR is expected to be 1.10% (at Bank wide level).

2. This spread maybe adjusted based on the risk profile of an individual customer i.e. Change in customer's creditworthiness or risk profile

Benchmark Cost of Funds	3M KLIBOR	**3.50%**
SRR costs	12M Average KLIBOR x Statutory Reserve Requirement (SRR)	**0.15%**
Base Rate (BR)		**3.65%**
Spread over BR*	Computed in consideration of: 1) Credit Risk 2) Liquidity Risk Premiums 3) Operating Costs 4) Profit Margins 5) Others **cannot be changed except due to change in creditworthiness of the customer*	**1.20%**
Customer Rate		**4.85%**

Saadiq has adopted the same methodology as the parent bank for its benchmark

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Illustration : Financing Effective Rate of 4.85% p.a.

Now : Base Financing Rate @ 6.85% p.a. → **Jan 2015 : Base Rate @ 3.65% p.a.**

Now

Bank's Margin

(-2.00% p.a.)

- Bank's Risk Spread & Income

Base Financing Rate

(6.85% p.a.)

- Cost of Funds
- Statutory Requirements Reserves
- Liquidity Reserves
- Credit Risk Premium
- Operational Risk (Costs)

Jan 2015

Bank's Margin

(+1.20% p.a.)

- Bank's Risk Spread & Income
- Liquidity Reserves
- Credit Risk Premium
- Operational Risk (Costs)

Base Rate

(3.65% p.a.)

- Cost of Funds
- Statutory Requirements Reserves

Potential Shariah Concerns

Risk-informed Pricing for the BR

- Customers will be evaluated based on their creditworthiness and track record by the Bank.
- The credit risk rating will determine the ultimate pricing quoted to the customer.
- A customer with a good track record will obtain better pricing.
- A customer with marginal track records will be quoted a "risk-informed" pricing to mitigate potential defaults.
- **Concerns**: Marginal customers will incur a higher pricing to cater for the perceived "higher risks".

Change in Spread over BR on change of customer's Creditworthiness

- The Framework allows for the Bank to revise the Spread over BR according to change in the customer's risk profile or creditworthiness during the financing tenure
- Customers are not required to explicitly "accept" the change in Bank spread.
- There is no pricing cap outlined for such revision (discretionary).
- **Concerns**: This can be construed as a punitive pricing revision, on top of the Late Payment Charges (LPC), and become an additional burden.

Adjustment of Instalment Amount instead of Extension of tenure on Pricing change

- For any revision in the pricing (BR revision or Bank Spread revision), the Bank will revise the Instalment Amount accordingly (default option)
- This will ultimately increase the monthly commitment of the customer during pricing change.
- It is discouraged to extend the tenure of the financing automatically, unless by specific request.
- **Concerns:** This will result in additional burden to customers, especially revisions due to creditworthiness.

Conclusion – Emphasis on Risks

1

PRICING STRATEGIES

Base Rate means greater transparency closely tied to actual COF. Risk pricing built into Bank's Spread must be "accurate" to cater for future customer risks, especially long-term products to ensure margins are maintained

2

TRANSFER OF RISKS

Pricing adjustments allowed to cater for changes in credit worthiness aimed to protect bank from risk (risk-transfer) rather than consumers (risk-sharing)

3

SHARIAH VIEW

Risk becoming important component in international standards e.g. Risk Informed Pricing and Basel requirements on Risks and Capital to ensure stability and endurance of financial institution. Shariah view on risks and impact on customer is not clear