Box A

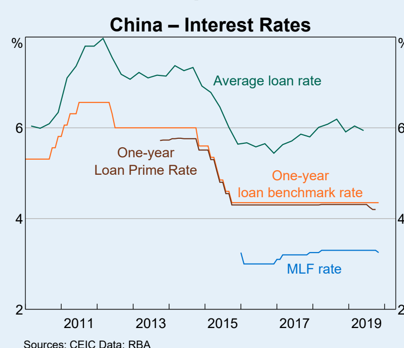
Recent Reforms to Lending Rates in China

In August, China's State Council and the People's Bank of China (PBC) announced that the Loan Prime Rate (LPR) would become the new reference rate for lending in China and reformed how it is calculated. The PBC expects these changes to strengthen the transmission of administered policy rates to lending rates in the real economy. This is consistent with the authorities' objective of moving to a monetary policy framework that is more focused on using interest rates as the instrument of policy than direct control of the supply of money and bank credit. These changes are also important steps in the ongoing transition towards market-based pricing of financial products and greater competition in the banking industry, which has been underway for more than two decades.

The Loan Prime Rate will now be the reference rate for lending by Chinese banks …

The LPR is the interest rate banks charge their most creditworthy customers. Up until now, it has been calculated as the average of quotes submitted by a panel of 10 banks, expressed as a multiple of the equivalent-term official benchmark lending rate (for example, 0.9 times the benchmark lending rate) and it was not generally used as a reference rate for pricing the loans of banks' other customers. Changes to the official benchmark rate required approval by the State Council and no adjustments had been made since 2015. As a result, the LPR did not vary much (Graph A.1).

Under the new arrangements, an expanded panel of 18 banks will submit quotes for the rate they offer their most creditworthy customers on one-year loans, expressed as a spread to the one-year rate offered by the PBC through the medium-term lending facility (MLF; for example, 100 basis points above the MLF rate). Changes to the MLF rate do not require State Council approval. The LPR will be calculated as the average of these quotes (excluding the highest and lowest quotes) and the result will be published on the 20th of each month. The spread between the LPR and MLF is generally determined by a range of factors, including bank funding costs, the demand for loans and the pricing of credit risk associated with lending to banks' best customers. The PBC has also introduced a five-year LPR that will be calculated and published in the same way as the one-year LPR. The eight banks added to the panel include regional, rural, foreign and private banks. These banks were chosen on the basis of several criteria, including the volume of their lending activity, their loan



pricing frameworks, and the extent of their lending to micro and small enterprises. The PBC expects the panel will expand further in the future.

The new framework requires that all new bank loans be priced relative to the LPR. The spread between the LPR and the interest rates charged on individual loans to businesses and households will reflect the demand for loans, the lending term and bank's assessment of the credit risk of these borrowers.

The main objectives of the new framework are to improve the transmission of monetary policy, increase competition for business loans among financial institutions and encourage banks to improve their pricing of risk. By linking the interest rate on all new loans to the MLF (via the LPR), the interest rate decisions of the PBC will flow through directly to the rates paid by businesses and households. It may also enhance competition in loan pricing, which could lead to a decline in the spread between the LPR and the MLF over time. The PBC had been concerned that banks were implicitly coordinating on a floor in loan rates, which meant that declines in market rates and bank funding costs were not being reflected in lending rates. The new arrangements may help to increase competition and break the implicit floor on lending rates. Finally, the new LPR framework could encourage banks to improve their ability to independently price the risk of different borrowers, potentially increasing their willingness to lend to higher-risk borrowers.

Meanwhile, some additional restrictions have been introduced for mortgage loans, reflecting the authorities' longstanding desire to avoid policies that lead to overheating in the housing market. In particular, the interest rate on first mortgages cannot be lower than the LPR, and the interest rate on second and subsequent mortgages must be at least 60 basis points above the LPR. Local PBC branches and sub-branches may increase these floors according to the conditions of the housing market in their jurisdictions. The relevant LPR term is that which best reflects the term of the loan, and mortgage loans will only be able to be repriced on a minimum cycle of one year, to slow the transmission of any potential monetary easing to the housing market.

… but it will take time for the effects to become apparent

Banks have started to price a range of their products based on the LPR, including mortgages, corporate loans, floating rate bonds, asset-backed securities, currency swaps and interest rate swaps. However, the PBC has recognised that it will take time for banks to adjust to the new arrangements and has set a timetable for implementation. By the end of September, 30 per cent of new loans should have referenced the LPR, which should increase to 50 per cent by the end of December, and 80 per cent by the end of March 2020. The PBC will monitor compliance with the new arrangements through each bank's quarterly macroprudential assessment, a review mechanism used by the PBC in recent years to monitor lending activity and control systemic financial risks.

Since the new framework was announced, the LPR has declined by 11 basis points and now sits 15 basis points below the old official benchmark lending rate, while the MLF rate has declined by 5 basis points.

The short-term stimulatory impact of these reforms is likely to be quite limited, because

loans linked to the LPR represent only a small proportion of the total stock of outstanding loans and this will only increase gradually. A rough estimate suggests that over the coming year a little less than a third of any fall in the LPR will flow through to the average interest rate on non-mortgage loans, while the impact on mortgage interest rates will be even smaller, reflecting their longer maturities. As a result, to date, the reaction to the reforms in debt and equity markets has been limited.

Because the LPR reflects the return that banks will receive on their lending to customers, it will be influenced by banks' funding costs. For example, the PBC expects cuts to reserve requirement ratios announced in September will release CNY 900 billion worth of liquidity, which is likely to place downward pressure on interbank market rates. While this will reduce funding costs, the change will be small, because Chinese banks are largely funded by deposits rather than interbank borrowing and benchmark deposit rates remain unchanged.

The reforms could weigh on the net interest margins of Chinese banks in the short term. Loan rates are expected to decline in response to any targeted easing by the PBC. Also, greater competitive pressures should gradually weigh on interest rates charged to borrowers. However, banks' deposit rates are informally guided by published benchmark rates, which have not changed since 2015, when the explicit ceiling on deposit rates was abolished. This could be a concern for some smaller banks that have come under stress in recent months. Despite this, a number of large banks have stated that they expect the impact on margins to be manageable.