



THE ROLE OF THE PRIME RATE AND THE PRIME-REPURCHASE RATE SPREAD IN THE SOUTH AFRICAN BANKING SYSTEM

1. Introduction

- 1.1 This document highlights the main conclusions of a more comprehensive study that was prepared jointly by staff from the South African Reserve Bank (the Bank) and The Banking Association South Africa (BASA), who served on the technical sub-committee¹ announced in a press statement on 22 May 2009. The study was prepared following a discussion around the spread between the repo rate and the prime rate at a meeting held on 21 May 2009 between the Governor of the Bank, executives of South Africa's five large banks and BASA.
- 1.2 This document clarifies the role of the prime rate in the domestic banking system as well as the spread between the repurchase rate and the prime lending rate.

2. The repurchase rate

- 2.1 In conducting its monetary policy, the Bank uses the repurchase rate to influence short-term market interest rates and, through the transmission mechanism, other interest rates, the exchange value of the rand, asset prices and real economic aggregates such as spending, economic growth and, ultimately, inflation.
- 2.2 The Bank's operational refinancing framework is based on an approach where the monetary policy interest rate, the repurchase (repo) rate, is the interest rate charged by the Bank on short-term loan facilities provided to banks. The central bank

¹ Convened by Dr RM du Plooy (SARB) and Mr C Coovadia (BASA), with members comprising Dr N Brink, Mr M Kock and Mr T Khosa representing the SARB, and Mr M Brits representing BASA.

creates a shortage of bank reserves in the money market by levying a cash reserve requirement and by draining liquidity through open-market operations, and then refinances this money-market shortage through refinancing operations by lending funds to banks at the repo rate – a fixed interest rate as set by the Monetary Policy Committee (MPC). Banks normally charge borrowers lending rates in excess of the repo rate and pay interest on deposits of similar maturities at rates mostly below the repo rate. Money-market interest rates fluctuate in close proximity to the repo rate, reflecting money-market conditions and market expectations about future changes in the repo rate.

- 2.3 The Bank directly sets the level of the repo rate, and announces the direction and magnitude of any changes to the repo rate after each MPC meeting. It is important to note that a single policy rate does not impede competition among banks, but merely sets a benchmark in terms of the monetary policy stance of the central bank.

In addition, the Bank exerts an indirect influence on market rates through open-market operations and moral suasion which, together with a number of external factors, including competition between banks, establishes the levels of interest rates across the yield curve.

3. Funding rates

- 3.1 Banks' cost of funding is not determined only by the level of the repo rate, but by market forces and conditions in the money market. Banks' total cost of funding is determined by their rand-denominated deposit rates, the cost of foreign funding and the cost of capital. The repo rate should, therefore, not be seen as a proxy for average funding cost of banks.

The Bank's direct influence on the average funding cost of banks has diminished over time, as the size of the money-market shortage has not kept pace with the growth in the banks' consolidated balance sheet over recent years. This has diluted the direct influence that the repo rate has on banks' average cost of funding.

- 3.2 In practice, the funding costs of banks are derived from the money-market yield curve, and the repo rate has an indirect effect on banks' lending rates via the yield

curve. The yield curve also reflects general liquidity conditions in the money market in terms of the supply and demand for funds at various maturities. The differing term mix of liabilities will also impact on the cost of funding of banks.

4. Lending rates

- 4.1 Banks' lending rates are determined by three main factors: their cost of funding, the credit risk profile of the client and the degree of risk appetite of the bank itself, which includes not only appetite for credit risk but also for liquidity and interest rate risk. Banks use their funding cost as a basis for determining the interest rate charged on a loan, by adding a risk premium that reflects the credit risk profile of a client and the bank's risk appetite at a particular time. The credit risk profile of a client depends on various factors, such as the creditworthiness of the client (ability to repay), the term of a loan, the type of loan, the extent of collateral provided, concentration risk and the mix of products offered to the client.
- 4.2 The risk appetite of a bank can react to various factors, such as a change in the quality of its own loan book, liquidity levels, a change in the economic outlook or a change in strategic focus. A decline in risk appetite (for example when non-performing loans increase and/or the economic outlook deteriorates) will cause banks to increase their pricing of risk, exerting upward pressure on lending rates even though funding conditions and the risk profile of a particular client may remain unchanged.
- 4.3 Because the various factors that determine lending rates vary over time, banks' lending rates fluctuate relative to the monetary policy stance of the Bank.

5. Net interest margin

- 5.1 The net interest margin (NIM) is the difference between banks' average lending rates and their average cost of funding. The banking sector's interest margins do not equate to the spread between the repo rate and the prime rate, and a fixed spread between repo and prime does not imply a fixed net interest margin.

- 5.2 Net interest income in South Africa typically makes up around 50 per cent of total income of banks. The make-up of a bank's NIM is complex, and is one of the results of detailed asset and liability management (commonly referred to as the "ALCO process"). It is affected by various factors that determine the cost of funding and lending rates, as well as expected losses through bad debts and operating costs. Margins are set with the objective of earning a risk-adjusted return on capital such that enough internal reserves (earnings) can be generated to support future asset growth, while ensuring banks have sufficient loss-absorbing capital.

6. The role of the prime rate

- 6.1 The role of the prime rate, which is also commonly referred to as the prime overdraft rate, has changed over time. With these changes, the spread between prime and the Bank's policy rate has also changed. A semi-formal link between the Bank's policy rate and interest rates has existed since the 1920's, ensuring that changes in the policy rate are passed on to the clients of banks.
- 6.2 During the 1980s, the prime overdraft rate lost some of its significance as its role changed from that of a "minimum overdraft rate" to a reference or benchmark rate – not only for overdrafts, but for various types of loans with different terms and risk characteristics. Banks increasingly quoted lending rates at a discount or premium to prime, and the conventional notion of the prime overdraft rate being a 'best' or "lowest" lending rate was no longer the case. Its role changed to that of a market reference or benchmark, but with the informal link between the monetary policy rate and the prime rate being maintained.
- 6.3 Currently, banks quote many of their floating lending rates to clients relative to prime. This does not imply that they price their loans off prime. As discussed earlier, lending rates are determined by a combination of factors. Once an appropriate lending rate for a client is determined, the bank offers this rate expressed at a link to prime. Establishing this link helps to facilitate the transmission of future interest rate adjustments to existing longer-term floating-rate loans. The prime rate therefore serves as a convenient reference for floating lending rates, but does not determine lending rates.

- 6.4 Over recent years, the average calculated yield on banks' rand-denominated loans and advances has fluctuated below prime, reflecting the fact that prime no longer represents a 'minimum' lending rate, and that there is not a fixed relationship between the repo rate and lending rates.

7. The spread between the repo and prime rates

- 7.1 The Bank introduced more flexible accommodation procedures² for banking institutions on 7 March 1998. These procedures were amended on 5 September 2001, when the spread between the repo rate and inter-bank call rates in the market was narrowed by 100 basis points from 250 to 150 basis points. Banks and other financial institutions were requested not to adjust any of their lending or deposit rates because of this adjustment, since this would defeat the purpose of the change. At that time, this technical downward adjustment in the repo rate caused the spread between the repo rate and the prime rate to widen from 300 to 350 basis points, as banks kept their lending rates constant. This spread was regarded as appropriate in the prevailing market conditions and interest rate structures. The understanding was that any future changes in the repo rate would be a signal that the Bank expects money-market interest rates to show corresponding changes. Consequently, the spread of the prime rate over repo has remained stable at 350 basis points since September 2001, with only temporary deviations due to timing differences.
- 7.2 As discussed, banks will determine their lending rates irrespective of the spread between the repo rate and the prime rate. Therefore, the size of the spread is immaterial as a determinant of lending rates, and its only impact is to make it contractually possible for banks to transmit changes in monetary policy to existing long-term floating-rate borrowers. Empirically, banks' average net interest margins have tended to fluctuate over time, sometimes significantly, above and below the level of the spread, depending on prevailing market conditions.

² Press release: 1998-03-07: Monetary Policy and Reserve Bank Accommodation Procedures. The Bank adopted a repurchase-transaction-based (repo-based) refinancing system which was modified in September 2001 and again in May 2005.

7.3 Conceptually, once a bank has established a lending rate it could link the rate to any external reference rate not just the Bank's repo rate. Linking variable rate loans to the repo rate would eliminate any misconceptions about the role of the prime rate and its spread to the repo rate.

7.4 However, although this structure may be simpler, it would not change banks' actual lending rates, basis for price determination or net interest margins: banks would still price their loans according to their own risk assessment and cost of funding, linking it to repo at variable margins. Should lending rates be linked to the repo rate this would, however, be accompanied by a temporary market disruption and legal complications. A change from prime to repo as a market reference rate would have to be implemented as from a specific date, applicable to all new loans. Existing loans linked to prime would have to be phased out as they mature, lapse or are re-negotiated.

8. The stability of the spread between the repo and prime rates

8.1 It is desirable to have a stable spread, as it affects the re-pricing of banks' assets and liabilities. A change in the current spread would disrupt the market because both banks' assets and liabilities would have to be re-priced and clients would have to re-negotiate lending and deposit rates. The yields of all products referenced to the prime rate would change relative to other products that are not referenced to the prime rate. Furthermore, because most of the prime-linked products have a specific term to maturity, unexpected changes to the spread would result in "windfall" capital losses or profits for counterparties, depending on whether the spread narrows or widens.

8.2 Any uncertainty about the size of the spread would encourage banks and their clients to benchmark the re-pricing of loans and deposits against other market reference rates. Basis/spread risk is a key risk in the banking sector and relates to the narrowing or widening of the spread between funding and lending rates. Thus a change in the spread between the repo and the prime rate would introduce additional and unpredictable spread risk.

- 8.3 It follows therefore that should the Bank prescribe a narrower spread between the repo and prime rates, over the longer term there is unlikely to be any material effect on the interest rates that clients pay on their loans, because loans will still be priced according to inter alia their degree of risk. New loans would merely be linked to the 'new' prime at less favourable margins, while banks would have to recover their reduced income on existing loans by either reducing deposit rates or from other sources of income, such as fees. A narrowing of the spread would result in disparate pricing between existing and new loans, introduce a once-off basis/spread risk and cause market disruption and re-pricing. This could disrupt the banking system, without any lasting benefits to bank customers.

9. The uniformity of the spread: should banks each quote their own rates?

- 9.1 With prime playing the role of a market reference rate, it is preferable that it should be the same for all banks, so that clients can compare the pricing of various banks relative to the same benchmark. A single prime rate and uniform spread facilitate rather than prohibit competition. It would be difficult for clients to compare the rates offered by banks if a bank has the ability to adjust not only a client's premium or concession, but also the benchmark at its own discretion.
- 9.2 If banks were to quote different prime rates, they would add various spreads to the repo rate to determine their own prime rates, and subsequently subtract concessions or add premia relative to these rates. As with the other alternatives, this is unlikely to change their net interest margins. However, the different offerings by banks will be less transparent to consumers, and ongoing basis/spread risk will be introduced (i.e. the risk that a particular bank's spread between repo and prime rates may be adjusted).

10. Conclusion

- 10.1 The main conclusion of the report is that the size of the spread between the repo rate and prime is immaterial to the setting of lending rates, as prime is primarily used as a reference rate or benchmark for pricing loans. Any change in the spread, or a change in the benchmark rate will not change the methodology for establishing actual bank lending rates, although it could cause some short-term problems and

disruption with existing agreements. A uniform spread helps to create a competitive environment for banks, which enables customers to choose between products and negotiate interest rates based on their credit profile.

- 10.2 It is concluded that there are no compelling reasons to change from the current fixed spread of 350 basis points between the repo and prime rates. It follows therefore that there should be a single prime rate for all banks.
- 10.3 It is also suggested that the “prime overdraft rate” should in future only be referred to as the “prime rate”, with a clear understanding that its role has changed from an actual “lowest” or “best” lending rate, to that of a reference rate to which banks link floating interest rates on loans and advances.
- 10.4 Finally, it is suggested that because lending rates differ significantly from prime at times, the Bank should closely monitor trends in banks’ actual lending and deposit rates. This would ensure a better assessment of the market forces that drive the pricing of loans, and the extent to which these forces offset or reinforce the monetary policy stance of the Bank.