IV. ANNEX

Recent Reform of Pricing Bank Lending Rates in Taiwan

Bank lending is essential to both individuals and enterprises to make their decisions on consumption or investment and to the economy as a whole to achieve sustainable development. At its core, the lending rate can serve as a useful financial indicator, if its pricing is based on actual market conditions. This annex provides a brief review of recent reform of pricing bank lending rates in Taiwan.

The Old Prime Rate System and Its Weakness

In the past, Taiwan adopted a prime rate system. This system was introduced by the Bank in March 1985 as one of a series of measures for interest rate deregulation. The prime rate is the interest rate charged by a commercial bank to its most creditworthy customers. It represents a key interest rate on which the entire structure of lending rates is built. Over the years, the system worked well, and prime rates established a close co-movement relationship with the Bank's discount rate.

In the early 2000s, the Bank cut discount rates continuously in response to economic slowdown, however, prime rates started exhibiting downward rigidity. The Bank cut the discount rate 15 times for a total of 3.375 percentage points from December 2000 to June 2003, while the five leading domestic banks only lowered their prime rates by an average of 0.782 of a percentage point. This downward rigidity in banks' prime rates hurt household and small- and medium-sized enterprises most since they bore unreasonably high interest burdens in a situation where market conditions showed that interest rates should have fallen. In addition, the prevailing downward rigidity hampered the transmission mechanism of monetary policy, and it became clear that there was something wrong with the pricing of prime rates.

Recent Reform in Bank Lending Rates

To address this issue, the Bank has recently introduced a number of measures to remove the downward rigidity of bank lending rates and to enhance the role played by the banking sector in the monetary transmission process. Among the steps taken were the introduction of adjustable rate mortgages (ARMs) and the Base Rate system that links lending rates to benchmark market interest rates. ARMs replace conventional mortgage rates, which linked to prime rates. Interest rates on ARMs derive from adding a markup to a market indicator. The extent of the markup is determined by the creditworthiness of customers, while indicators selected by individual banks are mostly on one-year time deposits offered by major banks.

The base rate system replaces conventional corporate loans rates. Interest rates under the new system are based on a certain markup to the base rate. The markup depends on the credit standing of borrowers. The base rate is usually an interest rate, such as the central bank's discount rate, the interbank overnight call-loan rate or the commercial paper rate, added by a percentage that reflects banks' operational costs and reasonable profits.

The whole reform is to make lending rates more responsive to market conditions and interest rate pricing more transparent. It has also reduced the debt burden of small borrowers and improved the effectiveness of monetary policy.

Four Steps Adopted in the Recent Reform

This reform was conducted step by step and included the following four steps:

1. Starting in the beginning of 2002, the Bank continued to encourage domestic banks to adopt the new pricing rule. By the end of March 2003, all domestic banks had adopted this new practice.

2. After all domestic banks adopted the new pricing practice, the Bank urged banks to convert all old loans based on prime rates into the loans based on the Base Rate system or ARMs, that is, all interest charged should be based on this pricing practice. At the end of 2005, the share of loans based on prime rates in overall loans outstanding was only 2.1 percent, indicating that most general borrowers were no longer charged higher lending rates based on the old prime rates.

3. The new practice also applied to the credit co-operative associations and the credit departments of farmers' and fishermen's associations. The Bank sent experts to provide assistance for those institutions to smoothly transform to the new system. In June 2005, all community financial institutions

adopted this system.

4. To ensure banks adopt this system truthfully, as requested by the Bank, the Bankers' Association at Taiwan requires its member banks to publicly announce their base rates. In principle, member banks should adjust their base rate every three months to reflect market conditions. In January 2006, all banks post their base rates and adjust the rates regularly.

Conclusion

Downward rigidity in prime rates was widely criticized as discriminating against borrowers with little bargaining power. It was also detrimental to the effectiveness of the Bank's monetary policy. For the past several years, the Bank worked closely with banks to reform the pricing system of lending rates. The old prime rate system was replaced with a new ARMs and the base rate system that links lending rates to benchmark market interest rates. This pricing system improves transparency, introduces flexibility, and is based on actual market conditions. In sum, the new pricing system not only reduces the unreasonable debt burden of small borrowers but also improves the effectiveness of monetary policy.