Yi Gang: The development of Shibor as a market benchmark

Speech by Mr Yi Gang, Deputy Governor of the People's Bank of China, at the 2008 Shibor Work Conference, Beijing, 11 January 2008.

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Thank you for your presence. Since its launch one year ago, Shibor has made remarkable progress. I'd like to share with you some of my observations.

First, Shibor is for market participants. At the initial stage, central bank promotion is necessary. But Shibor, as a market benchmark, belongs to the market and all the market participants. All parties concerned including financial institutions, National Inter-bank Funding Center, National Association of Financial Market Institutional Investors shall have a full understanding of this, and actively play a role in the operations of Shibor as stakeholders. The success of Shibor relies on the joint efforts of all the stakeholders.

Under the command economy, the central bank is the leader while commercial banks are followers. But from the current perspective of the central bank's functions, the bipartite relationship varies on different occasions. In terms of monetary policies, the central bank, as the monetary authority, is the policy maker and regulator, while commercial banks are market participants and players. But in terms of market building, the relationship is not simply that of leader and followers, but of central bank and commercial banks in a market environment. This broad positioning and premise will have a direct bearing on how we behave. On the one hand, it requires the central bank to work as a service provider, a general designer and supervisor of the market. On the other hand, it requires market participants and various associations to cultivate Shibor as stakeholders and players on a leveling playground.

Second, I'd like to elaborate on the relationship between Shibor and market-based interest rate. At present, lending and deposit interest rates are regulated with a floor lending rate and a ceiling deposit rate. The regulation is necessary so far because it dramatically cuts transaction cost and reduces the probability of vicious competition. But the side effect is limited research coverage by financial institutions on how to price deposits and loans. With time passing by, the preconditions for the adoption of market-based interest rate will become more mature. In the past, what worried us the most was possible vicious competition after market-based interest rate was introduced. But now a few large commercial banks have gone public, and have established Boards of Directors, brought in independent directors, strategic investors (including foreign strategic investors). All of these changes will restrict the behaviors of commercial banks to some extent. Now commercial banks can afford not to spend too many resources in research on pricing. But with the progress of market-based interest rate reform, pricing will take a large share of commercial banks' resources, and will reflect their core technologies and core competitiveness, consuming a lot of energy and resources. In fact, Shibor can play a benchmark.

Shibor must become a recognized and authoritative interest rate benchmark to replace the benchmark lending and deposit rates set by the central bank. This being achieved, the central bank could gradually retreat from its intervention. Simply put, interest rate pricing in fact releases pressure. When clients complain about high interest rate, commercial banks can pass the buck to the central bank because the central bank sets the interest floor. When Shibor matures, Shibor will become the culprit. Such a change though looks simple bears important legitimacy, authoritativeness, and persuasiveness, and can make Shibor a recognized and completely authoritative benchmark.

What is market-based interest rate? In my understanding, it means deregulation. But if the central bank deregulates deposit rate ceiling and lending rate floor when there is no other reliable benchmark to substitute them, the result could be worse. When is the right timing for deregulation? My answer is when a new benchmark matures. Shibor is an important benchmark, on which I have high hopes in the process of making interest rate more market-based.

Interest rate floor and ceiling is likely to exist for some period. Can the market-based interest rate transformation process start with discount rate linking with Shibor? In fact, discount facilities are loans. A breakthrough with discount rate will have far-reaching impact on the market-based interest rate transformation, and provide experiences for future interest rate reform.

Third, I'd like to move onto the relationship between Shibor and product innovation. There are a lot of innovative products based on Shibor. Hopefully more will emerge. There are also products based on other benchmarks, such as floating rate products based on 1-year required reserve rate. It is up to product providers as for on which benchmarks they'd like to base their products. But when designing products with a long maturity such as 10 years or 15 years, product issuers shall take into account the uncertainty of the market-based interest rate transformation in the future. Of course, Shibor also has uncertainties, so various aspects shall be taken into consideration when issuing new products. From a global perspective, Shibor represents a direction of reform. Shibor's failure would suggest the failure of China's money market and bond market. Without a proper pricing benchmark, the Chinese currency renminbi would be regarded as a failure, so would the Chinese economy. So the development of Shibor can only succeed without any leeway.

According to experiences elsewhere in the world, Shibor shall be used as a benchmark for product innovation. Shibor unavoidably has loopholes, so it's natural that some new products are based on benchmarks other than Shibor, such as the 7-day repurchase rate. We shall be open to such products from a commercial perspective because everything that exists must have a reason. These benchmarks may compete with Shibor in a meritorious manner. Only when there is competition, can we stakeholders make comparisons before Shibor becomes an established benchmark. No administrative measures shall be applied to suppress other benchmarks.

In terms of market development, the future trend of Shibor shall be taken into full account, and international experiences shall be drawn from, such as B2B, C2C, B2C and other types of online trading in developed countries. As far as innovation is concerned, we can also initiate innovation on our own, but new innovations are subject to the test of time and market. So when designing innovative products, it is advisable to learn from international experiences. In a long-term perspective, Shibor is very important for financial innovation and the development of derivatives. Insightful thinking is required when drawing from international experiences.

Fourth, the relationship between Shibor and internal transfer pricing. One advantage of Shibor is that it links the market on the one hand and internal transfer pricing of commercial banks on the other hand. Many commercial banks, as nationwide large banks, have internal transfer prices across regions, products, deposits and loans, and assets and liabilities. As a result, commercial banks' head offices are under constant pressure from branches with a deposit surplus and branches with a loan surplus. For example, deposit surplus banks demand a hike in the interest rate when they deposit fund with the head office. How can head offices convince their branches of the legitimacy of internal transfer pricing? It is not until Shibor is introduced to internal transfer pricing that can the rights and interests of various departments and branches of large commercial banks be balanced in a scientific, reasonable and persuasive manner because Shibor is an objective price that links the internal parties with external parties.

Internal transfer pricing is a basis for internal management, systematic management, risk management, economic capital and arithmetic of various indicators. If commercial banks have a relatively unified understanding of Shibor and core techniques in pricing, Shibor can be used in internal transfer pricing. This will be very important for internal management of commercial banks.

Fifth, the relationship between Shibor and the renminbi internationalization. The renminbi is China's main currency, a point that we shall bear in mind when contemplating the development of the money market. In the past, we only looked at the domestic market, but now we should adopt a global perspective. Many currencies in the world have their benchmark interest rates, including Libor, Euribor, Tibor and etc. The launch of Shibor shored up transaction volume in the money market. Comparatively speaking, Shanghai's money market capacity is incomparable to that of London and New York. But the renminbi will soon become an important currency in the world, so we shall steadily push ahead with the renminbi convertibility under the capital account. At present, great pressure of appreciation on the renminbi driven by large amount of capital influx is to a large extent due to a positive outlook of China's economy and purchase of renminbi-denominated assets by foreign companies and individuals. In fact, the money market is part of the financial infrastructure that will establish the renminbi's role in the world.

As such, we must have full confidence in Shibor. Whether Shibor will become a widely accepted benchmark will signify whether a renminbi market will be established, whether capital market convertibility will be achieved, whether the Chinese economy will be successful, and whether foreign investors would have confidence in holding renminbi assets. From this sense, Shibor shall gradually establish its status as a benchmark.

Sixth, Shibor is also a benchmark for other products and institutional arrangements. A lot of existing products are linked to some interest rates set by the People's Bank of China (PBC). So when the PBC adjusts interest rate, multiple factors shall be taken into account so as to balance the interests of various parties. PBC staff shall improve their professionalism and expertise. However, any move to balance interests involves different interest groups and produces a complex picture. So a widely accepted and objective benchmark is needed, and Shibor can take this responsibility.

I suggest that more products, from company-wide provident fund, public welfare fund, company-wide trust fund to wealth management products, housing provident fund and broker depository fund shall be linked to Shibor.

Seventh, the authenticity and quality of Shibor. In the previous year, Shibor made big strides. Delighted though, I also closely watch the quality and authenticity of Shibor. The spread between Shibor within 3 months and the actual trading rate is small, so market transactions are brisk. But the spread between long and medium-term Shibor rates and the actual trading rates is relatively large. Because Shibor is a benchmark for the inter-bank market that has become a main force for the money market and bond market, some of the protracted problems are also reflected in Shibor. For example, some trading rates include some factors beyond the market, including special arrangements and adjustments tailored to a specific counter-party. One rate that concludes a deal with one particular counter-party cannot apply to other counter-parties. Similar situations still exist.

We hope Shibor is less distorted, but whether a deal can be sealed concerns credit approval. The most standard practice is to base risk premium on the credit standing of different counter-parties and add the risk premium to Shibor. We don't want to see complicated factors (such as interest transfer) intervening trading rates to make trading rate and quoted Shibor rate further apart. The solution of this problem involves many aspects such as internal management, credit approval and delegation of power to branches. As far as transparency of trading price is concerned, there is such a belief that lack of transparency and extreme transparency shall both be avoided. In case of over transparency, after a transaction is made, all other counter parties know about the trading rate. But in fact, it is normal to add risk premium when trading with smaller banks. How to determine an appropriate level of transparency? We wish to provide a system as convenient as Reuters where one can publicize transaction information to the whole market and deal with individual counter-parties through a small window. But as far as price-quoting banks are concerned, price quotation and internal management shall become more clearly defined to eliminate interest transfer and other “noises” other than risk premiums outside the system, while such “noises” shall be dealt with by legitimate means.

The spread between quoted Shibor rate and actual trading rate, especially the spread for products with a maturity of over 3 months, is a major factor influencing the quality, credibility and authoritativeness of Shibor. There is room for improvement. I hope more studies can be done to find out the reasons why the correlation between quoted rates of products with a maturity of over 3 months and inter-bank borrowing transaction rate is low? How to increase the correlation? How about the correlation between long and medium-term Libor and inter-bank borrowing rate? How big is the gap between Shibor and Libor?

In conclusion, all of you have provided important advice including training programs. Shibor has been developing very fast. I believe the existing problems can be addressed in a fast manner so as to make Shibor a benchmark for the money market and for the short end of China’s bond yield curve.