

Study on the Impact of Interest Rate Marketization on Chinese Commercial Banks

Bohan Jian

Shanghai Jian Qiao University, Shanghai, China

Abstract: Interest rate marketization has had a far-reaching impact on China's commercial banking industry, promoting the improvement of banks' business innovation and risk management capabilities, while having a significant impact on banks' profitability models and asset-liability structures. Commercial banks must adapt to the market-based interest rate system, optimize resource allocation and improve service quality to meet the challenges brought by interest rate fluctuations. Interest rate marketization also promotes the deepening development of the financial market, enhances the transmission efficiency of monetary policy, and has a non-negligible role in the stability and efficiency of the entire economic system. This paper analyzes the meaning of interest rate marketization, the characteristics of China's interest rate marketization, and discusses its impact on China's commercial banks, and finally puts forward corresponding development countermeasures to guide the development of banking business and improve financial regulatory policies.

Keywords: Interest Rate Marketization, Chinese Commercial Banks, Impacts.

1. Introduction

Interest rate marketization, as an important part of financial reform, has brought about far-reaching impacts on China's commercial banking industry. With the gradual liberalization of interest rate controls, commercial banks are facing more intense market competition and significant changes in their operating environment. This reform has not only promoted the innovation of banking business and the improvement of risk management capability, but also had an important impact on the profit model and asset-liability structure of banks. Commercial banks must adapt to the market-based interest rate system, optimize resource allocation and improve service quality to meet the challenges posed by interest rate fluctuations (Rong, 2021). At the same time, the marketization of interest rates also promotes the deepening development of the financial market, enhances the transmission efficiency of monetary policy, and has a non-negligible role in the stability and efficiency of the entire economic system. Therefore, an in-depth study of the impact of interest rate marketization on China's commercial banks is of great theoretical and practical significance for understanding the process of financial reform, guiding the development of banking business and improving financial regulatory policies.

2. Meaning of Interest Rate Marketization

Marketization of interest rates refers to the process whereby interest rates are determined by supply and demand in the market, rather than being set directly by the Government or the Central Bank. In a system of interest rate marketization, financial institutions are able to set deposit and loan rates, as well as the prices of other financial products and services, on their own in accordance with the supply and demand for funds. The core of this mechanism lies in improving the efficiency of capital allocation, reflecting the true cost of capital and risk premium through the market mechanism, and thus promoting the effective allocation of

resources. In China, the market-oriented reform of interest rates is an important part of the reform of the financial sector, aimed at gradually relaxing administrative control over interest rates and giving market players greater pricing autonomy.

The advancement of interest rate marketization means that commercial banks will no longer be protected by the fixed interest rate policy and must find their own positioning and development strategies in the competition. This requires banks to increase their sensitivity to market changes, strengthen risk management, optimize their asset and liability structure, and innovate financial products and services to attract customers (Li, 2019). At the same time, the market-oriented interest rate system also provides banks with more business opportunities and profit models, but at the same time brings greater market risks and operational challenges.

In addition, marketization of interest rates involves the transmission mechanism of monetary policy. Under a market-oriented interest rate system, the central bank can influence market interest rates and thus economic activities by adjusting policy rates, which requires the central bank to improve its ability to monitor and regulate changes in market interest rates. For the financial market as a whole, the marketization of interest rates helps to form a more complete yield curve, providing an important reference for pricing and risk management in the financial market.

3. Characterization of Interest Rate Marketization in China

3.1. Construction and Improvement of the System in the Process of Interest Rate Marketization

In the process of China's interest rate marketization, institutional construction and improvement is the core link, which is not only related to the smooth progress of the reform, but also key to ensuring the stability and healthy development of the financial market. Since 2013, the People's Bank of China (PBOC) has gradually liberalized the control of financial institutions' lending interest rates, followed by

adjustments to the floating range of deposit interest rates until 2015, when the ceiling on floating deposit interest rates was completely abolished, marking an important step in the reform of China's interest rate marketization. The implementation of these reform measures reflects the gradual deepening and improvement of China's institutional construction in the process of interest rate marketization.

In terms of institution-building, China has emphasized the improvement of scientific internal pricing capacity and risk-pricing capacity, which is crucial for banks' loan pricing. Banks need to establish a sound internal price measurement system to ensure that policy effects can be transmitted to grassroots operating units through internal mechanisms, and at the same time, the assessment of grassroots operating units needs to be scientific and reasonable in order to reflect the policy intent in all operations of assets and liabilities. In addition, with the advancement of interest rate marketization, banks need to enhance their ability to manage interest rate and liquidity risks, especially in an environment where interest rates are fully marketized, interest rate fluctuations and capital fluctuations will increase, and interest rate and liquidity risks for banks will also increase, so they need to strengthen their risk management ability accordingly.

While promoting the marketization of interest rates, China has also focused on the gradual promotion of the convergence process to ensure financial stability. Interest rate convergence is a complex and sensitive process that needs to be promoted gradually on the premise of ensuring financial stability. In this process, various risks and challenges should be fully assessed, corresponding countermeasures should be formulated, a sound risk early warning and response mechanism should be established, communication and coordination with relevant departments should be strengthened, and policy continuity and stability should be ensured.

3.2. Gradual Acceleration of Interest Rate Marketization

The gradual acceleration of China's interest rate marketization process signifies the deepening of financial reforms and the enhancement of financial marketization. Since 2013, the People's Bank of China (PBOC) has taken a series of measures to promote the interest rate marketization reform into a fully open phase, with the core objective of achieving the marketization of deposit interest rates. In July 2013, China deregulated RMB lending interest rates, and bill discount interest rate controls were also lifted. In September of the same year, the self-regulatory mechanism for market interest rate pricing was established and began to operate a centralized quotation and release mechanism for benchmark lending rates. In 2014, the upper limit of the floating range for deposit rates was expanded several times, and central bank governor Zhou Xiaochuan proposed that an interest rate corridor model would be adopted in the future to regulate short-term interest rates. In April of 2015, local self-regulatory mechanisms were established in cities above the sub-provincial level across the country. In October of the same year, the central bank announced the abolition of the floating cap on deposit interest rates for commercial banks and rural cooperative financial institutions, etc., marking the basic completion of the 20-year-long interest rate marketization reform and the entry of interest rate marketization into a new stage (Guo, 2015).

The implementation of these reform measures has not only facilitated the enhancement of the autonomous pricing

capacity of financial institutions, but also provided a more effective channel for the transmission of monetary policy. With the advancement of interest rate marketization, financial institutions will be able to adjust interest rates independently according to the supply and demand of funds in the market, thus responding more flexibly to changes in the market and improving the efficiency of capital allocation. At the same time, it also means that competition among commercial banks will become more intense, which puts higher demands on banks' risk management ability and asset-liability management capability. In addition, the marketization of interest rates will help to optimize the credit structure and improve credit quality, enabling high-quality customers to earn more, while customers with higher risks and lower creditworthiness may exit the credit market.

3.3. The Process of Promoting Interest Rate Marketization has Followed the Principle of Prudence

The process of marketization of interest rates in China has embodied the principle of prudence, which has permeated the entire reform process. Since 1993, China's interest rate marketization reform has followed a gradual approach of "foreign currency first, then local currency; loans first, then deposits; long-term and large amounts first, then short-term and small amounts". This strategy reflects China's prudent attitude in promoting interest rate marketization, aiming to ensure the stability of the financial market and the sustainability of the reform.

With regard to the marketization of interest rates in the money market, China gradually liberalized interest rate controls, starting with the interbank lending market; in 1996, the Central Bank established a unified nationwide interbank lending market and created the interbank lending market rate (Chibor). Subsequently, the marketization of interest rates in the bond market was also gradually promoted, and interest rates for the issuance of treasury bonds and policy financial bonds were marketized. These steps laid the foundation for the subsequent market-oriented reform of interest rates and also provided practical experience for the marketization of interbank market interest rates and the issuance rates of treasury bonds and policy-oriented financial bonds.

With regard to the marketization of lending rates, China has gradually expanded the floating range of lending rates for financial institutions, requiring them to establish an internal pricing and authorization system for loans as a means of exercising the banks' interest rate pricing capacity. In this process, the People's Bank of China has gradually deregulated lending rates by gradually adjusting the floating range of lending rates, enabling banks to respond more flexibly to market changes.

With regard to the marketization of deposit rates, China has similarly adopted a gradual approach. Beginning in 1999, the central bank steadily expanded the floating range for deposit and loan interest rates and gradually promoted the marketization of deposit rates. During this process, the PBOC has focused on the construction of scientific internal pricing capacity and risk-pricing capacity, requiring banks to establish a scientific FTP system and to use LPR as the pricing basis for constructing a dynamic adjustment mechanism for loan FTP.

4. Impact of Interest Rate Marketization on Chinese Commercial Banks

4.1. Low Level of Market Economy Development

Against the background of China's low degree of market economy development, the impact of interest rate marketization on Chinese commercial banks is mainly reflected in several aspects. First of all, due to the imperfect market mechanism, commercial banks face greater market risks in the process of interest rate marketization. The fluctuation of interest rates increases the difficulty of banks' asset-liability management, and puts forward higher requirements for banks' profit model and risk control ability. Secondly, the intensification of market competition has made the competition among banks more intense, and banks need to innovate in products and services to attract customers, which to a certain extent increases the operating costs of banks. At the same time, due to the unsound credit system, banks face higher credit risks in credit allocation, and the non-performing loan ratio may rise, affecting banks' asset quality. In addition, the marketization of interest rates may also lead to a narrowing of banks' spreads, posing a challenge to their profitability. With a less developed market economy, banks are more sensitive to interest rate changes and more dependent on market information, which places higher demands on their market analysis and forecasting capabilities. Finally, the marketization of interest rates may increase the volatility of financial markets, posing a challenge to banks' liquidity management, and banks will need to pay more attention to the control of liquidity risk.

4.2. Regulate the Behavior of the Main Body of Interest Rate Operation

Interest rate marketization has had a significant impact on China's commercial banks, especially in regulating the behavior of the main interest rate operating entities. With the advancement of interest rate marketization, competition among commercial banks has intensified and the deposit and loan spreads have narrowed, weakening banks' profitability. This competitive pressure has forced banks to raise deposit rates to attract funds while lowering lending rates to remain competitive, resulting in a challenge to the traditional profit model of relying on the deposit and loan business. In addition, the marketization of interest rates has increased the risk of interest rate volatility, and commercial banks need to pay more attention to the impact of interest rate changes on their balance sheets, as well as on their net interest margins. Against the backdrop of interest rate marketization, banks' liquidity risk management has become more important, and liquidity has become an important means for commercial banks to enhance their risk resistance. At the same time, banks' business capabilities and security attributes are tested, and commercial banks with strong risk resistance can reduce capital losses and enhance asset preservation. Interest rate marketization also prompts commercial banks to innovate in their products and services to meet the diversified financial needs of their customers and to introduce new financial products and services, such as customized wealth management products and online financial services. Overall, interest rate marketization requires commercial banks to standardize their interest rate operations while strengthening

their risk management and enhancing their business innovation capabilities to meet the requirements of a market-oriented interest rate system.

4.3. Increased Interest Rate Risk as Well as Credit Risk

With the advancement of interest rate marketization, competition among banks has intensified, leading to a significant increase in the level of credit risk and the level of liquidity risk. The marketization of interest rates has forced banks to raise the level of interest rates in order to compete for market share, which has increased their interest rate risk and also exposed financial borrowing contracts to greater uncertainty, affecting macroeconomic stability. Due to the long-term interest rate suppression, the interest rate level after marketization will inevitably rise, the competition between banks to absorb deposits intensified, but the interest rate rises too fast, too high, will bring the "adverse selection effect" and "risk incentive effect" in the credit activities, so that the average asset quality declines, credit risk increases, and the average asset quality declines, credit risk increases, and the average asset quality declines. The average quality of assets declines, credit risks increase, and the risks originally borne by decentralized depositors fall mainly on the banks (Chen, 2006). In addition, the increase in the volatility of interest rate level will increase the repricing risk, benchmark risk, yield curve risk, option risk, banks prefer short-term loans, and short-term loans for borrowing enterprises, with high liquidity constraints, the enterprise is not easy to plan the use of funds in the business operation, if it is a long-term demand for the use of funds, you need to renew the short-term for the long term, it is more likely to repayment crises, thus bringing the credit risk of banks. This increases the likelihood of a repayment crisis, which in turn creates credit risk for the bank. Therefore, the marketization of interest rates not only increases the interest rate risk of commercial banks, but also makes the credit risk increase, which puts forward higher requirements on the risk management ability of banks.

4.4. Interest Rate Pricing Put to the Test

The marketization of interest rates has put the interest rate pricing ability of Chinese commercial banks to a severe test. With the deepening of marketization, the deposit and loan spreads of commercial banks have narrowed, and banks are facing significantly higher interest rate and liquidity risks. After the implicit floor for loans was broken, commercial banks priced their loans independently according to their own cost of funds, market supply and demand, risk premium and other factors, and lending rates dropped significantly. This requires banks to increase their sensitivity to market changes, strengthen risk management, optimize their asset and liability structure, and innovate financial products and services to attract customers. After the interest rate marketization reform, the synergistic pricing among commercial banks has been broken and their independent pricing ability has been enhanced, which puts banks in a more proactive position in the lending market, but they are also facing greater market risks and operational challenges. Banks generally use cost-plus pricing, but there is insufficient awareness of the marginal cost of funds, deposit rate rigidity makes it difficult to further reduce lending rates, the LPR curve is incomplete, and the pricing ability of small and medium-sized banks needs to be improved. Therefore, commercial banks need to scientifically use derivative products linked to LPR to reduce

the impact of interest rate changes on the value of assets and liabilities and to improve their interest rate risk management capabilities.

5. Countermeasures Suggestions for the Development of Chinese Commercial Banks under Interest Rate Marketization

5.1. Deepening Market Economy Reform and Accelerating Business Transformation

Against the backdrop of the marketization of interest rates, Chinese commercial banks are faced with the urgent task of deepening the reform of the market economy and accelerating the transformation of their operations. This transformation is crucial to the future development of banks, as it is directly related to whether banks can maintain competitiveness and profitability in the fierce market competition. With the advancement of interest rate marketization, banks' traditional deposit and lending business has been impacted and deposit and lending spreads have narrowed, forcing banks to look for new profit models and growth points. Banks need to shift from a crude business model to a more refined and specialized management in order to adapt to the new normal and new requirements of marketization.

Deepening market economy reforms means that banks need to pay more attention to market dynamics and increase their sensitivity to market changes, especially in asset-liability management, liquidity management, and risk management. Banks must optimize capital allocation, enhance the professional competence of their teams, improve quantitative analysis models, and strengthen data and system support. In addition, banks need to master pricing capabilities and establish refined, segment-specific and differentiated deposit pricing capabilities, as well as risk-based loan pricing capabilities, which require the establishment of appropriate organizational teams, data and system support.

Operational transformation also involves restructuring the business of banks, which need to increase their sources of non-interest income, improve the quality of their services, and expand into new business areas. This includes the development of intermediary businesses, such as wealth management and investment banking, which can generate a more stable income stream for banks and reduce their reliance on traditional deposit and lending businesses. At the same time, banks also need to strengthen and innovate their fintech capabilities, expand their operations using channels such as Internet finance and mobile banking, and improve customer experience to realize the success of their strategic transformation.

5.2. Cultivate the Market-Oriented Behavior of the Main Body of Interest Rate Operation, Clarify the Strategic Positioning, and Actively and Steadily Promote the Overseas Strategic Layout

The cultivation of market-oriented behaviors means that banks need to shift from a traditional business model that relies on policy protection to one that is more flexible and able to respond to market changes on its own. This requires banks to establish and improve their internal pricing mechanisms

and increase their sensitivity and responsiveness to changes in market interest rates, as well as to strengthen risk management, particularly in the areas of interest rate risk and credit risk management.

A clear strategic positioning is crucial for commercial banks. Banks need to formulate a clear development strategy based on their resource endowment, market positioning and customer needs(Zhang, 2006). This includes precise positioning of target markets, product lines and customer groups, as well as rational allocation of internal resources and capabilities. By doing so, banks can better capitalize on market opportunities and improve their competitiveness.

In advancing their overseas strategic layout, commercial banks need to consider the changes and trends in the global financial market and their own positioning in the global market. This involves not only the expansion of overseas markets, but also cooperation and competition with international financial institutions. Banks need to assess their own internationalization capabilities, including cross-border financial service capabilities, international risk management capabilities, and cross-cultural management capabilities, in order to find appropriate development opportunities in the global market.

5.3. Strengthen Interest Rate Risk and Credit Risk Management Capabilities

Against the backdrop of interest rate marketization, Chinese commercial banks are facing the dual challenge of interest rate risk and credit risk management capabilities. Strengthening these two capabilities is crucial to the sound operation of banks. First, banks need to establish sound scientific internal pricing capacity and risk pricing capacity, which involves the scientific and timely formulation of FTP (internal funds transfer pricing), as well as the scientific and reasonable appraisal of grassroots operating units. This not only affects the effectiveness of monetary policy, but also relates to the rational adjustment of banks' asset and liability strategies and the maximization of benefits.

Second, banks must improve their ability to manage interest rate and liquidity risks. In a fully marketized interest rate environment, interest rate volatility and funding volatility will increase, and accordingly, banks' interest rate risk and liquidity risk will also increase. Therefore, banks need to be proficient in tools such as interest rate derivatives to manage the risk of interest rate fluctuations and use asset securitization and other means to manage liquidity risk. These risk management capabilities should not only be applied to the bank's own operations, but can also be used as a technology output to provide risk management services to clients, thus bringing additional benefits.

In addition, banks need to strengthen institutional mechanism construction, promote interest rate marketization reform in a steady and orderly manner, increase the degree of LPR marketization, and improve the quotation model. At the same time, banks should improve the attributes of deposit interest rate marketization, appropriately increase the frequency of deposit interest rate marketization adjustment, and reduce the interest rate risk they face. Through these measures, banks can better cope with the challenges posed by interest rate marketization and ensure sound operation and controllable risks.

5.4. Enhancing Interest Rate Pricing Power

In the context of interest rate marketization, it is

particularly important for Chinese commercial banks to enhance their interest rate pricing capacity. The enhancement of this ability is directly related to the competitiveness and profitability of banks. First of all, banks need to establish a sound scientific internal pricing capability and risk pricing capability. This means that banks need to transmit policy effects to grassroots operating units through the internal funds transfer pricing (FTP) system and ensure that the assessment of grassroots operating units is scientific and reasonable, so as to reflect the policy intent in all operations of assets and liabilities. The accuracy of internal price measurement and the smoothness of the mechanism of transmission not only affect the effect of monetary policy, but also the rational adjustment of the bank's own asset and liability strategy, which in turn affects the maximization of benefits.

Second, banks need to improve their ability to manage interest rate and liquidity risks. In a fully marketized interest rate environment, interest rate volatility and funding volatility will increase, and banks' interest rate risk and liquidity risk will also increase. Therefore, banks need to be proficient in tools such as interest rate derivatives to manage the risk of interest rate fluctuations and use asset securitization and other means to manage liquidity risk. These risk management capabilities should not only be applied to the bank's own operations, but can also be used as a technology output to provide risk management services to clients, thus bringing additional benefits.

In addition, banks need to construct loan differentiated pricing models and strengthen the promotion and application of the models. This involves constructing and promoting the application of loan pricing models based on the RAROC pricing methodology in accordance with the principle of revenue covering costs, clarifying the principles and methods of loan interest rate pricing, and the rules of interest rate pricing authorisation and approval. Incorporating the quantitative results of internal credit risk assessment into the application of the loan pricing model to enhance the ability of customer risk screening; improving the construction of the economic capital measurement and operating cost sharing system to realise the scientific and reasonable determination of the loan execution interest rate based on the accurate accounting of the costs of funds, capital, operations and risks, taking into account factors such as the target return of the

products, the comprehensive contribution of customers and the Bank's business strategies, so as to effectively and timely incorporate cost control, risk management, return on capital and other business strategies into the loan execution interest rate. The Bank's business strategy intent of cost control, risk management and return on capital is transmitted to business units at all levels in a timely and effective manner.

6. Conclusion

The marketization of interest rates has had a profound impact on China's commercial banks, requiring them to enhance their market-oriented operational capabilities, risk management capabilities and to optimize their interest rate pricing mechanisms. Commercial banks must adapt to the market-based interest rate system, optimize resource allocation and improve service quality to meet the challenges posed by interest rate fluctuations. At the same time, banks need to strengthen their institutional mechanisms, increase the degree of LPR marketization, and improve their quoting models to ensure sound operations and controllable risks. In addition, banks should actively promote operational transformation and overseas strategic layout to enhance competitiveness and profitability. In summary, Chinese commercial banks need to adopt multi-dimensional strategies under the interest rate marketization to adapt to the deepening development of the financial market and the improvement of monetary policy transmission efficiency.

References

- [1] Rong, Y. Q. (2021). The impact of interest rate liberalization on commercial banks in China. *Marketing World*, (2), 97-98.
- [2] Li, G. Z. (2019). The impact of interest rate liberalization on commercial banks in China. *Business News*, (11), 22-23.
- [3] Guo, Y. M. (2015). A review of the impact of interest rate liberalization on commercial banks in China. *Financial Theory and Teaching*, (1), 58-61.
- [4] Chen, A. B. (2006). The impact and countermeasures of interest rate liberalization on commercial banks in China. *Special Zone Economy*, (12), 342-343.
- [5] Zhang, Y. (2006). The impact of interest rate liberalization on commercial banks and countermeasures. *Heilongjiang Foreign Trade and Economic Relations*, (9), 90-91.