Funds transfer pricing framework

Funds transfer pricing for assets and liabilities
Funds transfer pricing framework

Funds transfer pricing for assets and liabilities
Objectives of funds transfer pricing

- Provides consistent guidance in product pricing decisions
- Objective criteria for business group/product performance evaluation
- Removes interest rate/liquidity risks from line units and products and centralizes in one unit (ALM)
Framework for FTP implementation

Gross transfer of funds between ALM and business groups
Framework for FTP implementation

- Funds transfer pricing is based on gross transfer of funds to/from a central group
- All liability groups lend money to Asset Liability Management Group (ALMG) at corresponding bid rates
- Negative carry on regulatory reserves added to cost of liabilities
- All asset groups borrow money from ALMG at corresponding offer rates
MFTP in Indian context

- 3 year asset creation rate
- 3 year offer rate
- 1 year bid rate
- 1 year Liability creation rate
- 1 year Liability spread
- 3 Year asset spread
- SLR carry
- CRR carry
- Interbank curve
- Bid curve
- Mismatch Spread
Agenda

Funds transfer pricing framework

Funds transfer pricing for assets and liabilities
Capital & reserves

• Capital & reserves in FTP
  – Used as source of funding: Capital distributed to business groups
  – Not used as source of funding: Capital assumed to be held centrally and FTP based on 100% debt funding

• Pricing methodology modified accordingly

• Capital & reserves warehoused at ALM vs. corporate center
  – ALM borrows the funds from corporate center at pre-determined rate
CASA deposits

- Low interest cost but high operations cost
- Do not have explicit maturity and flows tend to be volatile
- FTP for core part of CASA based on
  - Average cost FTP: Fixed rate which will cover the operations cost
  - MFTP: Term deposit rates for behavioral tenures
  - Market benchmark FTP: Risk free rates for behavioral tenures
- FTP for volatile portion
  - Short tenure rates
  - Discount over FTP rates for core CASA
- Bills payables akin to CASA deposits
CASA deposits

• FTP based on term deposit rates or market benchmarks
  – True reflection of benefits
  – FTP income is not entirely in business group’s control, budgeting is difficult
  – May not motivate teams to increase volume if bid rates go significantly higher than budgeted rates

• Fixed rate FTP covering the operations cost
  – Business groups will be volume focused
  – Significant income in ALM if MFTP followed for assets
Term deposits

• Retail term deposits vs. wholesale deposits
  – Core/stable/long term vs. volatile/purchased
  – Low cost over medium term vs. market determined cost
  – High vs. low operations cost

• Factors to be considered for arriving at FTP methodology
  – Business group/branches are volume drivers vs. price deciders
  – Cost plus fixed transfer price income vs. market based common bid rate across all term deposits
Term deposits

• FTP rates set based on expected rate on marginal funds
  – Business groups are expected to be price deciders with control on funding rates
  – Market expectations could be in-built into bid rates
    • Possibility of low mobilization if market rates are higher than bid rates set
    • Possibility of retail rates higher than bid rates resulting in lower retail TD mobilization
  – Will be perceived as non-transparent if actual rates are consistently different from FTP rates
Term deposits

- FTP rates set based on most recent historical rates on marginal funds
  - More transparent but backward looking
  - Business groups may not mobilize funds if sudden spike in rates unless minimum FTP spread is given
  - Liability rates to be decided centrally and business groups are expected to be volume drivers
  - If fixed FTP spread is given, bid rate could be computed based on only wholesale deposits or blended retail & wholesale deposits
Offer rates

- Offer curve upto 1-year is calculated as bid/blended-bid rate adjusted for:
  - CRR and SLR negative carry
  - Liquidity charge for maintenance of liquid assets

- Offer curve beyond 1-year
  - Longer term liability curves may not be liquid and representative
  - Above methodology vs. specified term premia
  - Term premia depend upon the slope of the bank’s deposit rate curve and other market rates
Priority sector vs. non-priority assets

• General purpose lending requires creation of additional priority eligible assets
  – Shortfall results in investments with NABARD/SIDBI at very low rates

• For pricing of non-priority sector advances, a specific charge could be applied on the offer curve computed
  – To offset the negative carry on agri lending and RIDF investments
  – To protect the overall margin of Bank

• Specific charge could be computed based on incremental negative carry at the margin vs. average negative carry for the entire shortfall
Cash credit and overdrafts

• Non-maturity asset
  – Long-term for liquidity based on behavioral analysis
  – Short term for interest rate sensitivity
  – Volatile flows requiring maintenance of liquid assets
  – Difficult to manage in FTP & ALM

• FTP for drawn facility: Offer rates for behavioral maturity

• FTP for undrawn facility: Cost of liquidity based on historical volatility observed
  – Could be charged on undrawn facility or on drawn facility
  – Historical volatility considered for FTP should be in sync with ALM statements
• Fixed rate/long-period reset loans based on match funded offer rates for the respective tenures
  – Amortizing loans to be considered as series of fixed rate loans and not as loan for average maturity
  – Tenures used for matched funding could be adjusted based on historical prepayments observed
• FTP for long tenure loans with variable rate/short-period resets
  – Based on behavioral interest rate patterns: Possible only if volume is manageable
  – Based on funding strategy used: If the product volume is high
  – Basis risk inherent in FTP rates and benchmark used
• Tenure based liquidity charges to be considered explicitly
Treasury assets

• Trading assets are acquired with shorter holding period
  – Not ideal to match fund the trading assets
• TP of trading assets based on liquidity/expected holding period of such assets
  – Transfer pricing of liquid trading assets may be based on alternative shorter-term liquid assets yields
  – TP of illiquid trading assets to incorporate expected holding period offer rate
• Transfer pricing of liquid repo-able trading assets based on the repo funding cost adjusted for regulatory reserves cost, if any
Foreign currency assets/liabilities

- Limited fungibility between INR and FC liabilities
  - Can create an INR liability through FC liability and FX swap
- FTP for FC assets and liabilities based on
  - Arbitrage principle: FTP on INR assets and liabilities adjusted for swap cost
    - May result in being uncompetitive in FC at times
  - Independently managed book: FC asset pricing is based on FC liability pricing
    - Interest differential benefit, if any, passed on to the client
Special cases

• Interbank vs. non bank liabilities
  – Benefit of CRR to be given for interbank liabilities

• Benefit of SLR to be given for interbank assets
  – Subject to existence of interbank liabilities

• FTP for refinance borrowings and corresponding assets to be linked

• FTP for cash held by the bank to be same as FTP given to SLR securities
  – Cash is considered part of SLR

• NPA: Difficult to ascertain the interest rate/liquidity characteristics
  – Medium term fixed rate assets vs. cost incurred by the bank
Prepayments

- Wholesale asset prepayments result in unplanned cash inflows
  - Deployment in liquid assets at low rates
  - Could be considered as borrowing without reserve requirements
  - Prepayment premium computed and charged to client/business

- Prepayments in retail assets are predictable
  - Loan FTP is based on cash flows adjusted for prepayments
  - Prepayment charge if actual prepayments are significantly different
Non-fund facilities

• Devolvement of LC/BG
  – Cost of liquidity based on historical devolvement rates observed
    • Devolvement considered for FTP should be in sync with ALM statements
• Margin calls on derivatives
  – Cost of liquidity based on simulation exercises
  – Becoming significant due to regulations mandating central clearing
FTP and Base Rate

• All variable/floating rate reset loans to be linked to Base Rate
• Base Rate methodology vs. FTP methodology
  – Base Rate methodology is fixed while FTP methodology evolves based on internal strategic choices
• Basis risk is inherent between Base Rate and FTP
  – Difficult to manage the basis risk
  – Basis risk to be warehoused at business vs. ALM
Incorporation of strategic objectives in FTP

• FTP to be used along with other management levers
  – Volume targets wherever possibility of significant shortfalls/overruns
  – Volume targets wherever significant benefits in products and FTP rates do not decide the final pricing of products; e.g.: CASA
  – Incentive structure could be built into FTP rates for specific assets/liabilities based on strategic objectives of the bank
    • Retail deposits vs. wholesale deposits
    • Targeted products with specific focus; e.g.: retail assets
    • Trade credit with significant linkages with commercial banking
Sources of liquidity risk

- Long term loans requiring multiple rollovers of liabilities
- Volatile nature of demand deposits/working capital facilities
- Volatility due to
  - Undrawn committed facilities
  - Devolvement of LC/BG
  - Margin calls on derivatives
- Stress/contingency scenarios