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Promoted by Reserve Bank of India

Funds Transfer Pricing Methodologies

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May 15, 2014

Agenda

Funds transfer pricing framework

Funds transfer pricing for assets and liabilities

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Objectives of funds transfer pricing

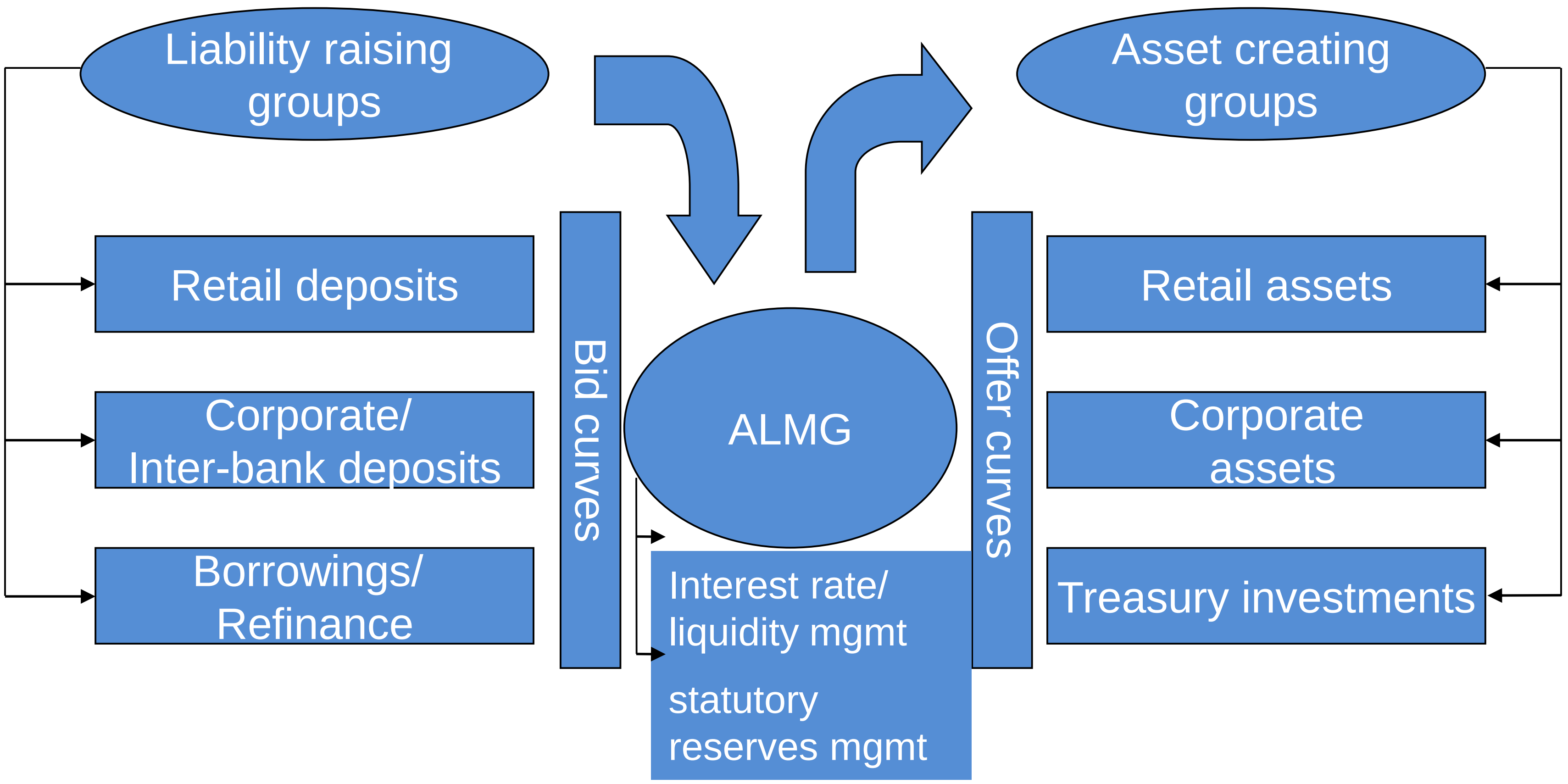
Provides consistent guidance in product pricing decisions

Objective criteria for business group/ product performance evaluation

Removes interest rate/liquidity risks from line units and products and centralizes in one unit (ALM)

Objectives of funds transfer pricing framework

Framework for FTP implementation

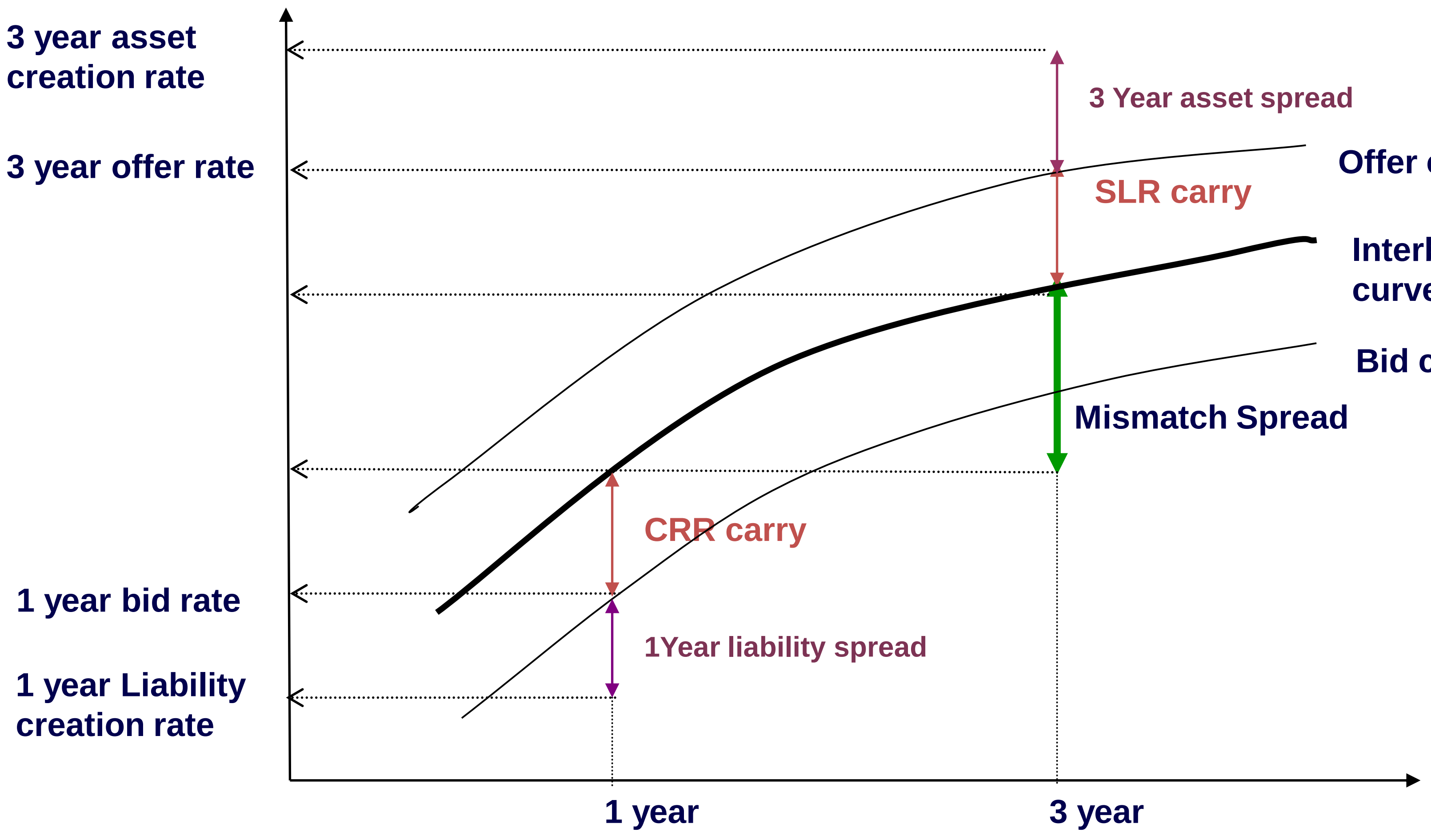


Gross transfer of funds between ALM and business groups

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



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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

Term loans

- 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

Thank you

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