



**CAFRAL**

CENTRE FOR ADVANCED FINANCIAL  
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# Transfer Pricing

**Smita Aggarwal**

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# Importance and Impact of Transfer Pricing

- Introduction
- Simulation Exercise in groups
- Discussion with a panel of experts

# Example 1

## Auto Loan

- Loan Amt.: Rs.1,00,000
- Rate of Interest : 12% p.a.
- Period of Loan : 3 years

## Deposit

- Deposit Amt: Rs.1,00,000
- Rate of Interest : 9% p.a.
- Period of deposit : 1 year

**What is the Net Interest Income for the period of loan?**

\* Footnote

# Example 2

## Branch 1

- **Only Liabilities**

- **Deposits**

- Total Outstanding : Rs.10 lacs

- Tenor : 1-3 years

- Rate of Interest : 9% - 10% p.a.

- Weighted Average Cost : 9.25%

## Branch 2

- **Only Assets**

- **Loans**

- Total Outstanding : Rs.10 lacs

- Tenor : 2-3 years

- Rate of Interest : 11.5%, 12% & 12.5% p.a.

- Weighted Average Interest : 12%

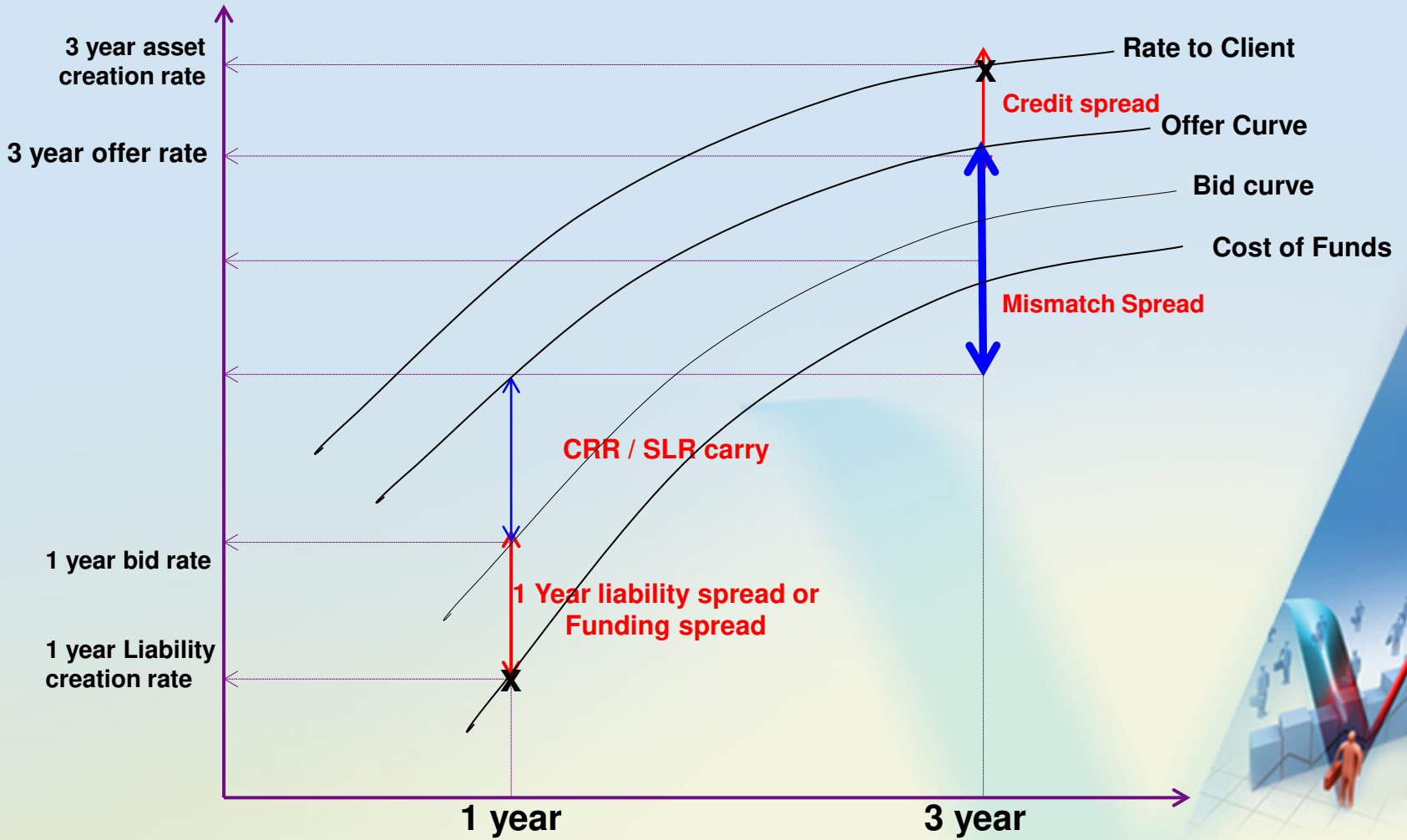
**How do you measure the performance of each branch?**

\* Footnote

Source: Source



# Transfer Pricing



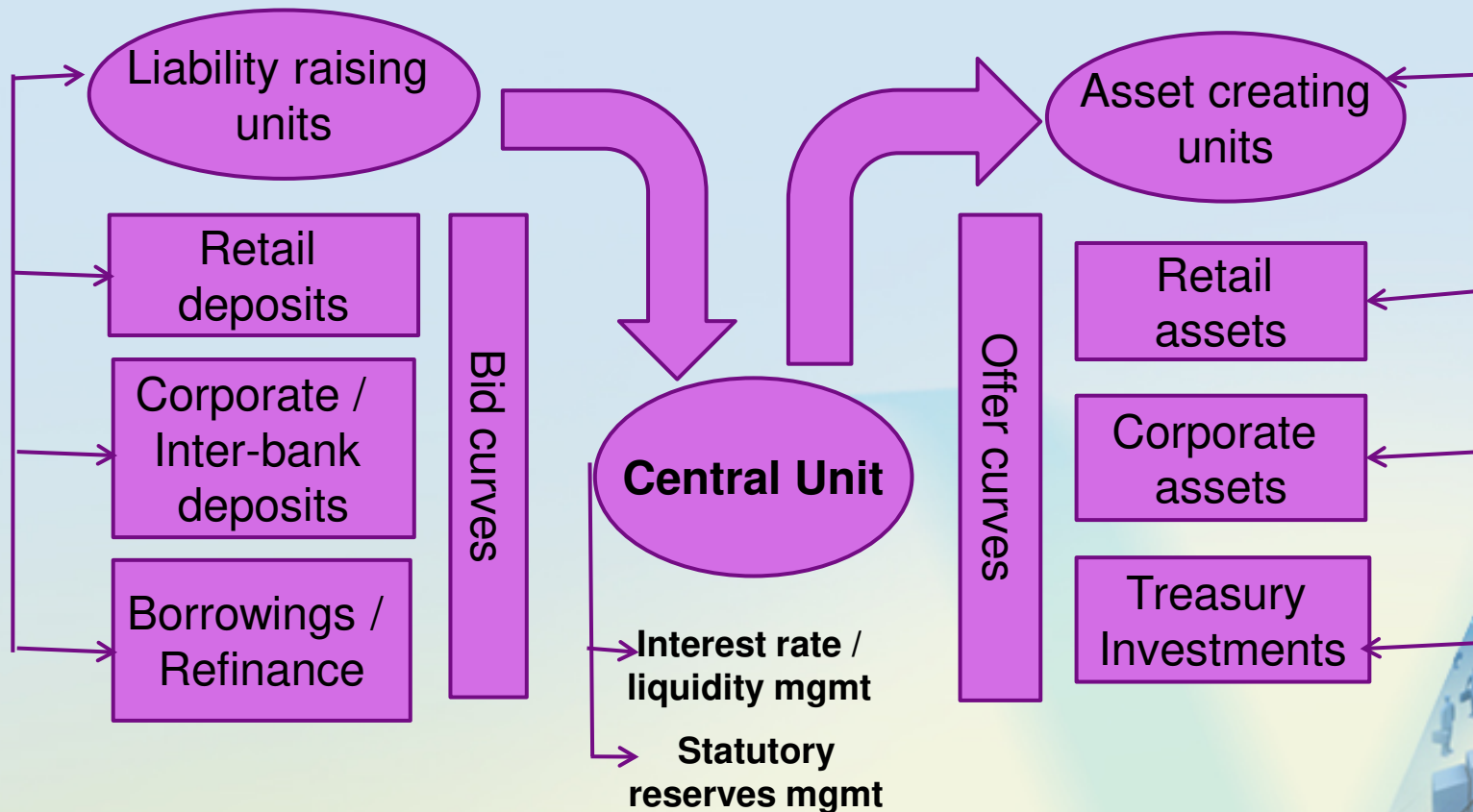
# Objective of Transfer Pricing

Transfer Price is an internal rate used to notionally transfer assets and liabilities between different units in a bank

- Provides guidance to make decisions to prioritise resource allocations.
- Transfers the interest rate risk from branches / business units to a central pool
- Provides objective criteria for business unit / branch / product performance evaluation
- Integral to asset liability management



# Transfer Pricing Implementation



➤ **Gross transfer of funds between ALM and business groups**

➤ **Asset pricing assumes that entire funding is through debt**

# Transfer Pricing Yield Curves

## Bid Rates

Different methodologies can be used to construct bid curve:

- ❑ Uniform rate based on average cost of funds
- ❑ Market benchmark rate
  - MIBID for 1 day to 3 months
  - G-Sec for 1 year to 15 years
  - Interpolation for 4 months to 11 months
- ❑ Maximum marginal rate
  - Based on maximum rate deposits / borrowings adjusted for term structure
- ❑ Marginal blended rate
  - Based on blended cost of marginal term deposits and CASA deposits

# Transfer Pricing Yield Curves

## Offer Rates

Offer curve is calculated as bid rate adjusted for:

- ❑ CRR and SLR negative carry
- ❑ Liquidity charge for maintenance of liquid assets
- ❑ Term premia depending upon slope of deposit rate curve and other market rates.

# Profitability of a business unit

## ❑ Net Interest Income

- Interest earned on assets – Offer rate (transfer price)
- Bid rate (transfer price) – interest paid on deposits

## ❑ Credit losses

## ❑ Operating Expenses

- Direct expenses
- Allocated costs

# Use of Transfer Pricing to drive business strategy

A skillfully designed transfer pricing policy allows each branch / business unit to prioritize on goals assigned by the top management.

- More attractive offer rate for priority sector loans
- Additional charge on offer rate for long maturity assets
- Cost of liquidity charge on cash credit accounts

# Simulation Exercise

Objective :

- To understand the impact of transfer pricing on business decisions

Goal :

- Maximize Net Interest Income
- Maintain gap position within limits

# Groups for Simulation Exercise

## Group I

1. Gauri Shankar
2. Jai Kumar Garg
3. M Sreenatha Sastry
4. B B Joshi

## Group II

1. Ashutosh Khajuria
2. Ram S Sangapore
3. R K Takkar
4. Charan Singh

# Groups for Simulation Exercise

## Group III

1. N Krishnamachari
2. B K Divakara
3. Melwyn Rego
4. Binod Kumar

## Group IV

1. P S Rawat
2. Mahesh Kumar Jain
3. Rajendra D Adsul
4. G Sreeram

# Groups for Simulation Exercise

## Group V

1. Rakesh Sethi
2. N R Narayanan
3. Raj Kumar Bansal
4. K R Mohanachandran

## Group VI

1. Amar Lal Daultani
2. Sanjay Mallik
3. Atul Kumar Agarwal
4. B S Rama Rao

Lets begin.....

# Calculation of Base Rate

☐ Cost of Funds

+

☐ Negative carry on CRR and SLR

+

☐ Unallocable Overhead Cost

+

☐ Average return on Net worth

# Various Methods for Transfer Pricing

- ❑ Single Rate Transfer Pricing
  - Uniform rate (based on average cost) applied to all assets and liabilities
- ❑ Market related yield curve
- ❑ Marginal highest borrowing cost
- ❑ Average blended cost based yield curve