



CAFRAL

CENTRE FOR ADVANCED FINANCIAL  
RESEARCH AND LEARNING

Promoted by Reserve Bank of India



# Funds Transfer Pricing Methodologies

Rakesh Jha, ICICI Bank

May 15, 2014

**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

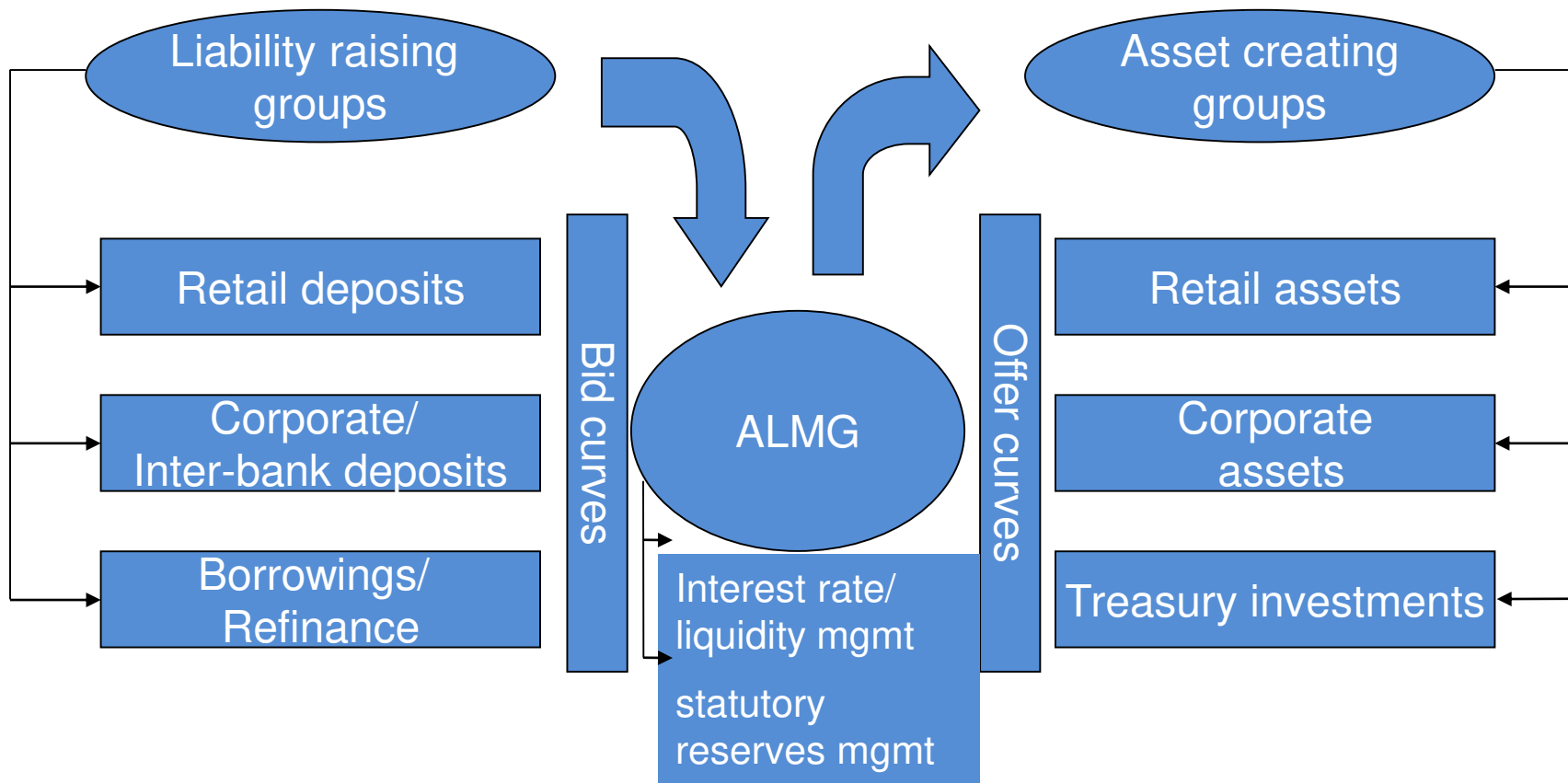
**Provides consistent guidance in product pricing decisions**

**Objective criteria for business group/  
product performance evaluation**

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

**Objectives  
of funds  
transfer  
pricing  
framework**

# Framework for FTP implementation

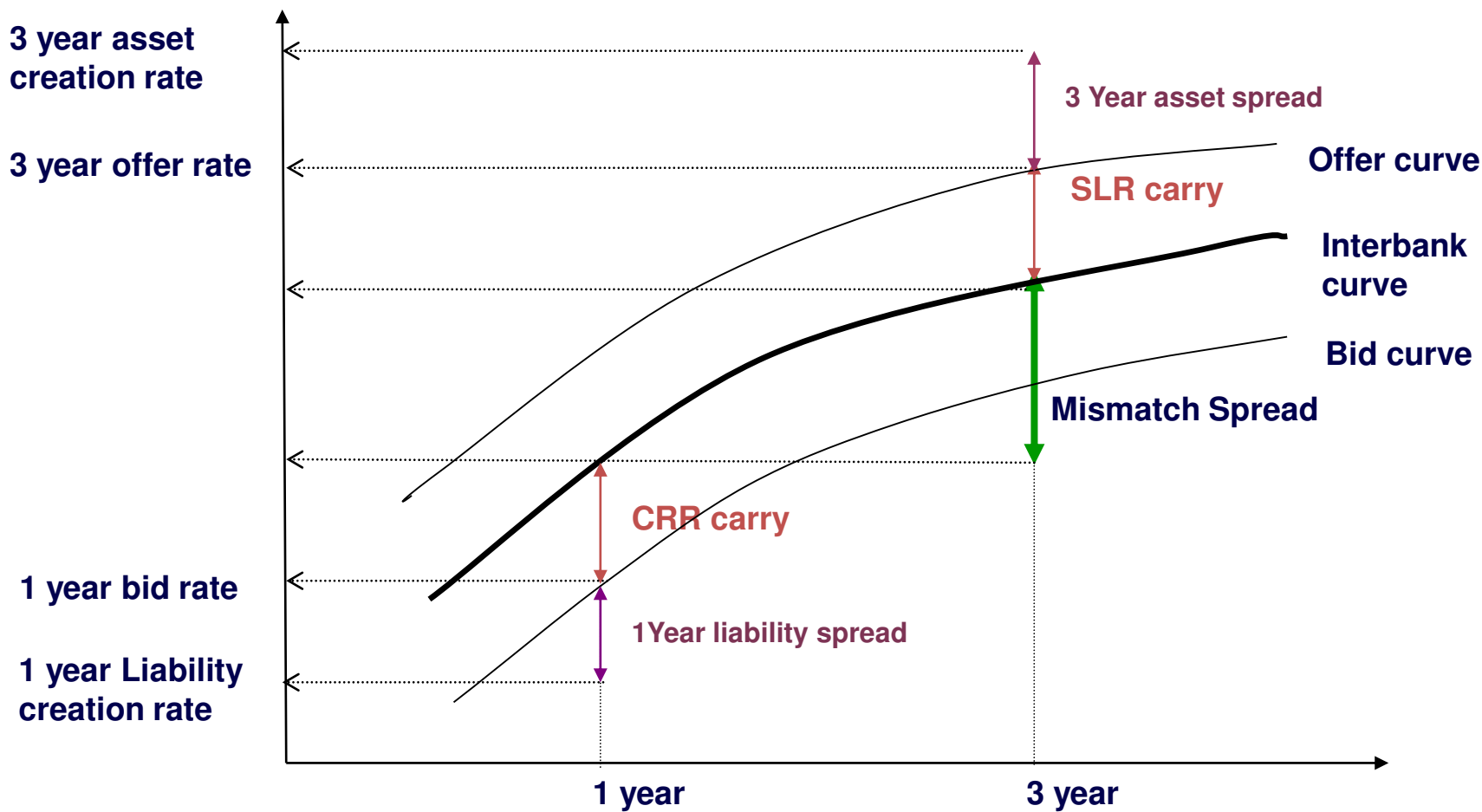


***Gross transfer of funds between ALM and business groups***

# 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



**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