Spread the risk

The Middle East is experiencing an ever more unstable geo-political climate that is challenging bank management to calculate the risks of long-term business service offerings, thus challenging the banking sector to enhance its performance management competencies through better management experience, stronger and efficient credit controls through a unified information technology system/platform and processes to better collate credit data, portfolio management and performance.

The banking sector worldwide, and especially in the Middle East, faces the challenge of sustainable profitability. Banks are facing a multitude of regulatory requirements to conform with Basel III, putting pressure on capital adequacy ratios in the form of increased capital requirements from shareholders.

Current historically low interest rates, increased competition and the fast growth of Islamic finance products, which rather than transfer risk, work on a system of shared risk, are eroding traditional profit margins through increasing compliance costs and expenditure on more flexible and innovative lending products.

Adopting the Fund Transfer Pricing (FTP) model is key to providing banks' management and employees with the operational and performance tools to better manage their profitability reporting via their own branches, customers, officers, products, segments and channels, in addition to improving their overall assets and liability management (ALM), creating a competitive advantage and strategic benefits.

By viewing the bank's income statement and analyzing the net interest income it would seem as though all loans are profitable and all deposits incur loss. But this is not the case. Each deposit is valued as a source for loans and likewise each loan has its own cost of funding.

What is Fund Transfer Pricing, its objective and its need?

In simple terms, Fund Transfer Pricing (FTP) is a method used mainly in banking to internally measure and evaluate the profitability of loans, deposits and other products. The deposit division gets funds from customers in the form of deposits, which are then handed on to the treasury division for appropriate deployment. These funds are then handed on to the lending division for lending to customers as loans. In case of shortage of funds from deposits for loans, treasury secures additional funds from the marketplace. The net interest income, composed of interest income and interest expense in principle constitutes the major component of a bank's profit.

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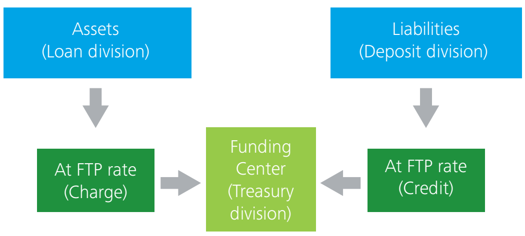
Fund Transfer Pricing is illustrated in the chart below. Once a deposit is received, it passes through the funding center (Treasury) on its way to the loan division. The funding center earns a spread for handling the interest rate risk resulting from the gap in the maturity of the funds.



The purpose of FTP is to set a value on each deposit and allocate a cost to each loan that a bank has and at the same time addressing the impact of liquidity, interest rate risk and maturity transformation on the bank's financials.

With increasing competition within the financial sector, information on products and customers profitability will optimize management decision on areas like cost control, levels of profitability and resource allocation.

Going back to the banking sector, compulsory deposits with central banks that are usually computed on the basis of specific percentages on sight and term customers' deposits subject to certain adjustments and exemptions in accordance with local banking regulations of each country are indirectly relevant to Fund Transfer Pricing. These deposits are not available for use in the bank's day-to-day operations and therefore can't be invested in lending, hence, decreasing the amount of funding available and increasing funding costs to the bank.

FTP is important since it insures that benefits, together with the costs and risks, are all allocated to the different business lines moving downwards to products and customers. FTP is not new: it has been there for product pricing purposes and analyzing profitability but has gained importance in light of the recent financial crisis and the current economic environment. A key factor in the recent crisis is the failure to compute Fund Transfer Pricing correctly, which ended up valuing very risky assets that looked profitable where in fact they weren't. All this resulted in a number of new regulatory requirements, including liquidity standards set by Basel III, impacting Fund Transfer Pricing and requiring a major response from financial institutions and how FTP structures are associated to the best practice principle for liquidity management.

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It will be naïve not to expect that these requirements will soon find their way to the banking sector across the region. Until then banks, whether commercial, specialized or Islamic are urged to use Fund Transfer Pricing and state their funding costs accurately. Banks need to follow two protocols: firstly, through training, mentoring and communication, unify their thinking and awareness regarding the importance of Fund Transfer Pricing; secondly, through focusing on strategies to promote the process of the FTP system and integrate it in their IT systems and benefit from its output.

by **Farid Massoud**, Principal, Audit, Deloitte Middle East