



Funds Transfer Pricing (FTP)

Insight

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An Introduction to Funds Transfer Pricing (FTP)

Following the drastic aftermath of the financial crisis in 2008, various standards were introduced to inculcate a practice of ensuring that sufficient liquidity was maintained by institutions globally. Establishing regulations for the Funds Transfer Pricing (FTP) process was a part of these reforms. In 2010, the European Banking Authority initiated the formation of a framework, by establishing guidelines for the liquidity cost benefit allocation.

What is Funds Transfer Pricing?

Funds Transfer Pricing is a methodology for pricing transactions carried out internally within an institution, i.e., between the functions and the central unit that manages the pool of funds. Institutions make use of this methodology to assess their profitability.

The development of a robust FTP framework will transfer any financial risk from the business functions to the centralized Asset Liability Management function. The framework will also serve as an accurate and fair performance measure for different functions, which will allow for improved decision making. Figure 1 provides an overview of the mechanism of the FTP process.

Critical Building Blocks

- **Principles and organizational structure:**
 - Instill principles in the framework that fulfill regulatory expectations.
 - Establish a governance framework that reflects the business model and is under the Asset & Liability Committee's supervision.
- **Curve setting:**
 - Deliberate the interest rate risk and liquidity funding risk components of the market yield curve.
 - Address challenges to derive the liquidity funding spread curve due to the lack of an observable market that provides pricing for term funding.
- **Internal profit and loss:**
 - Uphold transparency to enable functions and the Central Funding Unit to assess the impact of FTP decisions on the overall margin and risk profile.
- **Cash flow model usage:**
 - Derive FTP cash flows for on and off-balance sheet items.
 - Application of the same models and assumptions for risk measurement to ensure consistency and comparability.
- **Liquidity reserves:**
 - Allocate liquidity buffer costs and apply contingency risk costs (based on the liquidity reserve requirements).
- **IT Infrastructure:**
 - Build an infrastructure that supports granular FTP calculation, effective analysis and reporting capabilities and data collection and storage.



Figure 1: Summary of the FTP Mechanism

Common Challenges

Financial institutions are increasingly compelled to enhance their FTP practices due to a set of potential, yet common challenges. The rationale behind these enhancements lies within a growing recognition of the need to better understand and appropriately price the liquidity, funding, capital, prepayment, and other risks inherent in their businesses, as well as the need to align FTP with other Risk Management and performance measurement frameworks. Institutions are likely to face the challenges identified below:

Alignment with Revised Basel III

In line with the revisions, it is at the institution's discretion as to whether capital charges should be incorporated within the FTP framework, based on the revised Risk-Weighted Assets (RWA).

Breakage and Prepayment Charges

It is important that charges relating to early redemptions by customers and the implication of such charges on the FTP are deliberated.

Country and Currency Risk

To ensure that the institution can maintain a competitive position, the risk inherent with the domestic market and currency should be reflected within the FTP framework.

Single Curve

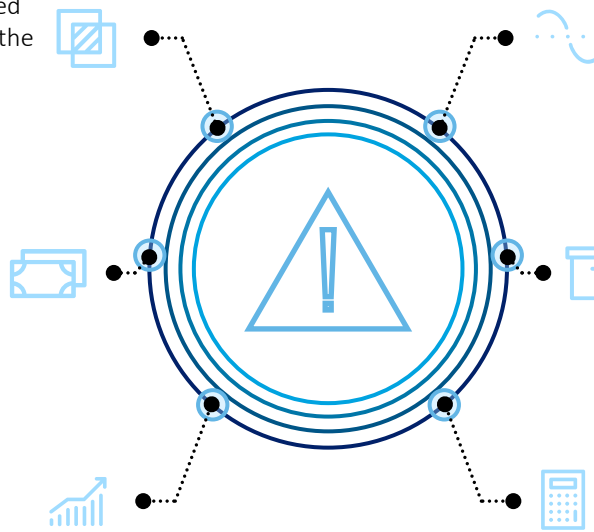
Maintaining a single-curve FTP approach may not be suitable in terms of appropriately pricing products and segments. It is important that the correct approach, most suited to the specifications of the institution, is followed.

Off Balance Sheet Items

The integration of charges applicable to Off-Balance Sheet items within the FTP, such as contingent liquidity charges, must be considered.

Liquidity Premium Computation

Determining the most appropriate methodology of computing the liquidity premium component, which should ideally be reflective of the market, within the FTP is highly essential.



Elements of a Compelling FTP Framework

Growing Profitably

It is crucial for institutions that aim to maximize their profitability to deploy a well-defined framework that incentivizes smart risk-return tradeoffs and establishes a clear understanding of how different products and business lines impact the institution's bottom line. This is where the FTP framework comes in; there are certain key elements that ought to be incorporated for a lucrative future:

- **Alignment with long-term goals:** Driving the institution's strategic agenda on both sides of the balance sheet will help ensure that all members of the institution work towards a collective goal. What will further promote this is the calibration of the individual functions' incentives with the institution's overall agenda.
- **Encourage participation of functions:** Increased participation will allow for the maintenance of transparency through the FTP framework and management of internal resistance to change. This would reinforce "big-picture" benefits at an institutional level, rather than at a functional level.
- **Governance and reporting:** The establishment of robust governance and reporting processes (in areas such as transparency, profitability, and goal achievement) will allow the institution to track progress and identify any areas requiring adjustments.

Fostering Business Engagement

There are several tradeoffs and strategic / tactical changes involved in FTP mechanics, where one function may be benefiting at the cost of another function. It is important to ensure that the benefit of the overall institution is taken into consideration, and that key stakeholders from functions are involved in the development / enhancement of the FTP framework. Furthermore, discussions of a divisive nature should be avoided at all costs.

In order to mitigate friction within the institution's functions, certain actions may be taken to encourage productive engagement by the functions:

1 Establish Guiding Principles

- Establishing principles that will form a basis to inform decisions that require judgment, which may result in a conflict.
- Determine whether a trade-off is required between principles (e.g., having accurate metrics that appropriately reflect risk vs. having a transparent framework).
- Foster a shared understanding of goals that builds trust for the purpose of informing management for better decision-making (e.g., metrics should reflect true economics as accurately as possible).

2 Early Involvement of Business Units

- Keeping business units involved will allow them to participate in the decision-making process in the framework development.
- Business units may provide useful feedback upfront that may inform downstream design decisions (e.g., desired granularity of reporting).

3 Conduct Pro-Forma Impact Assessments

- Pro-forma impact assessments provide a tangible basis to assess specific methodology choices.
- Sourcing data feeds for pro-forma calculations help identify current data limitations and corresponding IT builds required to reach target state.

4 Phased Implementation Planning

- Allows for a "parallel-run" period, including comparisons to prior (existing) metrics limiting business disruption.

Market Trends

The recent regulatory focus on liquidity and funding risks, coupled with the changing market dynamics and competitive pressures, has amplified the importance of robust FTP practices as an essential tool for effective Risk Management and Sustainable Profitability.

As such, financial institutions are proactively seeking to enhance their FTP capabilities to ensure greater accuracy, transparency, and consistency in pricing, risk allocation, and performance measurement across their businesses, while also improving their ability to manage and optimize their balance sheets, funding sources, and liquidity positions.

Some of the latest trends taking place in the market with regards to FTP are discussed below:

Dual Base Curve Approach

Implementing a dual base curve approach directs that a separate curve is applicable to assets and liabilities respectively (i.e., the benchmark offer rate is applied to assets, while the benchmark bid rate is applied to liabilities). This allows for heightened appropriate pricing and incentivization of select products and / or customers, while also encouraging the achievement of the institution's overall strategy and long-term objectives. The benefits of maintaining a bid-offer spread include the following:

- Helps maintain pricing discipline for the centralized funding unit (in terms of sourcing loans and accepting deposits) for all functions.
- Mitigates costs arising out of funding risk and liquidity risk, which are borne by the central funding unit.
- Compensates the central funding unit for the benefit provided to functions in terms of regulatory costs (such as regulatory capital add-on).
- Permits sufficient allocation of costs relating to the *required reserve effect* (this is defined as an institution's inability to lend all of the funds it has raised, due to the reserve requirement).

Contingent Liabilities

Calculating the charge for contingent commitments (such as lines of credit, collateral postings for derivatives and other financial contracts and liquidity facilities) is not straightforward. For such facilities, the best approach is to determine a reasonable worst-case scenario (which has a low probability) and charge sufficiently at the most granular level (i.e., the transaction, product, or business unit) for the costs of this outcome.

All institutions should charge contingent commitments based on their likelihood of drawdown, which considers customer drawdown history, credit quality, and other factors. Further, the likelihood of drawdown should be assessed using behavioral modelling and should depend on factors related to the customer, such as drawdown history, credit rating, and other relevant factors.

Trading and Derivatives Positions

The application of the FTP to Treasury products would vary for secured and unsecured funding. However, considering that not all trading book assets would be of an equal liquidity level, the policy may break down the asset types into the desired categories.

The Derivatives Book contains collateralized and uncollateralized positions, which are considered and managed on a portfolio basis. Cash flows based on these positions should be modelled into tenor buckets and charged / credited with the appropriate FTP curve.

Capital Allocation











The institution may choose to allocate free-flow capital from FTP prospective. This allocation shall be taken into consideration within the FTP.

Deloitte's FTP Capabilities

Our Value Proposition

- **Experience:** Leverage on deep and diverse experience to advise on latest industry best practices
- **Guidance:** Advise business leaders on nuances of complex matters and rationale.
- **Viewing angle:** Opportunity to obtain advice and alternative perspectives to achieve preferred treasury decisions.
- **Internal control:** Evaluate control environment and help align processes with relevant internal control framework
- **Complexities:** Evaluate implications of complex models and resolution of issues
- **Relationships:** Help provide continuity in knowledge on the company's business and concerns
- **Regulators:** Provide guidance regarding regulatory requirements to ensure compliance
- **Communication:** Ability to coordinate with a single point of contact for a range of services
- **Scale up:** Leverage on global connections to assist company in scaling up regionally

Our Service Offerings

	FTP FRAMEWORK REVIEW & GAP ASSESSMENT		DEVELOPING RFP AND VENDOR SELECTION FOR SOLUTION DESIGN
	MARKET BENCHMARKING		EVALUATING VENDOR FUNCTIONAL SOLUTION DESIGN
	FTP FRAMEWORK, POLICIES & PROCEDURES DEVELOPMENT		DEVELOPMENT OF USER ACCEPTANCE TESTING (UAT) TEST SCENARIOS
	DEVELOPMENT OF FTP METHODOLOGIES & MODELS AND FTP & LP COMPUTATION TOOLS		UAT EXECUTION AND OUTCOME REVIEW
	ASSESSING FTP MIS SYSTEM REQUIREMENTS AND DEVELOPMENT OF BUSINESS REQUIREMENTS DOCUMENT (BRD)		KNOWLEDGE TRANSFER SESSIONS ON RECENT MARKET DEVELOPMENTS AND PROPOSED SOLUTIONS

The DME Difference

- **Dedicated specialists:** DME's global network gives you access to the right skills wherever you need them. Our professionals have years of hands-on experience and have a large pool of know-how, international connection and network, and specialization in treasury.
- **Greater accuracy:** Highly trained professionals with relevant experience and up-to-date knowledge for each engagement to ensure the quality of service rendered.
- **Use of technology and ensuring discretion:** DME utilizes in-house templates and tools to support treasury operation of your company.
- **Providing helpful guides:** We can assist you by attaining significant process improvements at lower cost and risk that suit your Company.
- **Cost-benefit analysis:** The benefits of engaging with DME far outweighs the cost of engagement.
- **One-stop shop:** Our team comprises of various specialists, from accounting and tax advisory to finance and treasury operations, who can advise you throughout your business journey.

Our Team

With an understanding of the complex nature of FTP assignments, DME has combined the seasoned professionals to make a team thriving at the forefront of treasury innovation and challenges.

In case you would like to talk to us about any of the aspects covered in this document or would like to understand how our service offerings can benefit your organization, please feel free to contact us.



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