Fund Transfer Pricing

F T P

KPMG d.o.o. Beograd
Financial Services Team
2016

Would you like to see more and further than others in terms of your profitability?

Contents

Introduction to Fund Transfer Pricing (FTP)

Banks have realized the need for an **effective transfer pricing** system in order to manage funding, the balance sheet structure (financial or ALM risks), and **risk adjusted profitability**.

Taking into account decreasing market rates environment and the fact that majority of Banks NBI comes from Net interest income, the FTP system is crucial.

Net Banking Income of Serbian banking sector	**Q3 2015**
Net interest income	73%
Net fee and commission income	19%
Net income from fin. transactions	5%
Other income	3%
Total	**100%**

Source: National Bank of Serbia.
Note: Annualized data.

What is FTP?

- **Fund Transfer Pricing (FTP)** is a well known practice in finance. It is a part of the overall management information, accounting and control system which includes: pricing, budgeting and profit planning, ex-post profitability measurement (profit ability controlling) and ALM.

- It is a **widely used** and **comprehensive tool** in overall financial management. Some would say it's crucial for effective and efficient not only financial but banking business management.

- FTP system serves as main tool for **expost profitability measurement**, i.e. profitability follow-up and controling per various axis (business units, products, branches, relationship managers etc.).

- The FTP system groups together the **financial risks** generated by commercial transactions with in a Central Finance Unit (CFU). CFU is generally managed by the ALM/Treasury department, which has the necessary expertise and resources to assess and hedge the financial risks.

- This centralization of risks is done thanks to a **system of internal transfers** between the commercial (business) lines and the CFU. These internal transfers are made via the theoretical "purchase" of customer deposits from deposit centers and the theoretical "sale" of funds to loan centers. The pricing terms of such transfers constitute FTPs.

Introduction to Fund Transfer Pricing (FTP)

Internal (theoretical) fund transfer and ALM risk centralization could be presented as follows

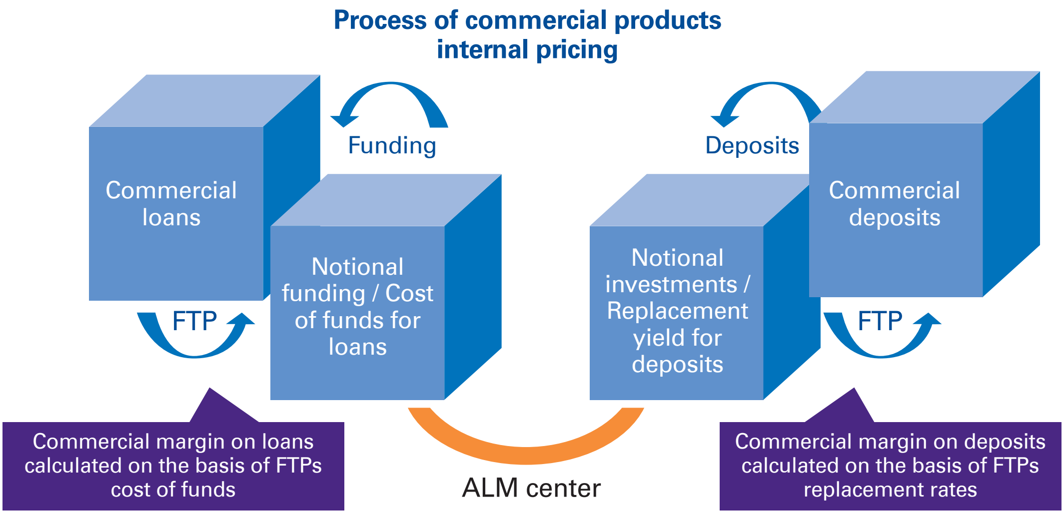


Figure 1 – Theoretical internal transfers

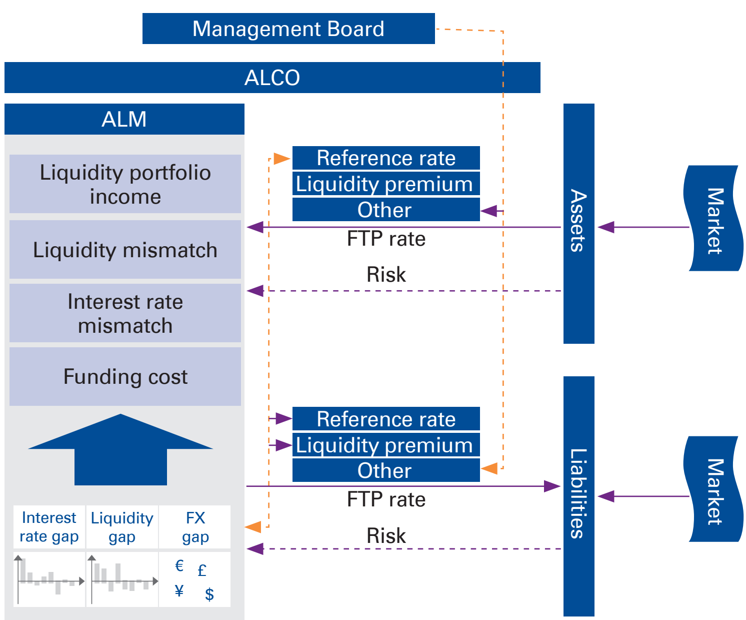


Figure 2 – ALM risks cantralization

What are main targets of FTP?

Strategic goals of FTP

- To define funding cost for the assets and to calculate NIM for asset items
- To define reinvestment yield for the liabilities and to calculate NIM for liability items
- To stabilize NIM for all commercial deals by transferring (isolating) interest rate, liquidity and FX risk from BUs to CFU
- To define pricing benchmark for clients' deals (pricing tool) and thus ex-ante profitability measurement
- To establish efficient ex-post profitability measurement per various axis and thus to link budgeting and controlling activities
- To impact BUs sales strategy through concept of incentives (subsidies) via Management FTP
- To signalize a real, existing market conditions in terms of market prices of sources and alternative placements, and thus influence commercial lines to "fine tune"the prices of their products

Integration of FTP into general Bank's management system

- FTP should align risk-taking initiatives of BUs with liquidity and interest rate risk exposure they create for the whole Bank
- BUs take risk they can control and manage
- BUs are responsible for clients pricing
- Fair assessment of economic performance of every BU, i.e. commercial margin then becomes the sole result of negotiations by BU with customers
- Business people shall understand how the profitability is measured and shall be motivated by profitability indicators
- FTP requires reliable IT system and support
- FTP requires comprehensive FTP Policy and Methodology

Regulatory requreiments and best practice

- Regulations on liquidity:
  - ✓ Minimum liquidity requirements from local regulator or from Basel III in form of NSFR and LCR requirement
  - ✓ Recommendations on Organizing Effective Liquidity Management
- BCBS requirements
- FSA requirements
- Best practices

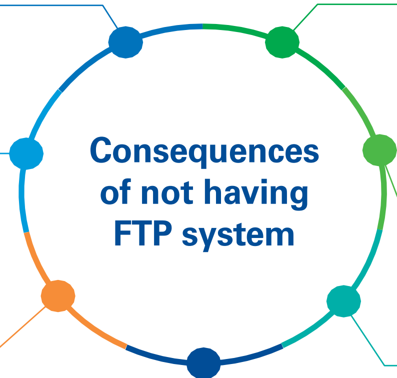
FTP changes the overall commercial mindset of the Bank

What are potential consequences of not following/having FTP?

Loosing money on products **mispricing.** Without FTP framework, based on actual maturity, some BUs are **charged less** than required rate to cover funding cost

Without FTP **top management is not able to distinguish** profitable BUs, segments, products, branches, front officers etc. from non-profitable ones

Volatile result of BUs due to not transferred and not hedged liquidity and IR risk



BUs are unclear on **real margin** of their products. Non-market based FTP overstates performance of some BUs and understates that of others and leads to "unfair" and inefficient performance-rewards decision

Performance of ALM Unit cannot be measured and volatile financial results of ALM-unit **(realized liquidity risks or improper liquidity management)** allocated back to BUs and distort their performance

Overstated profitability of non-funded products **creates wrong** incentives for BUs to disproportionally grow portfolio

Total level of **liquidity and IR risk** cannot be measured and managed. Bank bears hidden risk of maturity and IR transformation

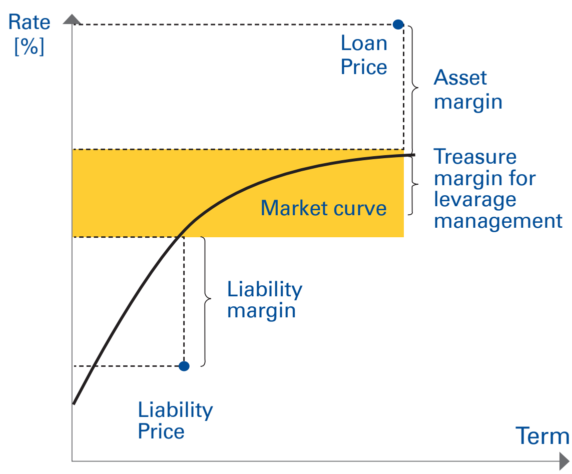
How we can help

We offer more than just FTP as is:

- ✓ Comprehensive gap analysis concerning Bank's current profitability management approach
- ✓ Benchmark analysis vs. best practice
- ✓ Recommendations for improvement of Bank's profitability system
- ✓ Journey beyond just FTP –OPEX allocation and Cost of Risk incorporation into products pricing
- ✓ Completely new profitability approach in order to reach targeted ROE and EVA
- ✓ PMO in terms of selection and implementation of new FTP tool (engine)

We have developed the robust and comprehensive FTP framework in line with **Maturity and Cash-flow Weighted Rate Approach** (MCWR).

Market rate based transfer procong method



Our approach to FTP is flexible and customized, driven by the specific needs, culture and strategic goals of our clients.

Exemplary scope of work

F T P

Basic module

Phase 1: Review of Bank's current FTP model and gap analysis

Review and gap analysis will be conducted in the following areas of the FTP model:

- Objectives and principles of FTP system with taking into consideration requirements regarding Bank's business and funding strategy
- Scope of FTP model applica-tion
- Components of FTP rates and methods for their determination
- Operational processes in scope of FTP system

Phase 2: Benchmark analysis

- Benchmark analysis of fund transfer pricing models used by leading financial institutions.
- During the benchmark analysis KPMG will review best practice solutions for selected aspects of FTP models applied by the leading financial institutions.

Phase 3: Recommendations

Preparation of conclusions and recommendations based on as-is and benchmark analyses. The recommendations shall be divided into two groups:

- Key changes designed to ensure security and consisten-cy of the FTP model in its key functioning aspects.
- Potential improvements with aim to add new features and to adapt the model to application for wider range of products.

Optimal module

Basic module

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Phase 4: Development of detailed concept of new FTP model

Development of detailed performance concept of target funds transfer pricing model. Developed solutions will encompass such aspects as:

- Objectives and principles of new FTP system
- Components of FTP rates and methods for their determination
- Methodology of assigning FTP rates to particular products groups
- Scheme of FTP system and division of task and competences.

Phase 5: Preparation of written Policy and Procedures for new FTP model

Development of formal documentation for FTP model based on the concept prepared by KPMG and accepted by Bank, including the following:

- Policy –describing new FTP model methodology, objectives and principles for new FTP model, organizational units involved in FTP process with division of task and competences.
- Procedure –description of methods and rules of tasks execution by particular unites involved in the process.
- Training of staff.

Advanced module

Optimal module

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PMO in order to help Bank to select and implement new FTP tool (engine)

PMO by KPMG shall help Bank to select a comprehensive FTP tool (IT solution), which shall be used as FTP engine in order to calculate and store FTP rates, compute margins and produce various profitability reports.

Such tailor made FTP tool shall meet "state-of-the art" financial best practice.

The FTP tool is to be developed either as in-house solution or external solution provided by vendors the KPMG cooperated with.

Exemplary scope of work

F T P

Indicative timeline

Why KPMG?

KPMG d.o.o. Beograd is the leading consultant of financial institutions in Serbia. Currently, we perform audit and consulting for more than 2/3 of the banking market in Serbia.

The practice in Serbia has rich experience in providing advisory services to the entire spectrum of financial institutions: banks, leasing companies, government bodies, foreign investors, insurance companies and other financial institutions, agencies and other companies that operate in Serbia. Our team also covers Montenegrin financial sector market.

KPMG d.o.o. Beograd currently has about 210 employees, including 9 partners. Our FS Team, responsible for clients in the financial sector, currently has about 30 employees, including one partner, two senior managers and three managers.

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