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Transfer Pricing and Performance Management

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FTP Objectives

- Product Pricing (introduce risk-return based product pricing framework, price products based on market benchmarks)
- Liquidity Management (fund mismatches, deploy aggregate surplus)
- Profitability Management (control NIM, control costs, set targets for interest and fee income)
- Balance Sheet Management (manage structural liquidity, transfer interest rate risk to central funding unit, re-allocate capital)

More on FTP's Profitability Objectives

FTP allocates NIM to various products and business lines, and allows banks to

- Measure business unit profitability separately from interest rate risk
- Centralize the measurement and management of interest rate risk
- Provide consistent product pricing guidance to business lines
- Set profitability targets for business units

Contours of End-State FTP …

In its most rigorous form:

- FTP should be applicable at transaction level
- It should apply to all assets and liabilities, trading activities, non-earning assets, non-costing liabilities, and equity
- It should follow matched maturity method
- It should factor in a spread over a Reference Rate, for various types of risks, e.g.,
- - funding liquidity
- - contingent liquidity
- - Credit
- - Options / Embedded options
- - Interest rate (m-to-m, basis, etc)
- - Commercial Margin

Typical current State of FTP …

- Different banks are at different stages, mostly nascent.
- In the case of SBI,
  - FTP has gone from Single-Pool approach, to Market-Related FTP, to Multiple-Pool (product) approach
  - It is not at transaction level
  - It applies only to credit (loan) assets and deposits
  - several other incentives are built into the FTP structure, to promote specific business activities and products
  - However, the linkage between TP profits of business units and the aggregate profits of the Bank is fuzzy

What is Most Appropriate ?

- SBI Card example

  - Is segment / division-wise FTP relevant?
  - Is product-wise FTP relevant?

Session Objectives

- Risk based pricing of assets
- Using the FTP mechanism to drive liabilities-raising behaviour
- Performance management of Business Units
- Strategic Decision making using segmented profitability
- Considerations that must be addressed when implementing Transfer Pricing policy

Risk based Pricing of Assets

- As per the RBI Working Group on Pricing of Credit (Jan 2014), spreads should be determined via a Board approved policy covering
  - specific operating cost,
  - credit risk premium,
  - tenor premium, and factors like
  - competition,
  - business strategy and
  - customer relationship

Risk based Pricing of Assets - 2

- Examples:
- Home Loans: SBI's Teaser Loans were at an initial rate of 8%. When MRFTP formulae were applied, brnaches ended up making a loss for every ruee of HL that they did!
- Loans to Top-rated Corporates: The common argument is that at proper risk-based pricing, it will be almost impossible to disburse credit to these entities

Using FTP to get Liabilities …

- Kotak, YES, IndusInd – 7% p.a. rate if interest on SB
- Can SBI do that?
- What are the alternatives?

Using FTP to get Liabilities … 2

- In SBI, the FTP formula for all term liabilities was that a branch would be remunerated a %-age of the interest paid (say, 110% for TDs)
- Thus, a branch with Rs. 25 crores of TDs at, say, 10%, would pay interest of Rs. 2.5 crores p.a., and earn Rs. 25 lacs
- Likewise for advances

- What is the pitfall?
- How can it be remedied?

Using FTP to get Liabilities … 3

- In SBI, all business segments have their respective deposits and advances targets.
- SME Dept also had its own deposits target
- The SME vertical Head proposed higher rates than market because SME deposits are harder to get
- Clearly, at those rates, it was not a profitable proposition at the all-Bank level. But, the pricing recommendation was driven in order to achieve the Division's budgeted volumes, unmindful of profitability

- How can FTP drive the right kind of behaviour?

Performance Mgt of Business Units ..

- Example:
  - Branch A has a 15-year term loan of Rs. 200 crores to a AA-rated corporate @10.75% p.a.
  - Branch B has 200 15-year home loans of Rs. 1 crore each, also @10.75% p.a.
- How should the FTP formula be structured for them?

Segmented Profitability and Strategic Decision-Making

- Example:
- Let us assume that Tractor Loans have a very high default rate
- However, prima facie, tractor loans yield ~12% p.a., while crop loans earn just 9% (7% + 2%)
- Since all budgeting at branch level is done only upto Operating Profit, and credit losses are a below-the-line item, branches do not explicitly realize that this activity is loss-making, and try to achieve topline budgets
- A suitable loading in FTP would give a clearer vision of strategic goal-setting in the segment

Considerations in implementing FTP Policy

- Rule – 1:
- One size DOES NOT fit all. For example, for credit cards company, or a home finance company, the FTP mechanism can be relatively simple and straightforward, tracking only the operating costs and losses of different clusters of products.
- These clusters can then be priced appropriately to give appropriate strategic direction to budgeting and goal-setting, and aligned incentives to the sales staff

Considerations in implementing FTP Policy-2

- Rule – 2:
- FTP is a very important tool to drive organisational profitability and strategy, but is only one of the tools
- Overall strategy of large organisations is a very complex matter; larger strategic considerations may need to look beyond pure mathematics of cost-benefit

Considerations in implementing FTP Policy-3

- Rule – 3:
- You must ensure that the tail is not wagging the dog!
- Example - Loss-making branches:
- RBI and DFS track for loss-making branches
- However, the computation of “loss” is completely dependent on the FTP formula used by banks
- So, the FTP formula can be iteratively tweaked to give the least number of loss-making branches

Considerations in implementing FTP Policy-4

- Rule-4:
  - Broadly, the FTP formulae should be relatively straightforward, and
  - a mechanism should exist for branches to know in real-time how they are faring, on the basis of the defined FTP framework vis-à-vis the budgeted targets

Considerations in implementing FTP Policy-5

- Rule – 5:
- The role of the funding centre is critical. When giving branches FTP income, it has to be ensured that the funding centre is not in large deficit. Otherwise, the TP profit of individual branches / verticals / segments will be unrealistically inflated
- Also, in general, it does not follow that the funding centre must distribute all surplus to operating units because that will hide operational inefficiencies in the relatively inefficient units

Considerations in implementing FTP Policy-6

- Rule – 6:
- Above all, for FTP frameworks to yield the desired benefits, there must be a clear linkage between FTP outcomes and performance-led employee benefits and individual and group level.

Thank You