



Profitability Funds Transfer Pricing

Definition

Funds Transfer Pricing is a management accounting process that assigns funding costs to asset originators (loans) and funding credits to liability providers (deposits). Funds Transfer Pricing (FTP) is the single most powerful and useful component of any profitability measurement system for financial institutions. Net Interest Margin is typically the most significant source of profits for financial institutions, warranting a detailed performance evaluation. For most institutions, a small change of just a few basis points in additional margin will have a significant impact to the bottom line. To this end, financial managers have worked to develop analytical tools to measure the NIM contribution of each individual account, household, product, or branch.

Historical Approach

One of the early attempts to measure branch performance was to treat each branch as a mini-bank – a stand-alone entity that was self-funding. For asset heavy branches, borrowings were allocated to “force-balance” the balance sheet. Average deposit costs or short-term borrowing rates were applied to address the liability funding cost. Likewise, if the branch was liability heavy, investments were allocated and respective return on investment rates were applied. Branches were then compared for performance.

The major problem with this form of branch measurement was that there was no adjustment for mismatch risk (the risk introduced when institutions choose to fund long-term assets with short-term funds). Financial managers measure risk to earnings at the consolidated level rather than at the individual branch level. This method also did nothing to measure the performance at the account level. Management needed a better way to measure performance. Financial managers began to look at branches in a different way. Rather than viewing branches as mini-banks, they began to look at them as retail stores, a summation of the products and services that they sold. And since mismatch risk doesn’t exist in the products themselves but rather between products, this risk could be isolated and removed at the account level. From this approach grew funds transfer pricing.

Methods

There are two main approaches to assigning funding rates, a pool method and the more sophisticated matched funded approach. Both methods look at the maturity and re-pricing characteristics of the asset or liability. A pool method assigns a single rate to a portfolio of loans or deposits based on high level assumptions. Matched Funded takes the pool approach to a granular level, assigning an individual rate to each instrument based upon its re-pricing or maturity characteristics. The rate assigned will depend on the funding curve selection, the funding date and the point on the selected funding curve.

Funding Curve

The rate assigned to each account reflects the value of the monies derived from outside market rates. Common rates used for this purpose are Treasury rates, FHLB Advance rates, or LIBOR. These rates are then utilized to construct monthly funding curves. Selecting which rates to use is often based on the financial institution’s funding source and borrowing position. Community institutions will typically utilize FHLB rates. Institutions with a low loan-to-deposit ratio might consider Treasury rates to encourage loan growth, since the risk-free rate would assign a lower loan funding rate.

Funding Date

For variable rate products, the re-pricing date is used as the funding date. The re-pricing date is defined as the last date the instrument had the opportunity to re-price, rather than the last date the rate actually adjusted. For fixed rate, closed-end products, the origination date is used as the funding date.

Point on the Funding Curve

For variable rate instruments, the point on the funding curve is determined by the re-pricing interval. Instruments that re-price quarterly would be assigned a three month point on the curve while instruments re-pricing annually would be assigned a 12-month point, etc. For fixed rate instruments, we weight average the principal cash flows and then select a single point on the funding curve corresponding to the weighted average life.

Central Funding Unit

The central funding unit is the mechanism used to funds transfer price the balance sheet for the financial institution. Often referred to as the Treasury unit, the CFU buys deposit funds via an earnings credit and sells loan funding via a funding charge. The residual from these calculations remains with the CFU along with any investments or borrowings. If the CFU "purchases" more funds than it can "sell," the excess funds would need to be invested. Likewise, if loan funding demand is greater than that which can be supplied internally, the CFU must acquire borrowed funds.

The actual calculation for the funding charge or credit is pretty straightforward:
 $(\text{FTP rate}) \times (\text{FTP balance}) = \text{FTP Charge or Credit}$

The FTP balance can either be a month-end or an average balance. The FTP Charge or Credit is adjusted to a monthly figure by dividing by 12 or by using the portfolio's accrual method.