# Internal Funds Transfer Pricing (FTP) in navigating challenging interest rates environment

## Challenging environment calls for Internal FTP recalibration

The financial industry is currently in **the midst of an interest rate hike cycle that is not seen since 2008**, amidst evolving market dynamics. Remarkably, there has also been a significant shift in the industry's focus towards liquidity risk, receiving greater attention compared to the last interest rate hike. Since 2010, financial regulators, led by the Basel Committee on Banking Supervision, have been actively introducing **liquidity risk measurement** and management practices under Basel III framework.

While historically there has not been a specific period where these two forces coincided, the interactions between the interest rate environment and liquidity risk management became more apparent as banks are seeing challenges in their FTP practices. **Three major challenges** are contended: **(1) volatile net interest income; (2) uncertain depositor behaviour, and (3) increased costs of maintaining liquidity buffer**. These factors carry profound a growing recognition and urgency for banks to address the diverse perspectives surrounding centralised fund management, inclusion of risk costs, and other operational considerations. FinTech, such as AI and machine learning methods, is also forecasted to be increasingly important in facilitating the operational processes.

To address these challenges, banks need to undertake refinement initiatives for FTP framework recalibration. This recalibration emphasises the need to integrate centralised risk management and cost allocation within a comprehensive FTP system, enabling banks to proactively optimise their financial performance.

This article aims to provide our insights on the latest trends in the FTP development.

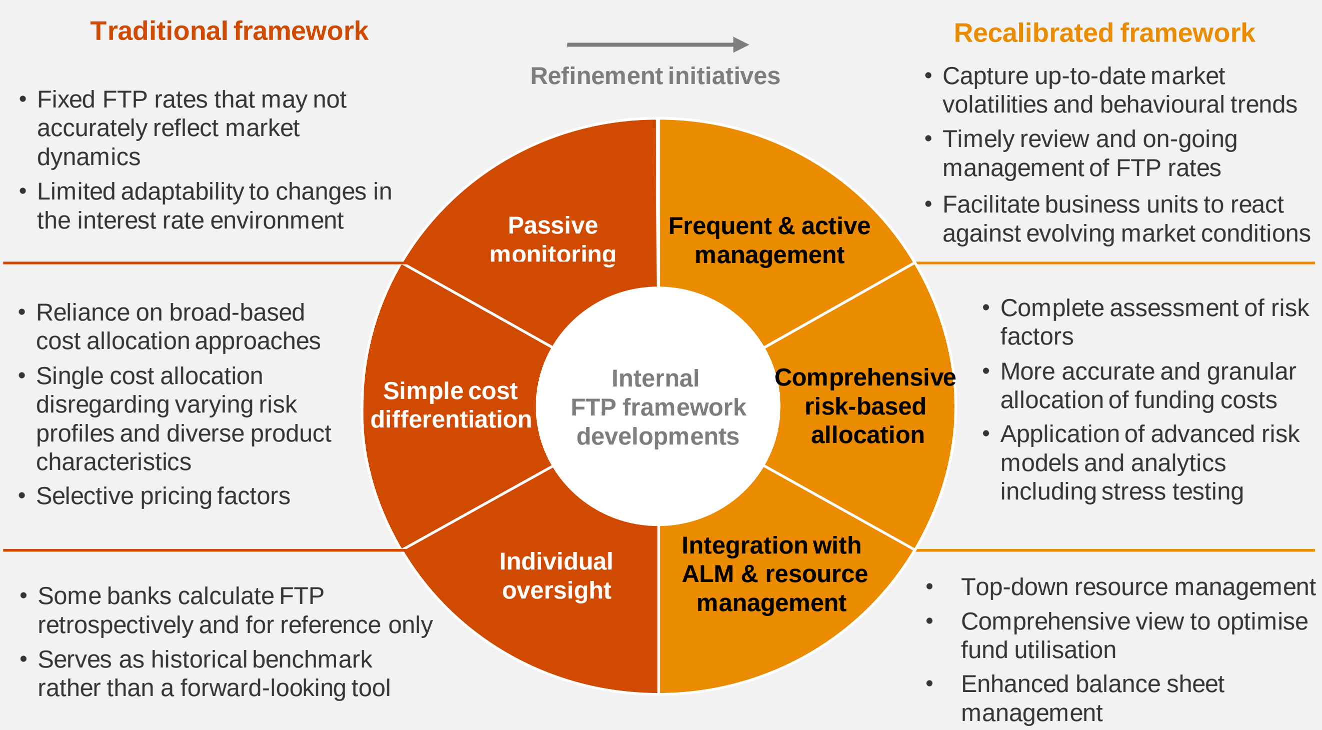



Figure 1. FTP Framework Development Trend

Recent market dynamics have presented banks with numerous challenges in maintaining a robust Funds Transfer Pricing (FTP) framework.

The overview below highlights key challenges affecting FTP that most banks are concerned of:

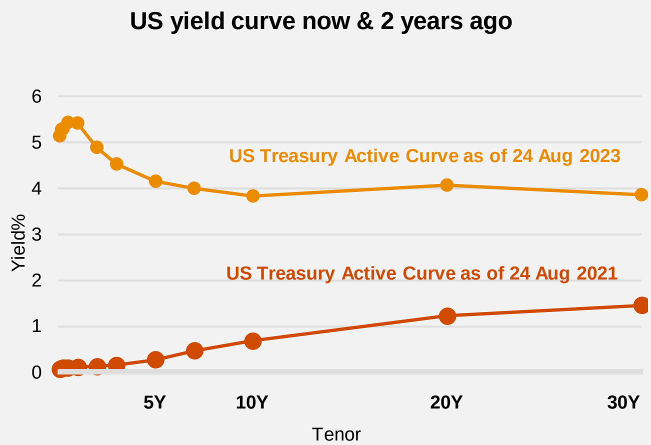



Figure 2.1. Inverted yield curve (As of 25 Aug 2023)

## 1. Affecting Net Income Margins (NIM) from inverted interest rates

The aggressive interest rate hikes by central banks in response to inflationary pressures have led to an inverted yield curve as shown on the left.

This creates challenges for NIM as short-term rates surpass long-term rates, affecting the tenor mismatch that NIM relies on. As a result, banks face increased pressure on their profitability and need to acquire better internal and external pricing strategies.

**Banks should have a holistic view in ALM planning and adopt dynamic FTP rate pricing mechanism, e.g., incorporate cheaper and longer tenor funding in short term to enhance the funding structure, or incorporate historical funding cost in marginal funding rate.**

## 2. Observed deposit behaviour difference under ongoing interest rate hikes

The market first witnessed interest rate hike in March 2022 which has persisted until the present.

Rising rates and inflation lead to more volatile and unstable deposit lives into the market. This poses challenges for banks to accurately forecast future cash flows and funding needs, and calls for additional stable funding sources that might increase funding cost from maintaining NSFR.

**Banks should regularly review their FTP methodologies and adopt relative behavioural assumptions to better address the current difficulties in FTP profiling precisely.**

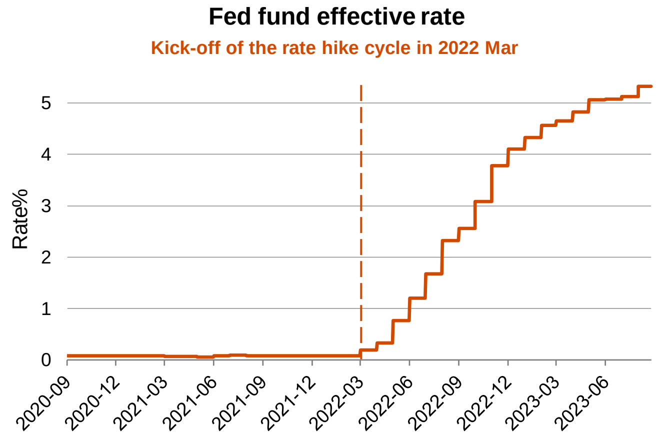



Figure 2.2. Ongoing interest rate hikes (As of 25 Aug 2023)

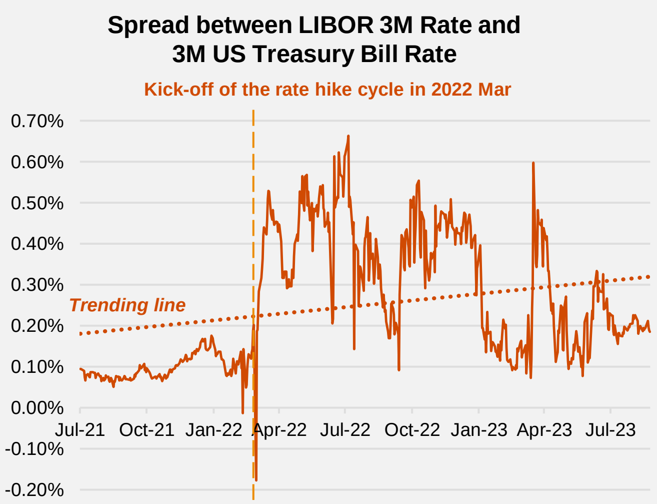



Figure 2.3. Higher HQLA maintenance costs (As of 25 Aug 2023)

## 3. Heighted liquidity requirements following higher HQLA maintenance costs

Furthermore, the rising rates have also increased the costs of HQLA, specifically the spread between market rate and HQLA return, which is harder for banks to absorb.

This emphasises the need for enhanced liquidity contingency risk management as well as accurate estimation of HQLA carrying cost. Banks may reassess their cashflow and HQLA holdings based on severe stress when deriving FTP rate adjustment.

**Banks should establish a valid and reasonable HQLA and other liquidity cost allocation mechanism such as central pool credit/charge mechanism and accurately allocate these costs to reflect the challenges posed by stressed environments.**

# Additional considerations for banks

In achieving all the complicated processing and fund management activities, a tech-enabled system could surely help from different perspectives: automation to save manual efforts, proactive monitoring and reporting to enhance funding pool visibility, and AI & advanced data analytics to facilitate management decision-making and strategy design.

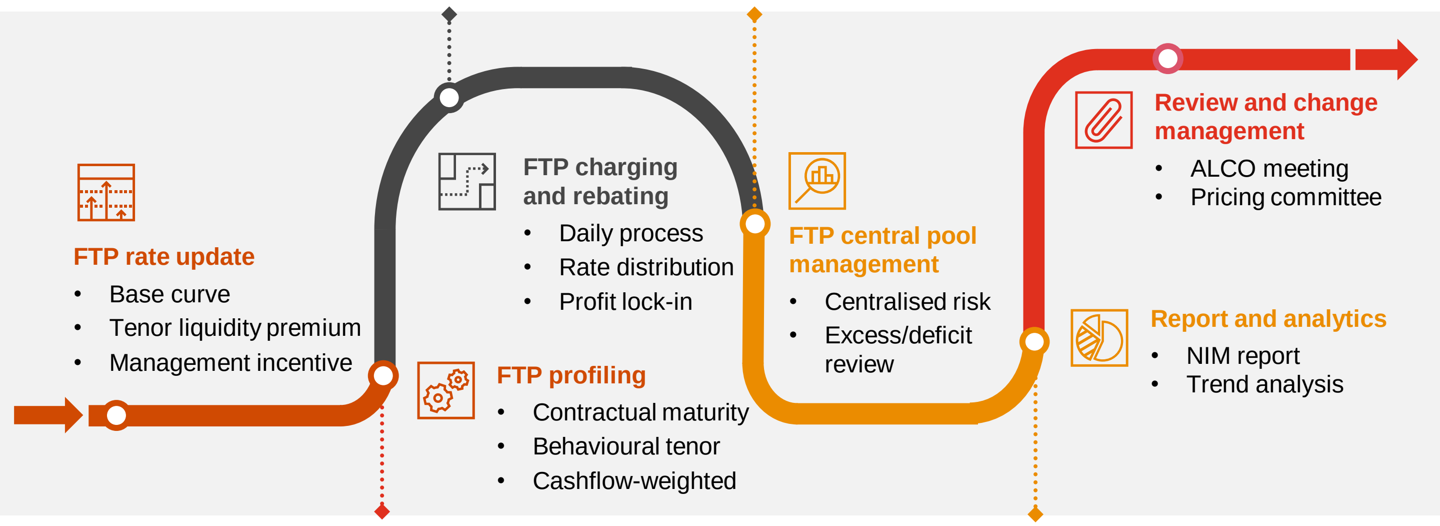
Here are additional considerations that require attention throughout the journey of implementing systems and new technologies within the FTP framework:

## Accelerate risk-adjusted pricing exercises

An **advanced FTP system** could easily incorporate latest risk costs into more frequent and automated **FTP rate distribution** and charging practices. Overall pricing could then be assessed with stress testing and scenario analysis, so banks can accurately reflect and allocate the potential impact of adverse events. Business units also can easily compare against the internal rate and lock in profit for new contracts.

## Leverage Central Funding Unit (CFU) positioning

There were diverse opinions regarding CFU positioning as a profit or cost centre. To efficiently manage associated costs and encourage profits, banks could consider better CFU position strategy according to business and risk performance, and explore various business targets including but not limited to achieving net-zero profitability.
This can be achieved by enabling **solid and robust CFU governance** and active management of FTP excess/deficit.




## Deepen your understanding on customer behaviours

FTP methodologies should fully reflect product features and funding sources starting with an appropriate tenor determination. For instance, behavioural profiling could be employed for deposits, supported by validated up-to-date behavioural assumptions.
**AI and other advanced statistical models** can play a more important role for rapidly adapting to new customer behavioural patterns.

## Accommodate latest business plan through FTP analytics

Banks should prioritize comprehensive reports to extract actionable insights on internal funding efficiency based on organizational business goals. More and more banks are exploring the possibility of having interactive monitoring management reports.
**Data analytics and smart dashboards** are also increasingly useful in identifying outliers and suspicious movements when connecting history and present.

Figure 3. Additional FTP considerations for banks

## How can we help?

FTP stands as a vital component in funding risk management and profitability measurement, and its significance has been further emphasised in the face of recent market turbulence. As a trusted professional services firm, PwC has supported numerous banks with the implementation and enhancement of their ALM and FTP frameworks by leveraging the latest technologies.

With our extensive knowledge on this topic, we are committed to leveraging our expertise and resources to offer valuable recommendations on FTP, empowering banks to swiftly adopt and enhance their approaches, which enables them to stay agile and responsive in the ever-evolving business landscape.

Our featured services include:

**FTP governance customisation**

- Target operating model design and implementation
- CFU establishment and management

**FTP system implementation support**

- Vendor selection and proof-of-concept
- Business requirement proposal

**FTP methodology revamp**

- FTP profiling approach optimisation
- Liquidity and interest rate risk cost allocation
- Dimensional FTP curve construction

**New technology adoption advisory**

- Smart dashboard design
- AI and machine learning (e.g. pattern digging, trend analysis) application

## Contact us

We would be delighted to discuss the contents of the fund transfer pricing enhancements outlined above and explore how it could bring value to your business.

Please reach out to us if you have any questions or queries.

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