The Funds Transfer Pricing conundrum: keep it simple but effective

Ahead of the publication next month of *Anthology: Past, Present and Future Principles of Banking and Finance*, here are some thoughts on the arcane issue of bank “funds transfer pricing”. This topic occupies a good chunk of the book’s chapter on liquidity risk management, so here is an introduction to it….

Bank internal funding is one of the more turgid, as well as controversial, issues in finance. Often the methodology is opaque in nature and problems arise because the true objective of an FTP mechanism is often lost in bureaucracy and process. But FTP is an important part of a bank’s liquidity risk management framework – hence the importance placed on it by regulatory authorities. It just seems that the bigger and more complex the bank, the more complex and less transparent FTP is, and the more likely one is to lose sight of what the FTP regime is for.

Orthodox maturity transformation business generates liquidity stress on the balance sheet, so for a number of reasons (the need to price loans correctly, the need to assign P&L attribution accurately and the need to ensure that the “right” business is undertaken) it is important to incorporate the cost of this stress into the internal funding mechanism. So FTP is the art of setting the term liquidity premium (TLP) into the business line pricing process, at the appropriate tenor. And the appropriate behavioural tenor can be determined via the same process that every bank is required to apply as part of its liquidity adequacy (ILAA) process.

As we have described it, FTP need not be a complex procedure.. As the business grows larger and more complicated, the variety of products on offer across different departments gives rise to specific liquidity risk exposures that need to be managed, and the proliferation of funding policies may create opacity. And as TLP is not observable explicitly, one needs to use proxies to calculate it. But these are not insurmountable problems.

To remain manageable one needs to follow some simple rules, *viz*.:

- set the objectives of FTP in an ALCO-approved policy
- describe how it will apply to each business line for both sides of the balance sheet
- publish the internal funding curve on a regular basis, and
- undertake regular review of the policy to ensure it remains fit-for-purpose.

It’s important to bear in mind that FTP is an internal process, essentially “left-hand right hand” stuff. The over-riding objective should remain to keep it simple, but effective.