Funds Transfer Pricing: Cracking the Code on Deposit Valuation

BY STEVE TURNER

Funds transfer pricing (FTP) is a critical tool in managing bank balance sheet composition, widely used to evaluate and optimize business line profitability and neutralize business line interest rate risk.

While FTP has been little changed at many institutions for years, questions about its applications and underlying methodologies have suddenly become front burner issues. Competitive deposit pricing, for example, often is viewed as “irrational” by FTP traditionalists who have not yet integrated factors such as customer behavior, balance sheet structure, and market prices for options and liquidity into their measurements.

Importantly, unrefined FTP methodologies have led many banks to severely underestimate the value of long-lived deposit accounts. Debates on the value of deposits have strained relations between the treasury and deposit-taking business units as they struggle with antiquated tools to validate responses to aggressive competitor actions. The result: stalling deposit balance growth at the precise time when these banks are staggering under the weight of large loan portfolios while stranded from wholesale funding markets.

To break out of this trap, progressive bankers are revising FTP to integrate balance sheet structural views into deposit pricing decisions, providing a much sounder basis for competitive pricing strategies. For example, some of these bankers are expanding their understanding of the money market deposit account portfolio through refined identification and behavioral analysis of MMDA customer segments. These same bankers also are developing multiple-path analyses of promotional certificates of deposit to reflect segment differences in how these CDs roll over.

Instead of revisiting FTP as a one-time crisis response, some banks have decided that the current heightened level of competitiveness in deposits (and, with a return to stable markets, loans) is here to stay, and they have upgraded their approaches to consistently generate the expanded and more precise information needed to make better long-term decisions. These progressive banks are applying refined FTP valuations in pricing, planning, and performance measurement. Analytical enhancements include measurements of the overall balance sheet liquidity position and a scientific understanding of likely customer behavior in various market and economic scenarios.
BREWING PROBLEMS WITH FTP
Extensively used for years within major banks, FTP seeks to illuminate the individual product profitability of loans and deposits by matching them with an unbiased wholesale market interest rate curve, most often the Libor/interest rate swap curve, to eliminate the benefits or costs of interest rate mismatches. The spread that remains, setting aside other risk issues, is the inherent value of these loans and deposits to the bank.

The accuracy of these measurements is complicated by customer behavior that affects withdrawals and prepayments in response to interest rate movements and liquidity stress events. Only recently have tools for measuring deposit behavior matched the precision available to treasury for measuring and managing market risks.

For example, many banks continue to labor under approaches that have been largely static for many years — in some cases decades. Often, historical patterns of balance sheet responsiveness to significant interest rate changes for MMDA and similar accounts are used to deduce the “fixed” and “floating” proportions of the deposit base. In turn, the designated fixed and floating portions are matched with respective long- and short-term market indexes to form a blended rate for the whole portfolio.

This basic framework is appropriate. Yet its usefulness often is limited by static, unrealistically symmetric and under-informed price elasticity metrics; insufficient granularity within product lines; and excluded evaluations of the liquidity benefit of loyal balances. In such circumstances, FTP applications are plagued by reliance on simplistic assumptions; limited relevance with specific customer groups, products and markets; potential unintended sales and marketing behaviors driven by FTP-induced performance incentives; and a heightened potential for reversals when actual results collide with isolated mathematical models.

These shortcomings point to four major types of FTP management challenges.

First is the challenge of management inaction, typically resulting from the oft-held perception that the institution can get by without investing in advanced FTP methodologies, and skip the effort and expense of refinements. While such attitudes perhaps were tolerable in prior healthy markets, they now are compromising important decisions on pricing and resource allocation. Indeed, FTP shortcuts have become outright handicaps in the struggle to cope with current market upheavals; to keep pace with competitors skilled in applying advanced measures; and to address balance sheet structural concerns, particularly in consumer deposit strategies.

Second, in many instances, FTP analyses have not been sufficiently granular to calibrate — and adequately anticipate — loan and deposit repricing and attrition behavior in varying interest rate and stressed liquidity environments. To be fair, the data and tools for gaining deep insight into customer behavior have evolved rapidly in recent years, allowing for measurement precision that was heretofore not possible.

Third, balance sheet structural positions have not been effectively incorporated into FTP valuations. That is, all else equal, a bank with a loan-to-deposit ratio of 0.70 should value liquidity differently than a bank with a 1.20 loan-to-deposit ratio.

While almost all banks have some form of liquidity measurement and contingency liquidity plans, many do not pursue liquidity measurement and management with the same commitment that is demonstrated in their capital management. The result is a gaping hole in their application of FTP, with little differentiation of FTP based on an advanced internal understanding of the bank’s unique liquidity position. With a structural understanding of the balance sheet in hand, a bank needing liquidity can better quantify the rationale for premium rates on deposits. Conversely, banks with excess liquidity can better justify a more aggressive posture in the lending markets.

Fourth, silo coordination issues often become evident when an integrated approach is precluded by communication and organizational impediments. In these situations, the financial market acumen of treasury and the customer behavioral knowledge in the business lines are not effectively brought together. By contrast, highly-advanced risk practitioners have learned to break down institutional walls, permitting the formulation of integrated responses to risk/return issues and opportunities.

GETTING ON TRACK
Although competition for deposits is ferocious in the current market, progressive bank treasury officers quite rightfully want to approach deposit valuation from the institution’s own center of gravity and not from a purely external perspective. Along with establishing a base market interest rate curve, leaders thoroughly assess the bank’s liquidity position and incorporate customer price elasticity insights as well. The resulting composite picture builds a better foundation for all-
important decisions about market pricing, resource allocation and balance sheet positioning.

There are three major steps in improving FTP (with a particular emphasis on its applicability to deposit pricing):

1) Balance sheet risk review — To anticipate emerging liquidity requirements, leaders comprehensively review the flow of deposits, borrowings, loans and investments, and evaluate how the aggregate funding position stacks up against bank targets, particularly in a hypothetical situation of a moderately stressed environment. This information is combined with other aspects of the bank’s liquidity position, including the overall riskiness of the bank relative to its target risk rating, to develop a composite liquidity profile that quantifies liquidity to levels of specificity not previously considered worthwhile. This increases the value of knowing how funding instruments, particularly deposits, likely will behave in stressed environments.

2) Behavioral modeling — To improve their understanding of the rate-driven circumstances in which customers are most likely to either extend or terminate various types of deposit accounts, leaders are incorporating precise calculations of price elasticity of demand. This permits a far more accurate discernment of durable vs. volatile balances, and the likely impact of various rate positions in changing market scenarios. Leaders also are overlaying new insights on how accounts will behave in stressed environments, often leading to greater differentiation of internal valuations of consumer and commercial deposits (and the liquidity benefit they confer).

3) Valuation refinement — Equipped with the results from steps one and two, leaders are developing a new generation of precision FTP models that put a much finer value to the repricing, liquidity, and elasticity characteristics of loans and deposits. This information is used as critical decision support for pricing models, planning, business line performance measurement, and long-term resource allocation.

CALL TO ACTION

From a larger perspective, these FTP initiatives are part of a pricing revolution in retail, small business, and commercial banking. Along with evaluating internal requirements and market and competitive factors, leading banks are systematically evaluating customer behavior, as expressed in price elasticity of demand. Such quantitative insights then become the basis for greater management integration between treasury and retail.

A recent study by Novantas highlights one of the great uncertainties in FTP methodology, which is how to place a value on long-lived deposit accounts. For example, how should the bank evaluate and value money market deposit account balances that are expected to stay with the institution in most rate environments? Or certificates of deposit that are routinely rolled over, effectively transforming, say, a one-year CD into a five-year liquidity instrument?

Each bank would reasonably be expected to answer these questions somewhat differently based on the understanding of their customers’ behavior; the competitive environment; the bank’s liquidity position; and the intensity of funding needs. These “organic” variations can cause dramatically different assumptions about the proportions of loyal vs. migratory (rate-seeking) balances, and valuation applied to the balances.

Furthermore, these organic variations are being magnified by sharply differing FTP methodologies, creating an enormous deposit valuation spectrum among major banks. Underscoring the stark differences in valuations, among 14 respondents to the FTP portion of the Novantas 2008 Deposit Pricing Best Practices Survey, there was a 239 basis-point dispersion of FTP valuations on MMDAs, and there was a 180 basis-point dispersion of FTP valuations on CDs.

Though never inconsequential, the competitive impact of such dramatic variations at least was more tolerable in years past, when deposit funding was more prominent. Going back to the severe lending downturn of the early 1990s, for example, U.S. depository institutions held roughly $90 of loans for every $100 of core domestic deposits. At midyear 2008, by contrast, the loan-to-core deposit ratio had skyrocketed to 135% — $135 of loans for every $100 of core domestic deposits. During the same time period, net interest margins have dwindled from roughly 4.50% to less than 3.50%.

In the current situation, where margins are under assault and banks have lent way beyond their deposit bases, traditional FTP approaches have contributed to more than a few situations where major banks have
underpriced deposits relative to their funding needs. At the other end of the liquidity spectrum, a few well-funded banks have forfeited precious margin by overvaluing deposits relative to their needs.

THREA DING THE MAZE
Leading institutions are threading this maze by marshalling treasury and retail resources in independent and joint investigations. Treasury is building a clear picture of the balance sheet situation, while the business lines are refining their understanding of customer deposit price elasticity. Together they are incorporating these insights into fresh, detailed observations of customer behavior — by market, product, term, and balance tier — to develop refined repricing and liquidity calculations for FTP usage.

These management and analytical advances enable the institution to:

- Project deposit repricing behavior.
- Estimate deposit balance retention in normal and stressed scenarios.
- Assess the degree of optionality in the portfolio, or the extent to which customers might terminate or extend accounts depending on rate movements.
- Measure the cost to hedge potential adverse optionality.
- Calibrate “liquidity premia,” or internal credits assigned to loyal balances.

Typically, two major performance problems come to light once institutions complete this extensive groundwork. First, it becomes clear that many decisions on deposit and loan formation are being made to the detriment of the net interest margin. Second, it becomes clear that resources often are being misdirected among business lines, with deposit-gathering activities typically undervalued relative to asset generation.

The good news is that the upside potential in addressing these problems is significant. Yet a carefully-planned management framework is needed to take full advantage, entailing much higher treasury/retail coordination than seen in the past.

Facing increasing stresses on balance sheets, continued narrowing margins, and fierce competition, financial institutions have ample reason to rethink their FTP methodologies. While the deposit business is an area of prime concern, it ultimately is part of a larger picture that should be reviewed as well.

Information and analytics that were not available 20 years ago, when FTP was becoming more formally established at larger banks, now should be incorporated to improve decision-making at this critical time.

With these adjustments in place, the bank will be in a position to make better deposit and loan pricing decisions; value these same assets and liabilities more effectively; and develop greater insight on the behavior of competitors.

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