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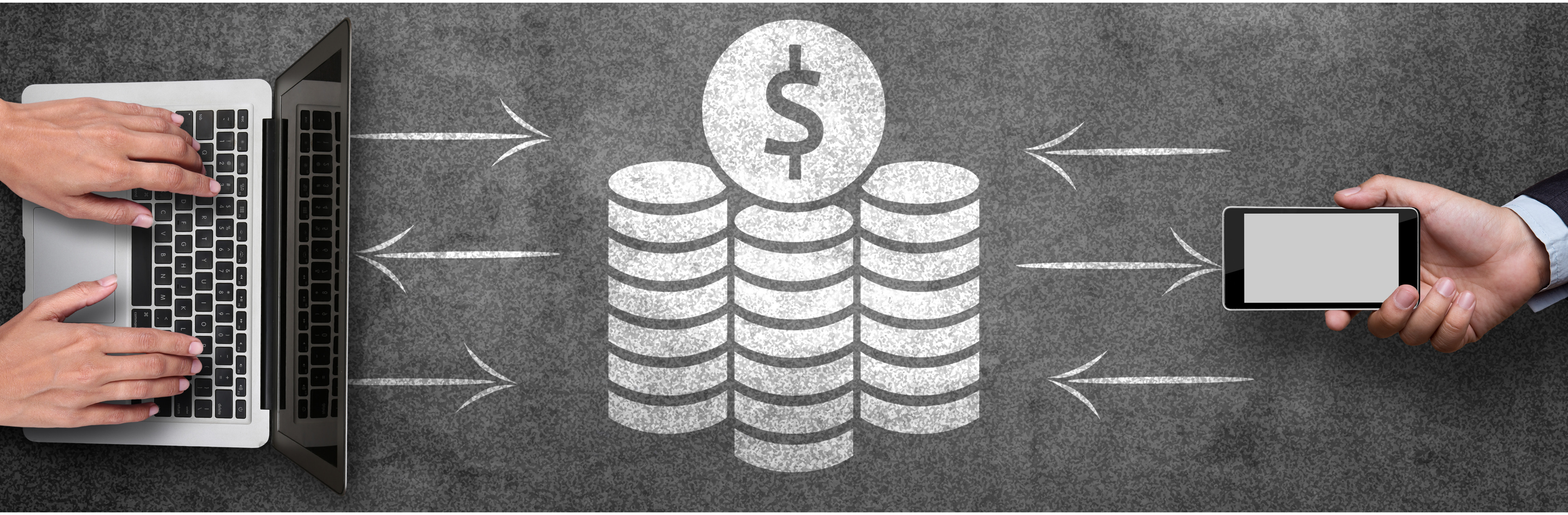

SPOILER ALERT

WITHOUT A WELL-DESIGNED FTP FRAMEWORK, THE STORY OF HOW YOUR INSTITUTION MAKES MONEY MAY BE A WORK OF FICTION.

Every financial institution has a story it tells its shareholders, its board members, its employees, its regulators and the general public about how it makes money.

A well-developed and robust story requires an acknowledgment of how risk contributes to earnings, taking into account that in addition to credit risk, interest rate and liquidity risk also contribute to the level and volatility of earnings. This disaggregation of earnings into risk-related components (factor analysis) requires a well-functioning Funds Transfer Pricing (FTP) process that quantifies the returns to taking and managing interest rate and liquidity risk. According to David Green, an accurate earnings attribution without FTP is simply not possible.

"Even at institutions that use FTP, if the organization doesn't have someone running it who is dogmatic about accurate attributions, FTP processes will almost certainly be perverted to conform to the preconceived story of how the institution makes money – a story which is almost certainly at odds with the facts," explains Green, the managing director in the financial services division of Exequor Group. "In effect, a fiction is crafted that makes executive management and shareholders feel good, at least temporarily, but this fiction will lead to incorrect product pricing decisions and unsatisfactory strategic balance sheet management decisions."

Green believes FTP is not as widely utilized as it should be throughout the industry for a number of reasons. Some institutions prefer operating under naive assumptions, however dubious, about how they make money, some believe FTP is a practice with which only the biggest banks can or should concern themselves and some dismiss its importance because regulators have not mandated its use. Nevertheless, Green is steadfast in his conviction that FTP is not optional.

"It is incumbent upon executive management to understand how their institution makes money," he says. "Now that interest rates are moving, interest spread and margin dynamics are in play, and simply forecasting more of what happened in the previous year will no longer work. A lot of financial institutions believe that FTP is a 'nice to have' or something that is only for big banks, but FTP is an essential profitability management tool for institutions of any size or charter type because all depository institutions have interest rate and liquidity risk."

Green believes that any financial institution that truly cares about how it makes money should keep the following five points about FTP in mind as it works to first understand and then tell its story.

FTP IS AN ESSENTIAL COMPONENT OF PROFITABILITY MANAGEMENT

Green says that without FTP, the earnings associated with interest rate and liquidity risk are embedded into product or segment measures, leading to an underappreciation for how interest rate and liquidity risk contribute to earnings and, thus, overstated product and segment profitability. FTP allows an institution to evolve from essentially saying interest rate and liquidity risk have nothing to do with earnings to being able to disaggregate earnings into these important risk factors.

"What FTP provides is a means of extracting the risk-related earnings out of the various products and business segments and moving them into a central business unit – what we call the mismatch center – for which ALCO is responsible," Green explains. "When an institution does not use FTP, there is no attribution of earnings to interest rate and liquidity risk. This means that earnings that should otherwise be attributed to these risks are misallocated to credit and operational risk, which in turn makes deposits and loans look more profitable than they really are. In addition to more accurate product and segment profitability measures, having all of the interest rate and liquidity risk-related earnings in one bucket makes it is easier to manage these risks, and finance will find it easier to hold ALCO responsible for these earnings."

GETTING EVERYONE ON THE SAME PAGE IS KEY

Green says that in most institutions interest rate risk and liquidity risk are measured by ALM (on behalf of ALCO), while profitability is managed by finance – these two balance sheet management functions are treated as separate and distinct, with each using different data sets, different models and different behavioral assumptions. As a result, they are almost certainly out of sync with one another and, upon close inspection, tell very different stories about how the institution makes money. For FTP to function effectively, risk and profitability must be understood as one in the same problem.

"It is not only a systems challenge – the need to implement a single modeling solution to meet the needs of both risk and profitability management – but you have to have a very rich understanding of what drives the behavior of all of the loans and deposits," Green explains. "This requires not just extensive historical data, but also a robust and continuous dialogue between risk management and the business units. When FTP is not used or is poorly implemented, this dialogue is not productive and is most often evidenced by extreme frustration and continuous tweaking of FTP rules to achieve expected outcomes. But when FTP is well-functioning, the dialogue is enlightening because the role of risk is clear and irrefutable. More importantly, when FTP is well-functioning, product managers are immunized from the earnings volatility associated with interest rate and liquidity risk, which means that granular budgets and forecasts of segment and product performance have a much greater chance of being achieved. When strategies are put into place, the distinct role of credit, operational, interest rate and liquidity risk are clear."

BE PREPARED FOR A WAKE-UP CALL AROUND THE STORY OF EARNINGS

Green says many of his clients tend to be surprised at the thin margins that are left in lending and deposit-gathering when they do an honest accounting of their interest rate and liquidity risk-related earnings.

"FTP clarifies the perception of earnings throughout the organization, so there is almost always some initial shock value when it is first put into place or is revised from previous constructions," he says. "But once an institution gets over that shock, and appreciates that the resulting story is much more accurate, it finds itself in a much stronger position to make important decisions around product pricing, strategic planning, capital management, capital allocation and performance measurement."

Simply following the market assumes that the competition is good at risk-based pricing. Green is quick to point out that when the U.S. economy is growing at only around 3%, any institution that is growing its balance sheet at a considerably faster pace must be stealing business from the competition, often by lending at lower rates and raising deposits at higher rates. Earnings are often further boosted by short-funding the assets, i.e. creating a mismatch. Without FTP, there is no way to understand the correct price for loans and deposits, nor is there any way to quantify how much the incremental mismatch contributes to the overall increase in earnings.

"If an institution isn't careful, the short time of increased earnings will be followed by the reality of future earnings volatility and possible margin compression."

DON'T WAIT AROUND FOR A REGULATORY MANDATE

With so many regulatory demands requiring their time and attention, many institutions are hesitant to commit the resources to developing and operating a comprehensive FTP framework unless specifically instructed to do so by an examiner. But Green says even if the regulators aren't demanding FTP (for now), any institution that desires a more thorough understanding of how it makes its money should take the plunge – with or without a mandate.

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> David Green, Managing Director – Financial Services Division, Exequor Group

"Because there is no regulatory requirement that institutions (outside of the SIFIs) utilize FTP – much less actually do it correctly – a lot of bankers have unfortunately decided that if the regulators don't require it, then it must not be necessary," he notes. "Possibly even worse, many institutions will say they're doing FTP, but when you lift up the hood and look closely, they're not doing it well; FTP methodologies are haphazard or arbitrary. Now that rates have finally started moving, these organizations are going to be very confused about what's happening with their P&Ls."

SUCCESSFUL FTP STARTS AT THE TOP

Green won't sugarcoat the effort required to implement a comprehensive and well-functioning FTP framework within an organization, especially one that is unaccustomed to such granular earnings analysis (e.g., where there is no distinction between volume and value). But he is equally adamant about the risk involved in trying to effectively steer an institution through its myriad earnings management challenges without the insights and clarity that FTP can provide. That's why he believes the value of FTP needs to be embraced and proselytized from the very top of the organization.

"Earnings management is not a trivial problem to solve – it influences everything that the institution does, including performance management," he says. "Because effective FTP will almost certainly challenge many long-held perceptions at the organization, the push for change must come from the top. This can be a challenge when management doesn't appreciate how interest rate and liquidity risk impact both the level and volatility of earnings. An unfortunate result of post-crisis Fed policy is that most people in an institution simply do not understand how an increase in market interest rates impacts earnings. Despite the challenges, however, the CFO must understand the critical need for FTP and lead the charge. It takes a lot of work to get FTP right, but in the end it will most certainly provide extraordinary clarity around how the institution makes money." ▪