Transfer pricing in International Bank sector and its influence on economic of Cyprus

Niftiev, Vadim

Business Administration Program, School of Economics Sciences and Business, Neapolis University Paphos

http://hdl.handle.net/11728/6747

Downloaded from HEPHAESTUS Repository, Neapolis University institutional repository
Transfer pricing in International Bank sector
and its influence on economic of Cyprus

By

Vadim Niftiev

Master in Business Administration

Neapolis University Pafos

Pafos, Cyprus

September 2014

A thesis

Submitted to the Faculty of MBA

in partial fulfilment of

the requirements for

the Degree of

MBA
Transfer pricing in International Bank sector
and its influence on economic of Cyprus

Dissertation

Committee Member
Professor Andreas Kakouris

Dean/Program Director
Name Surname / John Politis
I. ABSTRACT

Purpose – The thesis aims to investigate the preconditions of transfer pricing, its methodology, application and use in relation to international banking groups (IBGs), relating to transfer pricing manipulation and discuss on pricing strategies IBGs at various aspects of transfer pricing in Cyprus.

Design/methodology/approach – The thesis conducts literature reviews regarding a concerning the motives of transfer pricing application in banking, bank integration into the process, and then conducts expert interviews to select and summarize the methods of transfer pricing decision-making.

Findings – The thesis finds that decentralization and redistribution of profit centers by international regions with the greatest interest in funding, it becomes more and more in the spotlight in the field of transfer pricing strategy of IBG’s presence in Cyprus, and their real concerns are winning maximum economic profits, enhancing the competitiveness of the enterprise, and effectively repatriating profits to parent companies in order to facilitate greater economic profits.

Research limitations/implications – It is found from the model that most of the transfer pricing methods are based on strategies of differentiation’s attraction and placement margin, which circumvent the possible risks of low quotes. A possible reason is that current business operational patterns that have been limited to the market share of branches adopt the quantity-based pricing strategy of “narrow volume margin and large profit”. However, the transfer pricing in IBGs branches has great influence on the financial structures of the banks. The banks, as a result, must understand and reinforce the working of pricing transfer in the business development of branches and representatives.

Originality/value – The thesis collects questionnaires and investigation results from experts and scholars and uses a survey of experts to build a complete model of strategic pricing decisions that may be taken under actual IBG different methods in order to provide a link to IBG in making transfer pricing strategy and its use in branches and representative offices.
# TABLE OF CONTENTS

Abstract ................................................................................................................................. 4

Introduction ............................................................................................................................ 10
1  Literature review .............................................................................................................. 12

2  Bank’s General Framework ............................................................................................ 14

2.1 General framework for Banking and financial risk ...................................................... 14
2.2 Financial Intermediaries ............................................................................................... 14
    Transaction costs ............................................................................................................ 14
    Information asymmetry .................................................................................................. 14
2.3 Definition of a bank .................................................................................................... 15
    Access to payment system and financial liquidity ....................................................... 15
    Asset transformation ..................................................................................................... 15
2.4 Types of banks ............................................................................................................ 16
    Investment banks ......................................................................................................... 16
    Universal banks ......................................................................................................... 17
    Commercial banks ...................................................................................................... 17
    Para-banks .................................................................................................................. 17
2.5 Central Bank ............................................................................................................... 18
    Monetary policy ......................................................................................................... 18

3  Financial markets and risks .......................................................................................... 21

3.1 Financial markets ....................................................................................................... 21
    Interbank deposit market ........................................................................................... 21
    Government debt markets .......................................................................................... 24
3.2 Managing risks .......................................................................................................... 24
    Credit risk .................................................................................................................. 25
    Liquidity risk .............................................................................................................. 26
    Interest rate risk ....................................................................................................... 27
    Currency risk ............................................................................................................. 28

4  Multiple pool method .................................................................................................... 30

4.1 Market transfer prices ............................................................................................... 30
4.2 Building pools of transactions ............................................................................... 30
    Long term fixed rate products .................................................................................... 31
    Float and internal rate products ................................................................................ 31
    Blended term for indeterminate maturity products .................................................... 32
4.3 Calculating transfer rates ......................................................................................... 33
    Price period length ................................................................................................... 33
<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ex post or ex ante prices</td>
<td>33</td>
</tr>
<tr>
<td>Weighted moving average methodology</td>
<td>34</td>
</tr>
<tr>
<td>4.4 Adjusting prices for liabilities</td>
<td>35</td>
</tr>
<tr>
<td>Deposit curve</td>
<td>35</td>
</tr>
<tr>
<td>Reserve ratio adjustment</td>
<td>36</td>
</tr>
<tr>
<td>4.5 TPs for other assets and liabilities</td>
<td>36</td>
</tr>
<tr>
<td>4.6 Spread components in FTP portfolio</td>
<td>37</td>
</tr>
<tr>
<td>4.7 Corrective margins</td>
<td>38</td>
</tr>
<tr>
<td>4.8 Pros and cons of multiple pools</td>
<td>39</td>
</tr>
<tr>
<td>4.9 Historical multiple pool variation</td>
<td>40</td>
</tr>
<tr>
<td><strong>5 Matched rate method</strong></td>
<td><strong>41</strong></td>
</tr>
<tr>
<td>5.1 Benefits of MRM</td>
<td>41</td>
</tr>
<tr>
<td>5.2 Business unit results</td>
<td>41</td>
</tr>
<tr>
<td>Credit risk</td>
<td>42</td>
</tr>
<tr>
<td>5.3 Transfer price calculation</td>
<td>42</td>
</tr>
<tr>
<td>Float rate transactions</td>
<td>43</td>
</tr>
<tr>
<td>Internal rates</td>
<td>43</td>
</tr>
<tr>
<td>Transactions of indeterminate maturity</td>
<td>44</td>
</tr>
<tr>
<td>Fixed rate transactions</td>
<td>44</td>
</tr>
<tr>
<td>Prepayment option adjustment</td>
<td>45</td>
</tr>
<tr>
<td>5.4 FTP portfolio management</td>
<td>45</td>
</tr>
<tr>
<td>5.5 Variations of matched rate methodology</td>
<td>47</td>
</tr>
<tr>
<td><strong>6 Introduction to Transfer Pricing</strong></td>
<td><strong>48</strong></td>
</tr>
<tr>
<td>6.1 What is Transfer Pricing?</td>
<td>48</td>
</tr>
<tr>
<td>6.2 Transfer pricing in the EU context</td>
<td>50</td>
</tr>
<tr>
<td><strong>7 Introduction in TP Bank’s Sector</strong></td>
<td><strong>52</strong></td>
</tr>
<tr>
<td>7.1 Transfer Pricing Methods in the banking sector</td>
<td>52</td>
</tr>
<tr>
<td>7.2 Market pricing methods</td>
<td>52</td>
</tr>
<tr>
<td>7.3 The costs method</td>
<td>53</td>
</tr>
<tr>
<td>7.4 Transfer pricing</td>
<td>54</td>
</tr>
<tr>
<td><strong>8 Basic transfer pricing theory</strong></td>
<td><strong>57</strong></td>
</tr>
<tr>
<td>8.1 Introduction to fund transfer pricing</td>
<td>57</td>
</tr>
<tr>
<td>The need for fund transfer pricing</td>
<td>57</td>
</tr>
<tr>
<td>Definition and objectives of a FTP system</td>
<td>59</td>
</tr>
<tr>
<td>Defining transfer prices</td>
<td>59</td>
</tr>
<tr>
<td>Bank products</td>
<td>60</td>
</tr>
<tr>
<td>8.2 Single pool method</td>
<td>60</td>
</tr>
<tr>
<td>Advantages and drawbacks of single pool</td>
<td>61</td>
</tr>
</tbody>
</table>
Calculating internal transfer price ........................................................................62
Net or gross balance .............................................................................................62
Double pool method .............................................................................................62

9 Bankers TP Ethics ..............................................................................................64
  9.1 Introduction .....................................................................................................64
  9.2 Transfer Pricing Methods against the ethics of their application for national economies ............................................64
  9.3 Is ethics is the driver we should have in mind? ..............................................66

10 TP and Funding ..................................................................................................68
  10.1 Transfer pricing and Funding ......................................................................68
  10.2 Transfer Pricing Methods .........................................................................68
  10.3 Procedure for calculating the transfer price ..............................................70
  10.4 Funding - a method of internal (or transfer) pricing to the banking business .......................................................70
  10.5 Internal functions (transfer) pricing (of Treasury): ....................................71
  10.6 Stages of building a system of funding in the bank: ....................................72
  10.7 Overview of banking sector in Cyprus ........................................................72
International banking groups and their branches and offices in the territory of the Republic of Cyprus 73
  10.8 Use of transfer pricing schemes offices and branches of European international banking groups ............................................74
  10.9 Use of transfer pricing schemes offices and branches of international banking groups located
outside the territory of the European Union ..........................................................74
  10.10 Effectiveness of the use of transfer pricing schemes by different banking groups .........................................................76
Specificity of transfer pricing in banks with extensive branch structure ....................76

11 Results ..............................................................................................................79

12 Discussion and conclusion .............................................................................83

13 Recommendations ...........................................................................................86

14 Future Work .....................................................................................................87
The Ethic aspects of TP .........................................................................................87
Bibliography .........................................................................................................88