Is the Fund Transfer Pricing Ethical? An Interest Rate Swap Approach for Banking Companies

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Abstract. Banking profitability is ultimately induced by transfer pricing policy within each financial group. We deal with ethics of current prices to transfer the profitability between branches, the need for transparency in terms of information management systems, and delimitation from money laundering activities. Once a delimitation of ethics within these transactions is made, we identify the best method to face new challenges to better optimize the profitability of the bank, and the need for optimal taxation policy of economic environment. This research paper is using logics, financial behavior, deduction and introspection of banking market best practices. The study case emphasizes interest rate swaps as main instrument to handle day-to-day operations in completion of standard transfer pricing policy, in current days of interbank limits system deterioration.

Keywords: Transfer Pricing, Ethics, Taxation, Interest Rate Swaps, Profitability

1. Introduction

Under current prudential supervision, the question we raise is the correct delimitation of ethics in banking behaviour and legitimation of their methods and best practices to be used on international levels. Once the ethics of transfer pricing being delimited, the used methods will generate trustworthiness of market participants for the benefit of interbank financing, and counterparties' awareness of banking behaviour. Ultimately, the fiscal authorities all over the world will aware the importance of the measures within their capability of rising taxes, by imposing optimal taxation, comparable at international level.

2. Is the Fund Transfer Pricing Ethical? An Interest Rate Swap Approach for Banking Companies

2.1. Literature Review about Ethics in Transfer Pricing Methods

The particular methods used by financial authority constraint the pricing transfer policy with predictable effects on primary and secondary intra-trade trade and tariffs [6, pp. 1].From a corporate strategy perspective, a banking company wants to keep revenue in the local offices where revenue is being created; this will serve as an incentive to management who bear financial responsibility for local office operations [1, pp. 35]. Organization for Economic Cooperation and Development (OECD) is revising and updating key elements and provisions of its transfer pricing guidance; under these circumstances there are new or proposed disclosure requirements; these will increase the transparency of intercompany transactions and their transfer pricing risks [2, pp.5]. We denote the role of financial authorities, the movement of funds related to willingness to keep funds where these have been created, and a need for transparency. Transparency is meant to proper judge the ethics of transactions and increase trustworthiness of market participants.

Prior to selecting the best transfer pricing method, a summary of these methods is set forth as follows [3, pp. 11]: Comparable Uncontrolled Price method (CUP); Resale Price method (RP); Cost Plus method (CP); Transactional Net Margin method (TNM); Profit Split method (PS). Comparing these methods, CUP is assuming taking into account a reference (benchmark), independent to company, since RP is going to use a current market price, which is a counterparty based price transaction. CP method is trying to cover the historical cost and could not be realistic in times of market price decreases. TNM method is an agreed price and could derive from incapacity to practice a CP method in times of market price decrease. It is based on fairness and term structure of yield curve. Profit split method is a matter of ethical and uniform market conditions. Each of these methods could be ethical, if proper invoked in market conditions. Interest rate

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swaps are subject to CUP and TNM, if proper applied and to RP method when specific market conditions are invoked. The ethics of Resale Price method is motivated by extended desire to transfer the profitability to low tax fiscal authorities.

The methods of determining an appropriate price for sophisticated financing techniques (other than long term inter-company loans), such as discounted loans, and swaps could be fairly analysed [14, pp. 33]. Interest rate swaps should consider the interest rate and specific risk involved in interest rate composition, since discounted loans should take into consideration proper yield curve and specific risk. These methods should be documented, whatever will be, transparently presented to be debated, and further improved. If not, there are reasons to believe that unfairly margins are applied to cover unjustified risks and take advantage of transfer pricing policy. These transactions should be in line with uniform transfer pricing policy system for other types of interbank accounts. For consolidation purposes, the interbank accounts are hedged considering a Profit Split method. The using of this method should be declared as part of transfer pricing policy before using, otherwise the differences should be proper emphasized to determine the effective transfer price.

One of the most controversial and often least understood operations of multinationals, transfer pricing, can be used by multinationals to maximise their profits by tax avoidance and by obtaining tax rebates; additional profits come from tax avoidance; in other words it is possible for a multinational company to minimise its liability for corporation tax by transfer pricing; this is legal until governments legislate to prevent this practice [9, pp. 1]. Lacking the legal framework, we raise the issue of ethics, and having a proper framework, we raise the issue of proper implementation and documentation of operations to be fully transparent for the fairness in the market.

Having the methods in mind, and drivers, such ethics, transparency, and motivation, we raise the question of most appropriate method to be used, that is CUP or transactional Profit (net margin) [5, pp. 3]. Invoked methods are comparing a benchmark based price with a yield curve (modelled) price. Adding the specific risk to TNM method, this switch to Resale Price method, and there is a need for specific risk to be analysed. If specific risk is arbitrary set up, there is room for discretionary transfer pricing.

Other authors are grouping the transfer pricing methods in three categories, as follows: Transactional methods; Transactional Profit methods; and Unconventional methods [17, pp. 13]. Transaction based methods are the preferred methods of establishing transfer pricing (Comparable Uncontrolled Price method, Resale Price method, Cost Plus method) [17, pp. 13]. When no data is available, or available data is insufficient or of questionable quality, it may be necessary to resort to Transactional Profit methods (Profit Split method, Transactional Net Margin method)[17, pp. 14]. The authorities often resort to Unconventional methods for transfer pricing when other methods are not applicable (Advanced Pricing Agreement method, setting a priority criteria for a fixed period of time, and Global Formulary Apportionment method, based on a predetermined formula) [17, pp. 15]. These unconventional methods needs to be proper audited and documented to emphasize the fairness assumed behind independent variables of formulas. In most cases formulas incorporate specific risks, which are grossly hedged through Resale Price method. If documented, the Unconventional methods are better than Transactional methods, or Resale Price method.

Some transfer pricing regulations have been enacted with a view to provide a statutory framework which can lead to computation of reasonable, fair and equitable profit and tax so that the profits chargeable to tax do not get diverted elsewhere by altering the prices charged and paid in intra-group transactions leading to erosion of national tax revenue [12, pp. 1]. This issue is encompassing the core driver of behaviour and future ethics behind transfer pricing. In fact, and optimal taxation policy is not giving room to unethical behaviour. There is a tendency of multinational companies to over-report income in jurisdictions that impose heavy penalties [12, pp. 206]. This is in correlation with highly disclosure needed according to OECD. Tax harmonization is categorically undesirable because taxpayers are unable to benefit from better tax policy in other nations [12, pp. 206]. Consequently, the transfer pricing will always exist, and ethics behind it always be a subject under discussion.

While transfer prices may be set for purely internal reasons, there are often strong external motivations to engage in transfer price manipulation (over/under invoicing), the ethics of transfer pricing focusing on two different views: moral ethics and tax ethics [7, pp. 3]. There are proposals to changes in accounting standards and global norms to reduce abusive transfer pricing, because governments do not believe that transnational companies set their transfer prices fairly, but rather engage in widespread transfer price manipulation [7, pp. 3]. In other words, national governments are specifically concerned about situations where aggressive transfer pricing manipulation focused on tax or regulatory minimization moves "over the line" into abusive transfer pricing, which is defined as illegal or fraudulent transfer pricing [7, pp. 3].

2.2. Using of Interest Rate Swaps as Main Transfer Pricing Tool

National governments concerns denote the ethics in transfer pricing is a major issue of transnational companies, the banking companies having particular issues due to complexity of pricing the financial instruments and operations. A way to minimise the interpretations is using of expert system modules. In this respect there are raised issues for integration of transfer pricing policy into the *Management Information Systems* environment, and concerns for advantage of the expert system approach [19, pp. 1]. Funds transfer pricing programs are analysis tools that can be used to help a bank measure its profitability in different ways, allowing management to compare the profitability of different product lines within the company [10, pp. 119]. Banks had been obliged to find new ways to measure and evaluate the performance of different lines of business; the result of these innovations in management accounting was that banks succeeded in creating risk-based performance standards for lines of business, so as to avoid an uninspired allocation of resources to risky businesses that may appear superficially attractive [10, pp. 127]. With all these efforts there is room for proper dissemination of technical approaches and practical implementation and transparency against auditors and public authorities. Ethics is the driver we should have in mind due to unwillingness to tax harmonization as above mentioned.

An *overarching principle* for defining economic transfer prices employs a market-based pricing approach that equates the market value of an instrument with the present value of the cash flows. High-value fund transfer pricing systems tend to reflect the following *principles* [16, pp. 18]: all assets and liabilities must be transfer-priced (reporting units cannot simply transfer-price net positions); a consistent approach should be applied to interest rate risk measurement, risk-adjusted performance measurement, and customer product pricing; transfer rates should be based on cash market interest rates; funds transfer rates should be applied to individual transactions based on each maturity, re-pricing, and "vintage" assumption; funds transfer pricing assignments should last until final maturity; all instruments should receive a "locked-in" spread for each new transaction; the rate assigned should remove basis risk; when instruments have embedded options, an option cost over credit should be included in the assigned rate; a central mismatch unit should be used to monitor and manage interest rate risk; firms that have a broad mix of assets and liabilities sometimes use multiple yield curves; best practices allow for the decomposition of the contribution margin into its constituent components, such as option risk, liquidity risk, and credit risk.

The difference between interest rate and a transfer price is the interest margin, which allows calculating the internal interest profit on a transaction [8, pp. 37]. Fund transfer pricing is fundamental to evaluate the profitability of deposits and loans. Following the global banking crisis, there is needed rationing on the interbank market, creation of a Basel III contingency liquidity buffer, and necessity to adjust fund transfer pricing to the credit riskiness of specific assets of the bank; as well, there is needed to include a liquidity premium in the case of long-term funding, and finally a consistent methodology to incorporate the credit spread [4, pp. 1].

Interest rate swaps is an exchange of cash-flows between two counterparties, in our case, banking companies, after netting of floating or fixed cash-flows of first counterparty over the floating cash flow of second counterparty. The interest risk margin of banking companies needs to be protected against the decreasing interest rates of banking companies for their liabilities when blocked at higher interest rates. In this case, the interest rate swap is meant to pay a floating interest rate (liability side) and receive a fixed interest rate (equivalent to the level of interest rate for deposits). This way, if interest rates for deposits are decreasing, the bank is forced to pay a higher level of interest for deposits, under conditions of having low level of interest rates on assets side as well. By using the interest rate swaps, the fixed received leg of swap contract will hedge fixed (high) level of deposits, and floating paying leg of swaps will be hedged by new lower interest rate for assets.

If interest rates for deposits are increasing, this is in benefit of banks and high interest rates on assets will easily cover the lower fixed interest rates for deposits. This is a fairly operation instead of using options floors, which need appeal to a stock exchange, having the same benefit against decreasing of the interest rate for short positions (liabilities higher than assets on specific maturities and currencies). If interest rates decrease, the option is exercised and the difference between the exercised price (higher) and current spot price (lower) will hedge the loss from requirement to pay a higher interest rate for deposits than one at maturity on the market.

The interest rate swaps are done between banking companies, and between parent company and local branches. The floating legs, fairly, should use the basis risks and specific risks of counterparties. Simply ignoring the specific risks could generate higher spreads between the paying amount (fixed or floating), and receiving amounts (floating). Resale Price method is considering new basis risks and specific risk from one day to another. An ethical approach could determine the splitting of transaction into initial forecasted terms and disclosure, and future effective conditions, during intermediary valuation according to residual maturity forward price. The corollary consists of operations description, motivation (hedging, transfer pricing or speculative), criteria, standard pricing rules and principles, deviation criteria based on market new conditions, and disclosure activities. A proper determination is subject to relevant taxation of transferable funds. Under current blocking of interbank limits due to financial crisis, the interest rate swaps is a tool to surpass the inexistence of deposits limits on long term maturities, involving higher risk. The covering of longer maturities needs intensive dealing on overnight transactions to surpass this inconvenient. Under this framework, the parent company is establishing the transfer pricing policy for its own benefit, if taxation is higher on local markets. Authorities have two alternatives: to tax reasonable these kinds of transfers or modify the full income taxation policy to diminish the funds transferring activities.

Internal auditors can help evaluate effectiveness of corporate policies regarding international transfer pricing. International transfer pricing is a major issue for multinational corporations, as transfer pricing is a key element in corporate taxation strategies. Transfer pricing done correctly, can improve the overall success and value of an international company [11, pp. 1]. Transfer pricing is not an exact science but does require the exercise of judgment on the part of both the tax administration and the taxpayer [15, pp. 2]. Auditors are the people with necessary expertise to judge the fairness and ethics of transfer pricing policy to proper expose the company in terms or corporate behaviour and communication.

Competition has forced banks to apply developed funds transfer pricing systems [18, pp. 182]. Transfer pricing practices are responsive to opportunities for determining values in ways that are consequential for enhancing private gains, and thereby contributing to relative social impoverishment, by avoiding the payment of public taxes [13, pp. 342]. Under the umbrella of opportunity, the ethics is a matter of correct identification and assuming of market arbitrage and unconventional structuring of transactions. Offshore finance centres facilitate the transfer with its attractions of taxation and foreign exchange exemptions, exploited by non-resident companies [20, pp. 1]. In order to avoid money laundering, the adopted solution is known as "know your customer" [20, pp. 1] The best offshore banks in Singapore, for example, are developing today products and services tailored for North Americans, Europeans and Australians, including multi currency accounts [20, pp.1]. Under the triangle of transparency–ethics–opportunity, knowing the customer needs and legal founding of operations let finalise an optimal transaction.

3. Conclusions

The conclusion derived from this research paper is emphasizing the *need for ethical behaviour* of banking companies against transfer pricing policy. The proper solving of ethical issues locally, and internationally, together with optimal implementation could be *the key of prevention for market anomalies*, and understanding of profit splitting at internationally level. It is a matter of identifying the best practices, and *customize* to national and regional taxation legislation. The presented study case is a method of day-to-day operations used by banking companies, through interest rate swaps, lacking a system of interbank limits, into a contracted interbank market. OECD requirements and Basel III requirement for liquidity buffers will further impose the dissemination of detailed information of transfer pricing policies and specific risks to be incorporated, this research paper contributing to better understand the *banking transfer pricing behaviour* and rationales.

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