

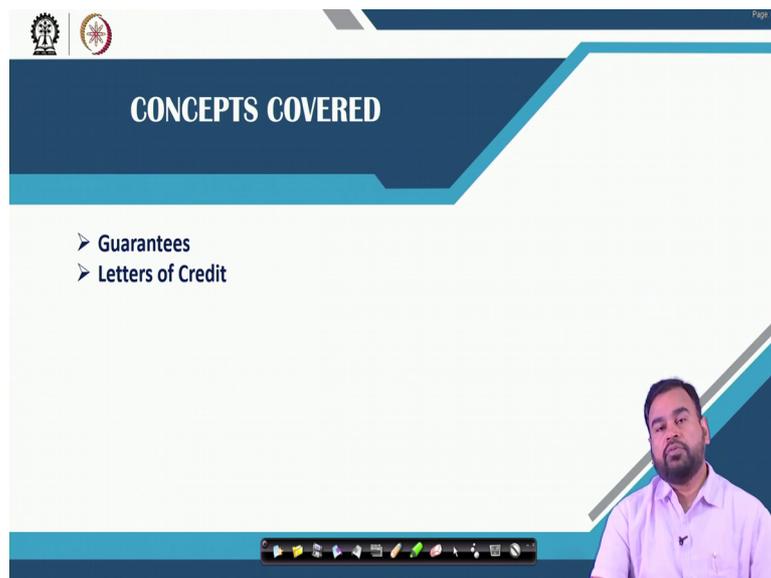
Management of Commercial Banking
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Lecture 54

Management of Off-Balance Sheet Activities 1

So, after the discussion on the deposit schemes and as well as the non-deposit liabilities, we can start the discussion on the, some of the other Off-Balance Sheet items what the Commercial Banks always hold. These are also the major sources of income for the Commercial Banks.

The Commercial Banks also maintain the profitability by using these off-balance sheet items and they also manage the risk by using these off-balance sheet items. So, in today's class we will be discussing about certain off-balance sheet items, then further we can go with many other off-balance sheet items what the commercial banks always use for their risk management and as well as the announcement of the profitability.

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Today's class, we will be discussing about the two things, one is your guarantees and another one is the letters of credit. These are the two major items or major off-balance sheet items, what the commercial banks across the globe always use whenever they try to manage their balance sheet or manage their profitability and liquidity for a particular time period.

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The slide is titled "Off-Balance sheet Activities" and features a background with various financial icons like gears, a tree, and a molecular structure. It contains three bullet points:

- Net impact of global volatility has increased variability of profits in financial market: Increase in risk of doing business
- Off-balance-sheet activities are financial services developed in response to increased risk as well as need to satisfy customers' demand, generate stable fee income, and increase their capital ratios
- Do not appear in the balance sheets as assets or liabilities

At the bottom right of the slide, there is a video feed of a male presenter in a light purple shirt. The NPTEL logo is visible in the bottom left corner of the slide.

So, here in this case, what exactly the guarantees means or what do you mean by this off-balance sheet items, what do you mean by the letter of credit, what are those different types of letter of credit, all kinds of things basically, what we are going to discuss today. So here, whenever you talk about the off-balance sheet activities, the impact basically, if you see, the impact of global volatility has increased the variability of the profits in the financial market and which basically increases the risk of doing the business including the commercial banks.

So, the off-balance sheet items can be consider as the hedging instruments or can be consider as a instrument which is not purely a banking activity, but still they provide certain services, by that the revenue generation can be made or the profitability can be maintained.

So, in this context what basically we can say, the off-balance sheet activities are the financial services, which is developed in response to increase risk, as well as need to satisfy the customer's demand, which can generate stable fee income and increase their capital ratios, which is the measure of the stability.

So, first of all the banks are able to maintain the capital ratio by using the off-balance sheet items. They can increase their fee income by using this off-balance sheet items, they can also able to reduce the risk through the diversification and other risk management process, by that the importance of the off-balance sheet items has increased by many folds.

But that do not appear in the balance sheet as assets and liabilities. They are basically called as the contingent liabilities or contingent assets, which is not realized yet, but that can be realized, but if it is realized, then the bank will be exposed to certain amount of risk. But if everything goes well, then the bank can generate certain kind of revenue without incurring any kind of specific risk. So, that is the basic objective of the off-balance sheet activities.

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Off-Balance sheet Activities

- Most off balance sheet activities are commitments based on contingent claims
- Contingent claims: an obligation by a bank to provide funds if a contingency is realized
 - Default by the party on whose behalf the obligation was written may trigger an immediate loss or may result in the bank acquiring a substandard claim
- Claims do not appear on the balance sheet until they are exercised
- Broad groups of off-balance sheet activities include
 - (1) Financial Guarantees
 - (2) Derivative Instrument
 - (3) Other types of off-balance-sheet activities (trade finance, cash management)

The slide features a blue and white background with decorative icons of gears, a network diagram, and a molecular structure. A presenter is visible in the bottom right corner of the slide frame.

So, that is why the most of the off-balance sheet activities are commitments, which are based on the contingent claims and contingent claim means it is an obligation by the bank to provide the funds if a contingency is realized. That means bank has not yet provided any fund, but if there is any kind of, bank is obliged to provide, but if there is an requirement bank will provide unless bank will not provide.

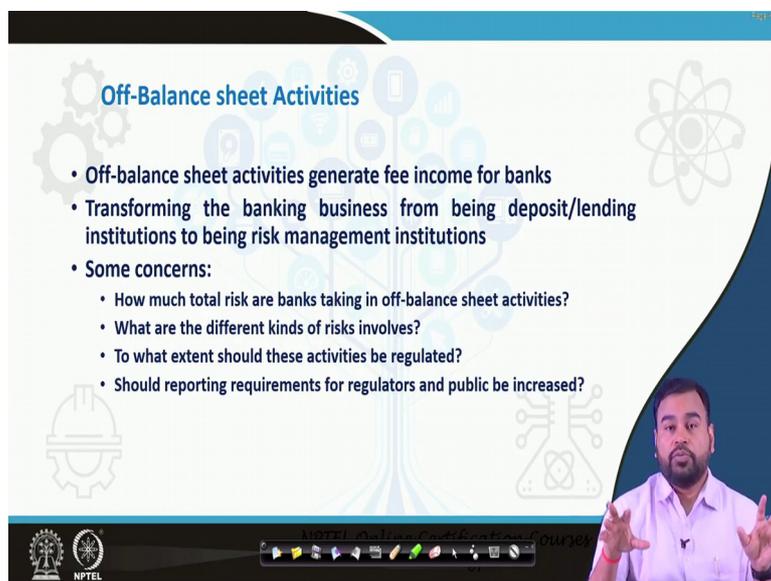
So, that means, it can be realized when there is a default by the party on whose behalf the obligation was written by the bank and that will trigger, then immediate loss or may result in the bank acquiring a substandard claim. So, that basically may happen, may not happen, because of that, this is not basically consider as an on-balance sheet item, this is consider as a off-balance sheet item.

Claims do not appear on the balance sheet until they are exercised, that is what basically already we have discussed. So, there are various groups of the off-balance sheet activities, you have the guarantees, many types of guarantees, we have the derivatives instrument, these are the broad classification, you keep in the mind.

We have the guarantees, we have the derivatives instrument, we have the other types of balance sheet, off-balance sheet activities like trade financing, cash management, insurance services, mutual fund service, there are many other types of investment banking services. So, these are other types of services, what the commercial banks can provide, which is called the other off-balance sheet activities.

So, in this context, in today's session, we will be covering up, the certain kind of our most important off-balance sheet activities in today's context, what the banks are providing. These are related to the guarantees and some instrument with respect to that is basically the letter of credit.

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The slide is titled "Off-Balance sheet Activities" and features a list of bullet points. The presenter, a man in a light blue shirt, is visible in the bottom right corner of the slide. The slide also includes the NPTEL logo in the bottom left corner and a navigation bar at the bottom.

- Off-balance sheet activities generate fee income for banks
- Transforming the banking business from being deposit/lending institutions to being risk management institutions
- Some concerns:
 - How much total risk are banks taking in off-balance sheet activities?
 - What are the different kinds of risks involves?
 - To what extent should these activities be regulated?
 - Should reporting requirements for regulators and public be increased?

Say, so, that is why off-balance sheet items generate the fee income to the bank, transforming the bank's business from being deposit or lending institutions to the risk management institutions, because the services are diversified. Now, the portfolio of the services are quite diversified, which is helping the banks to reduce the risk.

But there are certain questions basically raised with respect to that, there are some concerns. How much total risk are banks taking in off-balance sheet activities? What are the different kinds of risk involves whenever the bank goes for their off-balance sheet activities? To what extent the activities should be regulated? Whether it should be regulated or not? If it is regulated, then up to what extent this particular regulation should take place?

Should reporting requirements for regulators and public be increased? That means even if it is a off-balance sheet item, the bank has to provide the information that how much exposure

they have towards these kind of activities. So, whether those kind of things would be there in the bank's side or not or we should concern about those kind of things or not, that is basically, that are basically the major questions always we raise our self, that how basically this thing can be managed whenever we go for the balance sheet activities of the commercial bank.

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Guarantees

- An undertaking by a bank (the guarantor) to stand behind the current obligation of a third party, and to carry out that obligation if the third party fails to do so
- Example:
Bank makes a loan guarantee whereby it guarantees the repayment of a loan made from party A to party B
Assuming the guarantor's credit is better than of borrower, the rate of return required by the market on the borrower's debt obligation is reduced
From banks perspective, fees ranging from 10 to 150 basis points are charged, depending on the reduction in the borrower's debt costs and risk exposure of the bank

The slide features a background with various icons related to finance and technology. A speaker is visible in the bottom right corner, gesturing with his hand. The NPTEL logo is in the bottom left corner.

So, whenever you talk about guarantees, what do you mean by the guarantees? The guarantees is basically nothing but an undertaking, to stand behind the current obligation of a third party and to carry out that obligation if the third party fails to do so. That means if somebody has some kind of agreement with somebody and as a bank, I am the guarantor, if that person will not going to exercise or going to oblige that particular thing, then the bank has the duty to act on behalf of that particular person and pay and as well as or fulfil all those requirements are as per the agreements.

For example, if the bank makes a loan guarantee, whereby it guarantees the repayment of the loan made from party A to the party B. So, if at any point of time, if the party B fails, party A fails to pay the money to party B, then it is the bank's responsibility, basically has to fulfil that requirement and from the banking perspective, if you see, there is a fee basically bank charges in terms of guarantee, that is basically 10 to 150 basis point, that means 0.1, 01 percent to point, 0.1 percent to 1.5 percent, that is basically the charge basically they can make.

Which depends upon the reduction of the borrower's depth cost and risk exposure of that particular bank. So, the fees basically varies, but the bank charges certain fee against that, but

bank is highly exposed to certain kind of credit risk whenever this kind of activities the bank always try to carry out.

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Types of Guarantees

- **Financial Guarantee**
 - When the customer is required to perform financial obligations. Used in the place of cash deposit / earnest money.
- **Performance Guarantee**
 - When the customer is to perform a task or work. The bank will pay for the non-performance of work
- **Deferred Payment Guarantee**
 - Used for capital goods' imports. Amount has to be paid in future installments on agreed terms. The exporter requires a guarantee from importer's bank
- **Invocation Guarantee**
 - Amount claimed under the guarantee should be paid to the seller in accordance with the terms and conditions. Payment can not be withheld at the instance of the customer

There are different type of guarantees, the guarantees can be classified into many, many ways, one is your financial guarantee, we have the performance guarantee, we have the deferred payment guarantee, we have the invocation guarantee. There are four major broad types of guarantees, the bank can always carry out whenever the guarantees will be consider as a, we can say that off-balance sheet activities, the commercial banks carry out.

Whenever we talk about financial guarantee, when the customer is required to perform financial obligations. Mostly it is used in the place of cash deposit on the earnest money, what does it mean? For example, somebody has gone for a tender, somebody has going to do some kind of activity somewhere and to start or initiate that activities, they have to deposit certain cash or they have to deposit certain earnest money.

So, in the place of that, they may not deposit that earnest money or they may not deposit that cash, they can also produce a bank guarantee for that. So, at any point of time, if there is some kind of a failure will be there and that person is not able to fulfil that, then it is the bank who was provided that guarantee, that bank will be responsible to provide that services at that particular point of time, so that is called the financial guarantee.

We have the performance guarantee. The performance guarantee will work there, when the customer is to perform some task or the work and the bank will pay for the non-performance of the work. So, the one work has been assigned to somebody, any project has been assigned

to somebody and within a certain time period, the particular work has to be finished and against that the bank provides a guarantee that if this particular work will not be completed or the particular person is not able to complete the work, then the bank basically will finance that or bank will pay for that non-performance of the work or non-performance of the task.

That is basically called the performance guarantee. Then, we have the deferred permanent guarantee. It is mostly used for the import of the capital goods. So, the amount has to be paid in future instalments on agreed terms and the exporter basically requires a guarantee from the importer's bank. Whenever you are buying the big machines or big capital goods for the productions.

We are not in a position to repay the money or pay the money in at one go. So, if that is a instalment basis, payment will be made. So, in that time, the exporter basically always need a guarantee from the importer's bank that the payment will be made in the regular intervals, if at any point of time there is a default, then the money will be paid by the bank only. So, that is basically called the deferred payment guarantees, always can possible in the trading process.

We have invocation guarantee. Here, in this context, the amount basically which claimed under guarantees should be paid to the seller in accordance with the terms and conditions and payment cannot be withheld at the instance of the customer. What does it mean? If there is a certain kind of agreement and there is a bank is the guarantor, let the particular person who is providing the services or the person from whom the guarantee for, on behalf the guarantee's design, let that person will say the money should not be given.

Because there is some other kind of conflicts between the beneficiary and this particular person who is providing that particular benefits. But in that particular point of time, you cannot stop the payment, if there is invocation guarantee and the bank has to pay that particular money without the consent of the particular customer, even if the customer is not interested to pay that money, even if you, they say that the money will not be paid because of so and so reasons.

But still the bank cannot stop that particular payment, if the particular guarantee is the invocation guarantee. So, this is on the basis of the nature of the services or the use of that particular services, the different type of guarantees basically commercial banks provide to carry out the business or to carry out these off-balance sheet activities.

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Guarantee Guidelines

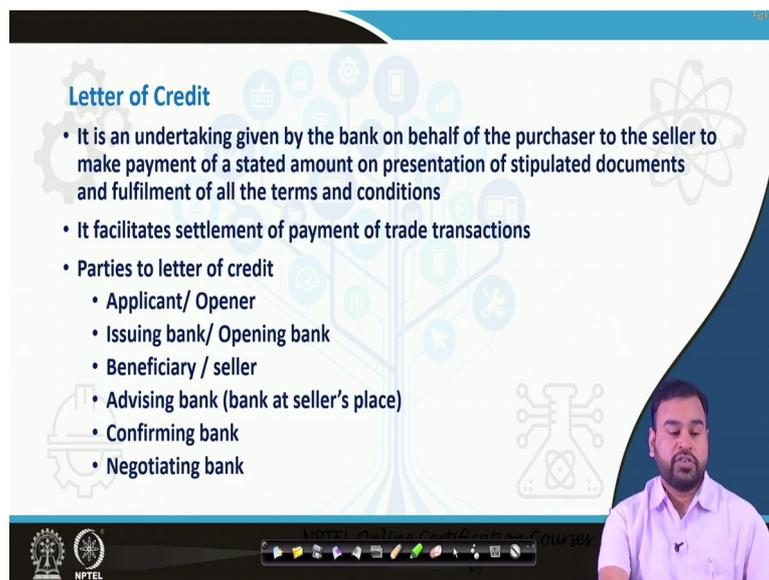
- The extent of monetary liability and the period of liability should be specific
- The guarantee can be issued for a maximum period of 10 years
- The guarantee should not be issued to those customers who enjoy credit facility with other banks

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So, there are certain guidelines with reference to India, if you see, the extent of monetary liability and the period of liabilities should be specific, that from the beginning that has to be mentioned. The guarantee what the commercial banks provide, that should be issued for a maximum period of 10 years, it should not exceed more than 10 years and the guarantees should not be issued to those customers who enjoy the credit facility with the other banks.

If any customer needs a guarantee from the bank A, but the customer has the credit facility with the bank B, then the bank A is not entitled to provide the guarantee to that particular customer who is not enjoying or who has not, getting any kind of credit facility from the bank A. So, these are the some of the guidelines which Reserve Bank of India has fixed for providing the guarantee to different type of customers.

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Letter of Credit

- It is an undertaking given by the bank on behalf of the purchaser to the seller to make payment of a stated amount on presentation of stipulated documents and fulfilment of all the terms and conditions
- It facilitates settlement of payment of trade transactions
- Parties to letter of credit
 - Applicant/ Opener
 - Issuing bank/ Opening bank
 - Beneficiary / seller
 - Advising bank (bank at seller's place)
 - Confirming bank
 - Negotiating bank

The slide features a background with various icons related to trade and finance, such as a gear, a tree, a person, and a document. In the bottom right corner, there is a small video inset of a man in a light purple shirt, presumably the presenter. The NPTEL logo is visible in the bottom left corner of the slide.

Then we can go for the letter of credit. So, what is letter of credit? It is also part of one type of guarantee only. So, this is again an undertaking which is given by the bank on behalf of the purchaser to the seller of, to the seller, to make payments of a stated amount on presentation of stipulated documents and the fulfilment of all terms and conditions.

So, the letter of credit is again certain kind of undertaking which is given by the bank on behalf of any kind of purchaser to the seller. It is mostly happening in the shipment case or the trading process, whenever we are trying to buy a certain commodity from the other countries or other places, that time in the domestic economy whoever is the bank, they provide certain kind of undertakings to that particular seller's bank, that the money will not be repaid by this particular entity, then the money will be repaid by them.

So, that is on the basis of certain terms and conditions and as well as the certain kind of requirements, whatever as per the guidelines. So, it basically facilitates the settlement of the payment of the trade transactions, mostly the letter of credit is used to facilitate the settlement of the payment of the trade transactions in the market. Whenever there is a letter of credit is designed, a letter of credit is prepared, who are those parties are involved in that, who are those entities, who are involved in that particular process?

One is obviously the applicant. We call them the opener, the opener of the letter of credit, the buyer who is basically going for this, applying or requesting the bank for a letter of credit. Then we have issuing bank, who is there in the particular economy, particular market or we can call them the opening bank, who basically issues this letter of credit. Then there is

another party there, we have a beneficiary who is the seller, who is providing this particular product to the buyer.

Then we have an advising bank, which basically there in the seller's place and there is a conforming bank, who is there is also there in the seller's place, that is a negotiating bank. But most of the cases, the advising bank on conforming bank and negotiating bank are more or less same. If the bank which is the issuing bank, which is the opening bank is not that popular bank in the seller's place, then the concept of the negotiating bank, conforming bank, advising bank will comes into the picture.

But if the same bank is existing there and the same bank is known to, a popular bank which is known to the seller then more or less these three types of banks are one only. So, these are the different parties of the letter of credit, who are basically involved in designing or maybe issuance of the letter of credit in that particular segment.

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The slide, titled "Types of Letter of Credits", lists the following types and their characteristics:

- **Documents against acceptance (DA)/ payment (DP)**
 - In the case of DA the documents are released against acceptance of a draft (term collection)
 - For DP, the payments are made against documents on presentation (sight collection)
- **Irrevocable Letter of credit**
 - The LC can not be amended without the consent of all parties
- **Revocable Letter of credit**
 - Can be cancelled or amended at any time without the prior knowledge of the seller
- **Confirmed Letter of Credit**
 - A bank other than issuing bank guarantees the payment of LC
- **Transferable Letter of Credit**
 - If the seller is not the producer of the goods

The slide also features the NPTEL logo in the bottom left corner and a video player interface at the bottom.

What are those different types of letter of credit? The letter of credits types are many. One is your documents against acceptance, we call the DA or document against payment that is called DP. In the case of DA, the documents are released against acceptance of a draft which is called a term collection and in the case of the DP, the payments are against the documents on presentation that is called the sight collection.

Another type of letter of credit is irrevocable letter of credit. Here, the letter of credit cannot be amended without the consent of all the parties, whatever parties we have, if it is revocable

then actually without the consent of the seller, that can be, that can be changed, the terms and conditions can be changed.

But in this case, it cannot be amended without the consent of all the parties who are involved in that particular process. In the context of revocable, already we have discussed that it can be cancelled, can be amended at any time without the prior knowledge of the seller.

Another one in the confirmed letter of credit, which is nothing but a bank other than the issuing bank, guarantees the payment of LC, issuing bank is not giving the guarantee, some other bank is providing the guarantee to the LC and transferable letter of credit, if the seller is not the producer of the good. What happens sometimes, we are buying certain product from somewhere, but the actual, the person who is selling the product is not the producer.

So, then there is some problem can happen in that particular case. But maybe, this particular seller will not pay the producer the money in the appropriate time. So, because of that there is another party involved in that. So, that is why the letter of credit can be transferred from the seller's name to the producer name if there is some kind of problem arises between the producers of the product and the sellers of the product. That is why that is called the transferable letter of credit.

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Types of Letter of Credits

- **Back to back Letter of Credit**
 - LC is used as a security for second LC
 - The validity coincides with the validity of original letter of credit
- **Anticipatory Letter of Credit**
 - Pre-shipment credit to seller for processing and packaging (red clause)
 - Advance up to a point with pre-shipment credit (green clause)
- **Revolving Letter of credit**
 - LC is issued for specified limit of account
- **Deferred Payment Letter of Credit**
 - The issuing bank make payments to the seller in installments within the predetermined period and buyer pays later
- **Standby Letter of credit**
 - In USA it is used in lieu of bank guarantee. Used to guarantee the financial payments

There are other types of letter of credit also, back to back letter of credit. If one letter of credit issued against a particular opener or initiator, then again, they need another letter of credit that can be also issued. It is basically as a security. The LC is used as a security for the second LC and the validity basically coincides with the validity of the original letter of credit.

The validity period will not be changed. The validity period will be coinciding with the original letter of credit. Then, we have anticipatory letter of credit that is the pre-shipment, shipment credit to the seller for processing or packaging. Generally, what happens that sometimes seller needs some money, because they want to, already the production is made, but they want certain money for processing and packaging of that particular product. So, then also some kind of letter of credit can be issued against that, that is called the red clause.

So, in the agreement, letter of credit is written in the red colour. That is why it is called the red clause and or sometimes, the advance can be given to a point with the pre-shipment credit, maybe apart from the pre-shipment credit, some extra money also can be paid to them, because of certain terms and condition, with certain terms and condition that is called the green clause. That will be written in the green letter, green colour. So, that is called the anticipatory letter of credit.

Then we have revolving letter of credit, the revolving letter of credit is issued for a specified limit of account, it cannot exceed a particular amount. So, that can be always considered from the beginning. Then we have the deferred payment letter of credit. Here, in the case of deferred payment, the issuing bank make payments to the seller in instalments within the predetermined period and buyer pays later. The deferred payment credit, bank first pays to the seller in the instalment basis and the buyer basically pays to the bank later with certain kind of interest.

Then we have a standby letter of credit. Mostly it is used in the US market to provide the guarantee for the financial payments. The standby letter of credit is used in the lieu of the bank guarantee and it is used to guarantee the financial payments which is happening in the US context.

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The slide is titled "Documents under Letter of Credit" and features a list of documents and a note on RBI guidelines. The background is light blue with a network diagram of icons. A presenter is visible in the bottom right corner.

- Bill of exchange
- Invoice
- Transport document
- Insurance document
- Other documents: certificate of origin, certificate from health authorities
- As per RBI guidelines bank should issue letter of credit to those who has enjoyed the credit facility with that bank

So, if you see this, then what basically we have seen, that there are certain documents which is required for the letter of credit or to make a letter of credit. We need a bill of exchange between the two parties. We want an invoice which is given by the seller to the buyer. We need some transport document, legal document, which is this particular transactions is legally valid and the business or the instrument what they are basically providing, these are the legal instruments, which is not banned or which is not basic is following certain kind of conditions or rules and regulations followed in that particular country.

The insurance of that particular product, because product is shipped to the sea and other things, so that is why it should be properly insured. The insurance document, that has to be proper. The certificate of origin from where the product is coming and also the certificate from the health authorities that this product is not hazardous and all kinds of documents which is basically should be there whenever the letter of credit will be issued.

As per RBI guidelines, the bank should issue the letter of credit to those who has enjoyed the credit facility with that bank, who have already has the credit facility with the bank. The letter of credit can also be issued to them because the past experience with those customers may be good and there is less risk exposure towards the issuance of the letter of credit to them. So, this is about the documents or the guidelines, simple guidelines, which is followed by the Commercial Bank whenever they provide the letter of credit to the different type of customers.

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Standby Letters of Credit (USA)

- Standby letter of credit (SLCs) obligate the bank to pay the beneficiary if the account party defaults on a financial obligation or performance contract
- Two types of SLCs:
 1. A financial SLC: related to a financial commitments, such as repayment of commercial paper
 2. A performance SLC: nonfinancial in nature; for example a commitment to complete a construction project or deliver a certain merchandise
- Banks earn fee income on SLCs and interest income in the event credit must be extended to the account party to cover a payment of funds to the beneficiary

The slide features a blue header with the title, a list of bullet points, and a video feed of a presenter in the bottom right corner. The background has a light blue and white abstract design with icons of a gear, a tree, and a network.

Now, we are coming back to a specific letter of credit that is, which is mostly used for the financial transactions in US. Here, the standby letter of credit basically is nothing but it is obligate the bank to pay the beneficiary if the account party defaults on a financial obligation or performance contract. There are two types of standby letter of credits we observe.

One is a financial letter of credit and a performance letter of credit, which is again synonymous to the overall letter of credit classifications. The financial letter of credit is related to the financial commitments such as repayment of the commercial paper and the performance standby letter of credit is non-financial in nature. For example, a commitment to complete a construction project or deliver a certain merchandise and all these things and banks earn some fee income on providing these kind of services to the different kind of customers at the time of requirement.

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Standby Letters of Credit

Uses of Standby Letters of Credit:

- For issuance of debt obligations (i.e. bonds, notes, and commercial papers) as backup lines for credit
- To ensure delivery of merchandise, performance of options or futures contracts
- To back other loans, or even guarantee alimony and child support payments

Example 1: Suppose city XYZ issues \$500 million bond with 7 year maturity to fund pollution control. -To be repaid by payments received by city from project users -If payments are not sufficient to cover interest and principal payments received, bond backed by irrevocable letter of credit from ABC bank	Example 2: Building contractors obligation to complete a construction project -If project not completed before stated date, bank required to pay beneficiary -Reason for incompletion of the project irrelevant -SLC as substitute for surety bond
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For issuance of the debt, if you want to use this standby letter of credit, how it is used, it can be used for issuance of the debt obligations like bonds, notes and commercial papers as backup lines of the credit. To ensure the delivery of merchandise, performance of options or future contract and to back other loans, even guarantee the alimony and the child support payments using this particular concept.

So, if you see this example, suppose a city XYZ issues 5 million bond with 7 years maturity to fund pollution control, then to be repaired by payments received by city from project users. So, if the payments are not sufficient to cover the interest in principle payment received, then bonds basically backed by the irrevocable letter of credit from the ABC bank will be used for that.

Then building contractor's obligation to complete a construction project, if the project not completed before the stated date, bank required to pay the beneficiary and reason for incompletion of the project is irrelevant and here, the standby letter of credit as substitute for the surety of the bond.

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The slide is titled "Standby Letters of Credit..." and features a list of five bullet points. The background is light blue with faint icons of gears, a smartphone, and a molecular structure. A presenter's video feed is visible in the bottom right corner. The NPTEL logo is in the bottom left corner.

- Evaluate account parties in the same way they evaluate commercial loans
- Since banks accept only credits that they believe are least likely to default and taken down (loans made): credit risk minimal
- To reduce risk further, many SLCs are backed by deposits and/or collateral
- Long term nature of commitments can cause risk to change over time; periodic renegotiation of SLC terms
- In event of take down, bank may book unreimbursed balance as commercial loan

It, the standby letter of credit case, the evaluation is always done in the same way, whatever way the commercial loans are evaluated. Since the banks accept only the credits that they believe are less likely to be defaulted, then the credit risk will be minimal. That is why the same approach they follow.

Many standby letter of credits are backed by the deposits or the collateral of the buyer or maybe the initiator and the long-term tenure of commitments can cause risks to change over time, periodic renegotiation of the standby letter of credit is also sometimes required because of the fluctuations of the pricing of the different assets which is used as the collateral. So, in the event of takedown, banks may book the unreimbursed balance as the commercial loan that also is possible whenever the letter of credit has issued for some specific reasons.

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The slide is titled "Standby Letters of Credit..." and lists four types of risks. It features a background with various icons related to finance and technology. A presenter is visible in the bottom right corner of the slide frame.

Standby Letters of Credit...

Risks:

- i. **Liquidity risk** also known as funding risk
- ii. **Capital risk:** losses can rapidly accumulate in even (say economic slowdown) can cause more than one borrower to default at the same time
- iii. **Interest rate risk:** either from possible changes in duration gap or increased (decreased) likelihood of default as interest rate levels increase (decrease)
- iv. **Legal risk:** Material Adverse Change (MAC) clause enables bank to withdraw from commitments under certain conditions. Clause needed to deter banks from taking excessive risks and exploiting banks guarantee

There are many risk involved whenever the letter of credits are issued and liquidity risk, already we know that, this is nothing but the funding risk. We have capital risk which can arise due to losses in terms of the slowdown of the economy or the default of the borrower at the same point of time. Interest rate risk, it is due to the possible changes in the duration gap or increase or decrease likelihood of default in interest rate levels or in the market.

Legal risk, there may be some kind of legal risk which may arise in between, material adverse change clause enables banks to withdraw from commitments under certain conditions, which is happening in US. Clause related to deter banks from taking excessive risk and exploiting bank's guarantee, the same way whatever way our Reserve Bank of India is also has imposed certain restrictions to avoid certain kind of excessive loss in terms of the defaults, which may happen with respect to this letter of credit business.

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The slide is titled "Standby Letters of Credit..." and features a background with various icons including gears, a tree, a hard hat, and a beaker. The text on the slide is as follows:

Pricing:

- May have upfront and annual fees
- Annual fees on SLCs are lower than loan fees in part due to lower administrative costs and other expenses because normally no funding needed

The slide also includes the NPTEL logo in the bottom left corner and a video feed of a presenter in the bottom right corner.

The pricing of this, they have upfront of the annual fees, they pay to propagate that kind of services from them and mostly the annual fees on the standby letter of credits are lower than the loan fees in the part due to the lower administrative cost in other expenses because normally no funding is required.

Virtually no funding is made in the beginning and that is why we are not incurring any cost for that. That is why the fee is less but there is excess risk involved in that, if there is some kind of default arises from the initiator point of view. So, this is the way the pricing is made for the letter of credit case.

(Refer Slide Time: 30:30)

The slide is titled "CONCLUSION" and features a background with a blue and white geometric design. The text on the slide is as follows:

CONCLUSION

- Off-balance-sheet activities are financial services developed in response to increased risk as well as need to satisfy customers' demand, generate stable fee income, and increase their capital ratios
- Guarantee is an undertaking by a bank (the guarantor) to stand behind the current obligation of a third party, and to carry out that obligation if the third party fails to do so. There are various types of guarantees.
- Letter of credit is an undertaking given by the bank on behalf of the purchaser to the seller to make payment of a stated amount on presentation of stipulated documents and fulfilment of all the terms and conditions.

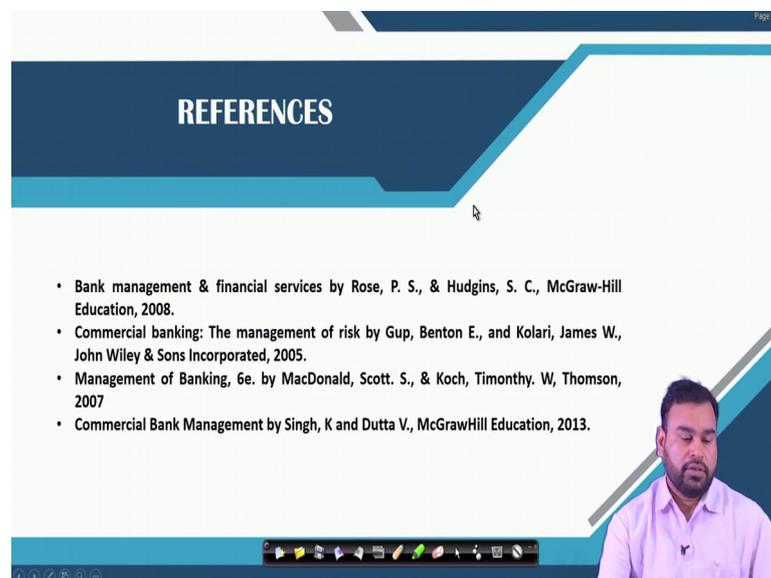
The slide also includes the NPTEL logo in the bottom left corner and a video feed of a presenter in the bottom right corner.

So, what we have basically discussed in today's session? The off-balance sheet activities are the financial services which is basically developed in response to increase risk as well as need to satisfy the customer's demand and it regenerates stable income and increase their capital ratio. Guarantee is an undertaking which the bank always provide to stand behind the current obligations of a third party and to carry out that obligation if the third party fails to do so and there are various types of guarantees, already we have discussed that part.

Letter of credit is also one type of guarantee, which is undertaking, which is given by the bank on behalf to the purchaser to the seller to make the payment of a stated amount on presentation of stipulated documents and fulfilment of all the terms and conditions and there are many types of letter of credit always we use for different purposes and on the basis of the nature of the utility of that particular business or particular purpose for whom this particular credits are issued or letter of credits are issued.

So, this is the way basically the guarantees and letter of credit works as off-balance sheet item for the commercial bank. Then we will be discussing about the other kind of off-balance sheet items in the forthcoming classes.

(Refer Slide Time: 31:51)



The image shows a presentation slide with a dark blue header containing the word "REFERENCES" in white capital letters. Below the header, there is a list of four references in black text. In the bottom right corner of the slide, there is a small video inset showing a man with a beard and a light-colored shirt speaking. At the bottom of the slide, there is a navigation bar with various icons for presentation control.

- Bank management & financial services by Rose, P. S., & Hudgins, S. C., McGraw-Hill Education, 2008.
- Commercial banking: The management of risk by Gup, Benton E., and Kolari, James W., John Wiley & Sons Incorporated, 2005.
- Management of Banking, 6e. by MacDonald, Scott. S., & Koch, Timonthy. W, Thomson, 2007
- Commercial Bank Management by Singh, K and Dutta V., McGrawHill Education, 2013.

These are the references what you can go through for this particular topic. Thank you.