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OFF BALANCE SHEET ACTIVITIES AND THEIR INVOLVEMENT IN BANKING BUSINESS OPERATIONS

Aleksandar Lukic[1]

**Corresponding Author: Aleksandar Lukic ✉ lukas075@yahoo.com*

Off-balance sheet activities became very important part of the banking business. This activities are a special category of bank activities. They represent the operations which are not evidenced in the bank balance sheet. The nominal value of off-balance sheet several times exceeds the value of balance sheet assets. Off-balance activities imply certain business changes in the means and obligations that are not bank's and do not cause changes in its balance structure. In other words, those are arrangements that in different ways involve bank, that do not influence the structure of bank's assets and liabilities but can have greater or less influence on its profitability. Considering strong competition with non-bank institutions in the recent years, the banks are more and more forced to concentrate in the direction of expansion of off-balance business, that subsequently often exceed the volume of bank's balance business.

Keywords: Banking sector, Off-balance sheet, Credit risk management, Banking regulation

INTRODUCTION

Contemporary financial environment is characterized by deregulation and liberalization of financial transactions, instability of the environment and risk. Enhanced degree of competition on the financial market supported by such environment forces banks to improve their business and to fight for their position on the market. Balance business does not guarantee security for the bank anymore because it is exposed to great number of external risks on which it cannot influence, and so the growing number of banks put stress on the off-balance business as the important factor for profit generation (Ketz, 2003).

Bank's off-balance arrangements can be categorized as products of loan and products of derivatives and comprise different kinds of traditional and contemporary off-balance credit substitutes that gain growing importance in contemporary banking. With adequate policy of approving off-balance credit substitutes banks can provide for themselves significant advantages with growing profits and improved allocation of means but these activities take with them certain risks that present specific combination of credit

[1] KBM Bank AD, Dept. of International Payments Kragujevac, Serbia.

risk, interest rate risk, liquidity risk and exchange rate risk.

Definition of Off-balance Sheet Finance and Comparison with Traditional Banking Operations

Off-balance sheet finance is an important part of modern accounting and finance, especially in the field of investment banking. Generally, off-balance sheet finance might be described as financial activities outside of the balance sheet. However, some stricter definitions are available from different perspectives. For example, off balance sheet finance is defined as a major category of corporate finance. Thus a change in the off-balance sheet asset can be viewed as capital investment and a change in the off-balance sheet liability can be viewed as a source of off balance sheet financing (Basel Committee).

Off-balance sheet activities are vehicles of information and risk-sharing services. They seek to unbundle the risks inherent in underlying assets and make it possible to repackage such decomposed risks into synthetic products and deal in the separately. The establishment of a credit line earns a bank a commitment fee, affords the customer protection against liquidity needs, but exposes the bank to offsetting liquidity risk which it is better able to bear. Banks also protect customers against, and themselves incur, asset risk through activities such as bill acceptances and standby letters of credit. In both cases, banks essentially guarantee payment of a customer's liability to a holder of its debt, should the customer default. Fees charged to a customer reflect the benefit of the lower interest rate by the market on the customer's paper, once a bank guarantee payment is attached. Although the initial incidence of a fee is on the bank's customer, the ultimate effect of the lower yield is equivalent to the holder of risky paper paying a premium to the bank, in terms of foregone interest, for protection against default. This is analogous to a depositor accepting a guarantee from a bank in lieu of unguaranteed interest income on primary securities. From the borrowers point of view, the interest rate risk they face can be averted by writing a cap or collar contracts with the bank. A cap is a put option which acts as a hedge to the buyer against rising interest rates. A floor, on the other hand, is a series of call options and when combined with a cap in a collar acts much like a fixed rate of interest. When borrowers negotiate a syndicated loan, they normally are allowed to choose the interest rate basis, the currency of interest and principal and when to draw down the loan. These choices can be exercised also off-balance sheet by means of basis swaps, coupon swaps, currency swaps back-up credit lines and futures or forward contracts (Hull, 1989).

From this comparison, it is clear that much the same functions are being performed in off-balance sheet banking as in traditional banking, and moreover, for reasons which are essentially the same as those explaining traditional intermediation by banks. Guarantees exploitopportunities arising from information asymmetries, where the bank has access to information about a borrower's 'real' credit risk and the risk premium which would otherwise be required bythe market for certain borrowers is greater than the fees charged to them by banks. Access to the inter-bank market means that banks may also be better able to bear liquidity risk. Any interest rate risk under a revolving credit can also be ameliorated in various ways, including shifting risk onto futures market. Clearly, banks possess skills in acquiring information and can

tap wholesale funding markets which enable them to issue guarantees and write commitments of various kinds. One reason for doing so is that such activities enable banks to achieve dramatic increases in leverageas measured by conventional balance sheet quantities. More importantly, contingent claims, dovetailed to meet customer requirements, not only help to strengthen customer relationship, but is also a major source of fee income (Rose, 2010).

Types of Off-Balance Sheet Activities

There have been eight major areas of off-balance sheet activity: Loan Commitments, Futures and forward contracts, Standby contracts/letters of credit, Option arrangements, Swaps and Loan Sales.

1. Loan Commitments - Under a loan commitment contract a bank guarantees to supply a maximum amount of loans over a fixed time period at either a fixed rate or some rate based on a formula tied to prime rate. In return the customer pays an upfront fee and often a fee on the unused balances. Technically one can view a loan commitment as providing a customer with a borrowing option which can be exercised profitably whenever the spot market loan rate lies above the contractual loan rate. This risk is compounded by the fact that many borrowers are likely to draw on their commitments at the same time, usually when monetary policy is tight and funds are in short-supply. Such incentives to borrow are likely to push up further any differences between a bank's cost of funds/spot rate and the formula/loan commitment rate. In addition banks can also be viewed as facing a quantity or takedown risk since under binding loan commitments they must always stand ready to provide the maximum or upper limit of the commitment while the borrower has the option to draw down anything between zero and the maximum commitment line depending on the states of the world that exist over the time interval during which the commitment is in effect.

2. Futures and forward contracts - Banks are heavy users of both futures and forward interest rate and foreign exchange contracts. Due to space we will concentrate here only on the risk of interest rate futures contract positions. Probably the major risk banks face is when they use futures contracts for micro- rather than macro hedging purposes. Advocates of macro hedging argue that banks should select their financial futures contract positions according to the overall portfolio risk exposure of the bank. That is, they should be used to hedge the banks aggregate asset and liability duration gap where duration measures the weighted average time of cash flows received frombank loan and portfolio investments. Since most banks have a positive gap, with the duration of their assets longer than the duration of their liabilities, they should short futures contracts to minimize their interest rate exposure. Unfortunately, many large banks are organized on a 'profit center' or departmental basis so that the natural organizational tendency is for each department to choose its own optimal hedges from a micro perspective, e.g., the securities trading department, the mortgage banking department, international subsidiaries, etc. Unfortunately these micro hedges when aggregated may actually work to increase a bank's risk exposure onan aggregate basis. Thus, use of financialfutures in hedging inventory risk, loan commitment risk may be counterproductive andeven conceivably increase interestrate risk. Inaddition to this problem of macro v's microhedging, basis risk will exist if the interest

rate futures contract(s) used do not have a close correlation with the interest rates on the assets and liabilities under consideration.

3. Standby contracts/letters of credit - There has been major growth in all types of standby contract/letters of credit issued by banks for both trade and non-trade purposes. In issuing such contracts the bank is acting as a guarantor, or an insurance agent, who like any insurance agent faces a loss if a particular state of the world arises. In a sense the bank's risk is essentially the same as the default credit risk faced in its standard lending operations and should be evaluated similarly even though these are contingent liabilities and are off the balance sheet.

4. Option arrangements - As with futures contracts many large banks have taken positions in both interest rate and foreign exchange options for the purposes of hedging. However, the payoff streams from writing a put or call are different from buying a put or call. Specifically, the maximum potential loss a bank can face on buying an individual put or call is the premium paid up front if the option expires out of the money. By comparison the maximum loss on writing a put or a call is theoretically unlimited. Consequently, potential risk exposure in writing call/put options on either interest-rates or foreign exchange may be more serious than buying puts/ calls.

5. Swaps - Swap refers to an exchange of one financial instrument for another between the parties concerned. This exchange takes place at a predetermined time, as specified in the contract. Swaps are not exchange oriented and are traded over the counter, usually the dealing are oriented through banks. Swaps can be used to hedge risk of various kinds which includes interest rate risk and currency risk. Currency swaps and interest rates swaps are the two most common kinds of swaps traded in the market. Large banks are also heavily in volved in the swap markets, both interest rate and foreign exchange. Interest rate swaps may be viewed as a viable strategy for a bank when it wants to put a long term hedge into place and there are no futures or options markets that offer contracts with maturities anywhere near that length.

6. Loan Sales - Loan sales are an alternative method banks have found, to swaps, futures and options, to reduce interest rate and credit risk by decreasing the duration of their assets. In a traditional banking paradigm, banks would originate loans and hold them to maturity, there by internalizing credit and interest rate risks. However, in a standard loan securitization, a bank would originate a number of loans usually mortgages but recently including credit card receivables and auto loans package these loans and then sell them off to an outside party. To the extent that this sale is without recourse the bank decreases duration and its credit exposure. However, if the loans are sold with recourse such that the investor has the option to return the loans to the bank should their quality deteriorate below some agreed level the bank is still subject to an off-balance sheet contingent liability or credit risk (Kolb, 1997).

Regardless of the type off-balance sheet finance creates plenty of benefits that are a new source of external finance, improving profitability, new tools to attain new lines of business in the banking industry and a possibility to leverage. These benefits are observations from banking industry in the first place, but it is emphasized and extended here that the same benefits can supposedly be expected by all private or public

corporations after adopting the principles of off-balance sheet finance.

CONCLUSION

Based on this article it can be concluded that the significance of off-balance sheet finance is undisputable in modern investment banking and more universally in modern accounting and finance. Off-balancesheet finance creates plenty of benefits that are a new source of external finance, improved profitability, new tools to attain new lines of business in the banking industry and a possibility to leverage. However, off-balance sheet finance is a subject to increased risk in banking as it increases both risk of deposit, liquidity risk as well as risk of losses, it creates a possibility to leverage and off-balance sheet finance also increases financial risk. The investment banking of mortgage credit derivatives seem to offer benefits and expose risks or disadvantages similar to the aforementioned benefits andrisks or disadvantages of structuring of off-balance sheet financing as such. However, banking of mortgage credit derivatives is a broad theme and off-balance sheet finance together with structuring mechanism are needed to perform the particular banking business.

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Hyderabad, INDIA. Ph: +91-09441351700, 09059645577
E-mail: editorijmrbs@gmail.com or editor@ijmrbs.com
Website: www.ijmrbs.com