Benefits and risks of off-balance-sheet

Business, Management

Off-balance-sheet activities refer to activities that are not included in the banks balance sheet but can affect the bank's current profits and losses of business activities . In a financial aspect, off-balance-sheet activities have a narrow sense and a broad sense of meaning. From the narrow perspective, off-balance-sheet activities are those businesses that closely related to the asset business or liability business in the balance sheet. Actually, the bank does not receive or pay in actual money, nor does it advance any money, but they may at any time be converted into an asset or liability by virtue of one of the provisions of the contract in the future. According to the relationship between assets and liabilities, these activities can be called contingent assets business and contingent liabilities business as well. From the broad perspective, off-balance-sheet activities not only include what explained above, but also clearing, agency, consulting and other businesses, mainly including a variety of security businesses, commitment businesses and financial derivatives trading, which based on traditional financial instruments, for example, futures, options and swap contracts. In this essay, it will discuss several risks and advantages of off-balance-sheet activities to the bank. It will briefly analyze some risks like credit risk, interest rate and exchange rate risk, and liquidity risk in asset securitization. Then, benefits of off-balance-sheet to bank like decreasing costs, decreasing several risks in bank's business process and rising in additional incomes will be introduced as well. Finally, it is the conclusion of the essay.

To some extent, off-balance-sheet activities influence the bank's future profitability and solvency. When a contingent event occurs, they will transfer from off-balance to become the actual bank assets and liabilities. Due to the uncertainty of contingent assets and liabilities, they are often accompanied with higher risks. Overall, off-balance-sheet activities have following several types of risk. Firstly, it is the credit risk. Credit risk means that the clients of off-balance-sheet business services defaults and leads creditors to suffer losses, which has been considered to be the most important risk for the commercial bank traditionally . Also, poor asset quality has probably been the cause of more bank failures than any of other exposures. Different kinds of off-balance-sheet activities may have varying degrees of credit risks. For example, in the guarantee business, if the guaranteed client goes bankrupt for some reasons and he cannot fulfill the contractual obligations, the guarantee bank needs to pay the compensation.

Secondly, it is the interest rate and exchange rate risk. It refers to the risk that banks suffer losses in off-balance-sheet activities due to changes in market interest rate and exchange rate. It may cause banks these risks in derivative financial instruments transactions such as swap transactions, option transactions and forward rate agreements. Under the trend of financial liberalization, internationalization and securitization in the world financial markets, interest rate and exchange rate risk are increasingly threatening the security of bank earnings. For example, the evaluation of interest rate risk must consider the impact of complex, illiquid hedging strategies or products, and also the potential impact on fee income that is sensitive to changes in interest rates . Assume there is a loan commitment agreement, the borrower can get money at a fixed or variable interest rate. However, if the market interest rate increases during the agreement's period, the bank's capital costs increase as well, which means the difference between the interest rate on loan agreement and capital cost can be small or probably negative, therefore, the bank might suffer a huge loss on this case.

Liquidity risk is the last point. It refers to the difficulty that a bank faces a shortage of positions when the contingent assets and contingent liabilities are converted into real assets and liabilities. Also, it is the reason why banks suffer losses when a transferable financial instrument cannot be sold at a price close to the market price quickly. In the asset securitization business, through this process, banks can finance new funds, which can increase the liquidity of their assets, but it causes increasing in liquidity risk too. Because investors and banks will transfer risks by selling their bonds when the market fluctuates violently, which leads the liquidity risk rises.

There are several advantages of off-balance-sheet activities to bank as well. At first, banks as providers of transaction services, they can have access of useful information about choosing better loans and then monitor clients' market performance at lower cost, since banks are specialized in obtaining and gaining information about credit risks . Then, banks can separate risks in a financial way when using off-balance-sheet activities. Because off-balance-sheet activities are vehicles of information and risk-sharing services. Banks can unbundle the risks inherent in assets and repackage these risks into synthetic products, which can be dealt in separate ways. At last, the establishment of a credit line can enable banks earn an additional commitment fee, not only affords their clients protection against liquidity needs, but also better enable banks to bear liquidity risks which they might face.

In conclusion, in this essay, it discussed variety of risks and benefits of off-balance-sheet activities to the bank. This essay introduced that banks might have risks like credit risk, interest rate risk and exchange risk, and liquidity risk while using off-balance-sheet activities. However, from the advantages of off-balance-sheet activities perspective, banks may decrease both internal costs and risks in business process and also gain an additional fee when doing these activities.