Unit III — Letter of Credit, Guarantees & Loan Commitments

Financial Credit and Risk Analysis | BMB FM 03 (also KMBN FM 05)

Unit III: Letter of Credit, Bank Guarantees and Loan Commitments

Syllabus: Quasi credit facilities — advantages of non-fund facilities; various types of NFB facilities; various types of letters of credit; assessment of LC limits; bills purchase/discounting under LC; loan commitments; unfunded lines of credit and their characteristics. Various types of bank guarantees — performance guarantee, financial guarantee, deferred payment guarantee; types of performance and financial guarantees; assessment of bank guarantee limit; period of claim under guarantee.

Exam Blueprint (2023-24 and 2024-25 papers)

Topic	Years asked	Marks
Types of Letter of Credit	**2023-24 AND 2024-25**	**10**
Letter of credit (define)	2024-25	2
Non-fund based facilities	2024-25	2
Classify types of NFB facilities	2023-24	2
Types of performance and financial guarantees	2023-24	2

YE QUESTION BAAR-BAAR AAYA HAI

Types of Letter of Credit is a **10-mark question in BOTH available papers**. Along with the Seven C's in Unit I, it is the most certain question in this subject. Learn **all the types with a one-line meaning and a use case**.

1. Non-Fund Based (NFB) Facilities — Quasi Credit

DEFINITION - RATTA MAARO

Non-Fund Based facilities, also called **quasi credit facilities**, are credit facilities in which the bank does **NOT part with funds at the time of sanction**. Instead, it **undertakes a commitment or obligation on behalf of the customer** to pay a third party **if the customer fails to perform or pay**. They create a **contingent liability** for the bank, which becomes a funded exposure only if the guarantee or LC is invoked.

(A 2-mark question in 2024-25, and a classification question in 2023-24.)

1.1 Fund Based vs Non-Fund Based — the basic comparison

Basis	Fund Based	Non-Fund Based
Outflow of funds	**Immediate** actual outflow	**No immediate** outflow
Nature of liability	**Actual** liability	**Contingent** liability
Balance sheet	Appears **on** the balance sheet as an asset	Appears **off** balance sheet, as a contingent liability
Bank's earning	**Interest**	**Commission / fee**
Cost to borrower	Higher (interest)	**Lower** (only commission)
Impact on bank's funds	Reduces lendable resources	**Does not** consume funds unless devolved
Risk	Immediate credit risk	Risk **crystallises only on invocation/devolvement**
Examples	Cash credit, term loan, overdraft	**Letter of Credit, Bank Guarantee**, letter of comfort, co-acceptance

1.2 Classification of NFB Facilities

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                NON-FUND BASED FACILITIES
                           |
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     |          |          |          |          |
  LETTER OF   BANK      CO-ACCEPT-  LETTER OF  DERIVATIVE /
  CREDIT    GUARANTEE   ANCE OF     COMFORT    FORWARD
  (LC)        (BG)       BILLS      (LoC)      CONTRACTS
     |          |
  Inland /   Performance /
  Foreign    Financial /
             Deferred Payment
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Facility	Meaning
Letter of Credit (LC)	The bank undertakes to **pay the seller** on presentation of stipulated documents
Bank Guarantee (BG)	The bank undertakes to **pay the beneficiary** if the customer fails to perform or pay
Co-acceptance of bills	The bank **adds its acceptance** to a bill drawn on its customer, making itself liable on maturity
Letter of Comfort / Letter of Awareness	A **softer, often non-binding** assurance about a customer's standing; weaker than a guarantee
Standby Letter of Credit (SBLC)	An LC that functions **like a guarantee** — payable only on the customer's default; widely used internationally
Derivative and forward contracts	Forward exchange contracts and other derivative limits also create contingent exposure

1.3 Advantages of Non-Fund Based Facilities

To the BANK:

1. **Income without deployment of funds** — commission is earned without using lendable resources
2. **Higher return on assets** — no funds are blocked, so the return on capital employed is high