BANK GUARANTEES IN INTERNATIONAL TRADE

Introduction

- Guarantees are one of the most important and commonly used instruments in doing business and facilitating business growth.

- Although there are may definitions for a guarantee one simple and basic definition is that, it is a promise by one party, who is referred to as the Guarantor, to be responsible for the debt, default, and miscarriage of another party, who is the Debtor, to a the third party, who is known as the Creditor.

Introduction contd………

Bank Guarantees have been one of the main types of guarantees that has been used to pay this key role in facilitating deals which otherwise would have been very difficult to achieve or even impossible.

The confidence placed in banks in meeting their obligations has resulted in the growing demand for bank guarantees as a security for obligations that one party makes to another party thereby making possible a transaction which otherwise would not have taken place.

Types of Guarantees

- Bid Bonds (Tender Guarantees)
- Performance Guarantees
- Advance Payment Guarantee s
- Retention Money Guarantees
- Payment Guarantees
- Customs Guarantees
- Facility Guarantees
- Maintenance Guarantees
- Shipping Guarantee

BID BOND

Also known as a Tender guarantee

A written guarantee from a third party guarantor (usually a bank), submitted to a Principal by a Contractor (bidder) with a bid to perform a contract.

A bid bond ensures that on acceptance of a bid by the Principal, the Contractor will proceed with the contract and will usually replace the bid bond with a performance bond.

If the Contractor does not accept the awarded contract, the guarantor will pay the Principal up to a maximum of the amount of the guarantee issued.

This is usually issued for an amount equal to between 1 and 2 percent of the contract value. It gives the contractor compensation for additional costs if the party submitting the tender does not take up the contract and it must be awarded to another party.

PERFORMANCE BOND

A written guaranty from a third party guarantor (usually a bank) submitted to a principal by a contractor on winning the bid.

A performance bond ensures payment of a sum (not exceeding a stated maximum) of money in case the contractor fails in the full performance of the contract.

Normally issued for an amount equal to between 5 and 10 percent of the contact value.

Performance bonds replace the bid bonds on award of the contract.

ADVANCE PAYMENT GUARANTEE

A guarantee issued by a bank, on behalf of a seller to a buyer, in relation to any advance payment that is made by the buyer to the seller to allow the contract to commence.

If the contract is not completed the buyer can claim reimbursement of the advance payment under the guarantee from the bank.

It may contain reduction clauses, which enable a reduction in the maximum amount upon evidence of progressive performance.

CUSTOMS GUARANTEE

Contractors often need to import equipment temporarily to carry out a contract. Import duty would normally be payable, but the customs authorities will grant exemption if the contractor undertakes to re-export the equipment on completion of the contract. The contractor then has to provide the customs authority with this guarantee, which prevents the contractor from selling the goods instead of re-exporting them.

This also applies to goods imported for Re- Export

SHIPPING GUARANTEE

Shipping Guarantees enable the buyers to obtain release of the goods from the carrier when receipt of bills of lading are delayed.

PAYMENT GUARANTEE

Payment Guarantee s are used as security for payment obligations.

It is also referred to as a Standby Letter of Credit.

MAINTENANCE GUARANTEE

Maintenance Guarantees ensure that the contactor does not abandon the contract after completion of the construction phase, but continues to honour any maintenance obligations as per the original agreement.

RETENTION GUARANTEE

A retention money guarantee is a non-payment guarantee and is an obligation of the bank to pay a customer (beneficiary) a monetary amount agreed in advanced in the event that, after receiving the retention money, the supplier (applicant) does not perform its contractual obligations during the guarantee term.

FACILITY GUARANTEE

This is normally not trade related. Its purpose is to provide security to another bank to advance money to an individual or company. It is often used when a company does not have any credit record and wishes to expand offshore.

UNIFORM RULES FOR DEMAND GUARANTEES
URDG 758

Contractual Basis of the URDG

- Effective only when incorporated into the guarantee (Art. 1)
- Contractual framework for dealing between guarantor and beneficiary, principal and guarantor or instructing party.
- Do not touch on the rights and duties of parties in underlying contract.
- Do not deal with legal issues.

ARTICLE 1b

Deals with the so called asymmetrical guarantees: Where, at the request of a counter-guarantor, a demand guarantee is issued subject to the URDG, the counter-guarantee shall also be subject to the URDG, unless the counter-guarantee excludes the URDG. However, a demand guarantee does not become subject to the URDG merely because the counter-guarantee is subject to the URDG.

Article 2— PRESENTATION AND DEMAND

Presentation means the delivery of a document under a guarantee to the guarantor or the document so delivered. It includes a presentation other than for a demand, ex., a presentation for the purpose of triggering the expiry of the guarantee or a variation of its amount;-

Demand means a signed document by the beneficiary demanding payment under a guarantee;

Article 2 - Definitions

Recognizes, that applicant and instructing party may be different entities. Applicant means the party indicated in the guarantee as having its obligation under the underlying relationship supported by the guarantee. The applicant may or may not be the instructing party; Instructing party means the party, ... who gives instructions to issue a guarantee . . . . and is responsible for indemnifying the guarantor . . . The instructing party may or may not be the applicant

It also says that the counter guarantor is not defined as instructing party !-instructing party means the party, other than the counter-guarantor, who gives instructions.

ARTICLE 3b

It was said that in URDG 458 some of their provisions referred only to guarantees, but not to counter guarantees, leading to the impression that a number of rules seems to cover only guarantees but not counter-guarantees.-

However Article 3b clarifies.
Except where the context otherwise requires, a guarantee includes a counter-guarantee and any amendment to either, a guarantor includes a counter-guarantor, and a beneficiary includes the party in whose favour a counter-guarantee is issued.

Article 19

Contains –for the 1st time ever –standards how to deal with documents under a guarantee.

Up to now the only set of rules giving instructions how to examine documents were the UCP. –

Local law as well as the old 458 remain silent to that question causing great uncertainty in the market

Article 20

Limits the guarantor by fixing the time limit for checking a demand under a guarantee to 5 business days following the day of presentation.-

Furthermore this article clearly and without any doubt states, that the guarantor has to effect payment when he determines that the demand is complying.

Article 5-

A counter-guarantee is by its nature independent of the guarantee, the underlying relationship, the application and any other counter-guarantee to which it relates, ... A reference in the counter-guarantee to the underlying relationship for the purpose of identifying it for it does not change the independent nature of the counter-guarantee. The undertaking of a counter-guarantor . . . . is not subject to claims or defenses arising from any relationship other than a relationship between the counter-guarantor and the guarantor or other counter-guarantor to whom the counter-guarantee is issued

Article 24

Contains a preclusion (sanction clause) for any guarantor not obeying to the rules by precluding this guarantor from refusing a demand as non complying.

Article 21-

Especially with long tenor guarantees, there might be a situation where payment under the initial currency of the guarantee becomes impossible or illegal.-There was a need in the market to find a solution for such guarantees and provide a clear regulation how to handle such a payment request.-

This Article says " **if payment cannot be made in the currency of the guarantee issued, then payment can be made in the currency of the place for payment"**.

This rule is not be misused by the parties to gain advantages in exchange rates or similar.

Issuance and Renewal of Bank Guarantees

- Exchange Control Department permits the following category of Guarantees to be issued as per the Direction No: 06/04/09/2012 dated 29th November 2012. Six types in all.
- Accordingly commercial banks are permitted to issue and renew the following six different categories of guarantees .

Category 1:

- A guarantee issued on behalf of a person resident in Sri Lanka in favour of a person resident outside Sri Lanka in respect of overseas contracts undertaken by the resident in Sri Lanka and discharge of which would involve a payment in foreign exchange remittable to the person resident outside Sri Lanka.
- There is no maximum limit for the following types of guarantees
    - Bid Bond, Performance Bond, and Advance Payment Guarantees
- Bank may issue guarantee other than the above types of guarantees upto the value of USD 1 Mn per contract (excess of this limit requires Exchange Control approval.

Category 2

- A guarantee issued on behalf of a principal/supplier who is a resident outside Sri Lanka in favour of person resident in Sri Lanka in respect of a contract in Sri Lanka subject obtaining counter guarantee from a reputed international bank

Category 3:

- In the event where the principal /supplier is a person resident outside Sri Lanka and a guarantee is to be given by his agent in Sri Lanka in faovour of a person resident in Sri Lanka in respect of a contract in Sri Lanka.

Category 4:

- In the event where a company incorporated in Sri Lanka (investor) is required to provide a bank guarantee to enable a company incorporated outside Sri Lanka (investee) in which the said investor is a share holder to raise facilities from financial institutions in the country where the investee is incorporated.
- A guarantee value not exceeding USD 250, 000 per investee may be issued on behalf of the investor subject to certain conditions.

Category 5:

- In the event where a company incorporated in Sri Lanka (investor) is required to provide a bank guarantee to enable a branch established outside Sri Lanka by the said investor to raise facilities from financial institutions in the country where the branch is established.
- A guarantee up to the value of USD 100,000 may be issued per branch established outside Sri Lanka by the investor subject to certain conditions.

Category 6:

- In the event where a person resident outside Sri Lanka undertakes a project in Sri Lanka as a contractor and a person resident in Sri Lanka is required to issue a guarantee in favour of the said contractor in the capacity of a sub-contractor.
- There is no maximum limit for the following types of guarantees
  - Bid Bond, Performance Bond, and Advance Payment Guarantees
- Bank may issue guarantee other than the above types of guarantees up to the value of USD 500,000 per contract.

GUARANTEES - A GLOBAL IMPETUS FOR ECONOMIC ACTIVITY.

LOCAL AND OVERSEAS ACTIVITY
EMERGING ECONOMIES
INCREASE IN DEVELOPMENT

INCREASED BANKING RELATIONSHIPS

EXISTENCE
SANCTIONS
SHARE HOLDING – Same Party
FINANCIAL POSITION TREND
RATINGS
RANKINGS - Country and Bank
OPINION - Correspondents