INTEGER WEALTH CAPITAL

BANK, BOND AND PERFORMANCE GUARANTEES – AN OVERVIEW

Defining financial guarantee instruments

1. **What is a Bank Guarantee.?**
   A bank guarantee is an assurance that a bank provides to a contract between two external parties, a buyer and a seller, or in relation to the guarantee, an applicant and a beneficiary. The bank guarantee serves as a risk management tool for the beneficiary, as the bank assumes liability for completion of the contract should the buyer default on their debt or obligation.

   Bank Guarantee (BG) is an agreement between 3 parties: the bank, the beneficiary, and the applicant. The beneficiary is the one who takes the guarantee, and the applicant is the party who seeks the bank guarantee from the bank. BG's are an important banking arrangement and play a vital role in promoting international and domestic trade.

   Bank guarantees serve a key purpose for small businesses; the bank, through their due diligence of the applicant, provides credibility to them as a viable business partner for the beneficiary of the guarantee. In essence, the bank puts its seal of approval to the applicant's creditworthiness, co-signing on behalf of the applicant as it relates to the specific contract the two external parties are undertaking.

2. **Types of Bank Guarantees**
   A bank guarantee is for a specific amount and a predetermined period of time. It clearly states the circumstances under which the guarantee is applicable to the contract. A bank guarantee can be either financial or performance-based in nature.

   In a financial bank guarantee, the bank will guarantee that the buyer will repay the debts owed to the seller. Should the buyer fail to do so, the bank will assume the financial burden itself, for a small initial fee, which is charged from the buyer upon issuance of the guarantee.

   For a performance-based guarantee, the beneficiary can seek reparations form the bank for non-performance of the obligation as laid out in the contract. Should the counterparty fail to deliver on the services as promised, the beneficiary will claim their resulting losses from non-performance to the guarantor – the bank.

   For foreign bank guarantees, such as in international export situations, there may be a fourth party – a correspondent bank that operates in the country of domicile of the beneficiary.

3. **Advantages of Bank Guarantees**

   3.1 To the applicant:
   Small companies can secure loans or conduct business that would otherwise not be possible due to the potential riskiness of the contract for their counterparty. It encourages business growth and entrepreneurial activity.

The banks charge low fees for bank guarantees, normally a fraction of 1% of the overall transaction, for the assurance provided.

3.2 To the beneficiary:

The beneficiary can enter the contract knowing due diligence's been done on their counterparty.
The bank guarantee adds creditworthiness to both the applicant and the contract.
There is a risk reduction due to the bank's assurance that they will cover the liabilities should the applicant default.
There is an increase in confidence in the transaction as a whole.

4. Disadvantages of Bank Guarantees

The involvement of a bank in the transaction can bog down the process and add an unnecessary layer of complexity and bureaucracy.
When it comes to particularly risky or high-value transactions, the bank itself may require assurance on the part of the applicant in the form of collateral.

5. Bank Guarantees vs. Letters of Credit

For a bank guarantee, the primary debtor is the buyer or applicant. Only when the applicant defaults on its obligation, will the bank guarantee step into the transaction. Often, a delayed payment is not a trigger for a bank guarantee. Contrastingly, in the financial instrument termed as a letter of credit, the seller's claim first goes to the bank.

Thus, a letter of credit offers more confidence that there will be prompt repayment, as the bank is involved in the transaction throughout the process. With a bank guarantee, there must be an inability to uphold the contract on the part of the applicant before the bank becomes involved.

6. Example of Bank Guarantee

In Dubai, an exporter called "ABC LLC." seeks a bank guarantee from an importer called "XYZ Pvt. Ltd" in India. In this case, "XYZ Pvt. Ltd" approaches Corporation Bank to give a bank guarantee on its behalf to the exporter. Now, if a corporation bank does not have a branch in Dubai, the corporation bank would issue the guarantee through the State Bank of India (SBI). Here, "XYZ Pvt. Ltd" is the applicant; "ABC LLC" is the beneficiary; "Corporation Bank" is the issuing bank and "SBI" is the correspondent bank.

This BG agreement acts as an undertaking. This agreement assures the beneficiary that the bank will pay the specified amount in the case of its applicant's default. As mentioned in the guarantee, the applicant might default in delivering the "financial" or "performance" obligation. In effect, the BG acts as a promise that in case the liabilities of the applicant (bank's customer) don't meet, the bank shall meet the contractual liability. One must note that the obligation to pay is not of the applicant but of the bank since the bank acts as the guarantor. BG contract is independent of the underlying transaction/contract that exists between the beneficiary and the applicant.

7. Summary

A bank guarantee is an assurance to a beneficiary that the bank will uphold a contract if the applicant and counterparty to the contract are unable to do so.
Bank guarantees serve the purpose of facilitating business in situations that would otherwise be too risky for the beneficiary to engage.
The underlying contracts to a bank guarantee can be both financial, such as loan repayment, or performance-based, such as a service provided by one party to another.

8. Bank Guarantee vs. Bonds: (The Difference.)

A bank guarantee is often included as part of a bank loan as a provision promising that if a borrower defaults on the repayment of a loan, the bank will cover the loss. A bond is a debt instrument that allows an investor to lend money to a corporation or government institution in return for an amount of interest earned over the life of the bond. A bond is essentially a loan issued by an entity and invested in by outside investors.

8.1. Bank Guarantees

A bank guarantee is not a debt instrument or a loan in itself. It is a guarantee by a lending institution that the bank will assume the costs if a borrower defaults on its liabilities or obligations. A bank guarantee is often a provision placed in a bank loan prior to the bank agreeing to loan out the money. The bank will charge a fee for the guarantee. A bank guarantee encourages companies and private consumers to make purchases they otherwise would not make, which increases business activity and consumption and provides entrepreneurial opportunities.

Commercial banks often provide bank guarantees to an individual or business owner who wants to borrow money to purchase new equipment, for example. Through the guarantee, the bank assumes liability for the debtor if they fail to meet their contractual obligations. In other words, the bank offers to stand as the guarantor on behalf of the business customer in a transaction. Most bank guarantees charge a fee equal to a small percentage amount of the entire contract, normally, 0.5% to 1.5% of the guaranteed amount.

There are different types of guarantees including performance guarantees, bid bond guarantees, financial guarantees, and advance or deferred payment guarantees. Guarantees are used for different reasons. Often, they are included in arrangements between a small firm and a large organization. The larger organization may seek protection against counterparty risk and will require the smaller party to receive a bank guarantee in advance of work.

8.2. Bonds

Bonds are used by governments and corporations to raise money and finance needed projects. A bond resembles an I.O.U. between a lender (the bondholder) and the borrower (the entity that issues the bond). The entity issues a bond at a par value, usually in denominations of $100 with a stated coupon rate. An investor effectively lends the bond issuer $100 and receives coupon payments from the entity that issued the bond until the $100 par value is repaid by the entity that borrowed the money.

A bond is issued with an end date, or maturity date. The maturity date is when the principal of the loan is due to be paid to the bond owner and includes the terms and amounts for the variable or fixed interest payments that will be made by the borrower. The interest payment (the coupon) is part of the return that bondholders earn for loaning their funds to the issuer. The interest rate that determines the payment is called the coupon rate.

Bonds are fixed-income securities and are one of three asset classes. The other two asset classes more familiar to investors are stocks (equities) and cash equivalents. Many corporate and government bonds are publicly traded; others are only traded over-the-counter (OTC) or privately between the borrower and lender.

9. Summary

A bank guarantee is often a component of a loan agreement whereby a bank promises to meet a borrower's obligations if they default on the loan. Banks will typically charge a fee to provide a guarantee.

A bond is used by entities to raise money. The entity issues a bond for a set amount, and the buyer of the bond essentially lends the entity the amount of the bond for a set period with a set interest rate.
Bonds are issued by an entity at a par value, usually in denominations of 100's, with a stated coupon rate.

10. Three different types of bonds and how they differ from guarantees

The purpose of Bonds and Guarantees is to provide the buyer/supplier/loan company or bank with insurance of sorts should there be a failure by the seller to meet their contractual obligations.

In the event there is a failure to deliver the services or goods to the Buyer, the bond can be 'called' and the Buyer can receive financial compensation from the bank.

11. Bid or Tender Bonds

A Bid Bond helps to provide security and trust that a contractor is financially in the position to take on a project, should it be awarded to them. These bonds are usually between 2% and 5% of the total contract value, and it serves as a deterrent to frivolous tender offers.
If there is no bid bond in place, it is possible for a contractor to be awarded a project, but not actually start. This would leave the supplier of the tender without a contractor.
If a bid or tender bond is in place however, in the event of the contractor falling through, the supplier would be awarded the value of the bond as a penalty against the contractor.

12. Performance Bonds

Performance Bonds guarantee that a product will be of a certain standard and a penalty is payable if they are not. This will usually be issued when a Tender Bond is cancelled. The Bonds act as financial guarantees and have no warranty that a bank will complete on a contract in the event that the customer fails to do so.

A performance bond is usually issued by a bank or insurance company to guarantee satisfactory completion of a project by a contractor.

When there is a task where a payment and performance bond is required then it will need a bid bond, to initially bid for the job. At the point where the work is awarded to the winning bid, a payment and performance bond will be needed as security of the job completion.

13. Advance Payment Bonds

This will provide protection to the Buyer when an advance or progress payment is made to the Seller prior to completion of the contract. The Bonds undertake that the Seller will refund any advance payments that have been made to the Buyer in the event that the product is unsatisfactory.

This is typical in large construction matters where a contractor will purchase high-value equipment, plant or materials specifically for the project. The bond will protect in the event of failure to fulfil its contractual obligations e.g. due to insolvency.
They will usually be on-demand bonds, meaning that the value set out in the bond is immediately paid on a demand, without any need for preconditions to be met. This is in contrast to a conditional bond where there is only liability if there is a breach of contract (or certain event has occurred as set out in the bond).

14. Warranty or maintenance bonds

These provide a financial guarantee to cover the satisfactory performance of equipment supplied during a specified maintenance or warranty period. The undertaking is by a bond issuer to pay the buyer an amount of money if a company's warranty obligations for products that are provided are not met and the amount will often be a stated percentage of the export contract value.

A warranty bond may be conditional or unconditional. If conditional, it may be a condition of the contract that a warranty bond is purchased before a buyer makes the final payment. In the event that obligations are not met, the buyer can call the warranty bond (requesting payment).
The bond is returned by the buyer at the end of the warranty period if the product that is provided has met the specifications.

15. Guarantees

A guarantee is issued by a bank on the instruction of a client and is used as an insurance policy, to be used when one fails to fulfil a contractual commitment. A financial institution issuing a Letter of Credit will carry out underwriting duties to ensure the credit quality of the party looking for the Letter of Credit before contacting the bank of the party that requests the Letter of Credit. Letters of Credit are usually open for a year.

The Letter of Credit is usually requested by the buyer and can be redeemed on demand if there is no payment by the Buyer on the date specified as set out within the contract.
The cost of a letter of credit is usually between 1-8% of the amount stated per year. The letter can be cancelled when the terms of the contract have been met.