

INTRODUCTION

- ◆ A contract of guarantee is defined as 'a contract to perform the liability of a third person in case of default'. The parties to the contract of guarantee are:
 - a. **Applicant** : The principal debtor : The person at whose request the guarantee is executed.
 - b. **Beneficiary** : The person to whom the guarantee is given and who can enforce it in case of default.
 - c. **Guarantor** : The person who undertakes to discharge the obligations of the applicant in case of his default.
- ◆ Thus, a contract of guarantee is a collateral contract, consequential to a main contract between the applicant and the beneficiary.

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PURPOSE OF Bank Guarantee (BG)

- ◆ BGs may generally be issued for the following purposes:
 - a. In lieu of Security Deposits / Earnest Money Deposits for participating in tenders.
 - b. Mobilisation advance or advance money before commencement of the project by the contractor and for money to be received in various stages like plant layout, design / drawings in project finance.
 - c. In respect of raw material supplies or for advances by the buyers.
 - d. In respect of due performance of specific contracts by the borrowers and for obtaining full payment of the bills.

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PURPOSE OF BG

- e. Performance guarantee for warranty period on completion of contract which would enable the supplier to realise the proceeds without waiting for the warranty period to be over.
- f. To allow the units to draw funds from time to time from the concerned indentors against past execution of contracts, etc.
- g. Bid bonds on behalf of exporters.
- h. Export performance guarantees on behalf of exporters favouring the Customs Department under EPCG Scheme.

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BUSINESS

- ◆ Banks should, as a general rule, limit themselves to the provision of Financial Guarantees and exercise due caution with regard to Performance Guarantee business.
- ◆ The subtle difference between the two types of guarantees is that under a Financial Guarantee, a bank guarantees the customer's (applicant's) financial worth, creditworthiness and his capacity to take up financial risks.
- ◆ In a Performance Guarantee, the bank's guarantee obligations relate to the performance related obligations of the applicant (customer).

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BUSINESS

- ◆ While issuing Financial Guarantees, Banks should satisfy themselves that customers would be in a position to reimburse the Bank in case the Bank is required to make the payment under the guarantee.
- ◆ In case of Performance Guarantee, Banks should exercise due caution and have sufficient experience with the customer to satisfy themselves that the customer has the necessary experience, capacity, expertise and means to perform the obligations under the contract and no default is likely to occur.

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BUSINESS

- ◆ Banks should not normally issue guarantees valid for more than 18 months. For BGs of more than 18 months, prior approval is required
- ◆ No Bank Guarantee should normally have a maturity of more than 10 years. BG beyond maturity of 10 years may be considered against 100% cash margin with prior approval

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BUSINESS

- ♦ Banks should normally refrain from issuing guarantees on behalf of customers who enjoy other credit facilities not with them but with other banks.
- ♦ Unsecured guarantees, where furnished by exception, should individually be for a short period and for relatively small amounts.
- ♦ All DPGs should ordinarily be secured.

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APPRAISAL OF BG LIMIT

- ♦ Banks should appraise the proposals for guarantees with the same diligence as in the case of Fund Based Limits. They may also obtain adequate cover by way of margin and security so as to prevent default on payments when guarantees are invoked.
- ♦ Whenever an application for the issue of BG (or sanction of a regular BG Limit as part of WC Limits) is received, Banks should examine and satisfy themselves thoroughly about the following aspects:

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APPRAISAL OF BG LIMIT

- a. The need for the BG and whether it is related to the applicant's normal trade / business.
- b. Whether the requirement is one-time or on a regular basis.
- c. The nature of BG, i.e., Financial or Performance.
- d. Applicant's financial strength / capacity (through an analysis of his financial statements, Cash & Funds Flow position and opinion reports) to meet the liability / obligation under the BG in case of invocation.
- e. Past record of the applicant in respect of BGs issued earlier, e.g., instances of invocation of BGs, the reasons thereof, the customers' response to the invocation, etc.
- f. Present outstanding on account of BGs already issued.
- g. Margin
- h. Collateral security offered.

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ASSESSMENT OF BG LIMIT

Assessment of BG Limit

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MARGINS

- ◆ Following are some of the factors to be kept in view by the Banks while determining the margins required:
 - a. Cash margins provide a cushion against invocation. Margin money may be in the form of Fixed Deposit.
 - b. The margin to be stipulated would depend on the borrower's means, resources, creditworthiness, security available, past experience with regard to issue of BGs, nature of guarantee and the nature of underlying transactions. If existing borrower, margin on BG may generally be the same as on Stocks, Receivables, etc.

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MARGINS

- c. In case of Advance Payment Guarantees, lower margins may initially be stipulated. Once the advance is actually received, depending on the amount not likely to be immediately utilised, higher margins may be built up by impounding of cash advances.
- d. In respect of non-borrower applicants, Bank's approach should normally be to obtain full margins. However, a credit risk can be taken on the applicants based on the financial indicators, credit worthiness, security available, etc.
- e. 100% margin should ordinarily be retained in respect of guarantees issued in connection with disputed Customs / Central Excise duties, unless otherwise specified in the sanction.

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SECURITY

- ♦ Apart from the margin, BGs are usually secured by an extension of the charge on Current Assets obtained to cover WC facilities.
- ♦ Adequate collateral security by way of Equitable Mortgage or third party guarantee should be taken depending on the merits of each case.

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Objectives of cash management

1. To meet cash disbursement needs (payment schedule)
2. To minimize funds committed to cash management



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Factors determining cash needs

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1. Synchronization of cash flows
 2. Short cost
 3. Excess cash balance
 4. Procurement and management
 5. Uncertainty

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