ARTICLE ON BANK GUARANTEE

INTRODUCTION:

Bank Guarantee means a comfort, which is being given by issuing bank, to a party (Beneficiary in whose favour the guarantee is issued) of losses or damages if the Client (on whose behalf the guarantee is being issued) fails to complete or conform to the terms of agreement.

By issuing the guarantee, the issuing bank is assuring payment of the certain amount of money (as specified in the bank guarantee) to the beneficiary in case of non-performance of a certain contract according to the terms and conditions contained in the same.

By furnishing the Bank Guarantee, the buyer binds itself with the seller that it has an implied commitment to fulfill the terms and conditions of the agreed contract. If it fails to comply with the same, the bank will honor it. The party to whom the BG is given cannot go to its bank and en-cash. It is just a comfort that if we do business with some unknown party, we might not be on loss as we are not aware honesty, sincerity and authenticity of that party.

The guarantees are not issued just in trades; it also given to government authorities for bidding of land, some project say hydropower or mines etc. For example when a company bid for a mines (ore or coal), it need to furnish the guarantee to the local authorities in which state it is going to bid. Also suppose someone needs bid for road project, it is requires to furnish the guarantee to the government authorities or the main contractor in case the company wish to work as sun-contractor.

Bank Guarantees are issued for some purpose and for a tenure which automatically get revoked on fulfillment of such purpose and/or completion of such specified period or vice versa. For example a bank guarantee might be revoked by the seller (beneficiary) when the buyer fails to pay the seller for the goods supplied. In such a situation, the bank pays the beneficiary to the extent of the amount of Bank Guarantee. Similarly, on the other side if the Seller fails to deliver the goods or complete the terms of agreement, the bank guarantee may be cancelled by the buyer.

Issuance of Bank guarantee is a secured transaction as the client needs to mortgage the properties and cash in the form of FDR for issuing of same. The bank will not give guarantee without securing itself.

BG is shown as contingent liability in the notes of account in balance sheet.

MARGIN MONEY & BANK CHARGES:

Bank Guarantees are issued against some margin money or at 100% margin which is keep in the form of FDR. Suppose a company need to furnish one time guarantee to some government authority, it will create a FDR (100% margin) and request the bank to issue the BG against such FDR.

Now suppose it is regular for the company to furnish the BG to authorities, contractors, in trade etc, it is suggested to request to bank to fix a limit subject to regular review. Branch moves the proposal subject to the required collaterals as per bank guidelines and term & conditions. The company needs to give the margin money which depends on the approval of sanctioning authority. The margin money normally ranges from 10% to 25% of the BG.

For example in case of real estate company which need to furnish the guarantees regularly to the local authorities for taking licence for development of every new residential and commercial projects. They normally have the limits with the banks which block the limit to the extent of BG amount and put up the margin in the form of FDR.

Bank charge some commission for this BG service which is again subject to bank guidelines and approval of sanctioning authority. The commission in linked to the tenure of the BG. Some bank charge the entire commission at the time of issue of BG whether it may 1 year or 5 year. Hence it is normally suggested that at the time of approval, request should be made that commission should be charged on quarterly basis.

There is one more thing which we should aware that bank charge commission on quarter to quarter basis i.e. if the BG cancelled after 3 months 5 days, the bank will charge commission for six months instead of 3 months 5 days. Some bank charge commission for six months or one year instead of quarter basis. But we can request for quarter basis charges at the time of moving the request.

TYPES OF BANK GUARANTEE

Financial Guarantee:

Financial Bank Guarantee is a bond which is not cancelable and ensures the payment of the interest and repayment of the principal amount as per the schedule agreed upon by both the borrower and the lender. A guarantor to this debt security is liable to pay off the liability in case the first party or the issuer of the Financial Bank Guarantee fails to make the payment.

Example: Suppose the company has taken loan from bank/financial institution which are being guaranteed by another company and/or the personal guarantee of the promoter-director and/or the guarantee given by the property owner. Again in case of buyers credit the bank guarantees of payment in case the client fails to good the payment.

Performance Guarantee:

The seller issues a Performance Bank Guarantee to ensure or give concrete commitment to the buyer through its bank. This method ensures the buyer the timely execution of an agreement to have the goods exported or delivered or services performed. In case the seller defaults on execution of the terms agreed upon the Performance Bank Guarantee ensures the buyer the payment of the guarantee amount by the issuing bank. Generally the performance Bank guarantee is 10 percent of the total assignment or project value.

Example: Guarantee to government department for bidding the projects, guarantee to contractors and seller in normal course of business.

ASSESSMENT OF LIMIT

BG is a non-fund based limit hence an assessment like working capital limit is not done. The purpose, amount and tenure of the guarantee are defined at the time of request. The information is gathered by the bank in the following:

Nature & amount of limit sanctioned	
Outstanding as on …………..	
Name of the beneficiary / ies in whose favour guarantees to be issued	
Nature of the guarantee limit required i.e. performance/ financial/ Bid Bond etc.	
Margin proposed	

Security	
Justification for the proposed limit	

Note: the above format is not standard. It may vary bank to bank.

Bank asks for the copy of contracts in hand for which the company requires the bank guarantee. For example in case of real estate projects the company gives a list of the projects and the tentative amount and tenure of the bank guarantees. In case the company need to bid for some project say road projects, mines etc, it need to give the proof that it is going to bid for the same and that much amount is require to furnish in the form of Bank Guarantee. Normally Offer Document is furnished before the bank which shows the amount, tenure and terms and conditions.

Bank pays a normal interest on the margin money which is being kept in the form of FDR. The FDR is released at the time of cancelation/revocation of bank guarantee along with interest.

The bank guarantees are issued in the format which is prescribed by the authority/party in whose favour the guarantee need to be issued. When the guarantees are issued in favour of government authorities, it is suggested that each word and line should be in the form as prescribed otherwise chances of cancellation of same very high.

For any query or assistance, kindly call or send a mail undersigned.

CA. Manoj Kumar Gupta

Cell: 9350760606

9899686676

E-mail id: mgupta2803@gmail.com