

Bank Guarantees.

What does Bank Guarantee mean?

- ❖ A “Contract of Guarantee” is a contract to perform the promise or discharge of liability of a third person in case of his default.
- ❖ There are three parties to the guarantee.
- ❖ The person who gives the guarantee is called “Surety.”
- ❖ The person on whose behalf the guarantee is given is called the “Principal Debtor.”
- ❖ The person in whose favor guarantee is given is called the “Creditor or Beneficiary.”

Liability of the Guarantor.

- ❖ The liability of the Surety / Guarantor is co-extensive with that of the principal debtor, unless it is otherwise provided in the agreement of guarantee itself. In view of this, guarantees are drafted in such a way that guarantor and the principal debtor are jointly and severally liable in the ordinary course of all times.

Types of Guarantees.

- ❖ Bank Guarantees are generally are of two types namely:
 - Financial Guarantees.
 - Performance Guarantees.

Financial Guarantees.

- ❖ A guarantee, which is issued in lieu of monetary considerations, is called financial guarantee.
- ❖ E.g. Tender deposit, Sales tax payments, Retention money etc.

Performance Guarantee.

- ❖ A guarantee, which is issued in respect of performance of a contract or obligation, is called Performance guarantee.
- ❖ In event of non-performance of obligation in terms of contract, the Bank assumes only monetary liability up to a specified amount.

Guarantees for specific transactions.

- ❖ A Bank guarantee can be issued for covering a single transaction only.
- ❖ E.g. Payment of Sales Tax.

Continuing Guarantees.

- ❖ A guarantee, which extends to a series of transactions, is called a continuing guarantee.
- ❖ If a guarantee is issued in favor of Customs authority on account of payment of Custom duty by the customer from time to time, upto Rs. 4 Lacs, the guarantee covers at any time Custom duty in arrears by the customers up to 4 Lacs during the period of the guarantee.

Guidelines to be observed.

- ❖ Guarantees should be issued on behalf of customers only.
- ❖ If a request for issuance of a guarantee is received, study the proposal and be satisfied with the genuineness of the request.
- ❖ Bank should satisfy that the customer would be in a position to reimburse the bank in case BG is invoked.
- ❖ In case of performance guarantee, branch must satisfy that the customer has the necessary experience, capacity and means to perform the obligation under the contract and is not likely to commit any default.

Master Circular - Guarantees.

- ❖ **Purpose:** UCBs may provide only financial guarantees and not performing guarantees.
- ❖ **Maturity:** Guarantee should not be issued for periods exceeding 10 years in any case.
- ❖ **Volume:** The total volume of guarantee obligations outstanding at any time may not exceed 10 % of the total owned resources of the bank comprising paid up capital, reserves and deposits.
- ❖ **Volume of unsecured guarantees:** Within the overall ceiling, proportion of unsecured guarantees outstanding at any time may be limited to an amount equivalent to 25 % of the owned funds (paid up capital + reserves) of the bank or 25 % of the total amount of guarantees, whichever is less.

Secured Guarantees.

- ❖ Banks should preferably issue secured guarantees.
- ❖ A secured guarantee means a guarantee made on the security of assets, the market value of which will not at any time be less than the BG amount.

Safeguards to be followed while issuing financial guarantee.

- ❖ The bank guarantees should be issued in security forms serially numbered to prevent issuance of fake guarantees.
- ❖ Guarantees above a particular cut off point should be issued under two signatures.
- ❖ Guarantee should be issued in triplicate:
 - One copy to branch.
 - One copy to beneficiary.
 - One copy to Head Office.
- ❖ It should be binding on the part of the beneficiary to seek confirmation of the Head Office, for which a specific stipulation be incorporated in the guarantee itself.
- ❖ The guarantees should not normally be issued to the customer who do not enjoy credit facilities with the bank but only maintain current account.

- ❖ Where the customers enjoy credit facilities with other banks, the reason for their approaching the bank for extending the guarantees should be ascertained and in variably reference should be made to their existing bankers.

Documents to be obtained for issue of BG.

- ❖ Application form from the party duly signed by authorized person.
- ❖ Board resolution in case of ltd. company.
- ❖ Counter guarantee on a stamp paper.
- ❖ Letter of lien & Set off on a stamp paper.
- ❖ Cash margin duly discharged.

Execution of BG.

- ❖ The guarantee should be executed on the stamped paper of requisite value in compliance with the requirement of the beneficiary.
- ❖ It should be ensured that stamp paper has been issued in the name of the Bank or the Beneficiary and the date of purchases of stamp paper is not more than 6 months from the date of issue of guarantee.

Margin Money.

- ❖ The following security can be taken as margin for issued of BG.
 - Term deposit receipt preferably issued by same branch.
 - NSC / KVP.
 - Share certificates of well-known company may also be considered.
- ❖ Maturity date of above security should be at least up to BG expiry date.
- ❖ 100 % margin should invariably be obtained in respect of BGs issued for guaranteeing the payment of:
 - Insurance premium.
 - Sales Tax.

- Income tax.
- MTNL.
- Custom / Excise duties.

Bank Guarantee Commission.

- ❖ BG commission @ % p.a. of BG amount should be collected for the entire BG period including claim period in advance at the time of issuing BG. (PL-)
- ❖ If the original BG is returned duly cancelled before the expiry date and if request is made for refund of commission, the same may be considered on merits of each case only after seeking prior permission of HO.

Monitoring of BGs.

- ❖ Entry should be made in BG register immediately on issue of BG.
- ❖ Lien should be noted on TDR as well as in computer records.
- ❖ Monthly balancing should be done and tallied with GL.
- ❖ Reminders should be sent in respect of BGs expired.

Records to be kept.

- ❖ Following records should be kept by the branch:
 - BG Register.
 - Customer wise BG Register in case of BG limit.
 - File of BGs issued but not yet cancelled.
 - File of BGs cancelled.
 - File containing Margin money.

Accounting entries to be passed.

- ❖ On issue of BG:
 - Debit: Bank guarantee issued account.
 - Credit: Liability for BG issued account.

❖ On reversal:

Debit: Liability for BG issued account.

Credit: Bank guarantee issued account.

Expired Guarantees.

- ❖ Once the guarantee period has expired and no claim has been lodged for payment, the guarantor's contingent liability too expires notwithstanding the position that expired guarantee has not been returned by the beneficiary. This will not alter the legal position of the Bank even after the amendment of Section 28 of the Indian Contract Act.
- ❖ After the expiry of guarantee period, the Bank should intimate the beneficiary by a registered AD letter. The letter should mention that guarantee period has expired and the beneficiary is not entitled to invoke the guarantee.
- ❖ If the expired guarantee document is not returned in spite of the notice sent by registered AD, the branch should reverse the relative entries and mark off the liability in the books.

Invoking of BG.

- ❖ If any BG is invoked before the expiry of the validity period:
 - An intimation should be given to the customer immediately.
 - The matter should be reported to HO.
 - Payment should be made immediately as bank has given an irrevocable undertaking to pay.

References.

- ❖ Master Circular- Guarantees issued by RBI to all UCBs.