Quadrant II - Notes

Paper Code: COD 120

Module Name: Guarantees: Definition and types of Bank Guarantees: Bankers duty to honour guarantee; precaution to be taken for issuance of Bank Guarantee, Deferred Payment Guarantees: Purpose of DPG's Methods of Payment.

Module No: 07

Bank Guarantees

The term 'Bank Guarantee' briefly stated means:

A guarantee given by a bank to a third person, to pay him a certain sum on behalf of the bank's customer, on the customer failing to fulfil any contractual or legal obligations towards the third person.

From the above, it can be seen that there should first be a commitment on the part of the customer to fulfil certain obligations to a third party.

This could be contractual or legal, i.e. imposed by law.

This commitment of the customer is guaranteed by a bank and if the customer fails to honour his commitment the banker pays the amount, it has promised to pay.

Once the bank gives a guarantee, then its commitment to honour the guarantee is onerous and as such, it is prudent that a banker before issuing a guarantee on behalf of his customer takes appropriate security and understands his rights and duties.

Various types of Bank Guarantees

Financial Guarantee

Performance Guarantee

Deferred Payment Guarantee

1. Financial Guarantee

These are guarantees issued by banks on behalf of the customers, in lieu of the customer's requirement to deposit a cash security or earnest money.

These kinds of guarantees are mostly issued on behalf of customers dealing with Government departments.

Such guarantees are also issued in situations where a party is required to deposit cash as a part of contract.

Most government departments insist that before the contract is awarded to contractor, he should show that he is willing to perform the contract and to ensure that no frivolous tenders are made, insist on an Earnest Money Deposit.

However, in lieu of the earnest money, government departments are generally willing to accept a bank guarantee.

In case the contractor does not take up contract awarded, then the Government departments invoke the guarantee and collect the money from the banks.

2. Performance Guarantee

These are guarantees issued by the bank on behalf of its customer whereby the bank assures a third party,

that the customer will perform the contract entered into by the customer as per the condition stipulated in the contract,

failing which the bank will compensate the third party up to the amount specified in the guarantee.

These types of guarantees are usually issued by the bankers on behalf of their customers, who have entered into contracts to do certain things on or before a given date.

Though the bank assures, that the conditions as stipulated in the contract will be compiled with by the customer, in practice, the banks on being served a notice of default by the third party, pays over the amount guaranteed without going into the technicality of the contract.

3. Deferred Payment Guarantee

Under this type of guarantee, the banker guarantees payment of instalments spread over a period.

This type of guarantee is required, when goods or machinery are purchased by a customer on long-term credit and the payment is to be made in instalments on specified dates spread over more than a year.

In terms of contract of sale, the seller draws drafts (bill of exchange) of different maturities on the customer, which is to be accepted by the customer.

The banker guarantees due payment of these drafts.

A deferred payment guarantee constitutes an undertaking on the part of the bank to make payments of deferred instalments to the seller (beneficiary) on the due dates, in the event of default by the customer (buyer).

While issuing a deferred payment guarantee, the banker has to assess the ability and sources of funds of the customer to honour the payment of instalments on due dates.

Bankers Duty to honour Guarantee

The obligation of a banker, to honour his commitment on a guarantee given by him being primary, casts a duty on the bank to honour it irrespective of the disputes the beneficiary and the debtor.

This has been accepted by Courts in India and they have refused to grant injunctions against banks from making payment under the guarantee except in cases of fraud or special equities in favour of the person on whose behalf the guarantee has been issued.

Precaution to be taken for Issuance of Bank Guarantee

The liability of a bank under a guarantee depends on two fundamental criteria, viz., the amount guaranteed and the period of the guarantee.

These two factors have to be specifically stated since, in the absence of any one or both of these factors, the bank's liability could be unlimited either in the amount guaranteed or the period during guarantee.

The banker should also obtain a counter guarantee from his customer on whose behalf he has given the guarantee, so that in case he is required to pay the guarantee he can fall back on the counter guarantee to claim the amount paid by him.

In the guarantee agreement, the amount has to be specifically stated, both in figures and words.

While stating the amount, that the bank would guarantee to pay, care should be taken to state whether or not the amount is inclusive of all interests, charges, taxes and other levies.

Bank should specify the period for which their guarantee subsists and an additional period during which a claim has to be made on the bank to make payment.

Taking into account the time to communicate the invocation, etc., the claim period should at least be 15 to 30 days after the validity period.

Though a bank guarantee is a contingent liability, it is always prudent for a banker to secure this contingent liability to cover himself in case it is enforced. This can be done by obtaining a counter guarantee-cum-indemnity executed by the customer in favour of the bank.

Deferred Payment Guarantee

Deferred Payment Guarantee is a guarantee that indicates that deferred (postponed) payments.

Suppose a bank's customer were to import capital goods on a deferred payment credit where the price is to be paid in instalments spread over a five year period, the exporter will have to wait for each instalments mature until the whole amount is paid.

In the meantime, the chances of the importer going bankrupt or failing to pay may arise.

To avoid such a situation the exporter can request the importer to obtain a guarantee that the payment in instalments will be made.

The importer would therefore, approach his banker to guarantee the payments in instalments.

This guarantee of the bank, assuring the exporter of the timely payment of the instalments, is in short, called 'Deferred Payment Guarantee.'

Purpose of Deferred Payment Guarantee

When import or export of raw materials or consumer goods is made, the payment is done either immediately or within 360 days. This period is called short term.

However, in the case of capital goods the amount involved being quite substantial, short-term credit would not be of much help to the buyer, unless he has made arrangements to get a term loan. Also, the requirement of substantial amount of foreign exchange may place the buyer at a great disadvantage.

To overcome this payment problem, concept of deferred payment was introduced in India.

In a deferred payment arrangement, the buyer/importer is not required to make the entire payment of the goods at one time; instead the price of the goods is paid in instalments over a period of time as per terms mutually agreed to with the seller.

Here, a third party, mostly banks and financial institutions, guarantee the payment of the instalments.

Method of Payment

The payment is usually done on the following terms:

Advance payment of 10% to 15% of the price of the goods is made by the buyer.

Another 10% to 15% on receipt of documents under letter of credit.

The balance amount is paid in instalments spread over a period of 1 to 7 years, which is secured by a 'Deferred Payment Guarantee.'

In a deferred payment guarantee, what is guaranteed is the timely payment of instalments and interest if provided.

This is done by issuing a deferred payment guarantee in which the following terms are mandatory:

The supply of goods by the seller to the buyer and the seller agreeing to postpone the payment of the price, this being the consideration of the guarantee;

The payment schedule of both the instalment and the interest;

The unconditional and irrevocable assurance of the bank that it would make payments on the invocation of the guarantee.

REFERENCES

Indian Institute of Banking and Finance: Legal Aspects of Banking, New Delhi, Macmillan 2005.

Varshney P.N.: Banking Law and Practise,New Delhi, Sultan Chand & Sons, 2005.

Indian Institute of Banking and Finance: Principles & Practices of Banking, New Delhi, Macmillan.

Sukhavinder Mishra: Banking Law and Practise, S. Chand & Co. Ltd, New Delhi.