Bank Guarantee

A bank guarantee refers to a promise provided by a bank or any other financial institution that if a certain borrower fails to pay a loan, then the bank or the financial institution will take care of the losses. The bank will assure the original creditor through this bank guarantee that if the borrower does not meet his or her liabilities, then the bank will take care of them.
A bank guarantee is a contract between 3 different parties and they include:

- The applicant (the party that requests a bank guarantee from the bank and borrows from a creditor)
- The beneficiary (the party that receives a partial guarantee)
- The bank (the party that agrees to sign and assures payment in case the applicant fails to repay the loan)

Bank guarantees are very commonly utilized among business entities. With the help of a bank guarantee, the debtor or borrower or customer will be able to purchase equipment, machinery, raw materials, acquire additional funds, etc. for commercial purposes. Bank guarantees help businesses as creditors will get a proper reassurance that the loan amount will be repaid by the bank if the business is unable to repay the loan entirely on time.

When a bank signs a bank guarantee, it promises to pay any amount according to the request made by the borrower. Hence, signing a bank guarantee implies a high risk for banks.
Bank guarantee comes in place of a debtor in case he/she is unable to make payments to the creditors. Bank would perform the duties of a debtor for a commission, which varies between 0.5-1.5% of the guaranteed amount. It has become a necessity to obtain a guarantee when the transactions are huge and instead of going for any 3rd party, the bank becomes an easy way out.

The parties involved are
1. Bank
2. Debtor
3. Creditor

Understand the Process of Bank Guarantee

- First, an applicant will ask for a loan from a beneficiary or creditor.
- While applying for the loan, these 2 parties will agree that a bank guarantee is necessary.
- Then, the applicant will request a bank to provide a bank guarantee for the loan taken from the creditor. The bank guarantee will be taken on behalf of the creditor.
- The bank now offer the bank guarantee to the applicant and send financial instruction to an advising bank.

Kinds of Bank Guarantee

• Deferred payment guarantee: This refers to a bank guarantee or a payment guarantee that is offered to the exporter for a deferred period or for a certain time period. When a buyer purchases capital goods or machinery, the seller will give credit to the buyer when the buyer's bank gives a guarantee that it will pay the unsettled dues of the buyer to the seller. Under this type of guarantee, payment will be made in installments by the bank for failure in supplying raw materials, machinery or equipment.

• Financial guarantee: A financial bank guarantee assures that money will be repaid if the party does not complete a particular project or operation entirely. According to the financial guarantee agreement, when there is a delay in the completion of the project, the bank will make the payment.

• Advance payment guarantee: Under this kind of guarantee, an advance payment will be made to the seller. There will also be a guarantee that if the seller fails to deliver the service or product accurately or promptly, the buyer will receive a refund of the payment.

• Foreign bank guarantee: A foreign bank guarantee is provided by a bank on behalf of a borrower. This will be offered on behalf of the foreign beneficiary or creditor.

• Performance guarantee: Under a performance guarantee, compensation of money will be made by the bank when there is any delay in delivering the performance or operation. Payment will have to be made even if the service is delivered inadequately.

• Bid bond guarantee: Under this type of guarantee, there will be a supply bidding procedure. This will be conducted by the contractor for the owner of an infrastructure or industrial project or any kind of operation. The contractor of the project will guarantee that the best bidder or the highest bidder will have the capability and authority to implement a project as per his or her preferences. The bid bond will be given to the owner of the project as a proof of guarantee and the bond will imply that the project will have to be devised according to the bid contract.

Overview

Documents Required to apply for a bank guarantee are

• Request Letter and Counter Indemnity cum Memorandum relating to charge over fixed deposit duly stamped (Franking as per respective State Stamp Act).
• Bank Guarantee text.
• Board Resolution for Private Limited Company/Limited Company.

Features

1.A Bank guarantee is drawn by an account holder, where he/she orders his/her bank to contact the bank of the other party.

2.Assets will be held by the bank as security

3.Bank Guarantees are non-transferable.

4.Nobody has the right to sell/purchase it.

5.CUSIP or ISIN numbers are not present in these guarantees.

6.These are issued for a specific period of time.

7.These guarantees terminate once they got expired.

8.The end value of such guarantees is nil. There is no maturity value and an investment element.

9.There is a huge difference between bank guarantees and ‘investment notes’.

10.This service is not provided to raise money by banks and so should not be confused with Medium Term Notes (MTN).

11.These guarantees are as strong as the bank issuing them.

Advantages and Disadvantages of a Bank Guarantee

Advantages

• A bank guarantee is mostly issued against collaterals or securities. Hence they have marginal charges as compared to the other lending instruments.

• The process of obtaining a bank guarantee is simple and can be completed quickly. This proves useful to those businesses that require urgent credit.

• For the seller, a bank guarantee substantially brings down the risk involved in trade and bridges the trust gap between both parties.

• Issuance of a bank guarantee to your name is proof of your good financial records, and can be instrumental in establishing credibility and attracting more businesses.

Disadvantages

• A bank guarantee is mostly issued against collaterals or securities. This may create problems for those who do not own substantial assets.

• Newly established companies or startups who do not have adequate financial history that banks can assess may find it difficult to obtain bank guarantees.

• Banks do not generally approve guarantees for companies that are incurring losses. Such organizations have to opt for other credit instruments that have higher charges.

Rules and Regulations for a Bank Guarantee

The Indian government has released a circular to its different departments wherein it has laid down the following guidelines for banks that provide bank guarantees.

• The officers signing the guarantees should also provide other details such as their name, designation, as well as, their employment codes, below their signature. This will help verify the bank guarantees faster.

• Once the beneficiary receives the bank guarantee, they are advised to check its authenticity by contacting the approver's bank(s).

• The initial period of the bank guarantee shall be six months which starts after the original delivery period. An automatic extension of six months can be provided by the banks if they wish to do so by adding a clause in the agreement.

• If the applicant fails to adhere to the agreement and does not deliver the goods/ services on time, the bank guarantee will automatically get extended based on the request for an extension of the delivery period.

• The bank guarantees used as collateral in the Directorate General of Supplies and Disposal contract administration, as well as, extension letters should be on non-judicial stamp papers.

Documents Required for a Bank Guarantee

If you hold a current account with a bank, you need to furnish the following documents to apply for a bank guarantee:-

• An application form

• A bank guarantee letter

• A Stamp paper (as per the State Stamp Act)

• A resolution passed by the board of members in case of a public/private limited company

Bank Guarantee Charges

Banks normally charge 0.50% to 0.75% quarterly on the total amount. However, these charges vary depending on the risk that the lender undertakes. So, the charges on a bank guarantee issued without collateral will be higher as compared to those issued in exchange of collateral. Additional charges include 18% GST that is levied on all banking services, and other charges like processing fees, documentation fees, handling fees, etc.

Bank Guarantee Procedure

The process of obtaining a bank guarantee is simple since all the leading banks and lending financial institutions provide this facility. Moreover, you are more likely to receive a bank guarantee from a bank where you already have an account or conduct regular transactions of any kind.Although companies as well as individuals can both apply and receive bank guarantees, it is common to see businesses opt for it since they are always dealing with situations where such financial instruments come in handy.

To apply for a bank guarantee, you can physically approach the bank, talk to its representative about your requirements or do so online if such a facility exists. They will then ask you to fill up a form wherein you will have to provide details such as the nature of the guarantee like the time duration as well as conditions in which it can be invoked etc. The time duration can be from three months to 10 years, whereas the conditions depend on the nature of the contract. We will talk about the different types of bank guarantees along with their respective terms and conditions further in this article.

Your bank may ask you to provide collateral in exchange for the bank guarantee. In many cases, banks also issue guarantees based on your fixed deposits, mutual funds, stocks, etc.

How does a Bank Guarantee Work?

Once the bank issues a bank guarantee, it is forwarded to the seller after which he/she proceeds to complete the trade without any upfront payment. The guarantee also defines the time period within which the buyer has to pay the seller. Once that is done, the bank guarantee becomes null and void.In the event of non-payment by the buyer within the stipulated time frame, the seller invokes the bank guarantee and the bank is liable to pay the seller.

We will explain this better with the help of an example.Suppose ‘company X’ manufactures apparels and receives a huge order. However, they lack the adequate resources to purchase enough raw materials to fulfill this order due to the pending payments from the previous orders.

Now, there is a ‘company Y’ that sells the raw materials that ‘company X’ requires. But they are hesitant to do business without any upfront payment and cannot merely rely on ‘company X’s’ word. So, ‘company X’ decides to apply for a bank guarantee from a bank for the total amount of the trade. The bank, upon taking a look at ‘company X’s’ financials and collateral, approves the guarantee and provides it to ‘company Y.’

This bank guarantee issued to ‘company Y’ means that if the buyer, i.e. ‘company X’ is unable to complete the payment within the stipulated time frame as stated in the document, the bank that has issued the guarantee will pay the seller.

Once ‘company Y’ receives the guarantee, it will proceed to complete the trade and supply the raw materials to ‘company X’ who then begins manufacturing the goods for the order. At a later date, within the stipulated time frame, ‘company X’ makes the required payment directly to ‘company Y.’ The bank guarantee then becomes null and void.

Apart from these, some general guidelines for banks while issuing bank guarantees are as follows:-

• Generally, a bank guarantee should not be awarded for more than 10 years. However, banks may make an exception to this after carefully considering the applicant’s asset performance and financial management.

• While bank guarantees can be of two types- finance guarantee and performance guarantee, banks are advised to approve financial guarantees in most cases, and performance guarantees selectively.

• Since banks deal with liquidity, they are advised to approve guarantees that mature quickly while the NBFCs can approve guarantees for longer maturity periods.

FAQs on Bank Guarantee

Q 1 - What is a bank guarantee?
Answer - A bank guarantee is a contract wherein the bank pledges to make payment on behalf of the borrower in case the borrower fails to conclude the trade as agreed upon by both parties.

Q 2 - When is a bank guarantee required?
Answer - Bank guarantees are required when there is a shortage of funds or the lack of trust between the two parties.

Q 3 - Is a bank guarantee refundable?
Answer - As soon as the applicant pays his/her dues to the seller within the stipulated time frame, the bank guarantee becomes null and void.

Q 4 - Who is the beneficiary in a bank guarantee?
Answer - In most cases, the seller is the beneficiary of a bank guarantee.

Q 5 - What is the difference between the expiry date and the claim date in a bank guarantee?
Answer - The claim date is the date on which a beneficiary claims the benefits of the bank guarantee while the expiry date is the date by which the claim has to be made.

Q 6 - What is the claim period of a bank guarantee?
Answer - The claim period is a time period within which the beneficiary can claim the benefits of the bank guarantee.

Q 7 - Where does the bank guarantee appear on the balance sheet?
Answer - A bank guarantee is considered a contingent liability.

Q 8 - What is the limit of a bank guarantee?
Answer - If a company regularly requires bank guarantees, the bank often issues them the guarantees with a fixed upper amount known as the bank guarantee limit.

Q 9 - When is a bank guarantee invoked?
Answer - A bank guarantee is invoked by the beneficiary when the borrower fails to conclude the trade as per the terms agreed upon by both parties.

Q 10 - Can a bank guarantee be amended?
Answer - Yes, a bank guarantee can be amended. Both, the amount, as well as, the duration can be increased or decreased by sending a formal application of the same to the bank.

Q 11 - Can a bank guarantee be revoked?
Answer - A bank guarantee is automatically revoked once its tenure is completed or the applicant pays the beneficiary.

Q 12 - Can a bank guarantee be extended?
Answer - Yes, a bank guarantee can be extended by sending a formal application of the same to the bank.

Q 13 - What is a bank guarantee to customs?
Answer - To avail exemption from import duties, in many cases, the importer has to submit a bank guarantee to customs along with a bond.

** Important Points To For All Applicants**

1. **Please Note, If There Are Existing Loans, Submit Payment Track Record And Sanction Letter To Respective Loan Provider For Finalizing Loan Amount Eligibility.**

2. **Credit Score Plays An Important Role In Finalizing Loan Amount & ROI****

3. **Timely Payment Of EMI Helps In Maintaining A Good & Healthy Credit Score.**

4. **Please Keep Sufficient Amount In Account Before ECS Hitting Date.**

5. **Wisely Usage Of Money Is Highly Required For Financial Planning.**

6. **Don't Miss To Pay Any EMI Amount , Neither Get Delayed On Due Dates.**

7. **There Can We Change In Loan Documentation Requirements From Time To Time And My Vary In Banks, NBFC & Private Lenders. Will Update , If There Will Be Some Changes In Documentations.**