

Guarantees in Banking Operations with Bank Customers

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Vasile Dedu

The Bucharest Academy of Economic Studies
vdedu03@yahoo.com

Adrian Enciu

The Bucharest Academy of Economic Studies
adrianenciu@yahoo.com

***Abstract.** In a crediting relationship, one of the parties involved – namely the creditor – is exposed to certain risks which impose taking measures to guarantee a debt. If, at the due date, the debtor cannot pay his/her debts and meet the assumed liabilities, the creditor can execute the legally constituted guarantees, on a contract basis, thus covering the debt.*

There are also situations when the state, being directly interested in promoting trade and cooperation with other economies or simply out of the wish to ensure a competitive and safer business environment, gets involved in insurance and guarantee operations. In such situations, the state does not intervene directly; it appeals to banks or to other specialized financial institutions.

Keywords: guarantees; real guarantees; personal guarantees; transfer of debt; risk.

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JEL Code: J21.

REL Codes: 11C, 11F.

In a crediting relationship, one of the parties involved – namely the creditor – is exposed to certain risks which impose taking measures to guarantee a debt.

If, at the due date, the debtor cannot pay his/her debts and meet the assumed liabilities, the creditor can execute the legally constituted guarantees, on a contract basis, thus covering the debt.

According to their nature, bank guarantees fall into two categories:

- a) Real guarantees;
- b) Personal guarantees.

Real guarantees are legal means of guaranteeing obligations by affecting one of the debtor's assets so as to ensure the execution of the assumed liability. The asset constituted as guarantee is protected from the pursue of other creditors whose debts are not accompanied by any real or personal guarantees, or whose secured debts have a lower level of priority than the bank, in which case the asset is meant to cover the secured debt of the bank. Real guarantees confer the following rights to the secured creditor:

- The right of preference, on grounds of which, in case of forced execution, the value of the respective asset is to be used to fully satisfy the secured creditor first, and then the claims of other creditors;

- The right of pursue, on grounds of which the creditor is entitled to pursue the asset, irrespective of its owner, in order to cover the secured debt;

In their turn, real guarantees can be classified into two categories, as it follows:

- Personal estate guarantees (pledge) – which may or may not allow the creditor to

dispossess the debtor of the asset constituted as guarantee;

- Real estate guarantees (mortgage).

Personal guarantees are legal means of guaranteeing obligations by engaging one or several persons in an accessory contract with the creditor, in order to cover the debt if the debtor himself/herself does not do it.

The personal guarantees regulated by the Romanian laws take to following forms:

- fidejussion (bond), settled by the article 1652 from the Civil Code;

- letters of guarantee issued by banks, financial institutions, insurance companies, administrative authorities (ministries), (inter)national companies which are competent in this field;

- personal guarantees regulated by special laws, which are based on the concept of fidejussion (for example: the guarantee constituted by a third party to cover the eventual damage that might be caused to an economic agent by an administrator, according to the Law no. 22/1969, with all the subsequent modifications).

The transfer of debts, although not falling into the category of real or personal guarantees, as it represents a specific means of transferring obligations, can be constituted to guarantee the credits given by the bank, as well as the afferent interests.

By its result, the transfer of debts ensures, as any other guarantee, the recovery of the bank debts, if it has been constituted under the strict observation of the rules and regulation in force.

As a cautionary measure, depending on each credit applicant's situation, the banks

can ask their clients to constitute one or several guarantees (guarantee mix) of the following:

- unconditioned guarantees issued by the Romanian Government;
- bank guarantees;
- bank deposits (collateral cash);
- the contract of insurance in case of non-reimbursement of the credit and the afferent interests (financial risk insurance);
- transfer of debts;
- mortgage;
- the contract of personal estate guarantees (pledge);
- fidejussion (bond);
- corporate guarantees;
- business plans.

In case of clients experiencing difficulties in observing their payment obligations in due time, thus presenting a significant non-reimbursement risk, the bank can ask the borrowers to sign promissory notes which, according to the Law no. 58/1934 on bills of exchange and promissory notes, modified by the Law no. 83/1994, constitute enforceable titles even after being made enforceable and can be put into forced execution without prior formalities.

To be accepted by the bank, the guarantees must meet the following cumulative and mandatory requirements:

- the existence of a distribution market or of potential buyers for the assets proposed as guarantees;
- the possibility of being rapidly turned into cash;
- the opportunity of being materialized into titles, authentic documents etc.;

- the assets are in a civil circuit, in the possession of the applicant or the guarantor and is not affected by other debts than the ones stemming from the creditor bank;

- the assets' owner is capable of bringing them back into guarantee;

- the assets that are bought and put into function prior to the credit application are in good functioning condition;

- the assets bought and still not put into function, as well as the assets which are to be bought and partially covered from credits are new and accompanied by quality and guarantee certificates.

The corporate guarantee is based on the firm engagement of the debtor, under the authentic or private signature, that he/she will circulate through the said bank the total/partial cash-flow resulted from its current activity; in fact, we are dealing with a transfer of debts which does not necessarily require legal procedures. The value accepted by the bank in the case of the corporate guarantee depends on the financial standing of the company, on the turnover circulated through the bank, on the company's reputation in the business environment and it can reach up to 75% of the cash-flow circulated through the bank by the respective company.

The business plan can constitute a guarantee for credits especially in the case of small and medium-size companies, which do not have other forms of guarantees at their disposal. The bank can accept as credit guarantee up to 50% of the cash-flow resulted from the business plan, provided that, according to the plan, the revenues are higher than the expenses.

The guarantee letters issued by other banks, as well as the payment default insurance contracts issued by the insurance-reinsurance companies approved by the creditor bank can be accepted as guarantees for bank credits.

The assets will be insured throughout the whole crediting period, with the risks specific to each category.

The borrower is bound through the credit contract to renew the insurance before the policy for the prior period expires.

The assets will be insured at their real market value, which must be at least equal to the value taken into account when calculating the credit guarantee (the value acknowledged in guarantee) and the damage recovery rights will be transferred to the bank.

The insurance policies will only be accepted within the limits of exposure reported by the insurance-reinsurance companies to the Risk Management Offices.

The credit officers will make sure that the insured value is at least equal to the value of the credit and its afferent interests.

In financial and trade operations with international ramifications, one of the most common guarantee instruments is the bank guarantee letter. It can be used, by defining and adapting its object, both for payments by documentary letters of credit, and for payments by payment bonds. The object of the guarantee is broadly represented by the effort to cover the buyer's obligation to pay the contract price, settled as countervalue for the received goods or services. From this point of view, the

guarantee of payment can take the following forms:

1. *Tender Guarantees/Bid Bonds*, which are solicited by the organizers of international bids as a condition of participation to it. If the Romanian exporter who has been awarded the bid refuses to sign in due time the contract written under the terms of the offer or fails to present the performance bond (if the tender book specifies it and the contract has been concluded), the bid organizer can claim the execution of the guarantee.

2. *Advance Payment Guarantees* are issued to account for the advance payment collected with export, national delivery, work performance or service contracts. This type of guarantee letter is issued when the foreign partners in a Romanian trade want to make the advance payments agreed in an export contract dependent on the full or partial secured advance recovery corresponding to the undelivered goods or the unexecuted works or services as specified in the contract.

3. *Performance Bonds* which mainly stand for a guarantee of the observance of contractual relations between partners in a transaction, from the point of:

- The full delivery of the contracted goods or the performance of works and services;
- The observance of delivery or execution terms for the contracted goods, works or services;
- The provision of quality goods, works and services;
- The setting-up and maintenance within agreed technical and functional

parameters, including during the period of technical guarantee for complex objectives.

4. *Payment Guarantees*, which have as object covering the customer's obligation to pay the contractual price, settled as a countervalue for the provided goods or services.

5. *Maintenance Guarantees*, which constitute a version of performance bonds. They often bear the same name, the difference being made only in the text of the guarantee; in this case, it covers the period of technical guarantee. If the commercial contract refers to merchandise deliveries for which the seller covers a period of technical guarantee (6 months, 1 year), this interval is usually covered by performance bonds.

6. *Temporary Admission Guarantees*, which contain the guarantor bank's pledge to pay for the countervalue of custom taxes and other budgetary debts afferent to the entry of goods, equipment, etc., in the importer's country, if after meeting the contractual obligations (completion of works), the account party does not return them to their country of origin and does not cover the above-mentioned payment obligations in favor of the customs duty unit.

7. *Retention Money Guarantees*, which are meant to cover the exporter's contractual obligations (the account party of the bank guarantee) afferent to the period of technical guarantee.

8. *Guarantee Limits*, within which the bank can issue several types of guarantee letters.

There are also situations when the state, while directly interested in promoting trade

and cooperation relations with other economies or simply out of the pure desire to ensure a competitive and more stable business environment, gets involved in insurance and guarantee operations. In such cases, the state does not act directly; it appeals to banks or specialized institutions. In Romania, EXIMBANK provides the following products to Romanian exporters on behalf of the state:

1. The EXIMBANK foreign payment default insurance policy – MARKET RISKS:

Until the end of 2004, EXIMBANK was involved in foreign payment default insurance operations on its own behalf, with COFACE reinsurance. In order to comply with the legal provisions coming from the European Union in this field, according to the *Law no. 440/2004 regarding the modification of the Law no. 96/2000 on the organization and functioning of the Romanian Import-Export Bank and the specific instruments to sustain the international trade*, EXIMBANK is now developing this activity on behalf of the state, while maintaining the reinsurance on the international private market (with COFACE).

This insurance policy covers the debts resulting from export contracts concerning general merchandise, consumer goods and short-term credit service performance, in order to prevent the following categories of market risks included in the definition of market risks which are covered as a result of market mechanisms.

■ *Political risks*, before and after delivery, connected to commercial risks

(risk of war, of civil war, of revolution or rebellion, any general moratory declared by the authorities of the buyer's country or of another country, any measure or decision taken by the authorities of the seller's country, the secured person's country or of another country, any political event or economic depression, legal or administrative measures that prevent or delay the transfer of the amounts paid by the buyer or by his/her guarantor, any other similar action or event);

- *Commercial risks*, before and after delivery, caused by the insolvency of the private buyers or their extended payment default (buyer insolvency, buyer's extended payment default);

- *Payment default* of debts belonging to governmental buyers before and after delivery.

2. *The EXIMBANK foreign payment default insurance policy – NON-MARKET RISKS (risks which are not reinsured, other than those included in the definition of market risks, which are not covered as a result of market mechanisms):*

This insurance policy covers the debts resulted from the export contracts regarding general merchandise, consumer goods and short-term credit service performance, against the following categories of non-market risks:

- *Political risks*, before and after delivery, connected to commercial risks (risk of war, of civil war, of revolution or rebellion, any general moratory declared by the authorities of the buyer's country or of another country, any measure or decision taken by the authorities of the seller's

country, the secured person's country or of another country, any political event or economic depression, legal or administrative measures that prevent or delay the transfer of the amounts paid by the buyer or by his/her guarantor, any other similar action or event);

- *Commercial risks*, before and after delivery, caused by the insolvency of the private buyers or their extended payment default (buyer insolvency, buyer's extended payment default);

- *Payment default* of debts belonging to governmental buyers before and after delivery;

- *Force majeure risks*: natural disasters or other similar events, with the exception of those occurring on Romanian territory, which hinder the execution of the export contract.

3. *The EXIMBANK medium and long-term insurance policy for export contracts* (The insurance policy for construction-assembly works and other export works/services and the insurance policy for export capital assets). These insurance policies cover export contracts which have in view complex export operations and/or delivery of products with extended fabrication cycle or other export works/services, against the following categories of risks:

- *Political risks*, before and after delivery, connected to commercial risks (risk of war, of civil war, of revolution or rebellion, any general moratory declared by the authorities of the buyer's country or of another country, any measure or decision taken by the authorities of the seller's country, the secured person's country or of

another country, any political event or economic depression, legal or administrative measures that prevent or delay the transfer of the amounts paid by the buyer or by his/her guarantor, any other similar action or event);

- *Commercial risks*, before and after delivery, caused by the insolvency of the private buyers or their extended payment default (buyer insolvency, buyer's extended payment default);

- *Force majeure risks*: natural disasters or other similar events, with the exception of those occurring on Romanian territory, which hinder the execution of the export contract;

- *Pre-delivery risks*: the risk of unjustified interruption of contract by the buyer and the risk of unjustified refusal of the buyer to take over the contracted goods.

4. *The buyer credit insurance policy:*

This insurance policy covers either a Credit Convention concluded for the buyer credit, granted by the exporter's bank (the Romanian commercial bank) on a medium and long term directly to the importer or to his/her bank, either a buyer credit granted by a Romanian bank and based on an individual export contract or several export contracts. This insurance policy offers coverage for the following categories of risks:

- *Political risks*, before and after delivery, connected to commercial risks (risk of war, of civil war, of revolution or rebellion, any general moratory declared by the authorities of the buyer's country or of another country, any measure or decision taken by the authorities of the seller's

country, the secured person's country or of another country, any political event or economic depression, legal or administrative measures that prevent or delay the transfer of the amounts paid by the buyer or by his/her guarantor, any other similar action or event);

- *Commercial risks*, before and after delivery, caused by the insolvency of the private buyers or their extended payment default (buyer insolvency, buyer's extended payment default);

- *Force majeure risks*: natural disasters or other similar events, with the exception of those occurring on Romanian territory, which hinder the execution of the export contract.

5. *The insurance policy for Romanian capital investment* has as object the Investment Project/Investment Agreement concluded between the Beneficiary (the Romanian investor) and the Host Country Government (the country where the investment is made) and afferent to the Project Investment to be implemented subsequently. This insurance policy covers the following categories of political risks:

- *Transfer risks* (the Host Country Government's actions to prevent the Beneficiary from exchanging Host Country currency into insurance currency or from sending abroad amount representing dividends, profits or other financial benefits resulted from the secured investment);

- *Compulsory purchase risks* (the Host Country Government's actions to prevent the Beneficiary from exerting his/her property or control rights over the secured investment, including the right to use the

constituted funds or the revenues resulting from the investment);

- *Risks of war and civil rebellion* (the risk of total or partial destruction of the secured investment's physical assets, including the Beneficiary's inability to execute vital operations for the financial performance of the investment, as a result of the above-mentioned events);

- *The risk of breaking/ending the Investment Agreement by the Host Country Government* (the risk that the Host Country Government breaks the contract obligations, provided that the project implementing is carried out to the benefit of the above-mentioned Government, within the framework of an Investment Agreement).

This type of insurance enjoys the option of reinsurance from the Multilateral Investment Guarantee Agency (MIGA),

based on the agreement concluded between EXIMBANK and this World Bank institution. The reinsurance is granted by MIGA for each policy signed by EXIMBANK to the benefit of the state, depending on the terms and conditions of execution of the respective investment project.

6. *The export production credit insurance policy* has as object of insurance a short or medium-term credit contract, concluded between the export-financing bank and the Romanian exporter and meant to secure the good and service range of offers abroad, as well as to finance the work capital. By means of this insurance policy, the financing banks are protected against risks of credit and interest payment default, as a result of the failure to execute or the poor execution of the export contract's obligations – exporter risks.

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