

## **GUARANTEES AND CO-ACCEPTANCES**

### **GUIDELINES (GENERAL)**

- Bank Guarantees (BG) comprise both performance guarantees (PG) and financial guarantees (FG) and are structured according to the terms of agreement viz., security, maturity and purpose.
- Banks should confine themselves to the provision of FG and exercise due caution with regard to PG business.
- As a General Rule, bank guarantees shorter maturities and leave longer maturities to be guaranteed by other financial institutions.
- Bank guarantees should not normally extend beyond 10 years. Banks may issue guarantees (BG) for periods beyond 10 years taking into account the impact of very long duration guarantees on their Asset Liability Management and in tune with their policy on issuance of guarantees beyond 10 years as approved by the Board.

### **Other guidelines**

#### **Norms for unsecured advances & guarantees**

- Banks' Boards have been given the freedom to fix their own policies on their unsecured exposures including unsecured guarantees.
- Unsecured exposure is where the realizable value of the tangible security, as assessed by bank/approved valuers/RBI inspecting officers, is not more than 10% ab-initio, of the outstanding exposure (funded and non-funded exposure including underwriting and similar commitments).
- The rights, licenses, authorizations, etc. are not reckoned as tangible security whereas annuities under Build-operate-transfer (BOT) projects and toll collection rights where there exists provision to compensate the project sponsor if a certain level of traffic is not achieved can be treated as tangible security.

#### **Precautions for issuing guarantees**

- Avoid giving unsecured guarantees in large amounts for medium and long-term periods and such commitments to particular groups of customers and/or trades.
- For individual constituent, unsecured guarantees should be limited to a reasonable proportion of the bank's total unsecured guarantees and constituent's equity. The BG exposure on behalf of any individual constituent or group is subject to the prescribed exposure norms.
- Not to encourage parties to over-extend their commitments as the BG contains inherent risks.
- Banks can give deferred payment guarantees on an unsecured basis for modest amounts to first class customers in exceptional cases.

### **Precautions for Averting Frauds**

- While issuing FGs, banks should satisfy about customer's ability/capacity to reimburse the bank in case it is required to honor the commitments under the FG.
- In case of PG, banks should exercise due caution and satisfy themselves that the customer has the necessary experience, capacity and means to perform the obligations under the contract, and is not likely to commit any default.
- Banks should refrain from issuing BGs on behalf of customers who do not enjoy credit facilities with them other than customers of co-operative banks against counter guarantee of the co-op. bank which have sound credit appraisal and monitoring systems as well as robust Know Your Customer (KYC) regime.

### **Ghosh Committee Recommendations** (Shri A. Ghosh, the then Dy. Governor, RBI)

- BGs should be issued in serially numbered security forms;
- While forwarding the BGs to the beneficiaries, caution them to verify the genuineness of the guarantee with the issuing bank.

### **Internal Control Systems**

- BGs for Rs. 0.50 Lakh and above are to be signed by two officials jointly. A lower cut-off point, depending upon the size and category of branches, may be prescribed by banks, where considered necessary.
- Allow deviation from the two signatures discipline should be only in exceptional circumstances. In such cases there should be a system for subjecting such instruments to special scrutiny by the auditors or inspectors at the time of internal inspection of branches.

### **Guarantees on behalf of Banks' Directors**

In view of the possibility of contingent liability becoming a funded liability in case of invocation, Banks should, while extending non-fund based facilities such as BGs, etc. to the directors or the constituents in which they are interested, ensure that:

- Adequate and effective arrangements are in place to honor the commitments out of their own resources by the party on whose behalf guarantee was issued, and
- The bank will not be called upon to grant any loan or advance to meet the liability, consequent upon the invocation of guarantee.

### **Bank Guarantee Scheme of Government of India**

- BGs are to be issued in the Model Form of Bank Guarantee Bond and in favour of Govt. departments in the name of President of India and any correspondence thereafter should be exchanged with the concerned departments only.
- In respect of BGs favouring the Director General of Supplies and Disposal (DGSD), the following aspects to be kept in view:-

- a) In order to expedite the process of verification of genuineness of the BGs, name, designation and code numbers of the signatory should be incorporated under their signature therein;
- b) The beneficiary of the bank guarantee should also be advised invariably to obtain the confirmation of the concerned banks about the genuineness of the guarantee issued by them as a measure of safety.
- c) The initial period of the BG issued by banks as a means of security under DGSD would be for a period of six months beyond the original delivery period with suitable clause providing automatic extension of the validity period by 6 months. Bank may obtain suitable undertaking from the customer at the time of establishing the guarantee to avoid any possible complication later.
- d) Like the tender form floated by DGSD, the Public Notice issued by the Customs Department stipulates, inter alia, that all BGs furnished by an importer should contain a self renewal clause inbuilt in the guarantee itself. Hence, BGs issued in favour of DGSD and Customs Houses should invariably contain suitable clause for automatic extension of the guarantee period etc.

### **Guarantees on Behalf of Share and Stock Brokers/ Commodity Brokers**

- Banks can issue BGs on behalf of share and stock brokers in favour of Stock Exchanges towards security deposit, margin requirements as per Stock Exchange Regulations.
- BGs can also be issued on behalf of commodity brokers in favour of national level commodity exchanges viz. National Commodity & Derivatives Exchange (NCDEX), Multi Commodity Exchange of India Limited (MCX) and National Multi-Commodity Exchange of India Limited (NMCEIL), in lieu of margin requirements as per the Commodity Exchange Regulations.
- Banks are required to obtain a minimum margin of 50% (out of which cash margin to be 25%) while issuing such guarantees in both the above cases and to observe usual and necessary safeguards including the exposure ceilings.

### **Obtaining Personal guarantees of directors - Guidelines**

#### **a) Not necessary**

- The lending institutions are satisfied about the management, economic viability, stake in the concern, financial position, cash generation, etc., obtaining of personal guarantee of directors may be dispensed with in respect of public limited companies.
- For widely owned public limited companies with first class rating and satisfying the said conditions, guarantees may not be insisted upon even if the advances are unsecured.
- Personal guarantee of professional directors in public or public companies under professional management need not be insisted upon in case they are connected with the management solely by virtue of their professional/technical qualifications without significant stake in the company concerned, etc.

**b) Considered helpful**

- In respect of closely held private or public companies where shares are held by a person or persons, or a group (not being professionals), obtaining the personal guarantee of principal members is considered as helpful for facilities granted by banks with the exception in respect of companies where, by court or statutory order, the management of the company is vested in a person or persons as director/s or by any other name, who are not required to be elected by the shareholders.
- In order to ensure the continuity of the management or to mitigate any negative impact due to acquiring the control of the company by different group, personal guarantee of directors may be insisted upon even if the company is not a closely held one.
- Where personal guarantees are waived, it may be necessary to obtain an undertaking from the borrowing company that no change in the management would be made without the consent of the lending institution.
- Banks may insist for personal guarantee of directors of public limited companies other than those rated first class and the advance is on unsecured basis and those financial position and/or cash generation capacity is not so satisfactory.
- Other circumstances such as:-
  - a) Delay in creation of charge on assets of the company to cover the interim period between the disbursement of loan and creation of charge on asset;
  - b) In case of subsidiary companies whose financial condition is not considered satisfactory;
  - c) Interlocking of funds between the company and other concerns owned or managed by a group; etc. personal guarantee of directors/parent company may be insisted upon.

**Worth of the guarantors, payment of guarantee commission, etc.**

- Banks should ensure that no consideration whether by way of commission, brokerage fees or any other form would be paid by the company to the directors directly or indirectly for obtaining their personal guarantee. Suitable undertaking to this effect has to be obtained from the company as well as guarantors.
- In exceptional cases, payment of remuneration may be permitted where the unit is not doing well and the existing guarantors are no longer connected with the management but continuance of the guarantee is essential because the new management's guarantee is either not available or is found inadequate.

**Personal guarantee in case of sick units**

- Banks, may in their discretion, obtain guarantees from directors (excluding the nominee directors) and other managerial personnel in their individual capacities so as to instill greater accountability and responsibility on their part and prompt the managements to conduct the running of the assisted units on sound and healthy lines and to ensure financial discipline.

## **Guarantees of State Governments**

- Bank may insist personal guarantees of directors in respect of finance to State Government undertakings/projects on merits only in circumstances absolutely necessary after thorough examination of the circumstances of each case and not as a matter of course.

## **Guarantees governed by regulations under Foreign Exchange Management (Guarantee) Regulations**

### **a) Bid bonds and performance bonds or guarantees for exports**

- Banks (AD) are authorized to issue performance bonds or guarantee in favour of overseas buyers towards bona fide exports.
- Prior RBI approval is required to be obtained by banks for issue of performance bonds/ guarantees in respect of caution-listed exporters. Due diligence is to be carried out to satisfy bona fides of the applicant, capacity to perform the contract and reasonableness of the value of the bid/ guarantee and they are in line with normal practice in international trade, and that the terms of the contract are in conformity with the Foreign Exchange Management Regulations.
- Banks can also issue counter guarantee in favour of their branches/ correspondents abroad in cover of guarantees required to be issued by the latter on behalf of Indian exporters, in cases where guarantees of only local banks are acceptable to overseas buyers in accordance with local laws/ regulations.
- Banks are required to honour the bonds/guarantees in case of invocation and make payments accordingly to non-resident beneficiaries.

### **b) Bank Guarantees (BG)**

Banks are authorized to issue BGs in certain cases as under:-

#### **i) Foreign Airlines/IATA**

Banks (AD-1) are authorized to issue BGs on behalf of Indian agents of foreign airline companies who are members of International Air Transport Association (IATA), in favour of foreign airline companies/IATA, towards their ticketing business, being a standard requirement.

#### **ii) Service Importers**

Banks can issue guarantee in genuine cases subject to verification of details for amount not exceeding USD 0.50 Mn. or its equivalent in favour of a non-resident service provider, on behalf of a resident customer who is a service importer. Suitable approval from Ministry of Finance, GOI, is required to be obtained for issue of BGs for an amount exceeding USD 0.10 Mn. or its equivalent in respect of Public Sector Company or a Department/ Undertaking of the Government of India/ State Governments.

iii) BG-Commodity Hedging

Subject to terms and conditions as may be stipulated by RBI, Banks can issue guarantee or standby Letter of Credit on behalf of a domestic party towards the margin payable by him/her covering hedging of his commodity exposures in overseas markets.

**Invocation of Guarantee**

Banks are required to honour any invocation of the guarantee and send a detailed report to RBI, Mumbai, explaining the circumstances leading to the invocation of the guarantee.

**Unconditional Guarantees in favour of Overseas Employers/ Importers on behalf of Indian Exporters**

Banks can also issue unconditional guarantees in favour of overseas employers/importers on behalf of Indian Exporters. While issuing such BGs, Banks should incorporate suitable clauses in the agreement, that when the guarantee is invoked, the bank would be entitled to make payment, notwithstanding any dispute between the exporter and the importer. This is to avoid possible non-acceptance of guarantees by Indian banks which would hamper the country's export promotion effort.

**Precautions in case of Project Exports**

- The sponsor banks should examine the project proposals thoroughly with regard to the capacity of the contractor/ sub-contractors, protective clauses in the contracts, adequacy of security, credit ratings of the overseas sub-contractors, if any, etc. irrespective of whether 'In Principle' package approvals at post bid stages for high value overseas projects exports by the Working Group evolved is in place.
- Due diligence should be undertaken prior to taking any commitments under such projects. While bid bonds and performance guarantees cannot be avoided, such guarantees should not be executed as a matter of course, merely because of the participation of Exim Bank and availability of counter-guarantee of ECGC.

**Guarantees for Export Advance**

While issuing guarantees favouring overseas buyers on behalf of exporters, banks are required to ensure that no violation of FEMA regulations takes place and banks are not exposed to various risks. It will be important for the banks to carry out due diligence and verify the track record of such exporters to assess their ability to execute such export orders. Banks should also ensure that the export advances received by the exporters are in compliance with the regulations/ directions issued under the Foreign Exchange Management Act, 1999.

## **Other Guarantees regulated by Foreign Exchange Management Rules**

Issue of the following types of guarantees is governed by the Foreign Exchange Management Regulations:

### **a) Minor Guarantees**

Banks are authorized to issue BGs freely on behalf of their customers and overseas branches and correspondents in the ordinary course of business in respect of missing or defective documents, authenticity of signatures and for other similar purposes.

### **b) Bank Guarantees - Import under Foreign Loans/Credits**

While Banks/FIs are not permitted to issue guarantees/ standby letters of credit or letters of comfort in favour of overseas lenders relating to External Commercial Borrowing (ECB) generally, such requests from SMEs and those from textile companies for modernization or expansion of the textile units are considered on merits by RBI under Approval Route.

## **Trade credits for imports into India**

### **Issue of Guarantees – Delegation of Powers**

Banks can issue BGs/Letter of Undertaking (LoU)/ Letter of Comfort (LoC) in favour of the overseas supplier, bank and financial institution up to USD 20 Mn. per import transaction for a period up to one year for import of all non-capital goods permissible under the Foreign Trade Policy (except gold) and up to three years for import of capital goods, subject to prudential norms issued by the Reserve Bank from time to time. The period of such guarantees/LoUs/LoCs has to be co-terminus with the period of credit, reckoned from the date of shipment.

### **Loans abroad against securities provided in India**

Banks can give guarantee in respect of any debt, obligations or other liability incurred by a person resident outside India, among others, where such debt, obligation or liability is owed to a person resident in India in connection with a bona fide trade transaction, provided that the guarantee is covered by a counter guarantee of a bank of international repute resident abroad.

## **Guarantees for Non-Residents**

- Banks (AD) can also issue guarantees on behalf of their overseas branches or correspondents in respect of the trade/debt transactions entered into by NRI customers of those entities with residents in India provided the same are counter guaranteed by the overseas branches/banks.
- While issuing such guarantees banks can also stipulate if they so desire a condition that the payment of the guarantee amount in case of invocation would be made only after receipt of the money from the overseas bank.
- Banks may make rupee payments to the resident beneficiaries immediately when the guarantee is invoked and, simultaneously, arrange to obtain the reimbursement from the overseas bank concerned, which had issued the counter-guarantee. In case of any non-

receipt of claim from overseas banks, the same should be reported to RBI indicating the steps taken by the bank to recover the amount under the guarantee.

- Banks may issue guarantees in favour of overseas organizations issuing travellers cheques in respect of blank travellers cheques stocked for sale by them or on behalf of their constituents who are full-fledged money changers holding valid licences from RBI, subject to suitable counter-guarantee being obtained from the latter.

#### **Overseas Investment - Guarantee on behalf of Wholly Owned Subsidiaries (WOSs)/Joint Ventures (JVs) abroad**

Overseas Investment should be within the present ceiling of 400% of the net worth of the Indian Party as on the date of the last audited balance sheet. Indian Party can offer any form of guarantee provided that:

- All financial commitments including all forms of guarantees are within the overall ceiling of 400% of net worth prescribed for overseas investment.
- No guarantee should be 'open ended' i.e. the amount and period of the guarantee should be specified upfront. In the case of performance guarantee, time specified for the completion of the contract shall be the validity period of the related performance guarantee;
- In case the ceiling of 400% of net worth exceeds due to invocation of guarantee, the Indian Party shall seek the prior approval of the Reserve Bank before remitting funds from India, on account for such invocation.
- Issuance of corporate guarantees (including performance guarantee) is required to be reported to RBI, etc.

#### **Restrictions on issuance on guarantees**

- Banks should not execute guarantees covering inter-company deposits/loans thereby guaranteeing refund of deposits/loans accepted by NBFC/firms from other NBFC/firms.
- Guarantees should not be issued for the purpose of indirectly enabling the placement of deposits with NBFCs. These stipulations will apply to all types of deposits/ loans irrespective of their source, e.g. deposits/ loans received by non-banking companies from trusts and other institutions.

Banks can issue guarantees favouring other banks/ FIs/ other lending agencies for the loans extended by the latter as per their Board approved policy.

- The guarantee shall be extended only in respect of borrower constituents and to enable them to avail of additional credit facility from other banks/FIs/lending agencies. It is to be treated as an additional exposure on them and the same will attract appropriate risk weight as per extant guidelines.
- The guaranteeing bank should assume a funded exposure of at least 10% of the exposure guaranteed.
- Banks should not extend guarantees or letters of comfort in favour of overseas

lenders including those assignable to overseas lenders.

- Banks should not issue guarantees or equivalent commitments for issuance of bonds or debt instruments of any kind by corporate entities;

#### Exceptions

- Banks sometimes, on account of temporary liquidity constraints unable to participate in rehabilitation packages of sick/weak industrial units, provide guarantees in favour of the banks which take up their additional share. Such guarantees will remain extant until such time that the banks providing additional finance against guarantees are re-compensated.
- In respect of infrastructure projects, banks may issue guarantees favouring other lending institutions, provided the bank issuing the guarantee takes a funded share in the project at least to the extent of 5 percent of the project cost and undertakes normal credit appraisal, monitoring and follow up of the project.
- Guarantees /co-acceptance facility provided by buyer's bank under Sellers Line of Credit (since renamed as Direct Discounting Scheme)
- Guarantees, on behalf of private borrowers who are unable to offer clear and marketable title to property, issued in favour of HUDCO/ State Housing Boards and similar bodies/ organizations for the loans granted, provided banks are otherwise satisfied with the capacity of the borrowers to adequately service such loans.
- Guarantees issued by banks on behalf of their constituents, favouring Development Agencies/ Boards like Indian Renewable Energy Development Agency, National Horticulture Board, etc., for obtaining soft loans and/or other forms of development assistance.

#### **Payment of invoked guarantees**

- Banks may laid down appropriate procedure for effecting payment to beneficiaries in case of invocation of the guarantee without delay and demur on the pretext that legal advice or approval of higher authorities is being obtained. Any delay on the part of the banks in honouring the guarantees when invoked would erode the value of the guarantees as also the sanctity of the scheme of guarantee and image of the banks/ tarnish the image of the banking system.
- Banks are required to appraise the proposal with due diligence, as in the case of fund based limits, prior to issuance of the guarantees so as to ensure that the persons on whose behalf the guarantees are issued will be in a position to perform their obligations in the case of performance guarantees and honour their commitments out of their own resources, as and when needed, in the case of financial guarantees.

- In the interest of the smooth working of the Bank Guarantee Scheme, it is essential to ensure that there is no discontentment on the part of the Government departments regarding its working.
- Any decision not to honour the obligation under the guarantee invoked may be taken after careful consideration, at a fairly senior level, and only in the circumstances where the bank is satisfied that any such payment to the beneficiary would not be deemed a rightful payment in accordance with the terms and conditions of the guarantee under the Indian Contract Act.
- For any non-payment of guarantee in time, staff accountability should be fixed and stern disciplinary action including award of major penalty such as dismissal, should be taken against the delinquent officials at all levels, etc. Non-compliance of the instructions in regard to honouring commitments under invoked guarantees will be viewed by Reserve Bank very seriously and Reserve Bank will be constrained to take deterrent action against the banks.

### **CO-ACCEPTANCE OF BILLS**

Under this facility banks accept commercial usance bills drawn on their constituents which would enable the latter to enjoy credit which otherwise the seller will not be willing to extend. In this facility the banks add the strength of their name and no finance is envisaged. RBI has directed banks to take suitable safeguards while extending such facilities, a few of which are as under:-

- Co-acceptance facility is to be extended only to borrower constituents upon ascertaining the need thereof and banks should ensure that only genuine trade bills are co-accepted and goods covered by the bills co-accepted are actually received in the stock account of the constituents;
- Verify the accompanying invoices to see that there would not be any over valuation of stocks;
- No co-acceptance to house bills/ accommodation bills drawn by group concerns on one another.

Besides the above safeguards:-

- Banks are precluded from co-accepting bills drawn under Buyers Line of Credit Schemes introduced by IDBI Bank Ltd. and all India financial institutions like SIDBI, Power Finance Corporation Ltd. (PFC), etc. Similarly, banks should not co-accept bills drawn by NBFCs and not to extend co-acceptance on behalf of their buyers/constituents under the SIDBI Scheme.
- Banks are permitted to co-accept bills drawn under the Sellers Line of Credit Schemes (since renamed as Direct Discounting Scheme) operated by IDBI and all India financial institutions for Bill Discounting operated by IDBI and all India financial

institutions like SIDBI, PFC, etc. without any limit, subject to the buyer's capability to pay, and compliance with the exposure norms prescribed by the bank for individual/ group borrowers.

- Co-acceptance of bill drawn under their own LC by bank defeats the purpose of issuing LC as the bill so co-accepted becomes an independent document and the special rules applicable to commercial credits do not apply to such a bill and the same is exclusively governed by the law relating to Bills of Exchange, i.e. the Negotiable Instruments Act. The negotiating bank of such a bill is not under any obligation to check the particulars of the bill with reference to the terms of the L/C.
- The discounting banks must, therefore, ascertain from the co-accepting bank the reason for such co-acceptance and upon satisfying themselves of the genuineness of such transactions, they may consider discounting such bills.

## **LETTER OF CREDIT**

### **Precautions**

- Banks do not extend any non-fund based facilities or additional/ad-hoc credit facilities to parties who are not their regular constituents, nor should they discount bills drawn under LCs, or otherwise, for beneficiaries who are not their regular clients.
- In case of import of goods, payment should be released to the foreign suppliers on the basis of shipping documents only upon ensuring that the documents are strictly in conformity with the terms of the LCs.
- Irregularities in the LC business such as non-recording of transactions in the books of the branch, issuance of LCs beyond delegated powers of the officials concerned, fraudulent issue of LCs involving a conspiracy/collusion between the beneficiary and the constituent, etc. may be avoided.
- Banks are required to honour their commitments under LCs and make payments promptly. Any dishonor/delay would adversely affect the character of LCs and relative bills as an accepted means of payment, besides, causing adverse impact on the credibility of the entire payment mechanism through banks and affect the image of the banks.

Source: RBI M. Circular

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