BANK DEMAND GUARANTEE AND STANDBY LETTER OF CREDIT AS COLLATERALS IN INTERNATIONAL TRADING OPERATIONS

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Abstract

Bank demand guarantees have become an established part of international trade. This financial instruments are often used in trade financing when suppliers, or vendors, are purchasing and selling goods to and from overseas customers with whom they don't have established business relationships. The instruments are designed to reduce the risk taken by each party.In this sense bank demand guarantees are similar to standby letters of credit. Similarities and differences among them are the subject of this paper.

Key words:bank guarantee, demand guarantee, contract, security claims, standby letter of credit.

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Introduction

One of the major issues in each contract is the payment and how to implement obligations of the parties. Reasonable concerns of the parties in the international trade are more than domestic trade. One of the most important instruments of security in the international trade are bank guarantees. Bank demand guarantees have become an established part of international trade and their activities are similar to the stand-by letters of credit. Demand guarantees and standby letters of credit are treated asautonomous contracts whose operation will not be interfered with by courts on groundsimmaterial to the guarantee or credit itself. Becouse of the importance which this instruments have in the international trade in this article we will deal with the definition of these collaterals and their comparasion.

1. Definition and characteristics of demand guarantees

A demand guarantee is generally a short and simple instrument issued by a bank (or other financial institution) under which the obligation to pay a stated or maximum sum of money arises merely upon the making of a demand for payment in the prescribed form and sometimes also the presentation of documents as stipulated in the guarantee within the period of validity of the guarantee. Many demand guarantees are payable on first demand without any additional documents, which reflects their origin in replacing cash deposits, although increasingly guarantees require at least a statement indicating that the principal is in breach. Therefore, a demand guarantee is like a substitute for cash and must be honoured on presentation of a written demand that complies with the provisions of the guarantee.A bank demand guarantee can be described as a personal security in terms of which a bank promises payment to a beneficiary if a principal defaults in the performance of his obligation in terms of the underlying contract. The bank has to pay if the documents presented with the demand for payment comply with the documents that are mentioned in the text of the demand guarantee. For this reason, the bank's obligations are autonomous from the underlying contract between the beneficiary and the principal; which means that, in principle, the bank must pay if proper complying documents are presented, even if the beneficiary and the principal have not stipulated that there is a default under the original underlying contract. In this regard, demand guarantees differ from surety

guarantees or bonds, in which the security lender is only involved if the principal party defaults in the performance of an obligation. there is a default under the original underlying contract. In this regard, demand guarantees differ from surety guarantees or bonds, in which the security lender is only involved if the principal party defaults in the performance of an obligation. (Bertrans, R., 2004.)

The purpose of the demand guarantee is to allow the beneficiary to have immediate access to funds necessary to remedy an alleged default under the underlying contract by the principal. The idea behind this structure is 'pay now and litigate later'. It prevents the performance of the project in question from being held up due to lack of funds while the parties in question litigate or arbitrate over the merits of a particular call by the beneficiary under the demand guarantee. This consideration is particularly significant in international transactions where conflicts of law issues may well cause litigation or arbitration to be even more expensive and time-consuming than they would be in a purely domestic transaction. In this regard, demand guarantees are different from traditional guarantees under the terms of which payment to the beneficiary is usually conditional on proof of a default by the principal. Demand guarantees are typically used in construction contracts, engineering contracts and contracts for the international sale of goods. (Goode, R., 2000.)

A demand guarantee is an abstract payment undertaking which, though intended to protect the beneficiary from loss in relation to the underlying contract, is separated from the underlying contract between principal and beneficiary, and is in form a primary undertaking between guarantor and beneficiary that becomes binding solely by way of its issue and the beneficiary's acceptance of it. Therefore, once the terms and conditions of the guarantee are met, the beneficiary is entitled to claim payment and he need not show default in any other way than that stipulated in the terms of the guarantee.

2. Standby letter of credit

A standby letter of credit is a financial instrument used primarily in international trade and domestic construction projects. This instrument is issued by a bank on behalf of the buyer and guarantees that the seller (beneficiary) will receive payment upon the presentation of specified documents in the event the buyer fails to pay the beneficiary according to the terms of

the contract. The buyer applies for an standby letter of credit at a commercial bank, presents either the collateral or credit substantiation to justify issuance of the standby letter of credit and pays the bank fee. As part of the process, the buyer provides the beneficiary information, the requisite shipping documents necessary for payment, the information for the bank representing the beneficiary (advising bank) and the specified period the standby letter of credit is valid (usually no longer than 12 months). In the event that the buyer fails to pay the seller, and the seller presents all of the specified documentation listed in the standby letter of credit to the issuing bank within the specified period, the issuing bank will pay the seller's advising bank the amount due. standby letter of credit is used primarily by buyers to assure sellers of their creditworthiness and ability to pay by guaranteeing payment. The standby letter of credit had its genesis as a means of circumventing a banking law that proscribes banks from assuming liability for the debt obligations of third parties. The standby letter of creditfulfills essentially the same purpose as a bank guarantee without the bank committing any of its assets to the transaction. Although the bank is liable for payment on presentation of an standby letter of credit and supporting documents, bank assets are not committed to the transaction because the buyer has either deposited sufficient funds with the issuing bank or,more typically, has been approved for a loan guarantee based on standard loan underwriting practices. (Scheller, M., 2008.)

The standby letter of credit is an adaptation of the commercial letter of credit to serve as a form of guarantee. Instead of requiring documents that, for example, evidence the shipment of goods under a contract of sale, the standby letter of credit is payable against documents that evidence (or, at least, imply) that the applicant is in breach of an obligation owed to the beneficiary. The underlying contract may also be one of performance, for instance, under a supply or a construction contract or one of payment, such as the repayment of a loan.(Klein, C., 2007.)

The standby letter of credit was created in the United States as a payment undertaking primary in form but intended to be used only as a fall-back ('standby') in the event of default by the principal in terms of the underlying contract. In the United States standby letters of credit are used in a huge range of transactions, such as lease agreements, stock purchases, financial security, commercial paper, trade investments and many other such contracts.

3. Comparative analysis of banking demand guarantees and standby letters of credit

As already mentioned, the banks in the United States have long used standby letters of credit as a substitute for demand guarantees, in other words, in transactions outside the traditional scope of the application of commercial letters of credit. There is a general misconception that standby letters of credit are legally distinct from demand guarantees. That is not true.

As banks in the United States were not in general permitted to issue guarantees, the term 'standby credit' was adopted to avoid the language of guarantees. From a legal viewpoint the standby credit is simply another term for demand guarantee. Both are undertakings for the payment of money that are independent of the underlying contract; both are documentary in character; and both are primary in form but secondary in intent. The difference between them is not one of legal characterisation, but of practice and business use. From a commercial viewpoint, the standby letter of credit is a different product, for it is used to support not only non-money performance (e.g., sale of goods or construction), but also an extremely diverse range of financial performances and is governed by banking practices that are in many respects more akin to commercial letters of credit than to demand guarantees. The standby letter of credit has developed into an all-purpose financial support instrument comprising a much broader range of uses than the normal demand guarantee. Therefore, standby letters of credit are used to support financial as well as non-financial obligations of the principal and to provide credit enhancement for the primary financial undertaking. However, in the United States, unlike other countries, standby letters of credit are used more to guarantee money obligations (as opposed to performance obligations) incurred in transactions on the capital market. The major difference between demand guarantees and standby letters of credit is that standby letters of credit are usually drafted in the form of a letter of credit. Banks have tended to apply to standby letters of credit many of the practices in current use for commercial letters of credit, for instance, banks may issue standby letters of credit for their own account as well as for that of their customers; arrange for confirmation of the standby credit by a second bank; and they may even arrange for payment by a third party rather than their own. Standby letters of credit are extremely similar to demand guarantees in respect of their function and legal regime, although they differ regarding

their form. However, as a matter of law, there is no distinction between these instruments. Although there are both historical differences in the development of the demand guarantee and the standby letter of credit, and some technical differences in the procedures followed, these two instruments still serve the same economic function and should therefore be treated as equivalent instruments. The guarantor/issuer of the standby letter of credit/demand guarantee undertakes to pay the beneficiary a certain sum of money because of the failure on the part of the principal to pay or to perform some other obligation. Demand guarantees and standby letters of credit are distinguished from the true (traditional) guarantee in that the beneficiary of the demand guarantee or standby credit has the right to payment, either upon simple demand without justification or upon demand accompanied by one or more specified documents. Such a specified document may be a statement of the beneficiary himself that the principal has failed in his obligation or it may be a statement of a third party as to such failure. (Louw, M., 2008.)

In both cases the guarantor of the undertaking is not interested in the performance or failure to perform as it merely acts upon receipt of the simple demand or of the demand and the specified documents, as the case may be. Even though the processing of a demand guarantee or a standby credit is identical to that of a commercial letter of credit, the economic function is quite different. The commercial letter of credit serves as a means of payment to the beneficiary when the underlying contract is properly performed, whereas the demand guarantee and the standby letter of credit serve as means of payment to the beneficiary when the underlying contract is not properly performed.

Conclusion

Buyers of goods or services, whether in their own domestic or international sector, often insist on demand guarantees. The provision of such a guarantee gives the buyer security for the due performance of the seller’s obligation in terms of the underlying commercial contract. In order to be effective, a bank will give its personal undertaking to pay in certain circumstances; for example, when a demand for payment is made by the buyer. If the demand is made in accordance with the strict terms of the guarantee, then the bank is obliged to make payment and to look to its customer for an indemnity. Similar properties in iternational trade has a stand by letter of credit

The standby letter of credit is a member of the family of independent undertakings that include commercial letters of credit and demand guarantees. What these undertakings have in common and what distinguishes them from dependent undertakings is that the person making the undertaking cannot avoid paying because he has not been reimbursed or because of some defence based on the underlying transaction.

Based on the analysis, we can conclude that the demand guarantee stands on a similar footing to a standby letter of credit. A bank which gives a demand guarantee or standby letter of credit must honour that guarantee according to its terms. It is not concerned in the least with the relations between the supplier and the customer; nor with the question whether the supplier has performed his contracted obligation or not; nor with the question whether the supplier is in default or not. The bank must pay according to its instruments, on demand, if so stipulated, without proof or conditions.

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