

# Swiss Finance Partners Group

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*Introduction to Bank Guarantees &  
Fin. Instruments*

2019

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## **Introduction to Bank Guarantees** **& Monetizing of Bank Guarantees**

### **What is a Bank Guarantee?**

A Bank Guarantee is where one Bank (the Issuing Bank) issues an indemnity to another Bank (the Beneficiary Bank) or directly to a Beneficiary, on behalf of its account holder. The Issuing Bank will expect its account holder to pledge 'assets' to the bank for its issue.

There are effectively two main types of Bank Guarantees, (1) A Direct Guarantee where the account holder instructs his bank to issue a Guarantee directly in favour of the Beneficiary, and (2) An Indirect Guarantee where a second bank is requested to issue a Guarantee in return for a counter-Guarantee. In this case the Issuing Bank will indemnify losses made by this second bank in the event of claim against the Guarantee.

A Bank Guarantee is considered a "Demand Guarantee" and as such is governed by the International Chamber of Commerce (ICC) Uniform Rules for Demand Guarantees (URDG).

Bank Guarantee's take many forms.

Some Guarantees are written to guarantee rental payments, some are written to guarantee payments upon the meeting of certain conditions. Some are even issued to guarantee loans and credit lines. All of them are written for a specific purpose to a specific party.

Each Bank Guarantee will be worded for the purposes it is intended. Some may be 'callable upon demand' or some may only be 'callable' when the Beneficiary provides notice of satisfaction of a pre-determined condition.

Currently, under the new Uniform Rules for Demand Guarantees (URDG 758) an underlying contract should be provided that states clearly the purpose of the Bank Guarantee and forms part of the Guarantee, for example a Rent Agreement or Payment Obligation.

### Types of Bank Guarantees

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(2) An **Indirect Guarantee** where a second bank is requested to issue a Guarantee in return for a counter-Guarantee. In this case the Issuing Bank will indemnify losses made by this second bank in the event of claim against the Guarantee.

The most purposes for the uses of Bank Guarantees are:

- Advance Payment Guarantee
- Performance Guarantee (Performance Bond)
- Payment Guarantee
- Conditional Payment Guarantee (Conditional Payment Undertaking)
- Guarantee securing a Credit Line
- Order & Counter Guarantee

Draft Bank Guarantee wordings for these types of Guarantees, acceptable to most banks can be downloaded from our [Downloads](#) centre on the SFP AG website.

### Characteristics of Bank Guarantees

Some important characteristics of Bank Guarantees should be noted:

- Bank Guarantees are written specifically for a purpose; where an account holder will instruct his bank to issue a guarantee to another bank on behalf of their account holder.
- The bank will hold adequate assets of the account holder as security for the Bank Guarantee.
- Bank Guarantees cannot be transferred to third parties unknown to the banks.
- They cannot be bought or sold.
- They do not carry CUSIP or ISIN numbers and are not tradable securities.
- They are issued for a specific time period.

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- Upon Expiry, Bank Guarantees are terminated, they are not traded.
- A Bank Guarantee has no end value and does not accumulate any investment element or maturity value.
- They should not be considered as ‘investment notes’.
- They should not be ‘touted’ on the open market as the issue of a Bank Guarantee is between closed parties (the Issuer and Beneficiary only).
- Banks do not issue them to raise money and should not be confused with Medium Term Notes (MTNs).

### **Buying Bank Guarantees**

Not to be confused with ‘leasing’ Bank Guarantees, which under certain conditions is effectively possible. Put simply, Bank Guarantee’s cannot be bought or sold.

**It is NOT possible to purchase Bank Guarantees.**

If you are approached by a party claiming to be able to ‘sell’ you a Bank Guarantee, our advice is to dismiss that party and report them to the local Financial Authorities.

### **Trading Bank Guarantees**

Utilising Bank Guarantees directly into a ‘trading position’ is not possible. However, to utilise a Bank Guarantee to raise credit lines and then enter those funds into a trading position is of course very possible.

To ‘trade’ a Bank Guarantee, meaning to enter it into an investment programme or structured investment product directly is not possible due to the fact that a Bank Guarantee is not cash. It is a demand guarantee designed to offer a guarantee against a loss or condition. It cannot be transferable nor cannot be divisible. Therefore, as a demand guarantee, it has no value to invest.

Having said that, it is possible (depending on the wording and purpose of the Guarantee) to apply to raise a credit line or loan against it. With these borrowed funds, one can invest into trading positions and purchase investment notes and structured products. This form of borrowing can often add comfort to the bank as investments of this type can be designed to liquidate prior to expiry of the Guarantee to repay the credit or loan. Borrowing against Bank Guarantees to invest into structured products and notes where full capital protection is maintained is indeed a sensible opportunity.

### **Cash-Backed Bank Guarantees**

The term ‘cash-backed’ Bank Guarantees is another misnomer. Whether a Bank Guarantee is issued on the strength of the instructing party pledging cash with his bank or stocks, shares, bonds or other assets makes no difference to the acceptance of the Guarantee whatsoever.

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The Issuing Bank will honour the Guarantee according only to its wording and not related in any way to its underlying security.

Parties offering facilities where they refer to 'Cash-Backed BG's only' should be avoided



### The Risks Explained

#### Issuing and Receiving Bank Guarantees:

##### Risk for the Issuer of a Bank Guarantee

The risks of issuing a Bank Guarantee are simple. If a condition is met and/or a demand for payment is made against your Bank Guarantee by the Beneficiary, then the Issuing Bank will settle the debt, in part or in full. If this happens the risk of the issuing party is that his pledge of assets made to the bank will be lost. The bank will take possession of pledged assets upon settlement of the Guarantee.

Settlement of Bank Guarantees can be made in part or in full. This means that a sum of money may be claimed under a Guarantee issued that is less than the amount of the Guarantee. In these circumstances, the issuer will only lose that amount of the pledged assets, plus a small bank charge. In the event that the full amount of the Guarantee is demanded, then all the pledged assets will be lost.

##### Risk for Receiving a Bank Guarantee

The risks of receiving a Bank Guarantee are zero. The Issuing Bank carries all of the risk. Save perhaps a few small bank charges, there is no risk of loss by receiving a Bank Guarantee.

##### Risk for Credit Lines Drawn Against Bank Guarantees Received

If you receive a Bank Guarantee and draw credit against it, the repayment of that credit or loan is secured by the Guarantee. It is not common practice for a bank to ask for additional security unless you exceed the face amount of the Guarantee.

However, it is not a common practice for a bank to lend credit that will certainly be defaulted leading to a claim on the Guarantee. The lending bank would want some kind of assurance that the credit can be repaid. Only as a last resort will the bank look to call the Guarantee.

When making applications to credit line Guarantees, a repayment structure should always be included to demonstrate the ability to repay the credit without calling on the Guarantee.

See [Credit Lining Bank Guarantees](#)

### Issuing A Bank Guarantee

Any person or corporate entity with an account held at a mainstream bank can apply to issue a Bank Guarantee. Provided they hold to their account adequate assets, there should be no reason why a Bank will reject an application to issue a Bank Guarantee for bona-fide business purposes.

The account holder will simply request his Bank to issue a Guarantee and supply them with the reasons behind its issue. The bank would have a simple application form for this service. The account holder will submit the bank the application containing details of the underlying commitment being entered into whilst supplying the bank with information such as; (a) how long the Guarantee should be for, (b) any conditions on the payment, (c) the amount and currency, and of course (d) details of the Beneficiary and their bank details etc.

The Bank in-turn will request that the account holder enters into some form of pledge agreement with them. This means that before the bank agree to issue a Guarantee, the Bank would require a pledge or lien over assets of the account holder to secure the Guarantee. The assets acceptable for a bank to issue a Guarantee are generally liquid assets such as cash at bank, stocks and shares and bonds. In other words, assets that can be instantly liquidated.

It is increasingly less common for banks to accept less liquid assets such as real estate property, although the decision to accept the asset is ultimately that of the bank.

In essence and for example, if an account holder wanted to issue a third party with a Bank Guarantee for US\$50 million, it would be necessary to pledge cash, stocks or bonds to the his bank for a minimum of this amount. It is highly unlikely that a bank would agree to issue a Guarantee on behalf of their account holder without holding assets of equal or higher value. It is 'for value received.....'.

Once the bank has charged, liened or blocked the assets on the account holders bank account at the bank, the same bank will issue a Guarantee in accordance with their account holders specifications.

The Issuing Bank will remit the Bank Guarantee to the Beneficiary Bank initially by SWIFT. (See [SWIFT](#))

Normally, the Bank may pre-advise the Beneficiary Bank by sending a SWIFT MT799 which is only a notice outlining the Issuing Banks instructions to remit a Guarantee, or to verify information in advance of the issue.

The Issuing Bank will then send the Bank Guarantee also by SWIFT MT760. (See [MT799](#) and [MT760](#).)

Most banks will also send an original paper copy (which takes the appearance of a letter) by post to the Beneficiary Bank. It is courteous for the Beneficiary Bank to remit a message or letter back to the Issuing Bank confirming its safe receipt and acknowledgment.

### **Receiving A Bank Guarantee**

If you are lucky enough to have a Bank Guarantee issued to you, you will certainly know what it is for. Most commonly, landlords may receive Bank Guarantees for rent deposits from their tenants for example.

If you have entered into a separate contract for an investor to issue you a Bank Guarantee to secure a credit line, then you would have certainly executed contracts with them by this stage.

It is highly unlikely that a Bank Guarantee will pop onto your bank account by surprise! If you do receive a Bank Guarantee and have no idea why, you should contact your bank immediately.

In receiving a Bank Guarantee, your bank will generally notify you and send you a copy of it (normally a SWIFT terminal printout) for your information. They will also inform you that it is verified and valid and will await your further instructions.

If you plan to receive a Bank Guarantee, it is important that you bank with a multi-national bank that understands them and can offer you a 'private' banking service. Generally we would advise working with Swiss Banks who operate the procedure well.

If you are intending to receive a Bank Guarantee from an 'investor' in order to secure a line or credit or loan, it is important to negotiate this facility with your bank before the Bank Guarantee arrives. This will save time and expenses.

The Bank Guarantee will normally be posted to a separate account in your name that the bank will open upon its arrival. It will be held on this account until it is either called for payment or it expires.

### **Credit Lining A Bank Guarantee**

If you intend to monetize or credit line a Bank Guarantee that you have received (or due to receive), it is important to ensure that the Guarantee contains no onerous conditions and that it is worded specifically for monetizing.

Draft Bank Guarantee wordings specifically used for securing credit lines can be downloaded from our [Downloads](#) centre on the SFP AG website. These draft documents are accepted by mainstream banks for monetizing.

Drawing credit lines against a Bank Guarantee that is conditional upon satisfaction of an action or other document may not be possible. For example, if you have a Conditional Payment Guarantee or a Rent Guarantee, a lending bank will not accept to credit line it as it cannot be considered as suitable security.

Generally, the purpose and intent of a Bank Guarantee should be made clear from the outset. If your intention is to monetize or credit line the Guarantee, then the Guarantee should be specifically worded for this purpose. If it is not, then you may very well find the Guarantee is worthless.

It would also be advisable to negotiate credit lines in advance of receiving the Guarantee. To provide draft wording to a potential lender and obtain his tentative commitment or term sheet prior to requesting issue of the Guarantee would be sensible.

### **Discounting A Bank Guarantee**

Discounting is a financial term. It means for a debtor to delay payment to a creditor for a given period of time by paying a charge or fee.

Since a Bank Guarantee is already an instrument to secure a future or conditional payment to specific parties, Bank Guarantees cannot be discounted.

#### **Bank Guarantees cannot be divisible or transferable.**

This is a common error and arises from misunderstanding the terminology. When one refers to ‘discounting a Bank Guarantee’, they often mean to credit line or borrow money against it. I would imagine that the term is misconceived by the fact that securing loans against a Bank Guarantee is often given on a Loan to Value (LTV) of the Guarantee’s face amount. A credit line against a Bank Guarantee may be given as a percentage of its face amount; i.e. to borrow 90% of the Bank Guarantee’s value is a ‘discounted’ amount of face value.

Some may refer to the fact that they already have a Bank Guarantee to their account from a third party and are willing to ‘transfer’ it to a lender (or buyer) in return for immediate cash. Since Bank Guarantees are written to a specific party for a specific purpose, they cannot be transferred or divisible. They cannot be bought or sold.

The term “to discount a Bank Guarantee” is an incorrect term and often used as ‘slang’ by unprofessionals who actually mean to ‘Credit Line’. Beware of any party that uses it.

### **‘Leasing’ Bank Guarantees**

Leasing is not really the correct term to use as it is not possible to actually lease a bank guarantee in this manner. It is a misnomer. We use the term loosely as its process is almost exactly that of commercial leasing. In effect, the Provider offers temporary ownership of his



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assets to the Beneficiary in return for a fee and at the end of the term the assets revert back to the ownership of the Provider. The assets are used to raise specific and non-transferable bank indemnities which the Beneficiary may utilize.

It is a misnomer as in effect no leasing takes place. Through a Collateral Transfer Agreement, a Provider will agree to place his assets with a facilitating bank.

The bank will charge the asset and will raise a bank indemnity against it in favour of the Beneficiary. This bank indemnity will commonly be in the form of a Bank Guarantee issued specifically for the purpose to the Beneficiary.

Collateral Transfer or Collateral Provision is the provision of assets from one party (the Provider) to another party (the Beneficiary) under a Collateral Transfer Agreement.

The Provider will effectively ‘lease’ his assets to the Beneficiary for a given term for a ‘rental’ or collateral fee.

Typically, the term of ‘lease’ would be 1 year but this can often be as long as 3 or 5 years, depending on the willingness of the Provider.

At the end of the term, the Beneficiary will return the collateral or allow it to lapse and indemnify the Provider against any losses that may be caused by the Beneficiary utilising the collateral or raising credit against it whilst it has been in his possession.

The Collateral Transfer Agreement will govern the conditions of the transaction, namely that the Beneficiary agrees to extinguish any lien or credit raised against the Bank Guarantee prior to its expiry. The Beneficiary will make provision that any loans secured against it are repaid at the end of the term of the Agreement.

Therefore, the Bank Guarantee being received by the Beneficiary is a Bank Guarantee issued for its intended purpose (for credit lines, security, etc). It should not be considered as a ‘leased bank guarantee’. Only the underlying assets of the Provider are effectively being leased (by definition of the word). This means that credit lining (or monetizing) such bank guarantees are in no way different from credit lining other bank guarantees issued for the purposes of raising credit.

Collateral Transfer therefore is an effective way for Providers to earn increased revenue from their assets and for Beneficiaries to raise bank credit.

### **Who ‘leases’ Bank Guarantees**

Traditionally, those sophisticated investors that hold large portfolios of assets such as medium to long term bonds generating low annuities may often be inclined to enter enhancement opportunities that allows them to receive additional returns over their portfolios. Generally these investors would enter into collateral transfer agreements allowing their assets to be used by third parties who pay them a rental fee and who enter into contract with them.

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This allows the investor to retain ownership of his assets and continue to receive his annuities thereon. In addition, the investor will receive additional returns from the rental fee giving him an enhanced return over his assets.

By collecting these assets into a pool and placing them with a world-renowned and acceptable bank, the investor will instruct the issue of a Bank Guarantee using these assets as the security. This Bank Guarantee will be sent to the receiving party. The receiving party will often credit line the Bank Guarantee in the usual way, see [Credit Lining Bank Guarantees](#).

Investors may be motivated to enter into collateral transfer agreements due to under-performance of their existing portfolios or where their portfolio has no annuity or is long-term. Some may be motivated by the quick returns that can be achieved.

Investors acting in this way may be referred to as “Providers” of collaterals. It is a growing area of collateral management.

### **Credit Lining ‘leased’ Bank Guarantees**

Credit Lining ‘Leased’ Bank Guarantees is in no way different from credit lining Bank Guarantees issued specifically for the purpose of monetizing.

As the Guarantee is specifically raised, it is not considered different in any way and does not alter the procedures or affect the standard ways in which Guarantees are monetized.

See [Credit Lining Bank Guarantees](#)

### **Costs of ‘leasing’ Bank Guarantees**

The costs and charges of arranging ‘Leased’ Bank Guarantees, or to give it its correct term, ‘establishing Collateral Transfer Agreements’, will largely depend on the Provider of the assets, i.e the Investor.

Depending on the status of the Investor and the quality of his portfolio being placed into the arrangement, it is common to attract investor’s interest at rates as low as 6% per annum to as high as around 12% per annum.

This is a ‘rental’ fee and is generally paid every year, or for longer contracts may be payable in advance for the term. Of course the longer the term, the lower the charges.

Applicants would be expected to fund legal costs and any associated bank fees and transfer taxes (if applicable). It would not be advisable to enter into any type of collateral transfer (or ‘lease’) arrangement unless one could afford to foot a bill of around 25 basis points (0.25%) of the amount they are seeking in advance and to ensure that they can sustain cost of borrowings at around 8% per annum, plus the costs of credit line interests of a further 3.5% per annum.

It is by no means a cheap way of borrowing, but it is quick and if done correctly can be very secure.

### **Format of a Bank Guarantee**

A Bank Guarantee will be drafted within strict and standard confines. When issued by SWIFT, the Bank Guarantee will contain fixed fields, each field is numbered and contains a specific item of data, such as date, expiry date, amount, etc.

When the Bank issues a Bank Guarantee, it will generally send it also in original form to the Beneficiary Bank by post of courier. It will take the form of a letter.

It will not look like a colorful certificate and will not contain fancy wax seals ! It will more than often look like a modest document printed on standard bank notepaper and signed off by an authorized officer of the bank.

### **SWIFT Messages**

SWIFT stands for Society for World-wide Inter-bank Financial Telecommunications and is an international organization. It provides means of secure communications between Banks and its members. Membership to the society is regulated and only vetted applicants are permitted to use the system at varying access levels.

It ensures that banks can communicate with each other and provided validation and verification checks on their communications. It operates largely as a database of varying levels of communication and transmittance of financial documents and messages. Physical documents cannot be sent by SWIFT.

To be able to send and receive authenticated SWIFT messages one must be accepted and subscribed to the Society.

Banks will have a trained SWIFT operator responsible for the management of SWIFT messages, both out-bound and in-bound. In smaller Private Banks, this may be one single individual. Larger banks will have SWIFT operator departments.

Each SWIFT message will have a Message Type (or MT) depending on the database field. For example, MT 100 relates to cash transfers and the sending of client funds between banks. MT 700 relates to Documentary Credits and Guarantees.

It is important to not complicate or refer to these SWIFT Message Types in professional communications since it will not concern either the client or recipient and is meant for inter-bank communication only.

## **MT799 Explained**

In dealing in Bank Guarantees (Demand Guarantees) and Letters of Credit (Documentary Credits), one may hear the phrase 'MT799'.

This is the SWIFT Message Type that Bank Guarantees can communicate authenticated free format messages securely. Inter-communicating banks may use this Message Type on their SWIFT systems to communicate various types of messages and offer pre-advise of intended transactions. This Message Type is free format, allowing the Operator to type freely various different messages connected with MT700 communications, i.e. Documentary Credits and Guarantees.

It is important not to get caught up in inter-bank jargon and would advise that this phrase is not used when discussing Bank Guarantees as it neither concerns the client nor the recipient. Its meaning is strictly inter-bank communication and nothing else.

## **MT760 Explained**

In dealing in Bank Guarantees, one may hear the phrase 'MT760'.

This is the SWIFT Message Type that Bank Guarantees are sent and received by inter-communicating banks. When sending a Bank Guarantee by SWIFT, the SWIFT Operator will enter the details on this Message Type relating to the specifics of the Guarantee.

It is only Bank Guarantees that are sent with this Message Type 760.

It is important not to get caught up in inter-bank jargon and would advise that this phrase is not used when discussing Bank Guarantees as it neither concerns the client nor the recipient. Its meaning is strictly inter-bank communication and nothing else.



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