TRADE AIDS

Bank guarantees, letters of credit and performance bonds are valuable business tools, says Will Spinney

Instruments where one party guarantees or stands behind the performance of another party (and outside intragroup arrangements) are in widespread business use. They may be a legal requirement, such as when tendering for some government contracts, and the issuer is almost always a financial institution such as a bank or insurance company. They go under many different names and some of the more popular options include an advance payment bond (which allows a customer to recover payment in the event that work is not finished or is of poor quality); a surety bond (which covers overall contractual performance); and a standby letter of credit (which has many uses, including supporting credit facilities).

A feature of these instruments (particularly if they are issued by a bank) is that they stand alone and are separate from the underlying supply contract. They establish a relationship between your bank (or other supplier) and your customer, over which you essentially have no control. Bank instruments are usually written so that the beneficiary can obtain immediate funds on a simple demand. They are essentially a blank cheque.

The instruments are very versatile and have many uses, so it is rare to find a company that has not issued some kind of bank guarantee, letter of credit, insurance or surety bond. But exporters, capital goods suppliers, long-term contracting companies and, in particular, extraction and construction companies tend to have the highest usage and these instruments form an important element of their capital structure.

Responsibility for issuing bank guarantees, letters of credit and performance bonds usually involves the treasurer at some stage, notably because they relate to credit usage. So the treasurer needs to understand the commercial dynamics around their issuance.

Supply and demand issues

To be able to issue these instruments, the issuer must have a credit line for the customer. The treasurer must therefore include this requirement, with appropriate headroom, within a funding/liquidity plan as part of an overall financial strategy.

The instrument should form part of the weighted average cost of capital or 'multiples approach' to leverage decisions.

The treasurer's role is to ensure the liquidity of credit facilities and the availability of suitable issuers. They also need to choose whether to centralise issuance of a guarantee or to keep it local, reflecting other decisions on treasury centralisation. But the interest of the treasurer does not end here. Other commercial factors that must be supervised by the treasury team include:

1. Economic. The full cost of the issuance must be taken to the underlying contract (and as with debt this is arguably higher than the headline rate). This might lead to cross-border charges and can result in losses. For example, when interest rates were 5% and fees were 1%, it was worthwhile seeking advance payments supported by a bond. If fees are 3% and interest rates are 0.25%, then some deep thought may be necessary. Advance payments are often cultural, however, and not something to refuse.

2. Text. The negotiation of the text of a guarantee is often the last thing to be looked at when talking to customers and suppliers, but there are pitfalls. Possible assignment of the instrument to a third party is one such issue and is not usually something you would do with a blank cheque. But there are other issues and it is easy to give in, which may not be the best course of action.

3. Expiry date. Many customers insist on guarantees without expiry dates, but these are inherently dangerous and often difficult for some banks to issue. Expiry dates beyond the life of committed facilities also need to be managed, usually by a requirement for cash collateral at maturity of the facility. Guarantees with expiry dates can lead to an 'extend or pay' demand, but that will, at least, focus minds. A good diary system is worth investing in, together with fast links to operating units to discuss commercial issues.

The management of these instruments in acquisitions and disposals also merits close attention by the treasurer.

As bonds, guarantees and letters of credit are an unavoidable part of trading, treasurers need to be on top of their liquidity, cost and commercial implications.

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