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## The importance of bank guarantees in modern business (business environment in Serbia)

### Abstract

In contemporary international payment transactions, there takes place frequent use of bank guarantees as collateral payment in commercial transactions. The bank guarantee is usually required when it comes to specific business agreements that require stronger commitment and assurance that all contractual obligations will be implemented exactly as indicated. Knowledge of the use of bank guarantees allows better negotiating position in making business, quicker response to the demands of public calls for tenders and the provision of their own claims. Because of its rapid and efficient implementation, the bank guarantee is one of the most commonly used collateral in international business.

**Keywords:** bank guarantee, business environment in Serbia, legal framework of bank guarantees.

**JEL Classification:** G21, M16, M21.

### Introduction

In the modern business environment, characterized by the spatial distance and the inability of the parties to perform a realistic assessment of the creditworthiness of a business partner, when it comes to commercial transactions, there is often a need for the use of instruments that secure payments. The reason for this is the fact that, in carrying out trade transactions, participants in international payments want for the security in the fulfillment of mutual contractual obligations to be as big as possible. In such circumstances, it is important to choose instruments of payment and security, which largely provide safety and minimize the effects of risk factors, whereby one of the most important instruments is the bank guarantee. Due to its lack of accessory, its abstractness and the fact that a quick and simple realization procedure allows coverage of a large number of risks, the subject of this paper will be legal regulation of bank guarantees and analysis of their use in Serbia. Through the presentation of the business environment in Serbia, we aim to provide a credible picture of how the use of bank guarantees represents an important instrument to ensure the enforcement of contractual obligations and payments. The authors believe that the existing legislation in this area is harmonized, but also give a recommendation that, in this regard, legal theory must follow the ways and needs of modern industrial practices. Therefore, legal activity in the coming period should be focused on the adoption of new or amendment of existing legislation in the field of regulation of the bank guarantee which, in comparison to other security instruments, represent the most effective mean of protection against financial risks.

### Literature review

Different literature sources were used for the analysis of the selected topic. In his work, Pavicevic (1999) dealt with the definition of the concept of the bank guarantee and the analysis of its importance in international trade. Furthermore, the subject of his analysis was the distinguishing of bank guarantees from other similar legal institutes and pointing out the advantages it has over other means of security. In their book, Ariana & Damirchiyeva (2013) orient themselves towards the research of the risks related to international payments and the manner of its operation. A special place in their analysis has the study of bank guarantees as one of the most important instruments to ensure the enforcement of contractual obligations and payments in international payment transactions. Bertrams (2004) deals with the classification of the types of bank guarantees, as well as the basic criteria for their classification. Accordingly, in his book, he gives an overview of the most important types of bank guarantees and points to the advantages it has over other collateral in international business. Knezevic & Lukic (2012) analyze the representation of bank guarantees in the modern banking business. The subject of their analysis are legal aspects of bank guarantees, but also a parallel view of their distribution and use in Serbia and neighboring countries. Micovic (2010) deals with the legal nature of the bank guarantee and, in his work, he gives an overview of the legal regulation of bank guarantee in common and civil law.

Vitez (2011) deals with the legal relations of the participants in the guarantee business, namely: the relationship between the creditor and the debtor from the core business, the legal relationship between the guarantor bank and the client, with special emphasis on the conclusion of agreements on the issuance of bank guarantees, the legal nature of the contract on the issuance of bank guarantees, as well as the rights and obligations of the parties

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that arise from this contract. Spalevic (2013) analyzes a bank guarantee as security from financial risks in the Republic of Serbia. Given the large number of risks affecting the company's operations in international traffic, management and risk control are increasingly becoming the central part of the strategic management of enterprises and the condition of its survival in the market. One of the most important instruments of security from risks in international business is certainly the bank guarantee. Knezevic (2015) deals with the legal regulation of the institute of bank guarantees in Serbia and, in his work, he gives an overview of the current situation and suggestions for some new legal solutions that should be made in order for the legal nature of the bank guarantee to be more fully defined.

In addition to these sources of literature and in order to provide a more effective analysis of the research subject, the paper used the financial statements of banks in Serbia and the laws regulating this area.

### **Methodology**

During the research process, the issue of bank guarantees will be discussed in an interdisciplinary manner, in order to comprehensively clarify a number of issues and propose appropriate solutions associated with these important instruments of security of payment in international trade. In accordance with the subject of the research, qualitative research methodology will be applied in this work. In the definition of the concept of the bank guarantee, when analyzing its legal nature and in identifying its key features, analytical scientific methods and procedures of descriptive and explicative analysis will be used.

Using the appropriate domestic and foreign literature will be the basis for pointing out the connection and mutual dependence of the studied phenomenon, and the source documents, studies, reports, statistical documentation and other sources will be used as the primary basis for the analysis of the importance of the bank guarantee in modern business.

In addition to qualitative, quantitative research methodology based on the use and explanation of relevant quantitative data will be applied in this paper. In this regard, it uses the corresponding quantitative methods, as follows: econometric models and methods and statistical analysis. For clarity of presentation of analyzed issues, different tables and graphs will be used.

Finally, methods of synthesis and generalization methods should enable us to summarize and link all relevant data and carry out the appropriate conclusions about the selected object of research.

### **The importance of bank guarantees in international business**

The bank guarantee represents a unilateral legal transaction by which a bank guarantor undertakes an obligation to guarantee to pay the beneficiary a certain amount of money specified in the guarantee if certain conditions are fulfilled, or if the debtor from the original contract does not fulfill or fulfills his contractual obligations improperly (Pavicevic, 1999, p. 129).

The bank guarantee is one of the most commonly used means of security that provides significant benefits to the participants in international business. By issuing guarantees, the interests of the seller are protected since the bank guarantee provides the collection of sold and exported goods. In international business, sellers are usually not aware of the financial situation of the customer and the results of his operations and, therefore, the sales contract with the unknown business partner contains certain risks, especially when it comes to the shipment of good without securing its payment. By opening a bank guarantee, this risk disappears, because aside from the buyer from the sales contract, the guarantor bank which issued the guarantee is also directly responsible towards the seller, and the seller will trust the guarantor bank and he is sure that the bank will pay him the amount from the guarantee if he fulfills the conditions specified in the contract (Ariana & Damirchiyeva, 2013, p. 436).

As an independent legal transaction, banking guarantee gained great importance in matters of international trade in recent decades, so today we can hardly imagine and conclude any serious contract with a foreign partner without its fulfillment being provided through a bank guarantee.

Compared to other means of personal security, bank guarantee proves to be more suitable, since due to its abstractness and lack of accessory it provides a broader protection of economic interests of the creditors. Thus, in addition to the risk of insolvency of the debtor and voluntary refusal of fulfilling the obligations, the bank guarantee may cover other types of risk such as: the risks of force majeure, administrative restrictions and risks of invalidity of the main business. These comparative advantages arising from the lack of accessory and from the abstractness of the bank guarantee, are accompanied by a relatively simple procedure of its realization that allows fast and uncomplicated payment claims (Bertrans, 2004, p. 47)

Due to such characteristics, bank guarantee occurs as an institution that significantly influences the

improvement of international economic relations. In modern conditions of ignorance and growing distrust among the participants on the global market, when it comes to all major auction and other business deals, contracts should be entered into primarily with well-known and reliable business entities from developed countries, even if their offers are not the best. With bank guarantees, companies from the less developed countries get a great deal on the competitiveness of their offerings in international affairs, because with their acceptance contractual partners are not placed in a less advantageous position in terms of risk of realization of their claims. Bank guarantees are, thus, creating a higher level of security of creditors

and significantly affecting the stabilization of relations in the international market.

### The bank guarantee as an instrument to secure payments in Serbia

Bank guarantees are one of the most important instruments of security in international business and, consequently, in Serbia. Granting of guarantees is one of the most important banking activities, in which banks must thoroughly examine transaction and the risk rating of their clients.

At the end of 2015, Serbian banking sector consisted of 30 banks, with an organizational network of 1.730 business units, which employed 24.257 persons.

Table 1. Overview of selected parameters of the Serbian banking sector on the day of 31.12.2015

	Nr. of banks	Assets	Participation %	Capital	Participation %	Network	Participation %	Employees	Participation %
		Billion RSD		Billion RSD		Nr. of business units		Nr. of employees	
Banks owned by domestic legal entities	7	729	23.9%	139	22.5%	473	27.3%	5.752	23.7%
State	6	550	18.0%	87	14.1%	416	24.0%	5.142	21.2%
Private	1	179	5.9%	52	8.4%	57	3.3%	610	2.5%
Banks owned by foreign legal entities	23	2.319	76.1%	480	77.5%	1.257	72.7%	18.505	76.3%
Italy	2	796	26.1%	176	28.4%	248	14.3%	4.155	17.1%
Austria	3	453	14.9%	93	15.0%	214	12.4%	3.397	14.0%
Greece	4	395	13.0%	90	14.5%	291	16.8%	4.412	18.2%
France	3	316	10.4%	49	7.9%	213	12.3%	2.558	10.5%
Rest	11	359	11.8%	72	11.6%	291	16.8%	3.983	16.4%
Total banking sector	30	3.048	100%	619	100%	1.730	100%	24.257	100%

Source: NBS – National Bank of Serbia.

Total net balance sheet assets of the banking sector in Serbia at the end of December 2015 amounted to 3047.8 billion dinars, and the total balance sheet capital of 619.1 billion dinars. Dominant participation in Serbia's banking sector belongs to the banks with foreign origin, and those are to the greatest extent banks originating from Italy, Austria, Greece and France, and their cumulative amount account for over 64% of the Serbian banking sector. At the end of the fourth quarter of 2015, total off-balance sheet items of the banking sector in Serbia amounted to 7134.4 billion dinars, with most of the off-balance sheet items (90.8%) referring to the risk-

free position, which largely comprises of received tangible means of security and received guarantees and sureties for the settlement of obligations of bank's debtor. Off-balance sheet positions are the most concentrated segment of business banks in Serbia. Part of the off-balance sheet items which are classified, or which are considered risky, at the end of 2015 amounted to 655.2 billion dinars. During this period, the assumed future commitments which included guarantees and other sureties, commitments for undisbursed loans and advances and other irrevocable commitments amounted to 452.7 billion dinars.

Table 2. Overview of the level of off-balance sheet positions of the banking sector in Serbia (in million RSD)

	Amount	The change compared to previous periods			
		Nominal		Relative	
		30.09.2015.	31.12.2014.	30.09.2015.	31.12.2014.
Issued guarantees and other sureties	271.007	7.773	3.289	3.0%	1.2%
Receivables from derivatives	446.669	6.780	-46.359	1.5%	-9.4%
Assumed and other irrevocable commitments	181.717	21.426	6.982	13.4%	4.0%

Table 3 (cont.). Overview of the level of off-balance sheet positions of the banking sector in Serbia (in million RSD)

	Amount	The change compared to previous periods			
		Nominal		Relative	
	31.12.2015.	30.09.2015.	31.12.2014.	30.09.2015.	31.12.2014.
Bonds received as a forfeit	148.104	-1.737	-67.215	-1.2%	-31.2%
Guarantees for commitments	84.644	3.244	759	4.0%	0.9%
Other off-balance sheet assets	5.917.913	33.252	1.057.489	0.6%	21.8%

Source: NBS – National Bank of Serbia.

As you may see in the table, the most significant off-balance sheet items that carry credit risk at the end of 2015 in banks in Serbia are claims from derivatives and guarantees and other sureties. Bank guarantees are contracts that oblige the bank as an issuer of the guarantee to make a payment or compensate the guarantee beneficiary for the loss incurred in case a certain creditor fails to perform its

obligations in accordance with the terms of the contract. In this way, by issuing a guarantee the bank exposes itself to related credit risks, which could be overcome by the same control processes and procedures. In the normal course of business, banks in Serbia mostly approve financial guarantees, consisting of payable and performance guarantees in dinars and in foreign currency.

Table 4. Overview of approved performance guarantees bank guarantees in banks in Serbia in the period 2011-2015 (in thousands of RSD)

		2011	2012	2013	2014	2015
Unicreditbank	in dinars	11.356.361	14.633.617	24.223.369	26.298.074	28.076.270
	in foreign currency	2.232.678	2.358.767	2.708.909	3.553.069	3.414.485
Serbian bank	in dinars	981.203	875.956	760.415	279.726	113.173
	in foreign currency	4.634.282	6.757.654	6.713.900	7.364.870	5.394.334
Piraeus bank	in dinars	5.452	16.197	870.227	604.821	541.659
	in foreign currency	17.616	60.514	26.378	1.675.754	1.842.435
JUBMES bank	in dinars	791.785	432.225	385.025	460.392	505.737
	in foreign currency	638.904	1.152.356	1.089.883	1.545.426	839.563
Erste bank	in dinars	2.532.147	4.049.615	6.084.031	6.260.084	3.797.991
	in foreign currency	869.477	754.871	766.391	1.489.374	4.254.053
BancaIntesa	in dinars	11.721.200	11.469.481	12.184.225	11.852.670	13.491.893
	in foreign currency	1.917.325	1.405.864	1.179.761	1.751.753	1.416.203
AIK bank	in dinars	3.507.991	1.803.200	2.125.872	3.681.954	3.055.926
	in foreign currency	1.792.030	991.703	775	1.359.839	1.535.209
NLB bank	in dinars	1.120.422	609.415	586.353	616.142	540.570
	in foreign currency	224.619	189.896	162.205	123.607	95.357

Source: financial statements of banks.

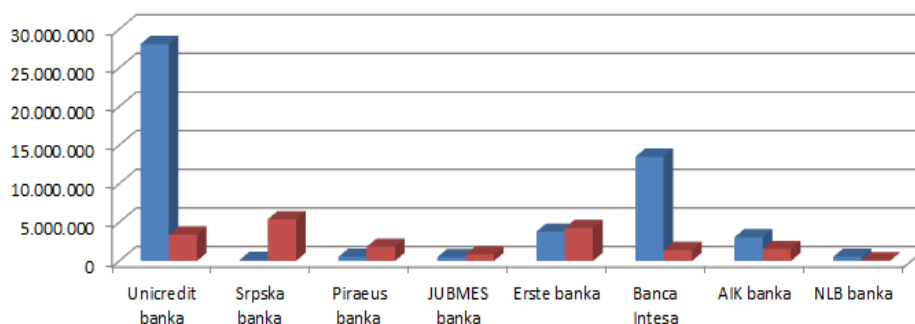


Fig. 1. Performance guarantees approved in 2015

Payable guarantees guarantee regular payment obligations under the contract of main business, for payment of liabilities for received loans or for the orderly settlement of other financial obligations

from business operations. In accordance with that, the most common payable guarantees that banks in Serbia approve of are: the guarantee of payment, the guarantee to secure loans and customs guarantees.

In addition, other frequent guarantees are guarantees for security deposits during the participation in the privatization of enterprises and guarantees issued in favor of the Development Fund of Republic of Serbia for the repayment of loans (Knezevic & Lukic, 2012, p. 47).

Table 5. Overview of approved payable bank guarantees in banks in Serbia during the period 2011-2015 (in thousands of dinars)

		2011	2012	2013	2014	2015
Unicredit bank	in dinars	8.024.435	8.109.189	9.336.651	8.148.731	10.412.279
	in foreign currency	8.758.463	9.427.355	5.496.059	8.445.433	9.621.742
Serbian bank	in dinars	1.247.185	1.807.105	947.233	781.971	237.783
	in foreign currency	171.433	176.077	152.623	30.033	33.567
Piraeus bank	in dinars	1.150.170	283.024	723.740	319.262	282.011
	in foreign currency	807.045	453.685	514.704	901.837	583.459
JUBMES bank	in dinars	583.949	471.660	366.565	791.967	544.338
	in foreign currency	87.770	112.315	253.824	34.378	13.379
Erste bank	in dinars	1.232.910	1.343.433	1.181.763	540.550	1.200
	in foreign currency	146.356	43.088	103.178	110.794	527.918
Banca Intesa	in dinars	14.773.531	13.217.135	11.754.072	9.482.359	9.190.002
	in foreign currency	10.579.575	10.012.363	11.378.167	13.568.853	12.489.925
Alk bank	in dinars	3.820.376	3.381.556	4.461.547	3.465.721	3.250.515
	in foreign currency	1.445.664	1.389.928	183.194	144.012	957.982
NLB bank	in dinars	1.202.344	687.818	508.897	269.009	211.307
	in foreign currency	118.372	108.942	73.715	52.762	34.306

Source: financial statements of banks.

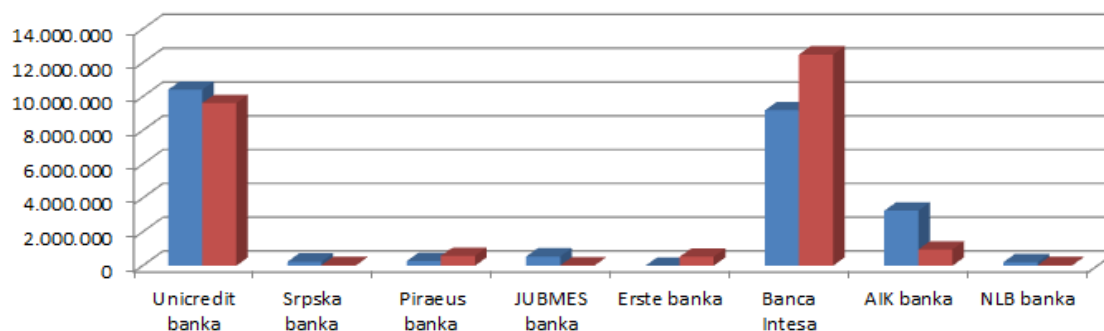


Fig. 2. Approved payable guarantees in 2015

Based on the given analysis, we can conclude that bank guarantees in Serbia are an important instrument for ensuring the enforcement of contractual obligations and payments. Due to the low liquidity of the economy, companies in Serbia are facing with partial or complete inability to collect receivables in their business operations, which is why it can be argued that the bank guarantee will be one of the most frequently used security instruments in the future.

### The legal framework of bank guarantees

Banking operations are separate economic activities whose main object of business is the turnover. Banking operations are legal transactions concluded between banking organizations concerning the legal turnover of money and performing business services. They are carried out according to the rules of the banking profession and other authorized entities instead of banks can participate in them, but the rules of banking operations (business) still apply to them (Micovic, 2010, p. 485).

Until the adoption of the Law on Obligatory Relations (Official Gazette of SFRJ, no. 29/78, 39/85, 45/89 – decision USJ and 57/89, Official Gazette of SRJ, no. 31/93 and Official Gazette of SCG, no. 1/2003 – Constitutional Charter), the legal system in Serbia has not adequately been regulating the affairs of the bank guarantee (bank guarantee operations/business). Legal issues of bank guarantees were resolved by using an analogous application of certain existing solutions in comparative law, as well as by insufficiently shaped domestic rules of customary law. With the adoption of the Law on Obligatory Relations, law in Serbia entered the order of the few legal systems in the world, which have been regulating the matter of bank guarantees by using substantial and legal norms.

The law defines the obligations of the bank towards the holder of a guarantee, whereas if the third party fails to fulfill the obligation at maturity date, the bank would settle the obligation if the conditions specified in the guarantee are fulfilled. The law prescribes the written form of a bank guarantee as a

condition of validity and its cash character. There is a possibility of ceding the rights from guarantees, along with the transfer of receivables provided by the guarantee. The law stipulates a special type of bank guarantee which contains the clause “without protest”, “first-call” or other words with the same meaning, which specifies that when it comes to this type of bank guarantee, the bank cannot point out those kinds of objections to the creditor from the main business, which the principal, as a debtor, has towards the guarantee beneficiary (Law on Obligatory Relations, Art. 1087).

Substantive legal provisions regulate the obligation of recourse of cash amount of the bank guarantee by the principal towards the guarantor bank that carried out the payment of the guarantee. The law provides an exceptional possibility of recourse by the principal from the beneficiary of the bank guarantee only in case when the beneficiary unjustifiably collects the guarantee from the bank, due to justified complaints from the principal towards him.

In the context of the above said statement, it follows that the business regarding the bank guarantee must be seen as an independent and non-accessory legal transaction, especially in the case of doing business in international trade. In the domestic law, sources of law governing bank guarantees, in addition to the Law on Obligatory Relations, also include other regulations which are mainly imperative. Banking Law (Official Gazette of RS, nr. 107/2005, 91/2010 and 14/2015) regulates the issues of establishment, operations, organization and management of the bank, as well as the termination of work of the bank as a joint stock company.

The banking operations are classified: deposit transactions (accepting and placing deposits), credit operations (lending and borrowing), foreign-currency and exchange operations, payment transactions (Knezevic, 2013, pp. 267-281), issuance of payment cards, transactions with bonds, broker-dealer operations, issuance of guarantees, avals and other forms of guarantees, buying, selling and collecting payments, insurance agency and other tasks which are essentially similar or associated with such operations (Banking Law, Official Gazette of RS, nr. 107/2005, 91/2010 and 14/2015, art. 4).

Special kind of banking services through which the bank performs certain services to third parties upon client's order include opening letters of credit and issuing bank guarantees (Knight, 2011, p. 57)

Foreign Exchange Law (Official Gazette of RS, nr. 62/2006, 31/2011, 119/2012 and 139/2014) and the Law on foreign credit business, regulate the issues of bank guarantees in dealings with foreign elements (Spalevic, 2013, p. 297).

According to the Foreign Exchange Law, the bank may, in accordance with the regulations of the Banking Law and this Law, issue guarantees, sureties and other forms of securities under current and capital transactions between residents and non-residents and obtain guarantees from foreign banks and guarantees and sureties of non-residents in these transactions. The Bank may, in accordance with the regulations on banks, obtain guarantees from foreign banks and guarantees, warranties and other means of security of non-residents from claims of residents (Foreign Exchange Law, art. 26).

Certain provisions of the Law on Credit Relations with Foreign Countries are important for banks, because they determine the conditions under which banks can engage in deposit, credit and other banking services with foreign countries, within which they may give sureties, guarantees and avals.

Along with laws as sources of law in domestic turnover, there are also bylaws. One of them is the Rule on compulsory elements of tender documentation in public procurement procedures, stipulating the mandatory elements of tender documentation in the public procurement process. Among the above-mentioned elements there are types of financial security provided, with special attention paid to the bank guarantee as a mean of security in public procurement (Tomic, 2009, p. 28).

In addition to this Rule, there is a large number of other by-laws, first of all, the decisions of the National Bank of Serbia and the regulations of the Government of the Republic of Serbia, specifying certain issues of bank guarantees. It should be noted that the Association of Serbian Banks accepted the sources of the autonomous commercial law, namely: Uniform Rules for Contract Guarantees from 1978 and the Uniform Rules for Demand Guarantees from 2010. Within domestic traffic, these rules can be applied as contractual rules, if the contracting parties expressly agree upon their application.

For quite some time, now Serbia has been working on the codification of civil rights law through the adoption of the Civil Code of the Republic of Serbia (Official Gazette of RS, nr. 104/06, 110/06 and 85/09), which is not limited to a simple reception of existing special laws in this area and their technical shaping in terms of the Code, but should include an analysis of existing legislation, their modernization and expansion and, in particular, their compliance with the achievements of modern civilization, law, legal theory and practice. Codification of existing legislation requires their harmonization with solutions ratified by international conventions, and other international standards, in particular, with the European Union law.

Starting from the applicable legislative solutions, a special significance in the Draft of the Civil Code of the Republic of Serbia has a part which regulates banking transactions. With the adoption of the new Civil Code banking activities should be viewed in the light of the new business environment and the need of harmonization with EU regulations. The Civil Code should regulate the bank guarantee in such a way that it leaves the possibility for strengthening and developing new, adaptable and changed regulations (Knezevic, 2015, pp. 445-459).

According to the draft of the new Civil Code, the institute of the bank guarantee should not be regulated in the section on banking activities, because this is not only the institute of Banking Law, but more specifically a specific personal security instrument, where the role of the guarantor doesn't necessarily imply the bank as its operator, but also every other economic entity.

### Conclusion

The permanent increase in the volume of business activities and complexity of business relations between economic entities has resulted in the

increasing problem of security claims and uncertainty of business. Bearing in mind the fact that the entities participating in the implementation of commodity and non-commodity turnover are faced with elements of insecurity and uncertainty, stemming not only from their financial position, but more often from the fact the various institutional factors, the paper emphasized the importance of using bank guarantees as security instruments in modern turnover. In addition to that, the paper provides an analysis of the use and of legal regulation of bank guarantees in Serbia. Serbia belongs to a narrow circle of countries in which the bank guarantee is regulated by law in a general manner.

Modern commodity-monetary transactions are characterized by abundance of subjects, their mutual ignorance and mistrust, as well as a variety of business risks. In these conditions, bank guarantee has affirmed itself as a very important and indispensable mean of security, guaranteeing maximum security to both the beneficiary and the principal in the realization of the contracted transaction.

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