



Performance guarantees

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Agenda

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 - Risk assumed by the Guarantor
- Implicit parental support
- No guarantee fee or nominal guarantee fee
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What is a performance guarantee?

- Related to contractual obligations ... usually project-related ... and long-term in nature ... a commercial transaction
- Involves an event occurring before there is any liability ... such as non-performance of terms in a contract
- Not a financial guarantee which involves a guarantee of payment of a third party loan or other debt obligation
- Frequently seen in industries, such as shipping, construction and engineering, defence, government

Players

- Guarantor - the entity that is issuing the performance guarantee (directly or through a Bank); usually the Guarantor is the Parent of the multinational group or a FinCo (member of the multinational group)
- Contracting Party - the member of the multinational group that is entering into a commercial contract with a third party and requires a performance guarantee to do so
- Guaranteed Party - the third party / counterparty to the commercial contract with the Contracting Party that is the beneficiary of the performance guarantee

Considerations...

- First, is it a requirement in the Contracting Party's industry that performance guarantee is provided in order for the Contracting Party to be able to conduct business?
- Second, would the Contracting Party have sufficient creditworthiness to obtain a stand-alone performance guarantee (standby letter of credit / guarantee) from a bank or (surety bond) from an insurance company?
- Third, does the issuance of performance guarantees provide an opportunity for economic benefit (profit) to the Contracting Party?

...Considerations

- Fourth, what is the economic risk being assumed by the Guarantor and can it be quantified?
 - Assumes the risk that the Contracting Party under the third-party contract would be unable to complete its contractual obligations to the Guaranteed Party and defaults on reimbursing the Guarantor for its payment under the performance guarantee
 - If the performance guarantee is called then the Guarantor "steps into the shoes" of the Contracting Party to complete the contract ... or ... pays the financial penalties as defined in the contract (and guarantee)
 - Typically, a bank would consider a performance guarantee to be less risky than a loan or financial guarantee (less capital is allocated to performance guarantees) ... thus lower price

Implicit parental support

- Does implicit parental support exist?
- What impact does it have on performance guarantee fee?

No guarantee fee

- Guarantees issued without any economic benefit to the Contracting Party. Does this ever happen?
- The risk to the Guarantor is non-existent. Is this ever the case?
- Nominal guarantee fee ... If risk to the Guarantor is low and/or benefit to the Contracting Party is not significant and/or Guarantor obtain sufficient collateral benefits from the commercial contract

Methodologies that DO NOT WORK for performance guarantees

- NO - Yield Spread Analysis
- NO – Interest Rate Savings
- NO – Option Pricing Models

Methodologies to consider...

- CUTS => Comparable uncontrolled stand-by letters of credit / letters of guarantee issued by banks on behalf of companies with comparable credit risk as the tested party to apply the CUP method
 - Letters of Credit facilities in Credit Agreements filed by companies with the US SEC
 - Tested party must be of sufficient creditworthiness to be able to obtain a credit facility to issue Letters of Credit
 - The risk associated with the performance guarantee must be quantifiable; related to the credit risk of the tested party

...Methodologies to consider...

- Profit split method => The relative contribution made by the Guarantor in providing the performance guarantee for the third party contract is economically significant in the circumstances
 - The Contracting Party is, due to its lack of creditworthiness, deemed not to be able to establish a letter of credit facility with a bank
 - The performance guarantee is a requirement of the Contracting Party entering into a commercial contract with the Guaranteed Party

...Methodologies to consider

- Other => using finance theory to determine the return the guarantor would require to compensate for the risks assumed
 - Monte Carlo simulation to calculate the expected value in the event that non-performance under the contract occurs
 - The expected loss (EL) in the event that the Contracting Party does not cure the non-performance event is the Probability of Default times the Loss Given Default
 - The return on the Guarantor's economic capital at risk (or unexpected loss)

Example 1: Bank issues guarantee

- Facts: The Parent has credit facilities with a bank which allows it to issue standby letters of credit / guarantee (LC). On behalf of the Parent's Subsidiary the bank issues a LC to a third party (Guaranteed Party) as a performance guarantee under a commercial contract between the third party (Guaranteed Party) and the Subsidiary, a related party of the Parent / Group (Contracting Party). The Subsidiary indemnifies the Parent for the LC issued by the bank drawing on its letter of credit facility
- Issues: The bank charges the Parent a guarantee fee based on the Parent's creditworthiness. But what should the Parent charge to the Subsidiary? The intercompany transaction is an indemnity from the Contracting Party to the Guarantor
- Methodology: Benchmark the arm's length LC fee that the Subsidiary would pay for issuance of a performance guarantee without the explicit support (guarantee of the Parent). Consists of bank's fee to Parent plus the use of Parent's LC facility

Example 2: Parent issues guarantee

- Facts: The Parent issues a corporate guarantee to a third party (Guaranteed Party) as a performance guarantee to a commercial contract between the third party (Guaranteed Party) and the related party of the Parent / Group (Contracting Party). The related party (Contracting Party) indemnifies the Parent for issuing the performance guarantee
- Issues: Could the Contracting Party have obtained a stand-alone performance guarantee from a third party?
- Methodology: Need to benchmark the arm's length LC fee for the Sub to issue a performance guarantee without the guarantee of the Parent. Downward adjustment to performance guarantee fee due to Guarantor's collateral benefits related to the commercial contract

Q&A

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