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INTERNATIONAL BANK GUARANTEES IN A GLOBALIZED WORLD

The financial, commercial, legal and political risks of international trade transactions

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Thesis presented to Escola de Administração de Empresas de São Paulo of Fundação Getulio Vargas, as a requirement to obtain the title of Master in International Management (MPGI).

Knowledge field: Internacionalização de Empresas

Advisor: Prof^a. Ligia Maura Costa

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To my parents, who have always been supportive and who made everything possible. To my brother, who was always there for me.

ABSTRACT

This thesis discusses the financial, commercial, political and legal risks of international trade operations involving International Bank Guarantees. It starts by defining the most usual international trade instruments and, then, defining Standby Letters of Credit, Performance Bonds and Bid Bonds issued according to the ISP 98, URGD 758 or UCP 600 as International Bank Guarantees.

Later, it explores each specific risk. The financial risks are divided into foreign exchange risk, applicant's default risk and bank reputation risk. It is considered as a commercial risks frauds and low quality products. Legal risks are legal battles and local legislation. There is a topic that discusses specifically the U.S. related risks, as the country has a very particular legislation when it comes to International Bank Guarantees. The political risks are related to commercial embargoes and sanctions, changes in foreign policy and to the deterioration of commercial relations.

The following section discusses how to mitigate each of the risks discussed. It shows whether or not this risk can be mitigated and if it also affects international trade operations that do not use International Bank Guarantees. Lastly, the thesis discusses about the ideal international trade instrument. At the moment, International Bank Guarantees are the best instrument, still not the perfect one as it has some limitations.

Key words: International Bank Guarantees, Standby Letter of Credit, Performance Bond, Bid Bond, International Trade.

RESUMO

Esta tese debate os riscos financeiros, comerciais, políticos e legais relacionados a operações de comércio internacional. A tese começa definindo os principais instrumentos usados em transações de comércio internacional. Em seguida, define como Garantia Bancária Internacional as Standby Letters of Credit, Performance Bonds e os Bid Bonds, emitidos de acordo com a ISP 98, URGD 758 ou UCP 600.

Depois, a tese explora os riscos específicos das Garantias Bancárias Internacionais. São considerados riscos financeiros o risco cambial, o risco de calote da parte que solicitou a garantia e o risco de reputação dos bancos envolvidos na transação. Riscos comerciais são as fraudes e produtos de má qualidade. Os riscos legais analisados são referentes a batalhas judiciais e legislação local. Além disso, há uma parte da tese dedicada a discutir especificamente os riscos relacionados a legislação americana, que é muito diferente dos outros países em relação a Garantias Bancárias Internacionais. São considerados riscos políticos embargos e sanções comerciais, mudanças na política externa e a deterioração das relações comerciais entre dois países.

A última seção da tese discute como mitigar os riscos envolvidos em transações com Garantias Bancárias Internacionais. Nesta parte, discute-se quais riscos podem ou não ser mitigados e quais riscos são inerentes a transações comerciais internacionais, independentemente do uso de Garantias Bancárias Internacionais. Conclui-se que, no momento, Garantias Bancárias Internacionais ainda são o melhor instrumento para assegurar transações comerciais internacionais. Contudo, estes instrumentos ainda não são perfeitos e estão sujeitos a muitos riscos e limitações.

Palavras chave: Garantias Bancárias Internacionais, Standby Letter of Credit, Performance Bond, Bid Bond, Comércio Internacional.

Glossary

ICC: International Chamber of Commerce

International Bank Guarantee: Standby Letters of Credit, Performance Bonds and Bid Bonds issued according to the ISP 98, URGD 758 or UCP 600.

EU: European Union

FGC: Credit Guarantee Fund (Brazilian fund to secure banks)

GPA: Grupo Pão de Açúcar, a Brazilian chain of retail stores.

ISP: International Standby Practices

OFAC: Office of Foreign Assets Control of the US Department of the Treasury

SBLC: Standby Letter of Credit

UCC: Uniform Commercial Code

UCP: Uniform Customs and Practice for Documentary Credits

URDG: Uniform Rules for Demand Guarantees

WTO: World Trade Organization

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1. Introduction

International trade exists since the early times, when merchants would travel around different countries trading and selling goods. The world has come a long way since then: industrialization, development of new technologies, communication and transportation, and globalization have enabled an increase in international trade and shortened the distances. However, despite being easier to establish economic relations with companies from overseas, there are many risks involved in international transactions that restrain its growth.

Until World War I, it was very risky importing goods from other countries and even selling goods overseas. On one hand, buyers were unsure about the quality of the goods they were paying for and couldn't be sure they would be delivered at all. On the other hand, sellers were afraid they wouldn't be paid for the goods they were selling. Thus, with the economic imbalances that World War I caused, it was necessary to find ways of mitigating risks and increasing the safety of international trade. This is the context where International Bank Guarantees were created (Costa, 1994).

1.1. International Bank Guarantees

International Bank Guarantees were designed to reduce the risks of international trade transactions, by introducing a third-part that is neutral to the operation and that entitled to act as a guarantor. It is issued by a bank (Guarantor) on behalf of a company to the benefit of a foreign beneficiary. This instrument is irrevocable, it can't be amended nor cancelled. It is to be paid on first demand, meaning that the Guarantor is entitled to pay the beneficiary immediately when claimed - without further investigating.

There are several types of international guarantees, some of them are defined and further explained below. However, for the purpose of writing this thesis it is necessary to delimitate that only Standby Letters of Credit, Performance Bonds and Bid Bonds, all of which should be issued according to the ISP 98, URGD 758 or UCP 600 are considered International Bank Guarantees.

1.2. The risks International Bank Guarantees

This thesis aims to understand the financial, commercial, political and legal risks of international trade operations involving International Bank Guarantees. Despite being created to eliminate the risks of international trade operations, International Bank Guarantees are still not risk free.

The first part of this thesis discusses the risks which those transactions are subject to, analyzing them through the side of Beneficiary, Applicant and Guarantor. Next, it discusses ways of mitigating and avoiding these risks for each of the parts. It is expected that at the end of this thesis, by using theory and practical examples, the following question is answered: are International Bank Guarantees still the best alternative to international trade despite its commercial, financial, political and legal risks?

2. Literature Review

International Bank Guarantees are a relatively new topic of study. However, in the past decades a significant amount of relevant work on International Bank Guarantees has been published around the world, especially in Europe and in the United States. Each country has its own laws when it comes to international trade; the International Chamber of Commerce (ICC) set rules and standards for International Trade and there are also other world level organizations such as the World Trade Organization (WTO) aiming to set fair standards. Despite all the regulation, there are still several legal disputes concerning International Bank Guarantees.

The main works on International Bank Guarantees that will be referenced in this thesis will be the work of Costa (1994), Dolan (1996) and Lesguillons (1985). The bank Nordea (Nordea Trade Finance, 2010) has published a practical and very informative booklet conveying an understanding on how International Bank Guarantees work, their role in international trade, as well as the rules and practices for the issuance of this instrument. The ICC also provides valuable information through the Uniform Customs and Practice (UCP, 2007) and on the rules it uses for arbitrating disputes related to international trade.

Gabriel (1988) has written a very useful and practical article discussing the risks and benefits of International Bank Guarantees. He considers aspects such as bank deregulation and financial risks. Polat (2012) discusses how International Bank Guarantees can be used for frauds due to the lack of information required prior to the payment of the guarantee.

Lastly, some of the findings were confirmed through interviews with people who have been working for years with International Bank Guarantees, such as Guilherme Lago (Appendix 1), Credit Suisse's Managing Director in Brazil and the Lawyer Luiz Augusto Prado Barreto (Appendix 3), who has worked with trading for years and has decades of professional experience in the area.

By using the referenced sources and more, this thesis will answer whether or not International Bank Guarantees are still the best alternative to international trade despite its financial, political and legal risks.

2.1. International Trade Instruments

There are several international trade instruments. The most used ones are the Letter of Credit; the Standby Letter of Credit; Performance Bond and Bid Bond.

2.1.1. Letter of Credit

A Letter of Credit, also known as Documentary Credit, is a method of payment rather than a guarantee. It is one of the most secure international trade payment methods when it comes to commercial transaction. This type of operation requires the bank to be completely neutral to eliminate risks and ensure soundness to the process (Costa, 1994). The ICC oversees the Letters of Credit through the UCP600, which has been effective since July 2007 (International Chamber of Commerce, 2017).

The payment to the exporter is guaranteed by the importer's bank upon the presentation of a series of documents regarding the Documentary Credit transaction (Danske Bank). The bank is entitled to ensure that all required documents were presented and that they comply with all the legal requirements; however the quality of the goods and other variables are not taken into account - only the documents supporting the transaction.

Here follows an example of a typical Letter of Credit:

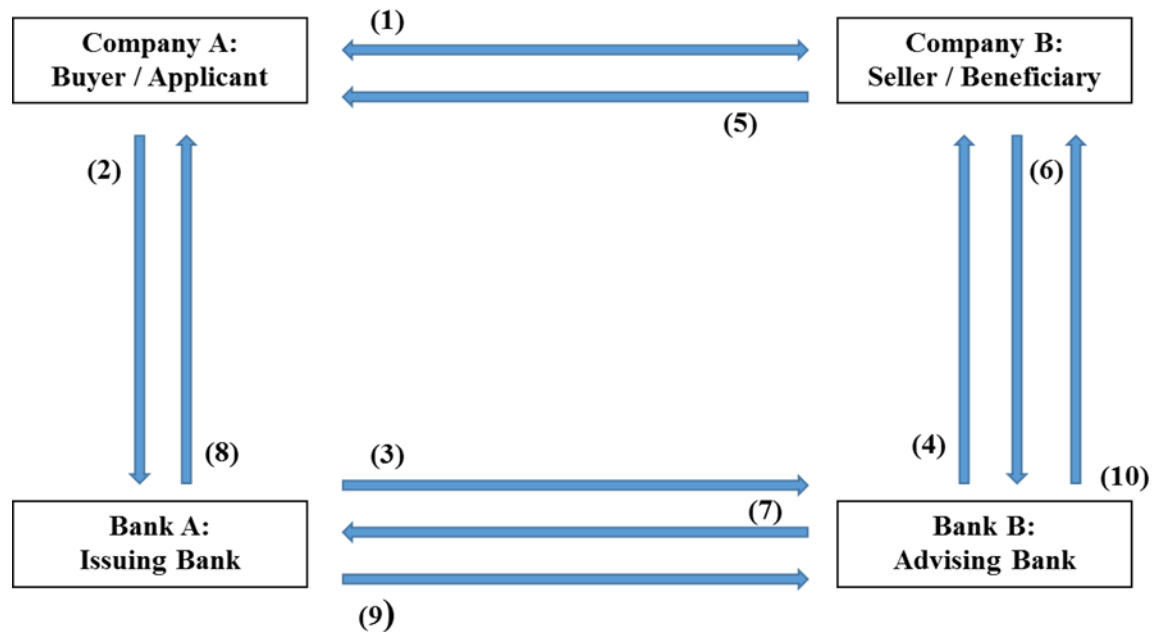


Figure 1 - Letter of Credit

- (1) Commercial contract between two companies
- (2) Company A applies for a Letter of Credit in favor of Company B
- (3) Bank A issues a Letter of Credit and sends to Company B's bank
- (4) Bank B authenticates the Letter of Credit
- (5) Company B ships the goods
- (6) Company B sends Bank B the documents of the transaction
- (7) Bank B sends Bank A the documents of the transaction
- (8) Bank A authenticates the documents and sends the documents to Company A so it can have access to the goods
- (9) Bank A makes the payment to Bank B
- (10) Bank B pays Company B

2.1.2. Standby Letter of Credit

Unlike the traditional Letter of Credit, a Standby Letter of Credit is a beneficiary oriented payment instrument, documentary by nature and independent of the financial transaction (MsLaughlin, 1993) meant to be used in case of default by the Applicant. It is not expected to be utilized by the beneficiary - as it is a last resort payment. Therefore, it is considered a guarantee rather than a payment instrument (HSBC, 2017). The SBLC is a sign of good faith in a business transaction, proof of ability to repay and of good credit quality.

Despite being more flexible than a traditional Letter of Credit, the SBLC is an irrevocable documentary commitment separated from the commercial agreement (HSBC, 2017). It can be used on the most diverse situations, usually taking the place of the Performance Bonds or other Guarantee arrangements (Gabriel, 1988), such as Bid Bonds, Advance Payment Guarantees, Retention Guarantees or Financial Guarantees (CIBC, 2017).

To have access to the guarantee, the beneficiary must prove to the bank through documents that the conditions of the contract haven't been fully honored. The ICC oversees the SBLCs mainly through the ISP 98 and the URGD 758. The UCP600, under certain circumstances, may also set the rules for the SBLC (International Chamber of Commerce, 2017).

Here follows a graphic example of how a SBLC works.

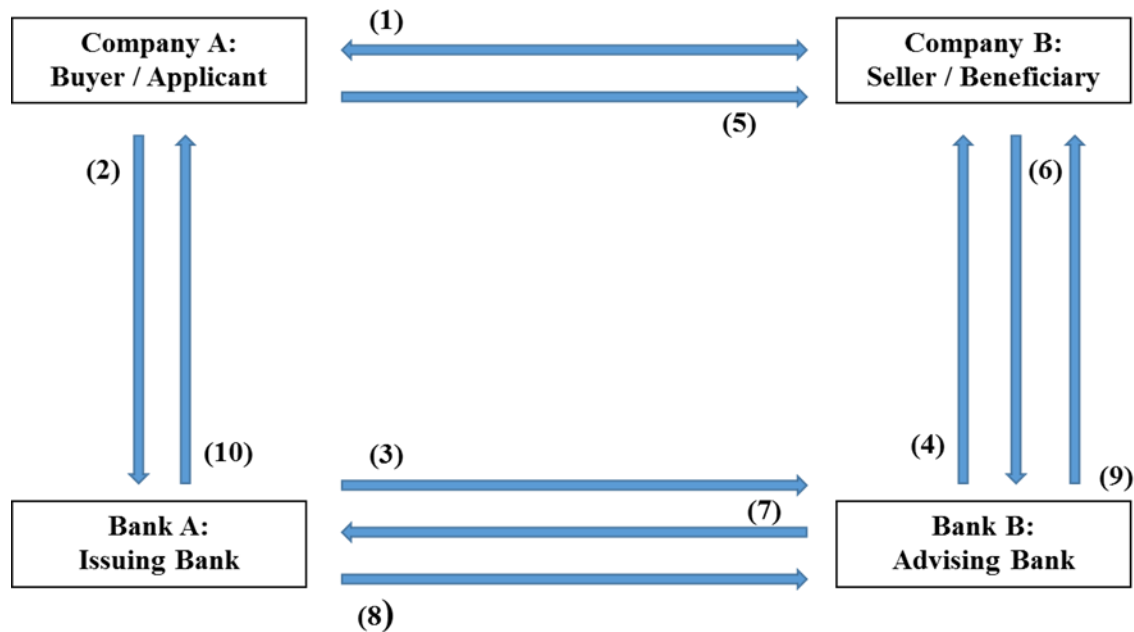


Figure 2 - Standby Letter of Credit

- (1) Commercial contract between two companies
- (2) Company A applies for a SBLC in favor of Company B
- (3) Bank A issues a SBLC and sends to Company B's bank
- (4) Bank B authenticates the SBLC
- (5) Company A defaults
- (6) Company B claims the guarantee and hands the required documents to Bank B
- (7) Bank B sends Bank A the documents to support the guarantee claim
- (8) Bank A authenticates the documents makes the payment to Bank B on first demand
- (9) Bank B pays Company B
- (10) Bank A tries to recover the money from Company A.

2.1.3. Performance Bond

A Performance Bond, also known as Contract Bond, is a specific type of guarantee mostly used in the real estate industry to ensure the Beneficiary against the failure of the Applicant to meet the

obligations specified in a contract. The Guarantor, which can be either a bank or an insurance company, is entitled to complete the contract itself or hire a third-party to complete it, upon agreement from the Beneficiary. The Guarantor is entitled to pay only up to the penal sum or limit of liability, never more than that (University of Colorado, 1997). There is currently a discussion in Brazil on the use of Performance Bonds as a way of ensuring Public Biddings and preventing corruption (Carvalhosa, 2016).

2.1.4. Bid Bond

A Bid Bond has the function of ensuring a project owner that a Bidder can comply with a bid contract and deliver a job as specified in the contract (Rodriguez, 2016). It makes the Beneficiary more comfortable on considering a bid proposition from an unknown company, knowing that upon the acceptance of a bid, the contractor will proceed and comply with the contract. If the contract is not fully respected, the Beneficiary is entitled to receive from the Guarantor the difference between the Applicant's Bid and the next Bidder (Ventrella, 2017). After the Bid has taken place and the project is already going on, the Bid Bond is usually replaced by a Performance Bond.

2.2. International Trade Instruments in the United States

When it comes to International Trade Instruments, the United States has a different legislation from the rest of the world. American banks are not allowed by law to issue instruments to guarantee a third part's performance as they are not part of the transaction and, therefore, cannot determine whether or not the contract has been fully complied (Maulella, 2002).

Not to stay behind banks from all over the world and still comply with the local legislation, American banks have created other ways of taking part in the International Bank Guarantee market by creating the SBLCs. The SBLCs are provided for and ruled in the Uniform Commercial Code (UCC) from 1952, which addresses most aspects of the U.S. commercial law.

Most American states have adopted the UCC rules in the 1960's (Dolan, 1996), with some local variation due to the autonomy of the states. The State of New York, in which most international disputes are settled, uses the UCC rules but disregards the Article 5. Furthermore, if it is specified in a contract that it is subject to the UCP, the state of New York will rule accordingly and respect the rules established in the contract.

2.3. International Bank Guarantees

For the purpose of writing this thesis it is necessary to further delimitate that International Bank Guarantees as instruments issued by a Bank (Guarantor) on behalf of a company (Applicant) to the benefit of a foreign beneficiary (Beneficiary).

As a Guarantor, the bank assumes the monetary risks of the operation. In most situations, International Bank Guarantees are guarantees on first demand, meaning that the bank is requested to pay the beneficiary immediately when claimed - without further investigating. Also, International Bank Guarantees are irrevocable, meaning that once it was issued by the bank it can't be amended nor cancelled during the period of time that was agreed on the contract.

Thus, for the purpose of this thesis, International Bank Guarantees will be defined as the Standby Letters of Credit, Performance Bonds and Bid Bonds, all of which should be issued according to the ISP 98, URGD 758 or UCP 600. They are all designed to indemnify the Beneficiary against a default event by the Applicant (Kozolchyk, 1989). Commercial Letters of Credit are not considered International Bank Guarantee as they are a method of payment.

3. International Bank Guarantees Risks

International Bank Guarantees were created to reduce the risks of international trade transactions, therefore there are still countless risks related to their use. Knowing and understanding those risks is important for companies and banks dealing with those instruments, allowing them to find ways of mitigating those risks and their impact or just being more prepared to deal with them and face the challenges as they come.

The risks related to International Bank Guarantees that will be analyzed in this thesis are the financial, commercial, legal and political.

3.1. Financial Risks

A financial risk is defined as the possibility of a monetary loss by one of the parts involved in the operation. It is probably the risk that is more likely to be taken into account by the banks and companies involved in such operations.

Despite being quite obvious, the parts usually don't take the necessary measures to mitigate those risks and are often surprised by them.

3.1.1. Foreign Exchange Risk

The increase in international trade led companies to expand and conquer foreign markets, exposing them to the volatility of the foreign currency rates and, therefore, to Foreign Exchange Risk (Lopes, and Frank, 2013). Minor variations in foreign currency rates are expected and happen all the time, however major changes may happen as a result of political, social, economical, environmental and other events that eventually disrupt the international market leading to direct or indirect losses in the company's cash flows, assets and liabilities and net profit (Papaioannou, 2016). Developing strategies to reduce Foreign Exchange Risk is really expensive, so most companies choose to manage only the most significant risks by using hedge instruments such as futures, swaps or options (Goedhart, Koller, and Rehm, 2015).

In international trade transactions, and more specifically in those involving International Bank Guarantees, Foreign Exchange Risk is expected and companies are willing to take it. However, abrupt changes in the market are never expected and may cause financial difficulties to the parts involved in the transaction. For example, the Applicant may undergo financial difficulties and go on default, causing the Beneficiary to require the Guarantor to fulfill the contract terms when it

wouldn't have been necessary otherwise. Another possible situation that would harm the Beneficiary would be the appreciation of its local currency, when the company would receive a smaller amount in the local currency, much less than it was expecting.

Thus, all parts involved in the international trade transaction are subject to the Foreign Exchange Risk. The Applicant may not be able to meet the required payment; the Bank may be subject to reimburse the Beneficiary for the International Bank Guarantee; and the Beneficiary may receive less money than it was expecting.

3.1.2. Applicant's Default Risk

A company defaults when it is no longer able to meet its financial obligations, such as payments and debts. It may be caused by several different reasons, such as poor administration, macro economical events, and others.

When it comes to International Bank Guarantees, the greatest concern is related to the default of the Applicant, who will become unable to fulfill its financial obligations and will default on the Beneficiary. As a result, the Beneficiary will request the Guarantor to comply with the International Bank Guarantee terms. In this situation, it is expected that the Guarantor will pay the beneficiary the fair amount and, after that, will go after the Applicant so it can be reimbursed. This process may be long and very costly and even then it's not certain that the bank will ever recover its money.

3.1.3. Bank Reliability Risk

In the international market a bank's reliability is of utmost importance to assure the parts involved in the transaction, so they can feel safe and secure. When it comes to banks, the amount of asymmetric information is huge despite the constant regulatory interventions (Hau & Langfield & Marques-Ibanez, 2012). To reduce this risk, international rating agencies have started analyzing and publishing reviews on the reputation of banks, the most important agencies being Standard & Poor's, Moody's and Fitch Ratings. The credit ratings express opinions about credit risk and credit quality, analyzing the ability and willingness of the rated company or bank of meeting its financial obligations and of defaulting (Standard & Poor's, 2017).

In the context of International Bank Guarantees, a bank's reliability is important for the beneficiary to feel safe and be assured that it will be fully paid in case the Applicant fails to fulfill its financial obligations. Thus, having a bank that is reliable and financially capable of honoring the International Bank Guarantee no matter the circumstance is really important for the operation to happen.

3.1.4. Bank Reputation Risk

A bank's reputation goes beyond its reliability. The banks with the best reputation in the market are those known for meeting its financial obligations no matter the situation. They usually choose to make a payment and then discuss the validity of it rather than taking longer to make the payment and putting its reputation of reliable payer at stake. They are known for being trustworthy and usually have a good relation with other banks, especially with overseas ones.

On the international market, however, there are banks that are known for choosing not to meet its financial obligations. As a result, most banks are not willing to make deals with them and opt out of confirming financial instruments coming from them. Also, some Beneficiaries may choose not to accept an International Bank Guarantee issue by a bank notoriously known for not paying on first demand or even for not paying at all.

As the Guarantors and the Beneficiary are usually located in different countries, making the contract valid and being sure it will be enforced is difficult, costly and takes a long time. So, to avoid further issues, it is always better to choose a bank top-notch bank with a good reputation rather than one with a questionable reputation.

3.2. Commercial Risks

In an international trade commercial operation involving International Bank Guarantees, there is a common expectation between the Applicant, the Beneficiary and the Guarantor. The Applicant expects to receive the goods in good shape at the right time and without additional costs or quality issues; the Beneficiary expects to receive the money on time; and the Guarantor expects not to be required to pay the Beneficiary because the Applicant has defaulted.

Commercial Risks are those inherent to carrying out a commercial relation (Boyce & Lake, 2009). In an International Bank Guarantee transaction, the most relevant ones are fraud and poor quality products.

3.2.1. Risk of Fraud

Even though International Bank Guarantees have been created to reduce the risks of international trade transactions, they haven't been able to completely do so. The International Trade Guarantees have as a characteristic the requirement of being paid on first demand, meaning that they must be paid within 48 hours upon the Beneficiary's request if the presented documents are complying with the contract terms. The Guarantor is not entitled to further investigate the matter, just to make the payment.

As a consequence, there is a considerable risk of fraud in International Bank Guarantee operations. There is a number of possibilities of fraud, the most common being to favor the Beneficiary or the Applicant.

For example, the Beneficiary may be favored by presenting an adulterated document saying that the Applicant hasn't entirely fulfilled the terms of the commercial contract or that they haven't been paid for. Under this circumstance, the Guarantor is entitled to fulfill the guarantee and only then to go after the Applicant to be reimbursed. However, if the Applicant is capable of proving that they have complied with all the contract terms, the Guarantor will need to go after the Beneficiary to get its money back. The process is lengthy and costly, usually in a foreign jurisdiction and there is no guarantee that the Guarantor will ever get its money back.

Another possible fraud situation favors the Applicant, as it may not fully comply with the terms of the contract. Then, the Beneficiary will correctly require the Guarantor to fulfill its responsibilities. After that, the Guarantor will try to be paid for that by the Applicant, who may claim it has gone bankrupt or just pay after a very long and costly legal battle.

It is even possible for the Guarantor to take advantage in a fraud situation by paying the Beneficiary when it shouldn't and requesting the Counter-Guarantor to step in.

In all of these situations there is an issue of broken faith and malice, in which at least one of the parts is deliberately committing fraud and trying to take advantage of the other parts involved in the operation.

3.2.1. Risk of Low Quality Products

Poor quality products are a reality in several commercial transactions, not only international ones. There is a wide range of different scenarios that may happen upon the delivery of goods with a quality that is inferior that what was agreed.

The first one is when the Applicant has already made the payment to the Beneficiary, in which situation it becomes quite difficult for the Applicant to retrieve its money. The second possibility happens when upon the arrival of the goods the Applicant refuses to pay for them alleging that they do not comply with the previously agreed specification. In this situation, either the Guarantor will have to make the payment on first demand or, if the documents are not fully compliant with the commercial contract, the Beneficiary will not be paid. Either way, the Applicant will have to deal with goods that do not meet its specifications and requirement, which can be quite an issue.

In situation of low quality products, there is a great potential loss for all parts involved in the operation and a considerable financial risk.

3.3. Legal Risks

Legal risks are the legal consequences originated in the business (Moorhead & Vaughan). Despite being a legal instrument created to mitigate the risks of international trade transactions, International Bank Guarantees are still subject to them.

These risks and the extent of its consequences may vary according to a country's interpretation and acceptance of International Bank Guarantees, the good faith of the parts involved in the trade operation and on how the contract was elaborated. The most significant risks that will be further explored are related to legal battles and local legislation. The U.S. also has a unique approach when it comes to International Bank Guarantees that requires specific attention, especially since most international disputes are solved in American courts.

3.3.1. Legal Battle Risk

Legal battles are a reality in most trade transactions as it is common for the parts to have conflicts due to misinterpretations, poorly written contracts, bad faith, quality of the product, delivery of the product and other endless possibilities. Despite being created to mitigate this risk, International

Bank Guarantees haven't been able to completely eliminate legal battles, which often cost a lot of money and effort, and take a long time to be solved, if they are solved at all.

International Bank Guarantees have as a primary characteristic the fact that they should be paid on first demand, meaning that the Beneficiary must be paid for upon the presentation of the required documents no matter the circumstance. Because of that, in some situations the payment to the Beneficiary is wrongly made and the issue must be solved on court, taking a long time for a final decision to be reached. Furthermore, if the payment has been correctly made and the Applicant does not agree to reimburse the Guarantor as agreed upon the signature of the International Bank Guarantee, the Guarantor must also go to court to retrieve its money.

To simplify this process and to reduce risks to the parts involved in transaction with International Bank Guarantees, upon the signature of the contract the parts usually agree on going to arbitration instead of the regular legal system and on the location and specificities of this arbitration. This option is usually cheaper and faster, however both parts should compromise in accepting and abiding by the final decision.

3.3.2. Local Legislation Risk

Legal battles involving parts located in two countries are more complicated than those in which the parts are located in the same jurisdiction. Each country has its own legislation that is very specific and solely valid within its borders. Before the creation of International Bank Guarantees there was a complex discuss regarding which law should be followed; nowadays there is an international guideline suggesting on how to deal with this situation.

International Bank Guarantees must follow their own guidelines, also known as brochures, which determine exactly how each field of the document should be filled as well as good practices and standards to be followed. Most countries accept the terms of International Bank Guarantees and judge them accordingly; however there are exceptions such as Colombia, that does not allow its banks to issue International Bank Guarantees or Mexico and Venezuela who have very specific ways of issuing and fulfilling those guarantees (Lesguillons, 1985).

Therefore, to minimize the risk of being harmed by issues regarding the local jurisdiction of a country, it is necessary to ensure that the local legislation will accept and support the terms of the contract. On the top of that, it is important to remind that the foreign company tends to be on

disadvantage if legally pursuing a local one. To avoid this situation, it is possible to agree on an independent location for the legal battle to take place, if it unfortunately happens. It is also possible to already choose the legislation that it is supposed to be judged accordingly and even choose between arbitration and the regular trial, as long as it is specified in the contract and that all of the involved parts have agreed on that.

3.3.3. U.S. Risks

International trade transactions involving at least one of the parts being located in the U.S. are common, and since the country has a very specific legislation regarding International Bank Guarantees it is important to further explore the matter. In addition, most International Bank Guarantee disputes are judged in the U.S. either according to the UCP or even according to UCC or American law.

3.3.3.1. American Banks

As previously mentioned, U.S. law does not allow American Banks to issue international bank guarantees to guarantee a third part's performance. Banks are considered incapable of determining the compliance of the contract since they are not part of the commercial transaction (Maulella, 2002). As a result, American banks are subject to a different law, which may cause differences and disagreements upon the non-fully compliance of an International Bank Guarantee contract.

Since American banks are supposed to follow the U.S. law, negotiating with them may imply in the bank or other part also being subject to the U.S. law even if they are not used to doing it or don't have the required knowledge for doing so. Furthermore, it becomes more complicated to involve an American bank in the counter-guarantee process, which is common in International Bank Guarantees.

The impossibility of American banks to follow the UCP standards puts a lot of obstacles on way and makes the process more costly, requiring lawyers who are used to dealing with this situation; more lengthy and subject to more risks and unforeseen situations.

3.3.3.2. State of New York

Unlike the other 49 American states, the State of New has a different law and a different understanding concerning international bank guarantees. It rules disputes concerning International Bank Guarantees according to what is determined in the contract. If it is not specified, then the

UCC rule will be followed, excluding the Article 5. This Article acknowledges International Bank Guarantees as a unique type of undertaking and it establishes its own statute of frauds for this type of guarantee. Furthermore, it also sets a special rule for when the credits become effective (Dolan, 1996).

Before dealing with companies from the State of New York or having a dispute settled in this state, it is necessary to understand the differences and similarities between the UCC and the UCP, since they may determine how the settlement of the dispute.

3.4. Political Risks

Political risk is the potential impact of government actions on investors, companies and on society. The term is more commonly used to refer to actions designed to penalize investors and companies, such as taxes, trade barriers, regulations, and others. (The Economist, 2017). A good example of how politics may impact on business happened in 2006 in Bolivia, when the country nationalized an oil and gas plant operation of the Brazilian company Petrobras (Folha de São Paulo, 2006).

A country's relation with other countries has a direct impact on international trade between companies, either by making it easier or making it harder or even forbidden.

3.4.1. Commercial Embargoes or Commercial Sanction Risk

Commercial embargoes and sanctions are tools commonly used by governments and international agencies to show disagreement with actions and policies of a country. When a commercial embargo or sanction is imposed, companies and citizens from the countries that adopted them are restrained from maintaining commercial relations with citizens and companies from the embargoed or sanctioned country (Edelman, 2014). Cuba has faced decades of commercial embargo, while Iran and North Korea are still facing it. The American Office of Foreign Assets Control (OFAC) maintains a list of people and countries that are facing any kind of sanction by the U.S. government. Even though it is something local to the United States, other countries and even banks make an effort to follow the restrictions listed by the OFAC (U.S. Department of the Treasury, 2017).

Considering that sanctions and embargoes may be instituted at any time, they may have a considerable impact on international trade transactions and on International Bank Guarantees. A good example is what happened between the U.S. and Cuba, which used to be allied countries until

1959, when Fidel Castro instituted a *coup d'État* and made Cuba a socialist country and allied to the Soviet Union (Felter & Renwick, 2017), which led to a series of sanctions and commercial embargo.

Thus, if one of the companies involved in an international trade transaction is from a country that is facing any kind of commercial sanction, the entire operation may be compromised in different ways, according to the part that is located in the sanctioned country.

On one hand, if the Applicant's country faces a sanction, it may not be allowed to receive the goods it has purchased or it may be prevented from making the due payment. In this situation, the Guarantor would have to step in and could even face difficulties in being paid back. On the other hand, if the Beneficiary is located in the sanctioned country, it may face difficulties in delivering the goods and it may also face issues when receiving the payment. In these kinds of situation, the risks are enormous and hard to be predicted.

Before making commercial deals with foreign companies, it is important to keep in mind that even if unlikely to happen, situations like this are a possibility and, if they happen, companies have to bear the losses, as one of the main goals of sanctions and embargoes are financially harming the economy of the country. Thus, there is a risk for every part involved in the International Bank Guarantee operation if the country in which one of the parts is located happens to be affected by a sanction or commercial embargo.

3.4.2. Risk of Changes in Foreign Policy

Foreign policy is the guidelines and policies adopted by a government regarding its relations with other countries (Collins, 2017). It is designed by the head of the government aiming to achieve complex domestic and international agendas through a series of steps (Hussain, 2011). Usually countries have a foreign policy agenda defined for the medium-term; however, since the head of the government has a say on it, if there are changes in the government, the agenda and foreign policy may also change. For example, this just happened in the United States in 2017, when Donald Trump was elected president. While his predecessor, Barack Obama, was working hard on improving the relations with Cuba; Trump is not keen on having strong ties with the Cuban government and is trying to make the approximation harder than it should.

The results of changes in foreign policy are hard to be measured, since they are complex and may have different effects on different scenarios. Changes in a country's foreign policy may positively or negatively affect its companies and their commercial parties located overseas.

3.4.3. Risk of Deterioration of Commercial Relations

Foreign policy determines the relations of a country with another one. However, unexpected events may change the relations and have serious impact on companies, on its operations and on its relations with commercial partners. For example, for years Russia provided the European Union (EU) countries with natural gas for heating. The EU countries are highly dependent on Russian natural gas. In 2016, 55% of the natural gas used in Germany came from the Russian state-owned Gazprom via pipelines; the UK had 30% of the natural gas consumed in the country coming from Gazprom, while Italy had 35% (Financial Times, 2017). However, relations between EU countries and Russia have never been the easy. In 2014, during a serious international crisis in which Russia invaded Crimea and cut the gas supplies to Ukraine, the EU countries started re-exporting Russian gas to Ukraine so the country wouldn't suffer with gas shortage. Russia wasn't happy about it and threatened to cut natural gas supplies to all EU countries if they didn't stop re-exporting its natural gas to Ukraine (Exame, 2014). If an EU company happens to be highly dependent on Russian gas, if the gas actually is cut, it may have had to paralyze its operations and incur losses.

This example shows how fast commercial relations may deteriorate under certain conditions and how companies may be directly affected by them. They can't directly do anything to prevent this from happening nor can they take measures to protect themselves once these restrictions are in place making it a risk hard to predict and even harder to deal with on international trade transactions.

4. Risk Mitigation

Despite being one of the most reliable and secure alternatives to protect the parts involved in international trade transactions, International Bank Guarantees are still subject to a series of risks. For International Bank Guarantees to be safe for the parts and actually become the best alternative for international trade, it is important that the risks mentioned are correctly addressed and mitigated.

4.1. Financial Risks

The financial aspect of a transaction is the one that companies and banks are more likely to worry about, since it has a direct impact on financial results.

4.1.1. Foreign Exchange Risk

Considering that international trade transactions usually involve two different currencies, which fluctuate over time, profits and losses just as a result from exchange variation are expected. To reduce and even to eliminate this effect, there are several financial instruments that may be used, such as futures, swaps and options (Goedhart, Koller, and Rehm, 2015). However, such instruments are expensive and require a certain level of knowledge, as they are complex financial instruments. For International Bank Guarantee contracts involving smaller sums of money, the effort and cost of mitigating the foreign exchange risk may not be worth it, but for bigger transactions they are basically mandatory.

4.1.2. Applicant's Default Risk

This risk is considerably more difficult to be addressed. It is not always possible for companies to be aware of their commercial partner's financial situation unless they are a public company that published their financial results periodically. Furthermore, this is the reason why International Bank Guarantees were created - to bring safety, reliability and soundness to international trade transactions.

In this situation the part that is more likely to suffer is the Guarantor. But since it is usually the most financially stable part of the transaction as well as it is the one that agrees to guarantee the Applicant, it has access to their financial records and, if it believes the Applicant may default, they can refuse to issue the International Bank Guarantee in the first moment or even charge more for that. Being subject to defaults is part of a bank's reality and they are used and ready to deal with

this sort of situation, having a financial cushion to be used under those circumstances that is determined by the Basel III regulatory framework from the Bank for International Settlements (BIS). (Bank for International Settlements, 2017).

4.1.3. Bank Reliability Risk

Bank related risks are easier to solve as the banks are chosen by Applicant and approved by the Beneficiary. Banks are strongly regulated by the local financial system being required to periodically publish their financial statements (Bank for International Settlements, 2017) and they are also rated by credit rating agencies, making it easier to find out more about a bank's reputation and make a conscious choice.

Also, since there is usually a Guarantor and a Counter-Guarantor involved in the transaction and they are part of the bank community and have relations with other banks, they may also indicate the ones they are more comfortable working with, reinforcing the reliability of the system and making the Beneficiary and the Applicant more comfortable during the process.

4.1.4. Bank Reputation Risk

A bank's reputation is strongly tied with its reliability and any person in the financial market can easily find out more about a bank's capability of meeting its obligations (Scott & Walsham, 2002). Furthermore, the same that applies to a bank's reliability is valid for bank's reputation. As in this sort of transaction there usually is a Guarantor and a Counter-Guarantor that are part of the bank community, they may indicate the reliable banks from the non-reliable ones. Also, banks from specific countries, such as India and Iran, are known in the market for not honoring the guarantees on first demand. Thus, to ensure that Beneficiary and Applicant won't face any issues regarding, it is necessary but possible to choose the banks involved in the transaction after a careful analysis.

4.2. Commercial Risks

Commercial risks are probably the most common faced by companies in international transactions, especially since companies frequently have new commercial partners and it is not always possible to know for sure about their intentions and practices. International Bank Guarantees were created to reduce and mitigate this specific risk. However, even if International Bank Guarantees make the

transactions safer and reduce the potential losses, these losses still happen in some situations and one of the parts is always entitled to bear the costs.

4.2.1. Risk of Fraud

This is one of the most difficult risks to be prevented when it is not inside your company. It is not always possible to know about your commercial partner's intentions and if they intend to commit fraud and harm your company. International Bank Guarantees are supposed to reduce the risk of a company being harmed by a commercial partner, however if a fraud actually happens it may take a while until the affected parts are compensated for that, if they are compensated at all (Kelly-Louw, 20088).

Thus, to mitigate this risk, it is possible for a company to ask for references of a potential commercial partner from banks, other companies, and customers. It is even possible to hire someone local to ensure that the company actually exists and complies with the legislation. Documents to prove that the parts are complying with the terms that they agreed on upon the signature of the International Bank Guarantee may also be required and, if expressly written in the contract that they are required and they are not duly presented, there may be a breach of contract.

4.2.1. Risk of Low Quality Products

Low quality products are a very common issue in international transactions. Since the Applicant will, in most situations, have access to the goods only at the last minute, they may be negatively surprised by the good's quality and refuse to make the payment and even to accept them at all. To mitigate and possibly eliminate this risk it is necessary for the good's description and requirements to be very clear in the contract. It is also possible to require that the goods should undergo some sort of quality test or that the Beneficiary presents documents issued by an expert stating that the goods are according to the contract specifications and that they are traceable (Amber Road, 2017). In case these documents are not presented or do not comply with the contract, the Applicant may refuse to make the payment and the Guarantor is not obliged to honor the International Bank Guarantee as well.

4.3. Legal Risks

Different interpretations of the law, mismatched expectations and unexpected issues may lead to legal battles if nothing is done to relieve and solve the situation. However, it is possible to take

some measures to prevent legal issues from arising and compromising the positive outcomes of international commercial transactions.

4.3.1. Legal Battle Risk

Risks of legal disputes are a reality when it comes to international transactions, especially since there is a cultural difference that leads to different expectations. To minimize this risk it is important that all terms of the contract are discussed among the parts and that there is an agreement upon the signature. Also, it is important to already discuss possible issues that may arise and how to deal with them, also writing each one of them down in the contract. Being overly prepared to deal with any kind of situation is necessary to avoid legal battles, which lead to a lot of stress and misunderstandings.

It is worth remembering that legal battles are lengthy and costly, not being a good alternative to any of the parts involved. Furthermore, companies usually choose mediation as the best alternative to solving issues that may arise, as it is faster and cheaper.

4.3.2. Local Legislation Risk

Since the parts of the commercial transaction are located in different countries, differences in the legal understanding are common. Also, the parts tend to assume that the local legislation is higher than the contract. To avoid such misunderstandings, it is necessary to discuss every point of the agreement as well as how to interpret it.

It is important that the contract makes it clear to which legislation it is subject, ideally an international rule such as the ISP 98, URGD 758 or UCP 600, from ICC. If that is not possible, it is important that the contract outlines under which country's legislation it should be judged as well as already establish a local for possible disputes to take place. By doing so, the parts cannot argue that they were unaware of the laws or unprepared. Anticipating possible issues may be a good strategy to avoid them from happening.

4.3.3. U.S. Risks

Companies doing business with partners located in the U.S. should be aware that their banks have some restrictions when it comes to issuing International Bank Guarantees. Also, they don't follow the ICC rules and brochures, being subject to the UCC instead. It is important to be prepared to deal with those differences to avoid problems.

4.3.3.1. American Banks

There are legal limitations for U.S. banks to issue International Bank Guarantees. For them to be capable of taking part in the international market of guarantees, a specific legislation has been created. To avoid problems regarding this, it is important for the company doing business with an American counterpart to be aware of the differences in legislation as well as to be attentive to the fact that there are differences in the law according to the state that the company is located. Not being attentive to small details may lead to surprises, however if the parts are prepared for dealing with those differences, no major issues are expected to arise.

4.3.3.2. State of New York

The State of New York is less complicated to deal with when it comes to International Bank Guarantees. It rules the disputes according to what is determined in the contract or, if not specified, according to the UCC, excluding the Article 5. If a company is aware of this specificities and ready to deal with them, with a well written contract, no major issues are expected. The State of New York is also known for being impartial and fair, being those reasons why companies from all over the world choose to settle their disputes in this jurisdiction.

4.4. Political Risks

Political risks are complicated to deal with, since they are out of a company's control and may have a big impact on international commercial transactions. However, to reduce this risk it is possible to carefully select countries to do business with and use insurance companies to ensure the operation.

4.4.1. Commercial Embargoes or Commercial Sanction Risk

This risk is hard to be mitigated completely. If a commercial embargo or sanction is already in place it is easier to know what is allowed and what is not. However, to minimize the risks of an embargo or sanction that are just put into place, it is important to be up to date with events that are happening in your country and especially around the world, because usually they result from political and economical events that are being discussed non-successfully for a while between two or more countries.

Other than that, it is necessary ensure that the other parts of the transaction comply with local and international rules, are not involved in money laundering, drug trafficking or any kind of illegal

act. Having a commercial partner being listed by the OFAC is also something to be avoided (Gürkaynak & Olgu Kama, 2013).

4.4.2. Risk of Changes in Foreign Policy

Like the risk of commercial embargoes or sanctions, changes in the Foreign policy of a country are not common and usually they are not expected to happen at any given time. Even if the changes do happen, they do not happen overnight. They are gradual, giving time for companies to understand its implications and to find ways adapt and deal with those changes.

4.4.3. Risk of Deterioration of Commercial Relations

This is a real risk that may be triggered by an unexpected event and escalate quickly, affecting the relation between companies located in the countries if nothing is done to change that. Countries aren't interested in having issues affecting their relations with other countries, since it bad for both sides.

In most situations, countries try to work out their issues as they come so they won't affect citizens and companies; however there are extreme situations such as North Korea and Cuba. This is a real yet uncommon reality, that companies can't do much to prevent themselves nor to improve the situation.

5. The ideal international trade instrument

International Bank Guarantees were created to support and enhance international trade, yet they are still subject to a series of risks previously discussed that may jeopardize international trade transactions.

Foreign exchange risk is a reality that goes beyond international trade commercial transactions, occurring in all sorts of transactions with parts in different countries. For example, if you have children studying abroad and you have to send money over to support them, you are already subject to foreign exchange risk. Thus, in a globalized world it is quite impossible to avoid such risk; however it is possible to easily mitigate this risk by using financial tools such as hedging, which is not so expensive and is done by most banks.

Having your business partner going into default and being able to meet its contractual obligations is also not exclusive from international trade transactions. There are countless examples of well-known and not so well-known companies that went into bankruptcy leaving their clients and commercial partners high and dry. International Bank Guarantees are one of the few commercial instruments that may protect the parts, from another parts' possible bankruptcy, by ensuring that the Beneficiary will get paid no matter what and that the Applicant won't have to make the payment if the goods or service don't strictly comply with the contract.

International Bank Guarantees are subject to bank related risks, such as their reliability and reputation. Because the bank has the important role of Guarantor, ensuring the soundness and reliability of such operation, so they must not fail. As banks are an important part of the economy and the impact of their poor results directly impact the economy, they are strongly regulated by the local legislation. To take part in international transactions, they must also comply with international rules, such as the Basel Accords. Furthermore, countries have their own means to ensure that the clients won't be harmed by an eventual bank bankruptcy. In Brazil there is the Fundo Garantidor de Crédito, also known as FGC, which serves as an insurer, paying a maximum amount to indemnify those harmed by a bank's bankruptcy. Also, International Bank Guarantees usually involve more than one bank, making it even safer as the chances of two banks defaulting are almost inexistent.

Concerning the default on purpose by a bank, it is important that both parts agree on the bank before the signature of the instrument. The international bank market rates banks according to their

likelihood of fulfilling their commitments. So, the parts have the option of not accepting banks that are not reliable or that may increase the risk involved in the transaction.

Most commercial risks are inherent to commercial transactions, even if the parts are located in the same country. Frauds may occur in several situations. A remarkable example is the Enron Corporation scandal in 2001, when the company inflated its revenue through fraudulent accounting practices making millions of dollars until the fraud was uncovered and the company filed for bankruptcy. Thousands of Americans lost millions that were invested in the company's shares and hundreds lost their jobs overnight (The Economist, 2002). So, companies can never be fully prepared to deal with fraud situations. In transaction involving International Bank Guarantees, at least the parts can protect themselves from their partner's possible wrongful behavior by having a bank insuring the transaction.

Other common commercial risk is getting goods with a lower quality than it was agreed or expected. It may be the result from mismatched expectations or even bad intentions. In any situation, there may be consequences for both parts. Either the Applicant will refuse to make the payment to the Beneficiary or the Applicant will get stuck with goods that are not as specified. International Bank Guarantees are an efficient way of avoiding this unpleasant situation by requiring that the Beneficiary complies with the contract specifications in order to ensure that it will be paid no matter what, even if the Applicant defaults.

Legal risks are also part of the risks inherent to doing business in any situation. There are several well-known legal battles among business partners that get into disagreements even after years or decades of partnership. The Brazilian retail group Grupo Pão de Açúcar (GPA) and the French Casino were partners for years until the chairman of GPA, Abílio Diniz, and the Casino's CEO, Jean-Charles Naouri, got into a very serious quarrels making it impossible for both to remain on the same company. After years of frustrated negotiations and an enormous amount spent with lawyers and legal fees, they finally reached an agreement with the help of negotiators.

Still discussing legal issues, local legislation is a major concern for companies operating abroad and should also concern those simply doing business overseas. Complying with local legislation is a basic requirement to avoid unnecessary problems. Legislation changes a lot from country to country and keeping track of the differences and complying with them is no easy task. Several questions arise when doing business abroad such as to what extent the company can be held

accountable for its actions, which are the practical consequences of not complying with the legislation, will it have effect on the company's home country. It doesn't matter if a company is involved in a transaction that has an International Bank Guarantee involved or not, the local legislation is still a challenge for every company doing business abroad, in some situations being necessary to hire a lawyer to show the ways of complying with the law.

The U.S. has a banking legislation completely different from E.U. countries and from most of other countries, which prohibits the banks to issue bank guarantees according to the UCP brochures. Thus, U.S. banks have a different way of operating International Bank Guarantees but they are still valid and accepted worldwide. At the same time, the country recognizes the importance of these instruments and accepts them. The State of New York even rules legal disputes according to the UCP brochure if this is how the contract was constituted.

Politics is also a concerning matter. It is based on long-term relations that may quickly deteriorate as a result of an action, a misunderstanding or disagreements. The possible outcomes of deteriorating relations between countries are never good. They start by barking at each other, raising their tones and making threats. The next steps are commercial and financial restrictions, travel bans. In the worst case scenario, the situation may even escalate to war. In any situation, the companies will suffer and face difficulties in a world in which they depend more and more on global supply chains and in which international trade is part of the daily business. This sort of situation; however is out of the companies' control. There is nothing that can be done to prevent the deterioration of the relations between two countries and commercial embargoes and sanctions from being put in place. This is a risk that should be borne by all companies operating in the international market. No International Bank Guarantee or any other kind of contract may prevent companies from taking this risk.

Considering the risks mentioned above, how to mitigate them and their consequences, it is possible to conclude that International Bank Guarantees are still the best instrument to be used in international trade transactions to protect the parts involved in the transaction. International Bank Guarantees make the transaction sounder and safer by involving a third-part, the Guarantor, and by laying out the rules of the game. It specifies which documents should be handed in, when the documents must be delivered, specifies the characteristics of the goods and all the details for the transaction to happen without any unexpected events.

Yet, it is necessary to point out that as it was laid by professionals who work on a daily basis with this instrument (Appendix1, Appendix 2 and Appendix 3), International Bank Guarantees are extremely costly. They are only viable for operations involving great sums of money. Furthermore, they are also very bureaucratic and require specialized professionals to issue and monitor them. Not all banks and companies are prepared to deal with such complex instrument. Also, on the bank's point of view it is not that interesting issuing International Bank Guarantees as they take up a client's credit limit.

All of the discussed shows that despite International Bank Guarantees not being the perfect instrument for eliminating the risks of an international trade transaction for their cost, bureaucracy, complexity and inability to completely eliminate risks they still are the best available instrument to ensure the safety and mitigate the risks on such operations.

6. Conclusion

This thesis aimed to analyze if International Bank Guarantees still are the best alternative to international trade, once it has a series of inherent risks - commercial, financial, political and legal risks. It analyzed the some of those risks and discussed actions that may be used to mitigate those risks.

Financial risks are common to all companies doing international trade operations, as they are exposed to foreign exchange variations. Furthermore, companies are exposed to risks related to bank that acts as the Guarantor of the operation and to the Applicant's risk. These can be reduced International Bank Guarantees. The commercial risks, fraud and poor quality of the goods, is common in international transactions and can also be considerably reduced through the use of International Bank Guarantees, which will define the terms of the contract and establish conditions upon which the Guarantee is valid. If the conditions are not met, the International Bank Guarantee is no longer valid.

Legal risks are a reality that may happen in any commercial transaction, international or not. Due to the International Bank Guarantee contract, laying out all the rules and usually establishing the arbitration to solve any possible disputes, the risks of getting into a legal battle with a commercial partner are considerably lower. Also, risks related to the differences in local legislation are a reality in all operations involving companies from different countries. About the U.S. very specific legislation on International Bank Guarantee, it is not a big problem. The State of New York is even elected as the place in which most international disputes are to be settled due to the impartiality, good and well grounded judgment and a relatively faster process.

The political risks that affect International Bank Guarantees are the most complicated and complex to deal with. They involve politics, which is usually something that businesses can't or won't be capable of dealing with. Relations may deteriorate in a matter of days and the costs may be high for companies to bear. In most situations this risk is predictable and companies can opt out of doing business that could potentially be affected by any kind of political restriction. However, sometimes politics is just unpredictable. Also, international trade operations using International Bank Guarantee are equally or less subject to this risk than those international trade transaction in which International Bank Guarantees are not involved.

Apart from the risks, International Bank Guarantees also have the disadvantages of being extremely costly, complex and bureaucratic. However, despite the many risks that International Bank Guarantees are subject to, they are still the best alternative to make international trade operations safer. They have been improving over time to keep up with the upcoming risks and to reduce some of them. Also, they are an instrument that is very fast to be executed and that still reinforces the sense of security for companies doing business with foreign partners. They still are a synonym of reliability and trust.

In the next years, it is expected that International Bank Guarantees are continuously modified to face the new challenges that arise every day. Those changes are will make International Bank Guarantees a safer instrument, more reliable and less prone to risks. Every new brochure comes with improvements that make companies trust them more and as a consequence they are used in more and more transactions.

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8. Appendix 1 - Interview with Dr. Luiz Augusto Prado Barreto

Lawyer and former partner at Cotia Trading (São Paulo, Brazil)

1. How often are International Bank Guarantees used in international trade and financial transactions? Is there a minimum amount of contract to make them financially viable?

International Bank Guarantees are widely used as a tool for reducing the risks of international transactions. There are few international transactions that don't use any kind of guarantee; however International Bank Guarantees are still very expensive and bureaucratic. It is important to point out that technology has enabled the use of alternative and less expensive means of payment even to transactions of expressive values such as PayPal and Amazon Pay. There is a trend of replacing traditional payment methods for electronic ones.

Furthermore, the trustworthiness of the Issuing Bank makes all the difference to the acceptance of the instrument. For example, in general, International Bank Guarantees issued by African, Middle Eastern and Asian banks usually require a counter guarantee from a well known bank in the market. Counter Guarantees increase even more the cost of International Bank Guarantees.

2. How is this instrument accepted in other countries and by companies? Is it widely required and well known in the market?

Most countries accept and recognize International Bank Guarantees upon the penalty of being excluded from the international market. There are few countries that do not accept them - the ones with no tradition on international trade. Most companies are familiar with the concept of International Bank Guarantees and try to be ready for them. Countries should also be prepared to deal with those International Bank Guarantees as they are complex and bureaucratic.

3. What are the alternatives to International Bank Guarantees? How do these alternatives compare to international bank guarantees?

Guarantees are meant to reduce risks, not to eliminate them. Without international guarantees the parts of the transaction would be subjected to the debtor's solvency risk, so the transaction would be based solely on trust and knowledge between the parts. However, it is important to recall that a good track record and a good reputation is not enough to fully guarantee a transaction as mistakes in the design, execution and others may happen. Alternatives to this instrument would be the

electronic means of payment, but in this situation there would be the risk of the companies controlling those electronic means and the commercial risk would still exist.

4. What are the advantages and disadvantages of International Bank Guarantees?

The main advantage is the security and simplicity of the instrument. The disadvantages are the elevated costs (which may be inputted in the cost instrument cost), unprepared banks and lack of knowledge about the product (from banks and clients).

5. What are the financial, legal, commercial and political risks of International Bank Guarantees? How do they compare to the risks of alternative instruments?

The risk of a country and the bank risk may be easily assessed through rating reports. The financial risks are proportional to the issuer's risks. So the quality of a SBLC issued by a top-knot bank is much better than the quality of a SBLC issue by a bank from a developing country. The political risks are not related to the level of development of a country and it is almost impossible to mitigate political risk as they are a reflex of the country's political situation. On the legal side there are few risks as the instrument is recognized internationally and its rules don't change in different countries. Furthermore, most disputes are set in a neutral location through arbitration and the countries that accept those instruments enforce the arbitration decisions.

The commercial aspects may be mitigated by using electronic means of payment; however it creates an additional risk by adding another part to the transaction. The electronic payment reduces the credit risk but increases the risk of having products that don't follow the specifications as the payment is released upon the delivery of the goods and not upon the approval of the product. When using an International Bank Guarantee, the bank ensures compliance of the goods through a certifier.

6. In your opinion, what is the best alternative to reduce the risks in commercial and financial international transactions?

SBLC are still the best alternative but there is a long way before it becomes the perfect instrument. The means of payment have developed in a very fast pace, ahead of the speed of commercial negotiations and of services. The main limitation lies on the documentation analysis, lengthiness and on the bureaucracy of the process.

9. Appendix 2 - Interview with Šimon Kolář

Former intern at CSOB and KPMG Risk Consultant (Prague, Czech Republic)

1. How often are International Bank Guarantees used in international trade and financial transactions? Is there a minimum amount of contract to make them financially viable?

Guarantees are standard practice in large exports of investment units, not in exports of e.g. consumer goods (some kind of supply finance or letters of credit might be used there). There is a minimum amount that makes it financially feasible and it is quite large, but it depends on the bank and on the transaction.

2. How is this instrument accepted in other countries and by companies? Is it widely required and well known in the market?

It is standard practice in all countries I am aware (I did export finance deals in Russia and around Latin America, Middle East, South East Asia), moreover in state contracts (like electricity plant constructions), mainly in developing countries, bank guarantees (along with full fledged finance of the whole construction) are a requirement for even being admitted to the selection process.

3. What are the alternatives to International Bank Guarantees? How do these alternatives compare to international bank guarantees?

Alternatives I don't know... they are designed to serve a specific purpose, so there are no direct alternatives I guess, but you can have state-supported types of guarantees, you can use other trade finance products, like the letters of credit etc. for similar purposes, derivatives or insurance if risk management is the purpose and you can get the deal.

4. What are the advantages and disadvantages of International Bank Guarantees?

I would say the pros is they can virtually eliminate the risk they are meant to eliminate (or replace it by more favorable one); con is that they are expensive and administratively nightmarish.

5. What are the financial, legal, commercial and political risks of International Bank Guarantees? How do they compare to the risks of alternative instruments?

The main risk is certainly the credit risk, which is increased by the fact the counterparty is far away and you might not know it very well, in this regard letters of credit are the main instrument, which virtually eliminates the credit risk

Other will probably be FX risk, but there the banks are quite capable of basically doing it for you by providing finance in the currency you will have receipts. Also export deals are usually done in international currencies like EUR or USD.

Then you have the legal and political risks, for which there is no standard instrument, I guess that is the purely exporter's job of finding a market he can operate in...

6. In your opinion, what is the best alternative to reduce the risks in commercial and financial international transactions?

SBLC are still the best alternative despite being very bureaucratic and costly.

10. Appendix 3 - Interview with Guilherme Lago

Managing director at Credit Suisse (São Paulo, Brazil)

1. How often are International Bank Guarantees used in international trade and financial transactions? Is there a minimum amount of contract to make them financially viable?

International Bank Guarantees are widely used. We deal with them at Credit Suisse on a daily basis. Most transactions involve multinational companies as they use international guarantees even for simple credit operations. International guarantees are also used in operations involving the Brazilian BNDES (National Bank for Development) and other development banks, as well as in emissions in the capital market as collateral for part of the project. Credit Suisse usually receives Standby Letters of Credit of receivables as collateral for credit operations.

Due to the elevated administrative costs, Credit Suisse only issues International Bank Guarantees for operations greater than BRL50 million, being at least BRL100 million the ideal minimum amount. Other banks in Brazil may issue International Bank Guarantees for smaller amounts to specific clients.

2. How is this instrument accepted in other countries and by companies? Is it widely required and well known in the market?

International Bank Guarantees are widely accepted worldwide. For some specific sector and niches, the use of international guarantees is the standard practice and used to reduce the credit discomfort or even as a regulatory requirement. It is important to point out that guarantees issued by Brazilian banks are rather weak in the market, mostly due to the country's rating.

3. What are the alternatives to International Bank Guarantees? How do these alternatives compare to international bank guarantees?

There are several alternatives to Standby Letters of Credit, Performance Bonds and Bid Bonds such as corporate guarantees (Letter of Credit from the Headquarters), collaterals and credit insurances (issued by insurance companies). In the legal aspect the regulatory treatment is the same for those alternatives, however the alternatives have exclusion clauses limiting their use and reducing its reliability and coverage, so under specific circumstances the payment of the alternative guarantee may be denied upon the allegation of those exclusion clauses.

4. What are the advantages and disadvantages of International Bank Guarantees?

The great advantage is the simplicity of the instrument and the perception of it being really effective and efficient. There is no question concerning its reliability and it is not negotiable, meaning that everything should comply with the documentation.

The disadvantages are the elevated costs and the reduction of the client's credit limit, while when using international insurances the credit limit is not affected.

5. What are the financial, legal, commercial and political risks of International Bank Guarantees? How do they compare to the risks of alternative instruments?

Regarding the financial aspect, International Bank Guarantees are safer than financial guarantees as Standby Letters of Credit do not have the exclusion clauses, which require good faith in the operation. Furthermore, banks are strongly regulated by the Basel Agreements and by the local Central Banks ensuring more soundness to the operation.

On the legal aspect, as long as the parts involved are aware of what they are doing, the risk is rather low as the instrument is widely accepted and follows the same rules no matter the situation. International Bank Guarantees also mitigate the eligible credit risk, being safer and more expensive than financial guarantees. To mitigate the political risks, an alternative is to issue the International Bank Guarantee instrument in an overseas branch of the bank.

What really counts upon the decision of which instrument to choose is the experience on using the instrument and the client being comfortable throughout the operation. It is also essential to consider the characteristics of each instrument and its limitations.

6. In your opinion, what is the best alternative to reduce the risks in commercial and financial international transactions?

Standby letters of Credit from a top-notch global bank are still the best alternative, followed by Standby letters of Credit from a second-rate bank. The third best option is the Performance Bonds, then forfeiting and lastly corporate guarantees.