



**BNP PARIBAS**  
CORPORATE & INVESTMENT BANKING

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# ECRI E&C Risk Group Forum - EMEA

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# Bonding Presentation / Q&A

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# Performance Bonds

*We live in interesting times*

**ECRI**

Corporate &  
Investment  
Banking



## Situation Today

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- Over the past few years many governments and corporations have planned or begun major infrastructure projects
  - Current backlog for the 15 largest U.S. based global E&C companies is over US\$200bn
  
- The current financial situation has led to:
  - Some slowdown in awarding of projects already in bid phase
  - Potential slowdown in project or next phase start date
  - Governments (US, China, Australia) considering or announcing stimulus programs that include domestic infrastructure projects
  - Beneficiaries becoming more selective in which issuing banks they will accept



## Comparison of Bonding Instruments

<b>Standby L/C</b>	<b>Demand Guarantee</b>	<b>Accessory/Contract Guarantee, Surety Bond</b>
<b>Independent &amp; payable against documents</b>	<b>Independent &amp; payable against documents</b>	<b>Payable upon occurrence of specified event</b>
<b>Specified amount</b>	<b>Specified amount</b>	<b>Amount of damages (usually with a maximum)</b>
<b>Specified expiry</b>	<b>Usually has a specified expiry</b>	<b>Expiry event</b>
<b>Rules: UCP or ISP (and UCC5 in the U.S.)</b>	<b>Rules: URDG, ISP, or local law</b>	<b>Rules: Local law</b>



## Bank Instruments

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- Standby letters of credit (SBLC) and demand guarantees (BG) are both issued by commercial banks
  - Until recently U.S. banks were not permitted to issue BGs and by practice still do not; instead they issue SBLCs
  - SBLCs are governed by either the Uniform Customs & Practices (UCP600) or International Standby Practices (ISP98)
  - BGs are governed by Uniform Rules for Demand Guarantees (URDG) and/or local law
  - Other laws that may apply are:
    - U.N. Convention on Independent Guarantees and Standby Letters of Credit
    - Local law in the country(ies) of the issuer (and confirmer)
  - Many countries allow issuance of both SBLCs and BGs, although generally one instrument is preferred
  - Bond should state which law applies and if more than one, which one governs in case of conflict



# Definition

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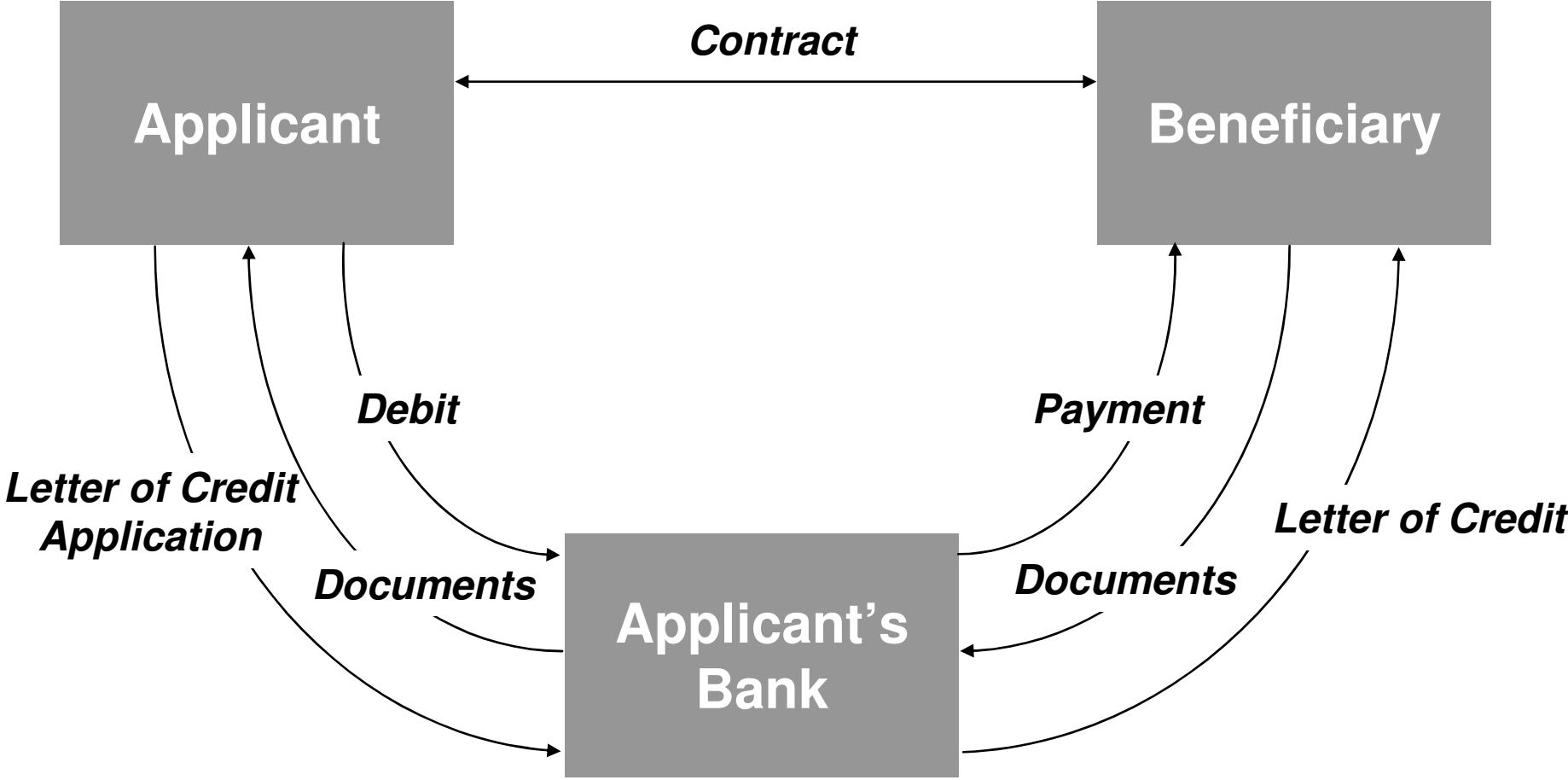
## Standby Letter of Credit

As opposed to a commercial letter of credit, a letter of credit that does not cover the direct purchase of merchandise, so called because it is often intended to be drawn on only when the applicant for whom it is issued fails to perform an obligation. Standby letters of credit are based on the underlying principle of letters of credit that payment is made against presentation of documents—whatever documents the applicant, beneficiary, and issuing bank may agree to, not necessarily documents showing shipment of goods.

- An SBLC and BG is:
  - Similar to a “guarantee” in nature...
    - But independent of the underlying contract
  - Documentary
    - Typically payable against a sight draft and written statement or other proof of default
  - “Standing by,” i.e., not meant to be drawn on
    - Beneficiary draws upon the SBLC/BG only in the event of applicant’s non-compliance with the underlying contract



# How Do SBLCs and BGs Work





## Counter-Guarantees

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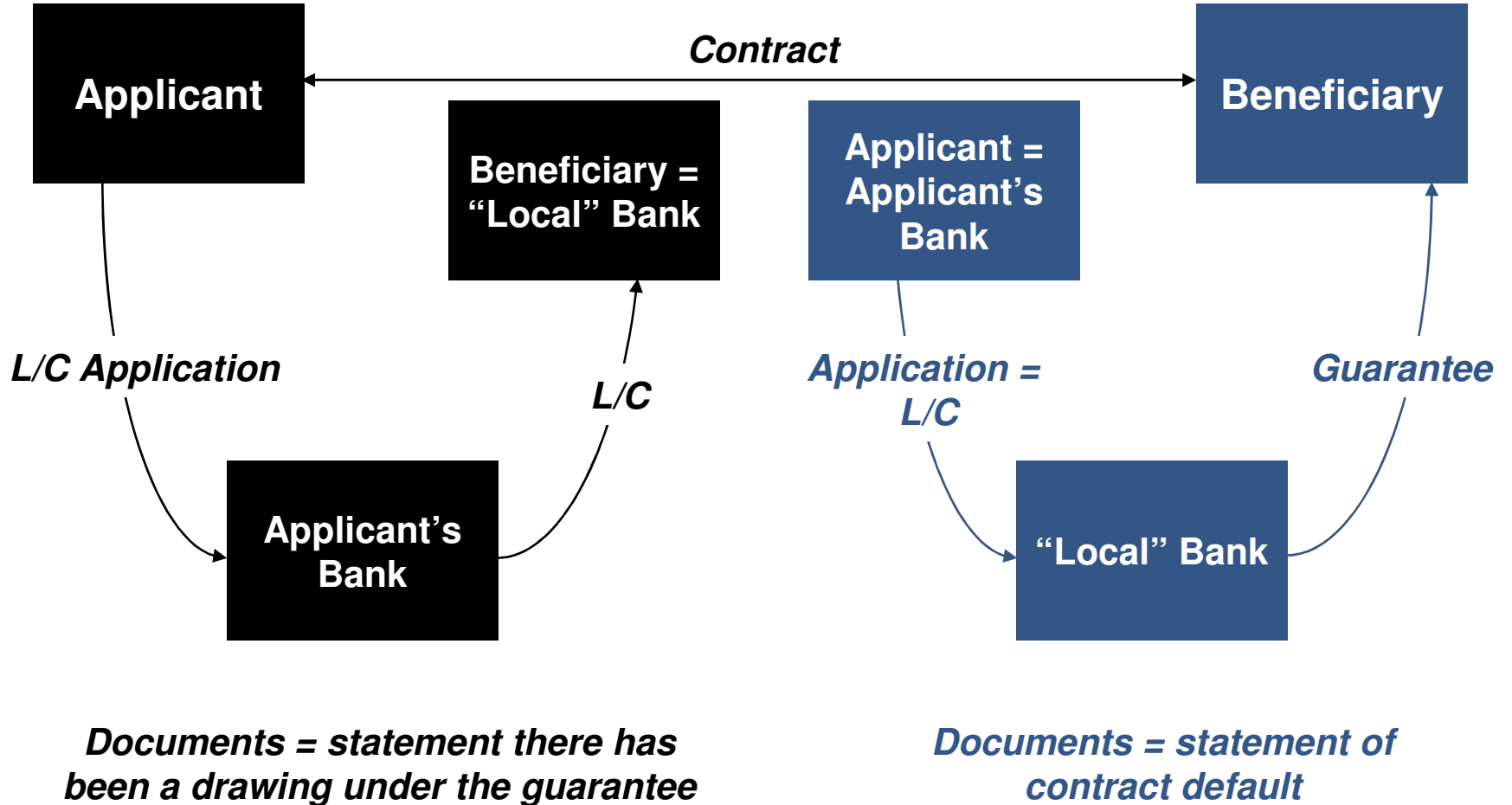
- Beneficiaries may request that their bond be issued by a local bank
- Counter-guarantees are used to meet this need
  - Issuing bank issues their counter-guarantee in favor of another bank
    - Their own branch or a correspondent bank
    - Generally issued in English
  - The receiving bank issues their SBLC or BG in favor of the beneficiary
    - Instrument may be subject to local law and may be issued in local language

A guarantee/counter-guarantee transaction has 4 separate contracts:

- The underlying contract (applicant-beneficiary)
- The L/C application/agreement (applicant-L/C issuing bank)
- The LC itself (L/C issuing bank-guarantor bank)
- The guarantee (guarantor bank-beneficiary)
- *There is no contract between the applicant and the guarantor bank*



# How Counter-Guarantees Work





## Issuing Bank Responsibilities

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Review workability of clauses and documents

- Recommend changes to the client
- May need to review text with correspondent bank or branch

Determine pricing and billing schedule

Determine method of advising

- By mail
- Via an advising bank
- Confirmation by advising bank
- Reissuance

Examination of documents and payment

***Disputes about the right to draw should be settled outside the SBLC transaction after payment has been made***



# Ambiguity

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## *Ambiguity is the fault of the drafter*

- If there is any ambiguity in the text, the courts will generally hold the issuer responsible
  - If a disputed drawing was paid, rulings most often go against the applicant/issuing bank
  - It is the responsibility of the applicant and issuing bank to insure that the text is clear to all parties

*Keep in mind that English may not be the first language of all parties and that the governing law may not be that of the issuing bank*



## Other Areas of Concern

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### ...to applicants

- Abusive drawings

### ...to beneficiaries

- **Court injunctions to block abusive drawings/fraud**

(motto: “Pay first, litigate later.”)

- **Bankruptcy of the applicant**

Before receiving payment/performance from the applicant

Within 90 days of receiving payment

Within 90 days of receiving L/C

- **Bankruptcy of the issuing bank (in the U.S.)**

The FDIC will disaffirm all undrawn L/Cs

If the bank is sold, you will be made whole

If the bank is liquidated, you will have a ratable claim

***“An SBLC/BG should not be better than cash.”***



## When Might an SBLC/BG Drawing *Not* Be Paid?

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- Expired L/C
- Discrepancies
- Political or economic event
- Fraud/injunction
- L/C issued during bankruptcy preference period, covering pre-existing debt
- Insolvent bank, liquidated



## Fronting Bank Responsibilities

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- In addition to the issuing bank responsibilities, fronting banks must:
  - Insure the application request meets the credit agreement requirements
  - Obtain approval from the Agent for the liability amount or any situations that may require approval from the Agent or participants (currency, tenor, etc)
  - Provide details of the issuance to the Agent for reporting and billing purposes
  
- In case of a draw, the fronting bank is responsible for the full amount of the payment even if one or more of the participating banks do not pay their share. As a result of current market conditions banks are:
  - Increasing fronting fees whenever possible
  - Reviewing credit agreements and tabulating their cumulative exposure to each bank or finance company; determining exposure to failed, merged, or sold banks
  - Reviewing when/if they want to continue as a fronting bank



## Capital Adequacy Requirements

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- Requirement: 8% of “Risk-Based” Assets
- Formula: Asset Amount x RW x CCF
- Credit Conversion Factors for L/Cs
  - Commercial: 20%
  - Performance: 50%
  - Financial: 100%
- Pricing formula: 8% x RW x CCF x ROC



# LCs & Bonding / Credit Crunch

**Mark Pegrum**

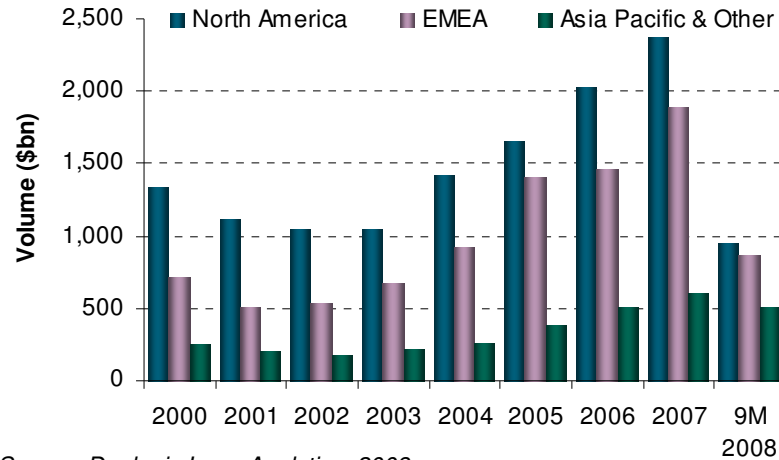
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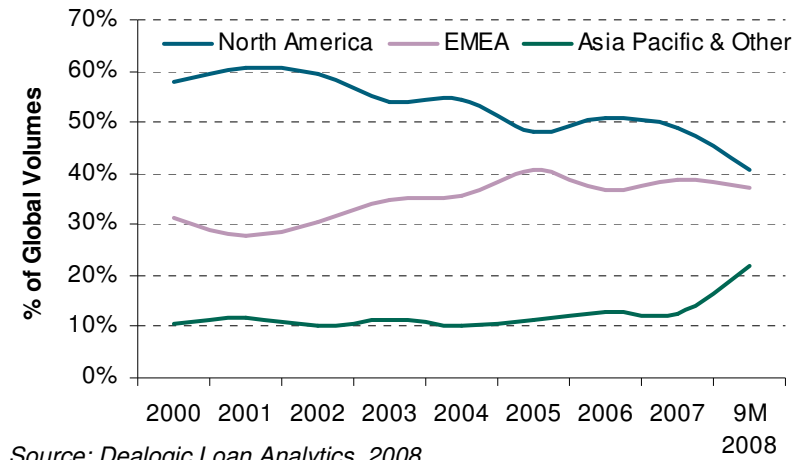
# Global Syndicated Loan Market Overview

## Global volumes by Region



Source: Dealogic Loan Analytics, 2008

## % of Global volumes by Region



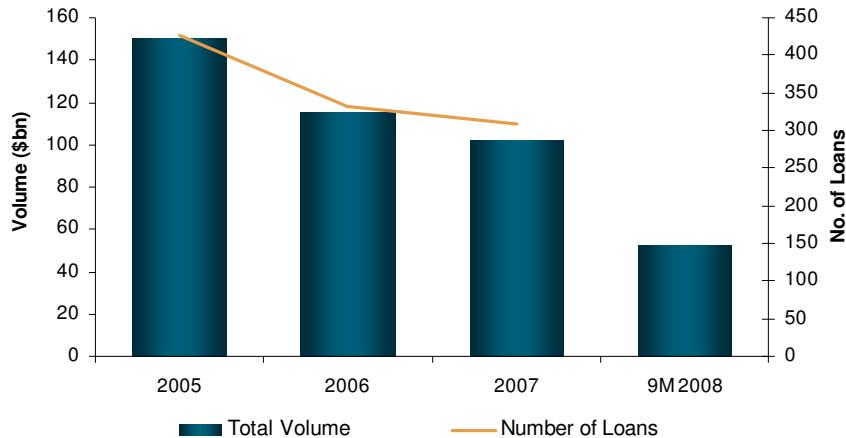
Source: Dealogic Loan Analytics, 2008

## Commentary

- For 9M 2008, Global Syndicated Loan Market volume decreased by 40% when compared to 9M 2007. Q3 2008 was the lowest quarterly volume since Q3 2004 with a 22% drop from Q2 2008.
- 9M 2008 Global volume comprised 41% North America, a 49% decline compared to the same period in 2007, 37% EMEA, 12% Asia Pacific (excluding Japan) and 10% Other.
- The downturn arising in H2 2007 from the subprime mortgage crisis in the US continues to result in liquidity and pricing uncertainty. 9M 2008 figures confirm the characteristics of the new loan market environment: Liquidity remains available for quality borrowers and those with potential ancillary business and the higher pricing trend is underpinned by banks' higher cost of funds and focus on capital.

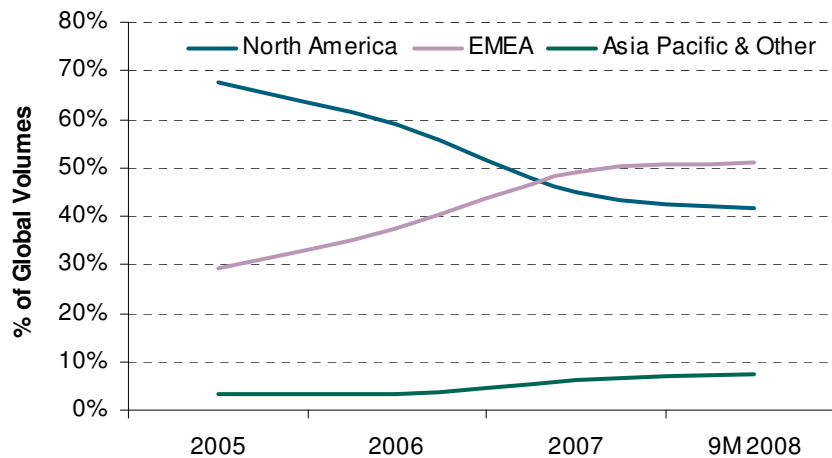
# Global Syndicated Market for LC Facilities

## Global Syndicated LC Facility Volume



Source: Dealogic Loan Analytics, 2008

## % of Global LC Facilities by Region

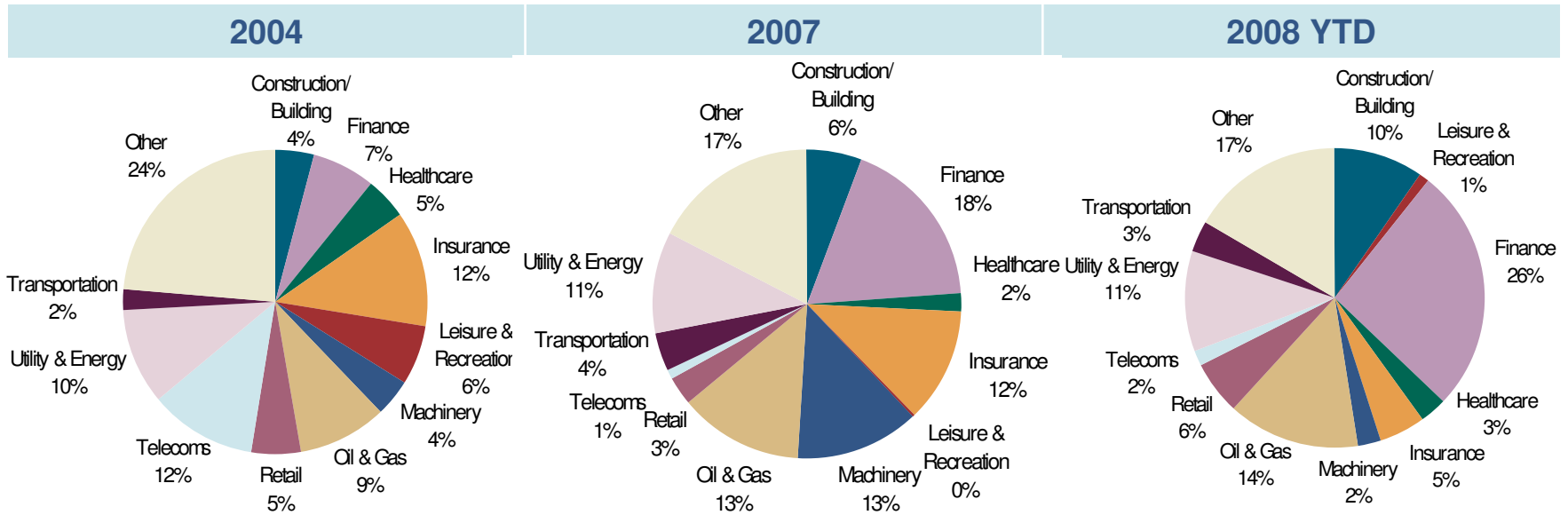


Source: Dealogic Loan Analytics, 2008

## Commentary

- Syndicated LC facilities include different types of facilities from the straightforward Letter of Credit, Guarantee or Bonding facility to the Revolving available fully or partially by way of Letters of Credit.
- In line with the Global Syndicated Loan Market trend, for 9M 2008, the volume of LC facilities decreased by 33% when compared to 9M 2007.
- This volume comprised 42% North America (versus 45% in 2007 and 59% in 2006), 51% EMEA (versus 49% in 2007 and 38% in 2006) and 7% Asia Pacific & Other (versus 6% in 2007 and 3% in 2006).
- Dealogic data refers to the market or country in which the transaction has been syndicated and not to the actual nationality of the Borrower. As such the increase in LC facility volume in the EMEA region is also due to the increase in US Borrowers (with European activities or projects) funding their activities in Europe.

# Global Syndicated LC Facilities by Industry – through the years

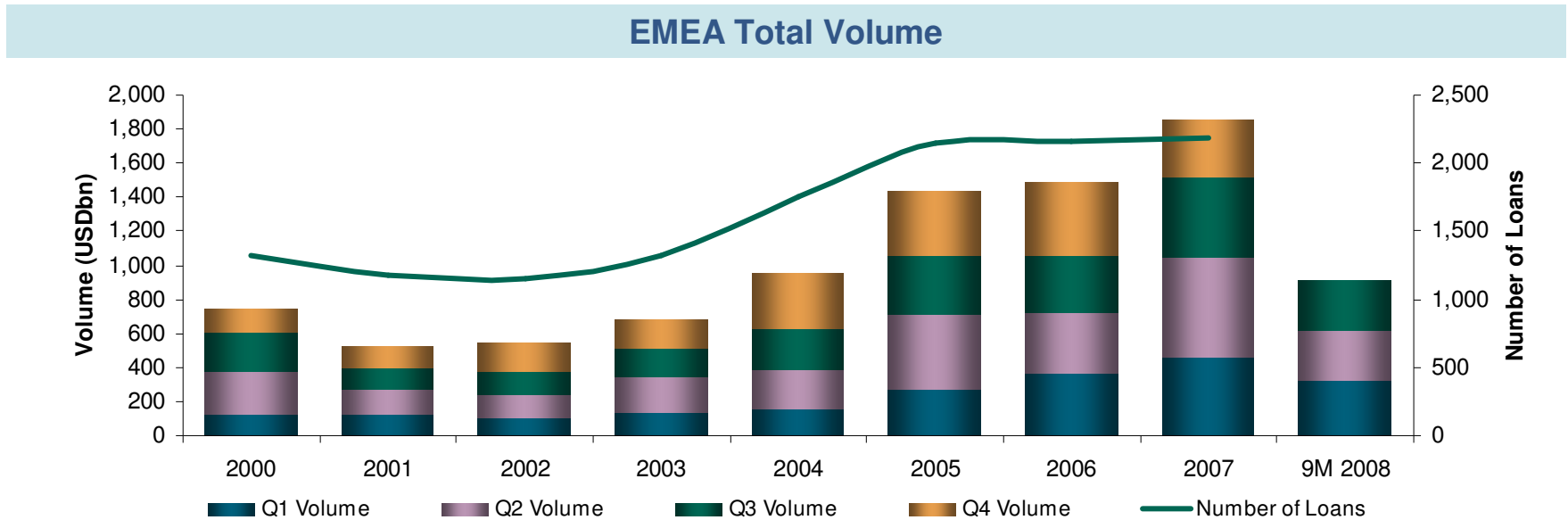


Source: Dealogic Loan Analytics, 2008

## Commentary

- The use of LC financing in different industry sectors has evolved and changed globally during the years.
- The largest increase in the use of this type of funding has been recorded in the Finance industry which increased from only 7% in 2004 to 18% in 2007 and 26% YTD 2008.
- Funding through LC facilities has also increased in the Construction/Building industry, from only 4% in 2004 to 6% in 2007 and 10% in 2008 YTD.

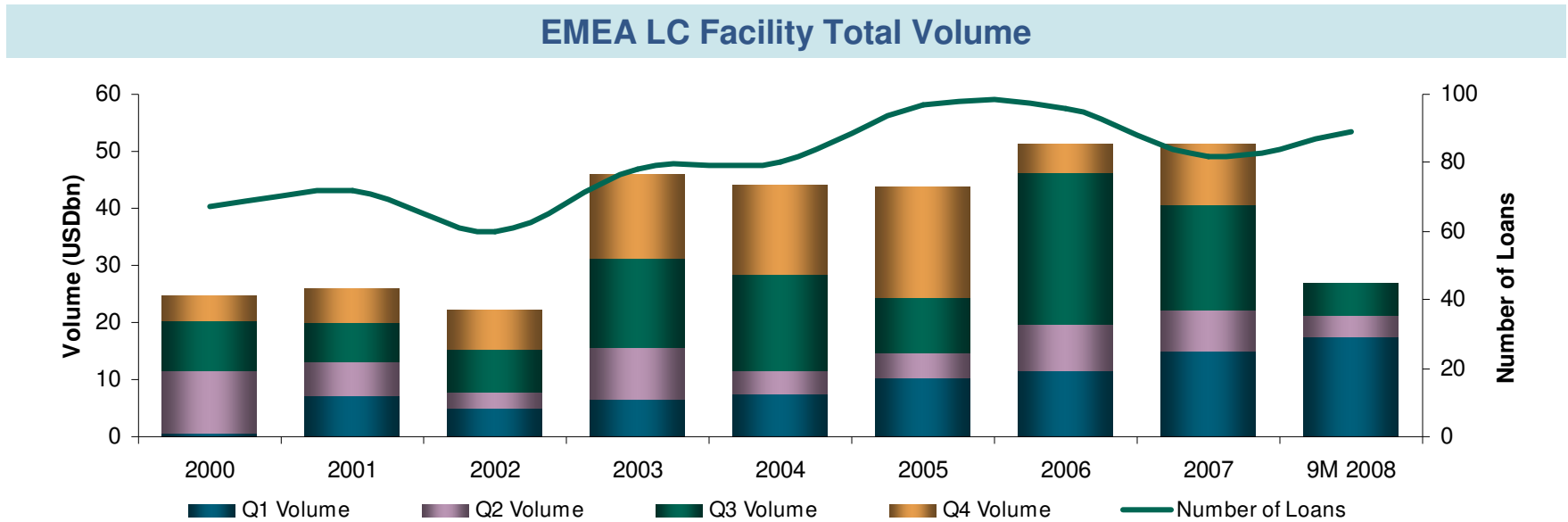
# EMEA Total Volume



Source: Dealogic Loan Analytics, 2008

- 9M 2008 EMEA total volume fell 44% to USD 860.9bn via 1,139 deals. Q3 2008 volume amounted to USD 288.8bn, 39% down on Q3 2007 volume (USD 473.0bn).
- However, 9M 2008 remains significantly above 9M 2004 figures, despite much more difficult conditions, as a result of acquisitions and event driven transactions. This contrasts with the strong volumes in 2003 to 2005, driven by high levels of refinancing, due to the attractive terms available in the loan market over that period.
- 9M 2008 EMEA syndicated loans comprised 90% Europe, 8% Middle East and 2% Africa.

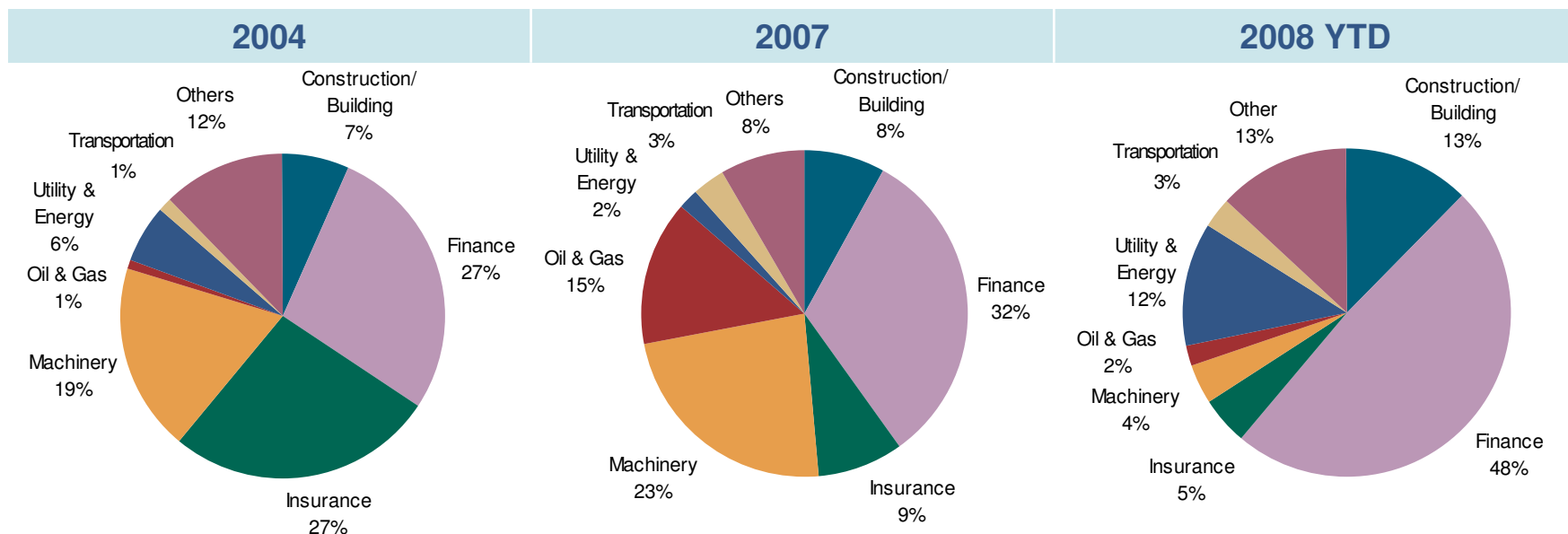
# EMEA LC Facility Total Volume



Source: Dealogic Loan Analytics, 2008

- 9M 2008 EMEA total LC facility volume fell by 33% when compared to the same period in 2007, with the largest decrease recorded in the third quarter of 2008. In fact Q1 2008 LC facility volume recorded a 17% increase on Q1 2007.
- However, the first 9 months of 2008 have seen 89 transactions versus 71 for the same comparable period in 2007 and 82 for FY 2007.

# EMEA Syndicated LC Facilities by Industry – through the years



Source: Dealogic Loan Analytics, 2008

## Commentary

- The use of LC financing in different industry sectors in the EMEA region has followed the same global trend.
- The largest increase in the use of this type of funding has been seen in the Finance industry not only globally but also in EMEA region (from 27% in 2004 to 32% in 2007 and 48% YTD 2008).
- The Construction/Building industry in the EMEA region has also increased its funding through LC facilities from 7% in 2004 to 8% in 2007 and 13% in 2008 YTD.
- The largest decrease has been recorded by the Insurance sector followed by the Machinery industry.



## Loan Market since August 2007 ... aftermath of US Sub-Prime

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- The main trends in the mainstream corporate investment grade market were use of capital and rising cost of funds
  - Given the increased scarcity and cost of available capital, most banks adjusted internal return models upwards
  - Higher funding costs consequently closed off sizeable pools of liquidity (e.g. 2nd / 3rd tier banks)
    - Problem recognised by British Bankers Association (see Financial Times dated 22 April 2008 – Julian van Kan, Chairman of Loan Managers Forum, said bankers should return to their old approach of taking loan quotes from dealer groups – rather than relying on screen-based LIBOR rates)
  
- Where banks are requested to renew and/or increase commitments for corporate clients, credit committees are very focused on the value of the relationship relative to pricing resulting in:
  - Frequency of declines now much increased – asset takers have virtually disappeared
  - Higher proportion of subscription at smaller ticket levels
  - Larger bookrunning / MLA groups - more reliance on larger banks
  - Negotiation of meaningful flex provisions - higher fee levels requested



## Market Outlook....

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Q4 2008

- Post Lehman, Merrill, Fortis, HBOS etc the loan market is effectively closed for large scale transactions, with many banks reluctant to take credit decisions in the present climate
- A very small number of true club loans are being done, but only by the closest relationship banks at much increased pricing
- Cost and availability of funds for many banks now an acute issue
- Preservation of capital over-riding concern - banks are still not lending to each other with viability of financial institutions themselves at risk – Government actions of 12/13th October should begin to ensure confidence returns but this will take time to recover
- Recapitalisation of many banks necessary before capital base is sufficient to support current size of banks' balance sheets



## Market Outlook.... Now through to 2009

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2009

What it is expected:

- Bank consolidation and market retreats will result in transactions comprised of fewer banks with larger holds and very limited general syndication
- Lack of liquidity will continue to influence underwriters and larger underwriter groups will be necessary
- Reduced availability of Banks willing to assume fronting roles.
- Credit will be rationed to primary clients who offer existing or committed ancillary business – ability to attract new banks will be much diminished
- Loans will cease to be priced as “entry level” product but on stand alone profitable basis and ancillary business (equity / advisory / bonds) has become a prerequisite for all participants
- As well as higher spreads, interest rate setting will be reference bank unless screen-based LIBOR is corrected
- Further increased pricing may result in institutional interest in investment grade corporate market, initially for lower rated credits
- Likely impact on overall size of M&A facilities
- US market features may cross to EMEA as arranging banks introduce more bank friendly aspects (e.g. standby lines priced off CDS) to attract all possible liquidity
- Loan market will need to restructure itself to cope with wave of refinancing starting late 2009 but increasing in 2010/11



## LC & Bonding Facilities in a Difficult Market

- In a market where the lack of liquidity is dominant the capital relief emerging from this type of financing will attract banks with such capital constraints
- As a further incentive LC facilities traditionally bearing a lower price than cash facilities are now being priced at the same level
- Basel II versus Basel I
  - Already implemented in Europe from January 2008 and planned in the US from January 2009
  - Banks benefit from a lower capital allocation required under Basel II for this type of transactions

### Basel I – Capital Allocation by Product Type

100%: Loans and Payment Guarantees

50%: Residential Mortgage Loans or LCs or Performance Bonds

20%: Bid Bonds, or LCs (if secured by pledged goods)

0%: if secured by cash or Certificate of Deposit

### Basel II – Capital Allocation by Product Type

100%: Loans and Payment Guarantees, and LCs exceeding 2-yrs maturity

80%: LCs with maturity between 1 and 2 years

50%: Residential Mortgage Loans and LCs with maturity below 1 year

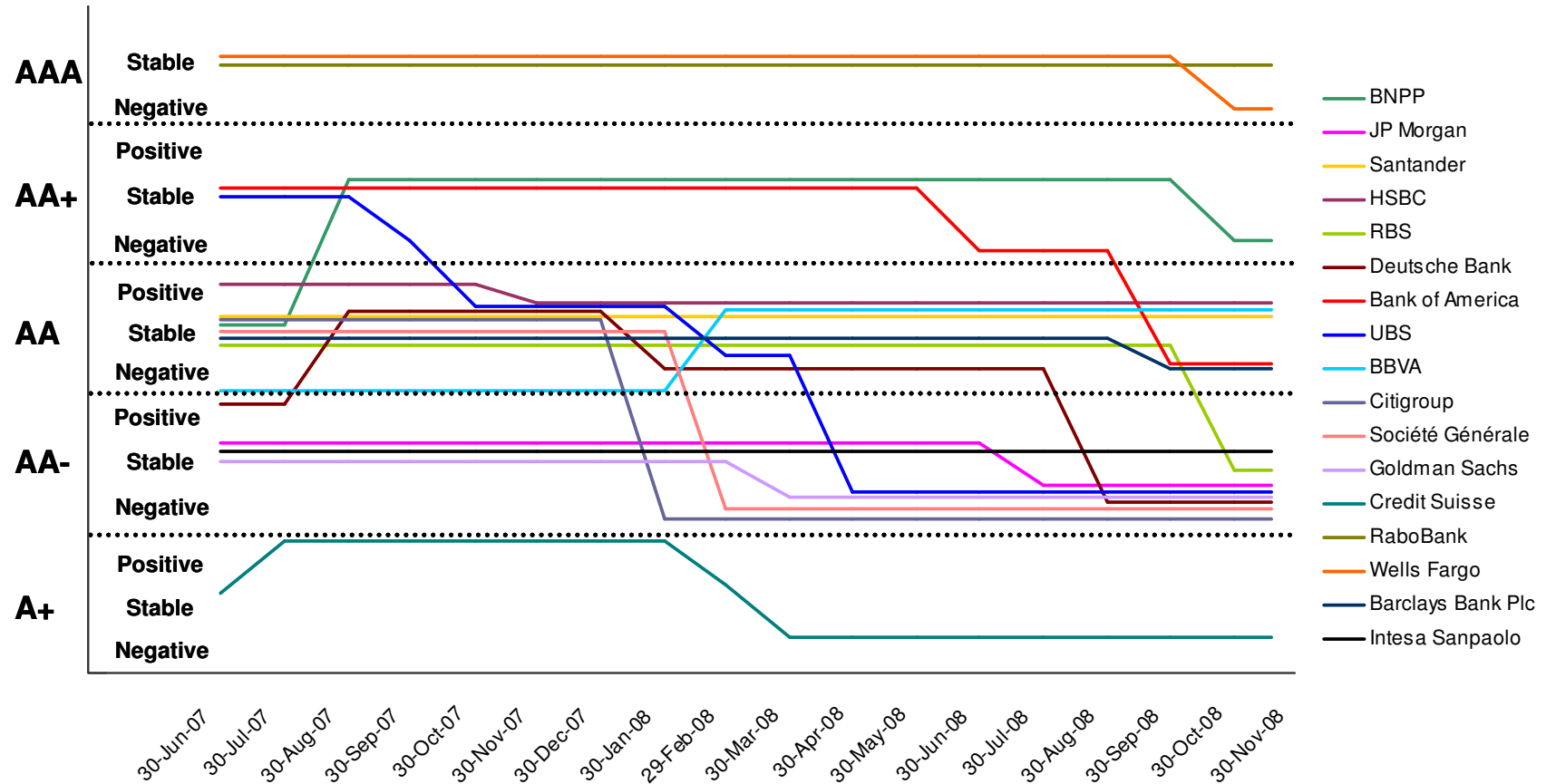
20%: LCs at sight on banks and Performance Bonds

15%: Performance Bonds in favour of contractor or subcontractor

10%: Bid Bond and Advance Payment Bonds



# Evolution of S&P's Rating and CDS Prices



CDS EUR 3Y	12/06/2007	17/11/2008	CDS EUR 3Y	12/06/2007	17/11/2008	CDS EUR 3Y	12/06/2007	17/11/2008
BNPP	3	58	Deutsche Bank	6	111	Credit Suisse	7	146
JP Morgan	9	96	UBS	4	146	Rabobank	2	101
Santander	5	83	BBVA	5	77	Barclays	4	145
HSBC	4	115	Citigroup	7	200	Intesa Sanpaolo	6	93
RBS	3	130	Societe Generale	4	103			



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