Overview of Surety Bonding

ERBA/ASWM Webinar

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Speaker

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Agenda

- Basic Surety Principles
- Surety Bond Elements
- Components of a Bond Form
- Other Considerations
- Surety Industry Comments

Basic Surety Principles

Surety bonds are a credit product, much like a bank letter of credit

Bond programs are supported in a manner similar to banking relationships. Ongoing financial and operational disclosure and due diligence are required to support the extension of credit. Sureties underwrite with an expectation of zero loss.

Sureties are also provided a corporate guarantee from the customer in the form of a general indemnity agreement.

Required by public & private entities as financial protection

In the US, federal law (Miller Act 1935) and statutory law ("Little Miller Acts") require that a prime contractor awarded a contract for the construction of any public building or public work must provide a performance and a payment bond in an amount the government considers adequate for the protection of the general public.

Basic Surety Principles

Surety bonds are non-cancellable, and obligations under the bond expire according to the language within the underlying agreement and the bond.

Bond forms will outline the rights of all parties in the event of a claim. It may also contain language that prescribes the appropriate conditions for release, a reduction in penal amount, or what conditions will need to be met to file a claim.

Surety bonds are backed by the significant balance sheet of large insurance companies with reserves to adequately address claims and large reserves, as necessary.

A surety’s claim department is as important as its underwriting, to address contractual disputes, arrange takeover options, and to act in the role of a mediator so that the bonded project may achieve its success criteria with the least amount of financial or operational impact.

Surety Bond Elements

What are the documents in a surety transaction?

1. **Indemnity Agreement**: An agreement between the principal and the surety mandating that the surety company will be held harmless and indemnified if the Surety receives a claim or pays out a loss on the Principal's behalf under the Performance Bond.

2. **Bond:** A written agreement between three parties where the surety legally obligates itself to the obligee in the event of default of the principal under the contractual agreement.

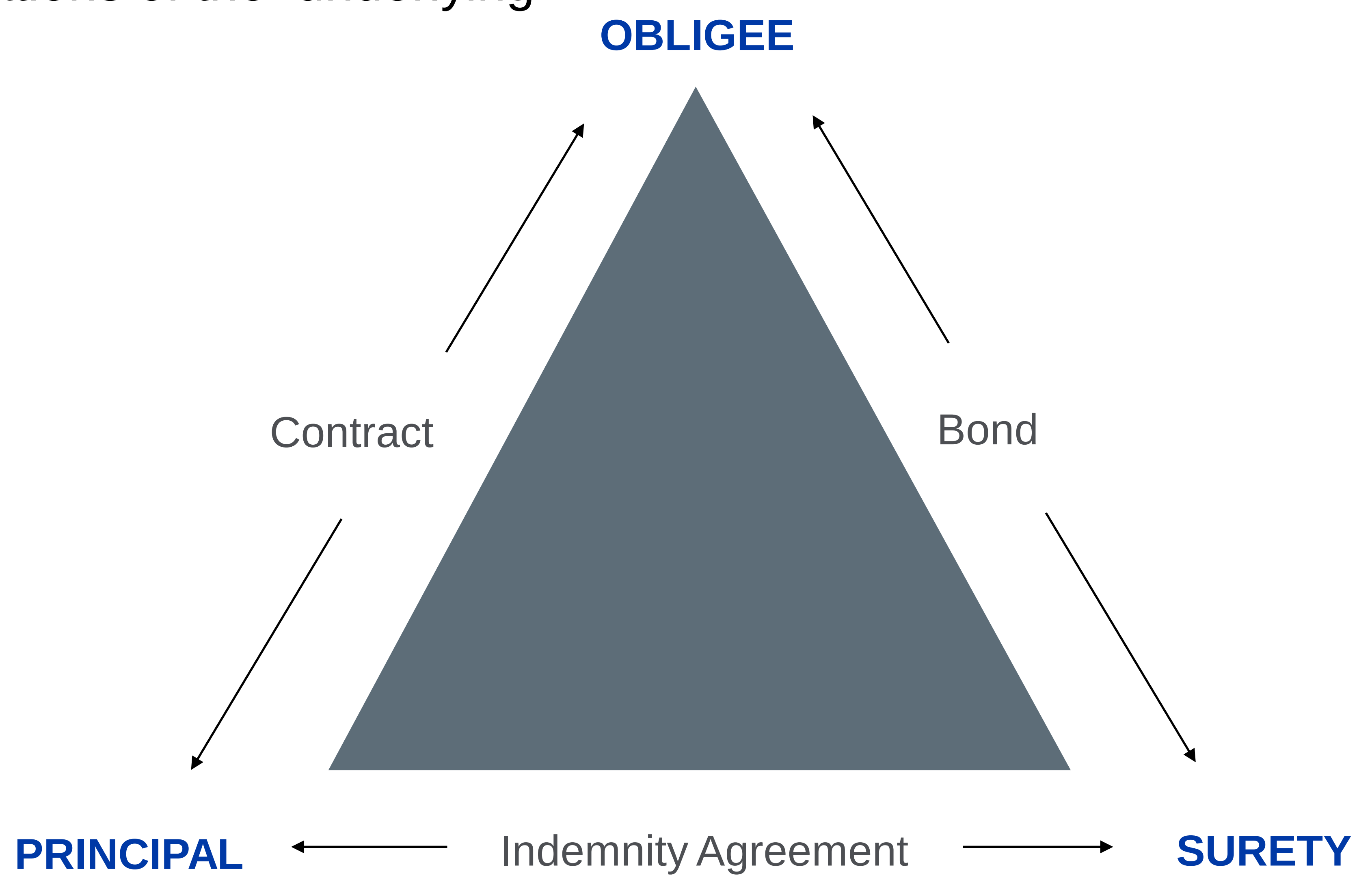
3. **Contract:** The agreement between the principal and the obligee. The bond supports the obligations of the underlying contract.

Who are the parties in a surety transaction?

1. **Surety:** The party that guarantees the performance of the principal under the terms and conditions of the underlying Contract.

2. **Obligee:** The party (beneficiary) for whom the work or service is being performed. This is typically the project owner or counterparty to the agreement.

3. **Principal:** The party who performs the work or services, such as the contractor or responsible party.



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Components of a Bond Form

- Identifies the parties: Principal, Obligee, Surety
- States the Penal Sum of the Bond
- References the Permit Number and Underlying Agreement, such as the Mitigation Banking Instrument
- Surety’s Obligation and Principal’s Condition for Performance
- Conditions for Default
- Surety’s Rights and Responsibilities
- Surety’s Required Notice to Replace or Terminate
- Signatures and Power of Attorney

Components of a Bond Form

Conditions for Default

- As the bond guarantees an underlying agreement, the contract will take precedence
- The bond form will typically provide a notice window, such as 30 days
- Requires a material breach of the underlying contract
- Common reasons for default include non-performance, payment claims from subcontractors or suppliers, and financial deterioration

Components of a Bond Form

Surety's Rights and Responsibilities

- In the event of a default, the Surety may:
  1. Take over the contract and complete using the Principal or a replacement contractor;
  2. Re-bid the contract and tender the Obligee a new contractor paying the Obligee for the amount of any loss;
  3. Waive its right to perform and pay the amount of the loss it determines is due;
  4. Deny liability
- These rights are one of the largest differentiators between bonds and letters of credit
- If there are signs of non-performance, the Obligee can put the contractor on notice and involve the surety's claims department
- The surety has a duty to respond to any notice within a specified amount of time
- Ultimately, goals are aligned in completing and fulfilling all contractual obligations

Components of a Bond Form

Surety's Required Notice to Replace or Terminate

- As a financial assurance, a surety bond is one of multiple options available to secure the Principal's obligations to the Obligee
- There are many reasons where a surety or the Principal may want to provide alternative assurance; the notice from the surety will provide adequate time to address what will be ultimately acceptable to the Obligee
- Between 30 to 90 days is viewed as standard

Other Considerations

- Bonding specific scopes and providing agreeable step-down provisions

- Annual language to reduce uncertainty of long-tail exposures

- Factors that impact pricing include:
  1. Project duration
  2. Project complexity
  3. Credit quality

- A list of acceptable sureties for federal projects in the United States can be found on the US Treasury Circular 570, which also details each surety's underwriting limitations, states in which they hold licenses, and their NAIC #: https://www.fiscal.treasury.gov/surety-bonds/circular-570.html

Other Considerations

- Surety should be considered as a pre-qualification and evidence of strength
- Financial underwriting includes review of:
  - Credit rating, capital structure, liquidity, debt profile, profitability, equity, financial controls and reporting
- Operational underwriting includes review of:
  - Leadership team, depth of organizational structure, project track record, risk management process and protocol
- Project underwriting includes review of:
  - Project size, location, complexity, duration, contract terms & damages, owner relationship

Surety Industry Comments

- Surety market remains stable and profitable, in spite of COVID impact on uncertain budgets
- $6.9 billion in direct written premium for 2020 in the United States
- Uptick in loss activity from FY 2019 (19.0%) to FY 2020 (22.8%), first time over 20% since 2009
- ESG impact has slowly entered into some carriers' underwriting process
- For carriers, claims department is as important as the underwriting leadership

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Thank You