Surety Information Office (SIO)

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The Surety Information Office (SIO) is the information source on contract surety bonds in public and private construction. SIO offers complimentary brochures and CDs and can provide speakers, write articles, and answer questions on contract surety bonds. SIO is supported by The Surety & Fidelity Association of America (SFAA) and the National Association of Surety Bond Producers (NASBP). All materials may be accessed at www.sio.org.

The Surety & Fidelity Association of America (SFAA)

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The Surety & Fidelity Association of America (SFAA) is a District of Columbia non-profit corporation whose members are engaged in the business of suretyship worldwide. Member companies collectively write the majority of surety and fidelity bonds in the United States. SFAA is licensed as a rating or advisory organization in all states, as well as in the District of Columbia and Puerto Rico, and it has been designated by state insurance departments as a statistical agent for the reporting of fidelity and surety experience. SFAA represents its member companies in matters of common interest before various federal, state, and local government agencies.

National Association of Surety Bond Producers (NASBP)

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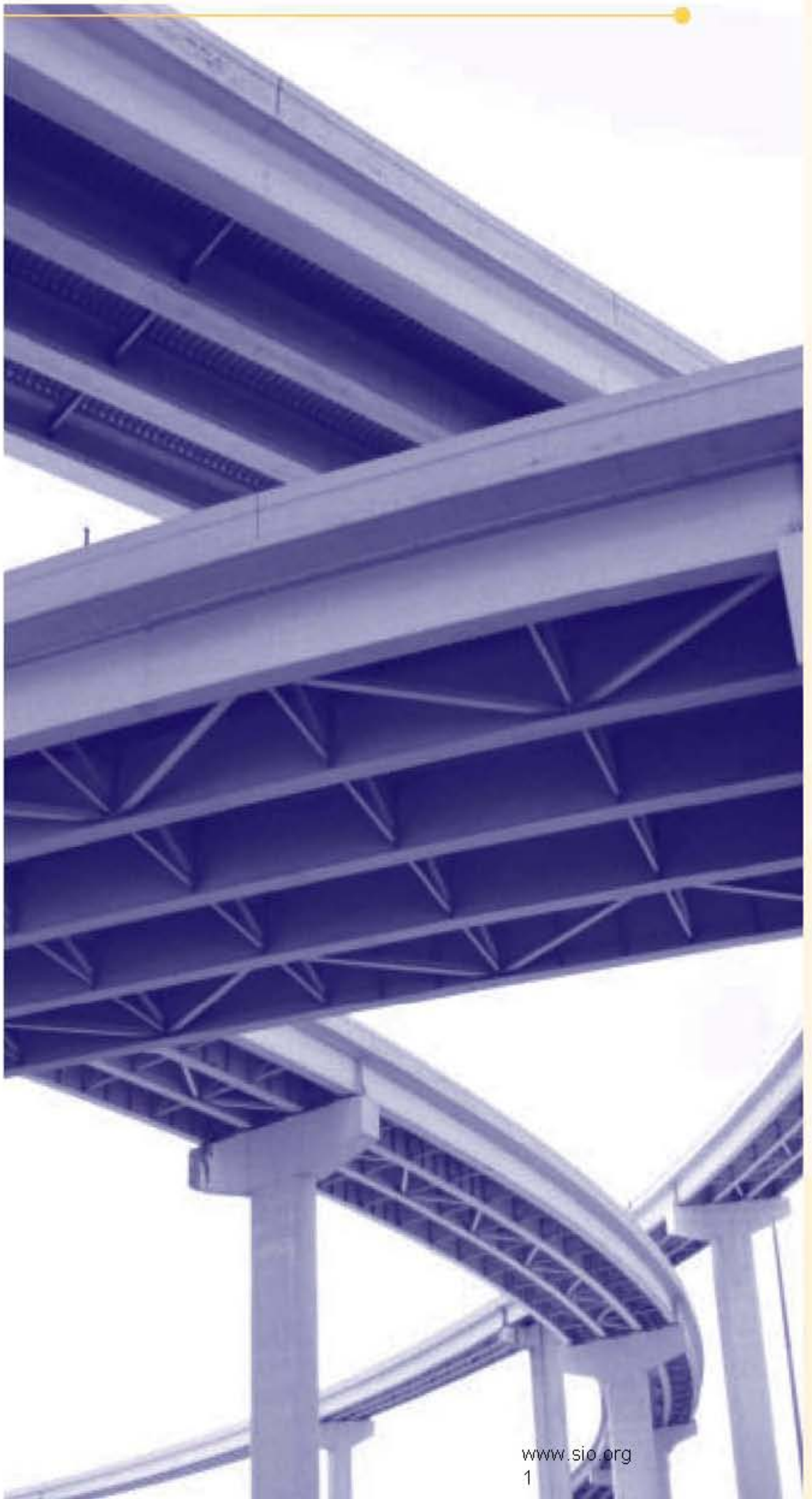
The National Association of Surety Bond Producers (NASBP) is the international organization of professional surety bond producers and brokers. NASBP represents more than 5,000 personnel who specialize in surety bonding; provide performance and payment bonds for the construction industry; and issue other types of surety bonds, such as license and permit bonds, for guaranteeing performance. NASBP's mission is to strengthen professionalism, expertise, and innovation in surety and to advocate its use worldwide.

Surety Bonds Or Bank Letters Of Credit



BORROWING CAPACITY

Surety Bonds

- Performance and payment bonds are usually issued on an unsecured basis and are usually provided on the construction company's financial strength, experience, and corporate and personal indemnity. The issuance of bonds **does not diminish the contractor's borrowing capacity** and may be viewed as a credit enhancement.

Bank Letters of Credit

- Specific liquid assets are pledged to secure bank LOCs. Bank LOCs diminish the contractor's line of credit and appear on the contractor's financial statement as a contingent liability. The contractor's cash flow in funding initial stages of construction and retention amounts throughout a contract term can be adversely affected.

DURATION

Surety Bonds

- Surety bonds remain **in force for the duration of the contract** plus a maintenance period, subject to the terms and conditions of the bond, the contract documents, and underlying statutes.

Bank Letters of Credit

- An LOC is usually **date specific**, generally for one year. LOCs may contain "evergreen" clauses for automatic renewal, with related fees.

HOW TO OBTAIN

Surety Bonds

- The **contractor obtains the bond through a surety bond producer**. A list of surety bond producers is available through the National Association of Surety Bond Producers (NASBP) at www.nasbp.org.

Bank Letters of Credit

- The **contractor obtains the LOC** through a banking or lending institution.

COST

Surety Bonds

- Generally **0.5% to 2% of contract price**. Bond is project specific, covers duration of contract.
- Included in contractor's bid price.

Bank Letters of Credit

- Cost is generally **1% of the contract amount** covered by LOC (usually 5% – 10%) — e.g. if the LOC covers 10% of contract, Cost = 1% x (10% x Contract Amount) x years of contract.
- Included in contractor's bid.

Construction project owners may use bank letters of credit to provide financial protection in the event of contractor default. However, completion of the construction project is the primary goal, and a letter of credit offers no such assurance. When it comes to limiting exposure to the inherent risks of construction, choosing the best form of risk management can make a big difference.

Bank letters of credit and contract surety bonds provide similar financial protection. However, contract surety bonds have an edge when compared to bank letters of credit and their effect on borrowing capacity, duration, coverage, cost, and claims and contractor prequalification.

DEFINITIONS

Surety Bonds

- A **three-party agreement** among the surety, the *obligee* (the project owner), and the *principal* (the contractor).
- A performance bond **protects the owner from non-performance and financial exposures** should the contractor default.
- A payment bond, aka labor and material bond, **protects certain subcontractors, laborers, and material suppliers against non-payment by the contractor**.

Bank Letters of Credit

- A bank letter of credit (LOC) is a **cash guarantee to the owner**, who can call on the LOC on demand. The LOC converts to a payment to the owner and an interest-bearing loan for the contractor.
- The **performance** of the contract has **no bearing** on the bank's **obligation to pay** on the LOC.

PREQUALIFICATION

Surety Bonds

- A surety company and producer assess the contractor's business operations, financial resources, experience, organization, existing workload and its profitability, and management capability to **verify the contractor is capable of performing the contract**. The purpose is to avoid default.

Bank Letters of Credit

- The banker examines the quality and liquidity of the collateral in case there is a demand on the letter of credit. If the banker is satisfied that the **contractor can reimburse the bank if demand is made upon the LOC**, there is no further prequalification.

COVERAGE

Surety Bonds

- Performance bond - **100% of the contract amount** for project completion.
- Payment bond - **100% of contract amount** protects certain subcontractors, laborers, and materials suppliers and protects owner against liens.
- At least 10% coverage for maintenance of defects the first year after completion.

Bank Letters of Credit

- The LOC may be obtained for any percentage of the contract, but **5% to 10%** is typical.
- No protection/guarantee that subcontractors, laborers, and materials suppliers will be paid in the event of contractor default. They may file liens on the project.

CLAIMS

Surety Bonds

- If the owner declares the contractor in default, the **surety investigates**.
- If the contractor defaults, the **surety's options** are to:
  - Finance the original contractor or provide support;
  - Takeover responsibility for completion (up to penal sum of bond);
  - Tender a new contractor; or
  - Pay the penal sum of the bond.
- With payment bonds, the **surety pays the rightful claims** of certain subcontractors, laborers, and suppliers up to the penal sum of the bond.

Bank Letters of Credit

- The bank will **pay on an LOC upon demand** of the holder if made prior to the expiration date.
- There is **no completion clause** in an LOC. The task of administering completion of the contract is left to the owner.
- The **owner must determine the validity of claims** by subcontractors, laborers, and materials suppliers. If there is not enough money from the LOC to pay all of the claims, then the owner has to decide which claims will be paid and which will be rejected.