

Performance Bonds v. Bank Guarantees

Project owners typically accept both guarantees issued by banks and performance bonds issued by acceptable insurers. These guarantees and bonds are required by the project owner to secure the obligations of contractors under construction and works contracts.

The following is a short comparison as we at Bonded NZ see the position.

Performance Bonds	Bank Guarantees
<p>Document Format</p> <p>A contract surety bond is a three-part agreement where the surety guarantees to the project owner that the contractor will perform the contract in accordance with the contract documents.</p> <p>A performance bond protects the owner from nonperformance and financial exposures should the contractor default on the contract. It is directly tied to the underlying contract and if the contractor is unable to perform the contract, the surety has responsibilities to the owner and contractor for project completion.</p>	<p>Document Format</p> <p>A bank guarantee may take the form of a performance bond or a form of letter of credit.</p> <p>But banks generally require that bank guarantees which take the form of a performance bond include a clause which allows the bank to pay out the bond even though there may have been no default under the contract with the project owner.</p> <p>While such a clause might be necessary to protect the bank in regard to other facilities that the contractor has with the bank, the exercise of its payout rights by a bank, may not be advantageous for the contractor, as the amount paid by the bank will become immediately due and payable by the contractor to the bank.</p>
<p>Security</p> <p>With few exceptions, performance and payment bonds are issued on an unsecured basis. That is, they are usually provided on the construction company's financial strength and experience and contractor's indemnity and personal guarantees from the contractor's owners.</p> <p>The issuing of bonds has no effect on the contractor's bank lines of credit and in some instances, can be viewed as a credit enhancement. Unused borrowing capacity can be viewed as an off-balance sheet strength.</p>	<p>Security</p> <p>A bank will almost invariably require an indemnity from the contractor, personal guarantees from the owners of the contractor, and hard security from whoever is able to supply it.</p> <p>Specific assets are pledged to secure bank bonds. Bank bonds reduce existing lines of credit. They are reflected on the contractor's financial statement as a contingent liability. Having assets tied up, or an available line of credit diminished, is counter-productive to both the project owner and contractor.</p> <p>The contractor's cash flow in funding initial stages of construction and retention amounts throughout a contract term can be adversely affected when assets are pledged to a bank or the contractor reduces its borrowing capacity as a result of the bonds being issued as part of a credit line.</p>

Performance Bonds

Cost

In some instances application fees will be sought, but usually applied to the credit of the first premium if the application is successful.

The cost of a bond varies from 1% to 3% per annum plus GST, and is calculated on the face value of the bond. Once paid the premium is fixed.

The premium is payable up front in one lump sum absent any arrangements with the surety.

There is no ongoing facility fee.

Claims

Depending on the bond format the surety company will have a number of alternatives in the event of a call, or a threatened call, under a bond. They are:

- Finance the original contractor or provide support necessary to allow it to finish the project;
- Arrange for a new contractor to complete the contract;
- Assume the role of the contractor and subcontract out the remaining work to be completed; or
- Pay the amount of the bond.

Bank Guarantees

Cost

The cost of a bank bond varies and is fluctuating in today's market. Rates may change during the duration of a bond.

The banks fees are payable at 3 or 6 month intervals and may be payable on the facility amount as opposed to the amounts actually issued.

Other administration fees may be payable.

Overall cost, direct and indirect is hard to assess given that hard assets are tied up with a bonding facility.

Claims

While banks have the same alternatives as mentioned alongside, the reality is that given that banks will be holding hard security, and given also that their expertise lies in areas other than mediating in contracting disputes, banks will be inclined to pay out and look to the contractor for re-imburement.

Bonded NZ regards surety bonds issued by insurance companies as having the following main advantages over bank bonds:

1. Surety bonds do not tie up a contractor's hard assets.
2. Surety bonds do not impinge on bank lending limits.
3. Insurance companies do not insist on being able to pay out when they wish.

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