BONDS

A SHORT GUIDE TO THE SURETY BUSINESS

What is a Bond?

A bond is a legally enforceable document which covers the obligations and responsibilities of a contractor/supplier under a written agreement with an employer/buyer. It provides an indemnity, most usually in the form of a monetary sum, in the event of the failure by the contracting part to fulfil his obligations. Bonds are given under hand and seal and to give effect to them consideration in the form of a premium charged is levied by the Surety.

Who gives a bond?

The surety market is made up of merchant, clearing and international banks, specialist surety companies and one or two insurance companies, but in theory any single person or corporation can act as Surety as long as that entity is acceptable to the beneficiary under the bond, i.e the Employer.

A bond should not be confused with an insurance policy. There are some essential differences between the two:-

•A bond is a contract of guarantee whereas insurance is a contract of indemnity;

•A Bond underwriter must make allowance to cover few fortuitous large claims. An insurance Underwriter therefore uses his premiums to build up a fund out of which to pay claims which are Expected to arise.

•Once issued, a Bond can not be cancelled until the subject matter of the guarantee has been satisfactorily completed. With certain exceptions, most insurance policies can be cancelled before expiry.

Why is a bond given?

A bond is given because the terms of a contract made between the employer and the contractor require it. It is mostly required as a normal condition of the contract for two reasons:-

- The ability to provide the bond indicates to the employer that the contracting party has the financial and managerial strength to carry out the contract – as evidenced by the willingness of a third party guarantor to stand behind the contractor.

- In the event of the failure of the contractor / supplier to carry out the terms and conditions of the contract it guarantees a sum of money to which the employer/buyer has recourse to cover some, if not all, of the financial loss he has suffered as a result of the failure of the contractor.

Types of Bonds

Bonds can be given to cover any written agreement between two parties, but most commonly they come in four types:-

(i).Performance Bond

This covers the general obligations of the Contractor under his contract.

(ii).Advance Payment Bond

This bond would cover any money advanced upon signature of the contract to enable the contractor to finance the start up of the works. This would involve significant sums of money being spent by the contractor on plant and machinery for housing etc.before the contract could get under way. This bond guarantees the repayment of the monies so advanced in the event of the failure of the contractor prior to the completion of the works or occasionally prior to the completion of the amount of work which is of equal value to the sum advanced.

(**iii).Release or Retention Bond**

In any contract the employer would normally retain out of certificates issued detailing the amount of money the contractor has spent, such sums usually being a maximum of 10%, but more usually 5%, and often on practical completion the contractor wishes to obtain release of all monies held by the employer and can do so by giving a retention money bond in lieu.

(iii). A Bid Bond

This bond is usually required on big contracts where proof of the seriousness of the contractor’s intent is needed.

Bid bonds also require that not only does the contractor enter into a contract with employer should he be awarded the contract but also that he can provide a performance bond at the same time.

In this event it is obvious that underwriting the performance bond takes place before the giving of the bid bond.

(iv) CUSTOMS BONDS.

TYPE OF COVER

In respect of certain goods, customs duty is due on arrival in a country unless prior arrangements have been reached with the authorities for such duty to be deferred or waived. Customs Bonds indemnify the authorities against loss by reason of non- fulfilment of their obligations by traders etc. to whom permission has been given to handle dutiable goods to payment of such duty.

Customs and Excise Bonds

Customs duties apply to certain imported goods whereas Excise duty applies to certain goods manufactured locally.

A Customs Bond is a “rebate” bond and is required from persons importing certain dutiable goods without paying duty thereon the understanding that they are put to certain specified use in industry. Should they be used or disposed of in any other way, the appropriate duty has to be paid.

The bond guarantees:

That the goods concerned will be used for specific purpose.

Or

That the duty will be paid on any goods not so used.

An excise bond is required by manufactures of dutiable materials, e.g. tobacco and spirits.

The bond guarantee the payment of duty and the observance of the provisions of the appropriate laws and regulations.

Counter Indemnity

The Surety's role in providing a bond is also to lend the security of his assets and financial strength to enable the contractor to carry out the terms and conditions of his contract.

If the underwriting is done correctly then the Surety should never suffer a loss, albeit that in a swiftly changing financial scene a good, sound company today may be a lame duck two or three years hence.
In order to tie up the relationship between the contractor and the Surety it is deemed essential that the contractor enters into an agreement of indemnity, usually referred to as a counter indemnity.

This document acknowledges the potential indebtedness of the contractor to the Surety in the event of any call being made under the bond or bonds issued by the Surety.

It covers not only the potential liability under each and every bond but also the additional costs and expenses which the Surety may incur as a result of giving these bonds.

Underwriting

A surety, when presented with a case, must satisfy himself on three counts:-

•The financial state of the contractor;

•The managerial capabilities of those in charge of from the site office to the Boardroom;

•The terms and conditions of the contract.

Financial State

Each surety has his own yardsticks by which to measure financial performance but there are some general principles which guide underwriters. The contracting company or its parent/grandparent, if there is one, must:-

•be profitable;

•have a record of growth;

•have an excess of current assets over current liabilities – commonly referred to in the UK as Working capital and in the U.S.A as Net quick assets.

•A net worth – total assets ex goodwill less total liabilities which would be at least twice the potential liability under a bond facility or, if a one off, of the bond.

There are many accountancy books which give definitions of Balance Sheet terms, but in brief a Surety underwriter must prove to himself that the recent financial history (three years audited Balance Sheets) can show inter alia:-

- Continued and increasing, if possible profitability;
- Increase in margins;
- Adequate short term financial resources to finance his day to day operations and finance his outstanding work. Evidenced usually be sizeable cash in hand or substantial unutilised overdraft facilities.
- That the increase in creditors is in line with the increase in activity (i.e turnover) and debtors. Should there be a disproportionate increase in creditors the company may be very slow payers and hence “living off” them to help finance operations.
- No major increase in long term indebtedness, i.e loans, mortgage , etc unless for purposes of acquisition or expansion.
- Increasing net worth which gives the Surety his underlying security for providing a bond facility.

In addition an underwriter must satisfy himself that the queries raised by the balance sheet (and there are always some) have been answered to his satisfaction, which means “digging” behind the figures.

Managerial Capabilities

Appreciation of the capabilities of a company's managers is gained more through experience than reading text books.

The presentation of information, the details, the internal control systems, the reporting systems, the checks on individual's authority within the Group, the processing of information and documents from site to Head Office, are all areas in which to probe.

It is important to understand and appreciate how the company's internal control procedures operate. Site visits give you an idea of workmanship, control of labour, etc. Works or factory visits do likewise to manufacturing premises. Good housekeeping always creates a good impression.

•The manufacture of the articles in strict conformity with the approval formula.
•That there be no attempt to defraud the government of duty
•Proper rendering of all returns, statements and inventories.
•Due observance of the appropriate legal requirements and regulations.

NOTE

Financial Guarantee are often confused with solvency Guarantee and when underwriters are approached to accept a risk, the actual definition of the bond to be covered should be ascertained. Once a risk is accepted, head office will automatically follow up financial statements from year to yea

Questionnaires.

All questionnaires in relation to Bond business should be fully completed. Any applicant who declines to give the fullest information should be immediately viewed with suspicion.

Collateral

If an underwriter decides in principal to provide surety ship, he will in most cases look for collateral. In the event that the insured is a proprietary company, it is desirable that the directors be asked to stand surety personality but, of course, a complete analysis of their statement of assets and liabilities will need to be undertaken.

If the insured is a subsidiary, the counter-guarantee may be obtained from the parent company. The subsidiary will nearly always be a limited liability company and therefore a legal separate entity, so that without the counter guarantee the surety would have no legal right of recovery from the parent.

It the insured is a public company with no parent or associate willing to act an counter-surety, the underwriter will probably seek some form of collateral, e.g. charge on land or buildings, or cession over unencumbered assets, with appropriate valuation.

Counter-indemnities can never make a poor bond risk into a good one. First if the counter surety is an individual who makes a practice of pledging his private property, it is almost impossible to investigate his affairs closely enough and to keep them under surveillance for the duration of a contract to ensure that his unencumbered assets are always adequate to meet his obligations. His financial position may alter materially.

Secondly, the counter surety, whether individual or corporate, may well be in the same business as the contractor and his fortunes may thus be affected adversely at the same time.

Thirdly, it is often expensive and complicated to excuse a counter-surety, even if the instrument is correctly drawn up and leaves no loopholes. It is therefore worth mentioning briefly the validity of the bonds.

CLAIMS

In view of the diversity of risks covered by bonds, each type having its own specialised features, it is not practicable to lay down claims procedures which will have a common application to all of them.

Therefore, all claims falling under Bonds should be referred to management immediately with a copy of the Bond and full details of the circumstances giving rise to the claim.

RATING

All types at between 1.50% to 2.5% on penal sum.

THANK YOU

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