MARSH

New Applications for Surety Bonds

CONTENTS

1 What are surety bonds

2 Benefits

2 Establishing a surety bond facility

3 Common misconceptions

3 Potential uses for surety bonds

4 New applications for surety bonds

4 Future developments

5 Case studies

Over the past 24 months new and expanded uses for surety bonds have emerged, beyond the traditional use within the construction sector. They can provide clients with a number of advantages and, for businesses that have traditionally used bank guarantees, are a viable alternative which also enable such businesses to diversify their capital sources and release debt capacity within existing banking facilities.

WHAT ARE SURETY BONDS?

Surety bonds are a form of guarantee issued by a surety, rather than a bank. There are three parties to a surety bond:

1. The Surety (as guarantor).
2. The party who is required to perform the subject matter of the bond, i.e. the contractor or service provider.
3. The party in whose favour the bond is issued – and who has typically requested the guarantee to be provided, i.e. the beneficiary.

Under the surety bond, the surety agrees to hold itself responsible to the beneficiary up to the specified amount of the bond and subject to its terms for the non-performance of an express obligation, i.e. the obligation of the contractor to the beneficiary.

If the contractor fails to perform the obligations for which it was required to provide a bond or guarantee, the beneficiary of the bond can present the bond to the surety and receive up to the bond amount. Beneficiaries can include corporations, utilities, government authorities and councils.

It's important to note, however, that a surety bond is not an insurance policy. Rather, it is a contract of guarantee offered by a surety, who is able to utilise its financial strength to guarantee that qualified clients will meet their contractual obligations. The beneficiary may claim upon the surety bond from the surety who, acting as guarantor, will pay up to the amount guaranteed under the bond. The surety will claim the amount of such payment from the contractor, pursuant to separate arrangements it has agreed (usually an indemnity) with its client, the contractor/service provider.

Surety bonds issued in Australia are typically unconditional, which means no proof of loss is required to be submitted when presenting the bond. Once the beneficiary presents the original bond to the surety and the beneficiary confirms the person presenting the bond is an authorised representative of the beneficiary, the surety will pay the bond amount in accordance with the terms of the bond. Sureties typically pay the bond amount within 24 hours of the bond being presented, making it an attractive alternative to a bank guarantee.

Surety bonds can also be irrevocable, so once a bond is issued it remains valid until it is returned to the surety, or otherwise it terminates on the agreed expiry date or upon being paid in full. The obligation to pay the bond amount is unaffected by the ongoing financial strength of the contractor.

Beneficiaries of surety bonds can include corporations, utilities, government authorities and councils.

BENEFITS

There can be substantial benefits to using surety bonds in place of bank guarantees. For example, they can help to preserve bank limits for other purposes such as working capital and hedging or to fund expansion plans, acquisitions and investments.

They are typically subordinated to senior security holders and in many circumstances they can be unsecured. Facilities can be committed or uncommitted or a combination of both. In our experience, they are typically more cost-effective than a bank guarantee and rates have shown less volatility than bank guarantees.

Surety bonds can be provided on a direct basis, where the surety bond is accepted by the beneficiary, or via a bank fronted structure, where a bank issues a guarantee on behalf of the contractor but the bank's recourse is to the surety.

ESTABLISHING A SURETY BOND FACILITY

It usually takes between four and six weeks for a surety to process an application to establish a new surety facility. The surety will focus on the applicant's financial strength, their ability to undertake the contractual obligations, and the broader macroeconomic factors influencing the sector in which the applicant operates.

The surety will review the applicant's audited historical financial statements in order to undertake a credit assessment. The minimum eligibility criteria typically includes the contractor having an annual turnover of approximately $50 million, that its operations are profitable and net tangible assets should not be less than approximately one-and-a-half times the bond amount, although this may be less for large clients with annual turnovers of more than approximately $500 million.

In its due diligence, the surety will also review the applicant's historical execution of similar projects and their pipeline of projects. Once the facility is established, the surety can issue bonds on behalf of contractors within 24-48 hours of an application being received.

In our experience, surety bonds are typically **more cost-effective** than a bank guarantee and rates have shown less volatility than bank guarantees.

COMMON MISCONCEPTIONS

While usage and acceptance of surety bonds has increased significantly and is now widespread, occasionally there are some misconceptions which are worth addressing.

Comparison to bank guarantees

Myth: That bank guarantees are a superior guarantee instrument than surety bonds.

Reality: Surety bonds typically contain identical key wording to bank guarantees and have the same obligations. However, unlike bank guarantees, which can be used to guarantee a financial obligation, surety bonds cannot be used to guarantee the repayment of principal and interest.

It's also worth noting that surety companies operating in Australia are highly rated, (typically between A and AA- by S&P) and they are regulated by APRA.

Comparisons to insurance policies

A surety bond is not an insurance policy; it is a contract of guarantee from the surety to the beneficiary that guarantees the contractor will meet its obligations as described in the contract between the contractor and beneficiary.

A surety bond protects the beneficiary, not the contractor. While there is an upfront premium, there is no deductible, no excess, and for unconditional bonds there is no requirement to prove a loss.

Importantly, once issued, unconditional bonds are paid on demand just like a bank guarantee. That is to be distinguished to an insurer's response and evaluation to a claim made under an insurance policy.

Willingness to pay

Being unconditional instruments, when a bond is presented to a surety they must pay the bond amount. In the recent past, sureties in the Australian market have paid out in excess of $400 million. In our experience, most payments were made within 24 hours of the bond being presented.

POTENTIAL USES FOR SURETY BONDS

- Performance bonds
- Bid/tender bonds
- Advance payment bonds
- Maintenance bonds
- Retention release bonds
- AEMO credit support
- Rehabilitation obligations
- Workers compensation liabilities
- Rental bonds
- Petroleum bonds

Marsh has developed structures to enable surety bonds to be a viable and attractive option to bank guarantees.

NEW APPLICATIONS FOR SURETY BONDS

Recently a number of new uses for surety bonds have emerged.

Rehabilitation obligations

State and federal governments require mining, oil and gas companies (among other industries) to provide financial assurance in favour of the state or federal government as security for their obligation to rehabilitate their sites on cessation of activities. Typically this has taken the form of a bank guarantee or, if the corporate is highly rated, a corporate guarantee may be accepted.

In response to the often significant liability and the negative effect that bank guarantees impose on corporate lending limits, Marsh is working with the various counterparties in the mining, oil and gas industries, state governments and sureties to develop acceptance of surety rehabilitation bonds for the Australian market. In the interim, bank fronted surety bonds may be a viable alternative.

Bonds for self-insured workers compensation liabilities

Workers' compensation program management can be complex, with premiums often representing the next highest cost to the business after employee salaries.

For employers with an appetite and capacity to bear risk, obtaining a self-insurer license can be an important workers' compensation cost management tool. Hybrid schemes, such as the retro paid-loss premium schemes, are also an option for qualifying employers.

Participation in these schemes will typically require the employer to post security to the state regulator.

Participants have traditionally used bank guarantees to support their self-insured status and retro-paid loss workers compensation programs. More recently, Marsh has developed structures to enable surety bonds to be a viable and attractive option to bank guarantees.

Participants in the Australian electricity trading market

Participants in the National Electricity Market are required by the Australian Energy Market Operator (AEMO) to provide credit support in relation to their obligations to pay for electricity purchases in the spot market. The amount of credit support is determined by AEMO and includes factors such as estimated load, regional volatility, risk of load and seasonality.

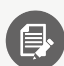
Most AEMO participants provide bank guarantees to satisfy their credit support requirements. However, a bank fronted surety bond facility can be cost effective, release debt capacity under existing banking facilities and the fronting bank can have no direct recourse to the corporate.

FUTURE DEVELOPMENTS

Marsh is working with leading sureties and key industry players to expand surety bonds into other areas:

- Replacing bank guarantees with surety bonds during the bid stage for infrastructure projects.
- Using surety bonds to guarantee sponsor equity contributions.
- Security for 'take or pay' obligations.

Bank guarantees may have significant liability and negative effects on corporate lending limits.



CASE STUDY: SURETY GUARANTEE FACILITY TO REPLACE A BANK GUARANTEE FACILITY

CLIENT

Unlisted, established company

BACKGROUND & CHALLENGES

- Heavily geared balance sheet, negative tangible assets
- Lenders had first ranking security
- Surety was lower cost but not accepted by all beneficiaries
- Existing portfolio of guarantees and bonds

OBJECTIVE

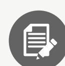
To establish a guarantee facility that can:

- Preserve existing lender security arrangements
- On-board existing guarantees and bonds
- Reduce cost of guarantees
- Have wide acceptance

OUTCOME & ACHIEVEMENTS

Marsh was mandated to arrange a guarantee facility which included the option to issue bank fronted surety bonds or direct surety bonds:

- Sureties were subordinated to senior lenders
- Lower cost than bank guarantees
- Facility includes both a committed and uncommitted surety and bank fronted tranches



CASE STUDY: SURETY FACILITY FOR AN ELECTRICITY RETAILER

CLIENT

Electricity retail company

BACKGROUND & CHALLENGES

- Lenders had first ranking security
- Surety to be unsecured
- APRA regulations
- Facility to be committed
- Facility had to comply with strict payment regime per the Australian Energy Market Operator rules
  - 60% of the credit support to be paid within 1hour
  - 20% payable within 7 days
  - Balance payable within 2 days

OBJECTIVE

To establish a guarantee facility that can:

- Preserve existing lender security arrangements
- Comply with AEMO policies (guarantor rating, timeliness of payment etc)
- Reduce cost of guarantees
- Diversify capital sources

OUTCOME & ACHIEVEMENTS

Marsh was mandated to arrange a bank fronted surety bond facility:

- Surety is unsecured
- Lower cost than bank guarantees
- Committed surety and bank fronting facilities
- Reduced utilisation of banking facilities

MARSH

For more information, contact the colleagues below or visit our website at:
www.marsh.com.au

ERIC WOJCIK

Australian Practice Leader
Credit Specialties – Surety
+612 8864 8687
eric.wojcik@marsh.com

META HUDSON

Principal
Credit Specialties – Surety
+612 8864 8280
meta.hudson@marsh.com

MARSH IS ONE OF THE MARSH & McLENNAN COMPANIES, TOGETHER WITH GUY CARPENTER, MERCER, AND OLIVER WYMAN.

DISCLAIMER: Marsh Pty Ltd (ABN 86 004 651 512, AFSL 238983) arrange the surety bond and is not the issuer of any surety bond or guarantee. This is a general overview of surety bonds. Any statements concerning actuarial, tax, accounting, or legal matters are based solely on our experience as surety brokers and risk consultants and are not to be relied upon as actuarial, accounting, tax, or legal advice, for which you should consult your own professional advisors. We recommend you read any proposed surety bond and indemnity agreement so you have an understanding of the terms and conditions of any bond and the terms and conditions of any indemnity agreement with the issuer before you decide whether this suits your needs. This document and any recommendations, analysis, or advice provided by Marsh (collectively, the 'Marsh Analysis') are not intended to be taken as advice regarding any individual situation and should not be relied upon as such. The information contained herein is based on sources we believe reliable, but we make no representation or warranty as to its accuracy. Except as may be set forth in an agreement between you and Marsh, Marsh shall have no obligation to update the Marsh Analysis and shall have no liability to you or any other party with regard to the Marsh Analysis or to any services provided by a third party to you or Marsh. Marsh makes no representation or warranty concerning the application of surety bonds or the financial condition or solvency of any surety. Marsh makes no assurances regarding the availability, cost, or terms of surety bonds. LPCA 16/0048 | PEM_A_2736

Copyright © 2016 Marsh LLC. All rights reserved.