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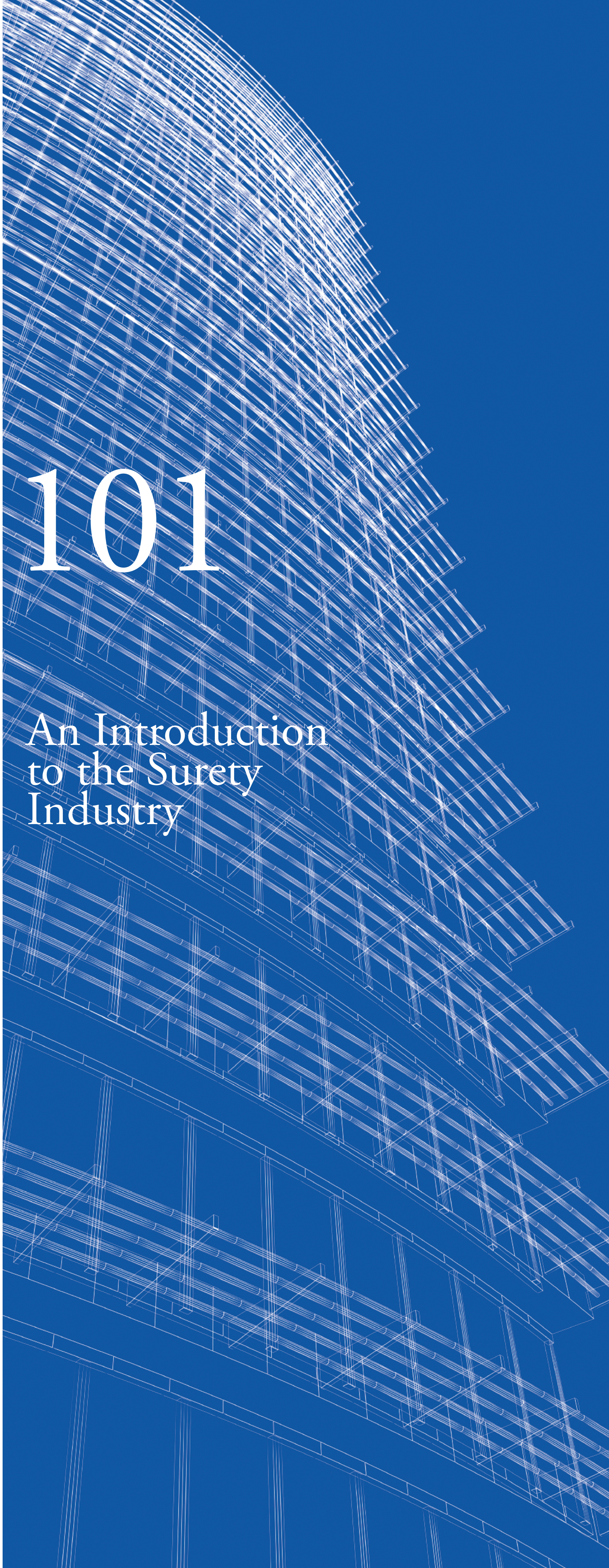
Surety 101



An Introduction to the Surety Industry

Surety bonds have played a major role in Canada's growth since they emerged as a modern North American industry in the late 19th and early 20th centuries. The confidence provided by this invaluable financial tool has supported hundreds of billions of dollars of investment in projects ranging from highways, streets and infrastructure to factories, shopping malls and office towers.

Surety bonds have also supported the development of the modern construction industry. By underpinning and encouraging sound, solid business practices and wise business decisions, surety bonds help to ensure the success and growth of bonded firms.

From small local projects to huge public and private developments, surety bonding provides the assurance of successful completion. In many cases where surety bonds are part of publicly funded infrastructure and development projects, surety bonds protect all of us from loss. Whether public or private sector, large or small, surety bonding has played an important role in creating our history and will play an important role in building our future.

Helping to Build a Nation

In any country growth is always a goal. A healthy economy is a growing economy. That growth spells prosperity.

Western Surety and its predecessors have grown with the economy of the west and of Canada. In fact, the surety industry has played a key role in that economic expansion.

Growth also means significant investment. Whether it's building factories, offices and retail space or creating the highways, streets and infrastructure that will support new development, vast amounts of public or private money are involved.

No matter how well planned and well managed these projects may be, there is always an element of risk. There is always the chance, no matter how small, that problems will arise and a project will falter.

Some formal assurance that a project will be completed, even in the face of unforeseen circumstances, makes it much easier to capitalize on opportunities.

Providing that assurance is the role of the surety industry. Surety bonds are perhaps the most comprehensive risk management tool in existence today. They assure the project owner that the contractor is capable and qualified to do the job. Should a contractor default, the surety provider arranges for project completion.

Surety bonding is a careful, rigorous, and highly professional process. Surety companies prequalify contractors and then assure project owners that these contractors are capable of performing the contract according to its terms and conditions. The surety company also assures that the contractor will pay certain labourers, subcontractors, and suppliers associated with the project.

The surety provider offers this assurance based on their assessment of the contractor and their knowledge of both the financial and hands-on aspects of the construction industries. The contractor's history, capacity, financial strength, character, credit history and a host of other factors are considered. This thorough assessment lets the surety provider provide assurances that the contractor runs a well-managed, profitable enterprise, deals fairly, and performs obligations as agreed.

A successful, long-term surety provider must consistently "back the right horse" to survive. The reason is simple.

It's the surety company's resources that are on the line.

Not a Traditional Insurance Policy

In traditional insurance like car or home coverage, the insurance company collects premiums from a large customer base. This creates a substantial pool of money. The insurer knows there will be losses and sets premiums to cover these anticipated costs. If you have a car accident or your house is damaged, money from this pool pays for repairs.

When a surety company issues a bond, it is backed by the company's own resources. The bond is really an extension of credit, with the assumption that there will be no losses. The bond premium, which is typically between one half of one percent and two percent of the contract amount, is primarily intended to cover the underwriting expenses of the surety company.

If there is a default, the surety company must cover 98% to 99.5% of the contract cost out of its own pocket. With contracts commonly worth tens and even hundreds of millions of dollars, the surety industry is not a place for the faint of heart or who are not true experts in the field.

Surety is a game where only the best players survive.

What Are Surety Bonds?

In simple terms, a surety bond is an agreement among three parties. In most cases, these parties are the surety company, the contractor or principal and the project owner or obligee. The project owner may be a private business or a public entity such as a government or a crown corporation.

The surety provider assures the project owner that the contractor will perform a contract by completing specified work to a specified standard. Terms can also include assuring that the contractor adheres to specific regulations or will pay certain labourers, subcontractors, and suppliers associated with the project.

If the contractor fails to perform the work as specified, the surety company is responsible to see that the project is completed.

The surety provider offers this assurance based on its assessment of the contractor, combined with its expertise in both the financial and hands-on aspects of the construction industries. The contractor's history, capacity, financial strength, character, credit history and a host of other factors are considered before a bond is awarded.

Surety bonding is a careful, rigorous, and highly professional process. The reason for this diligence is simple. If the contractor fails to meet their obligations, the surety provider must bear the cost of completing the contract. With major project budgets commonly in the tens of millions, if not the hundreds of millions of dollars, the consequences of poorly-made decisions can be disastrous.

Assurance, Not Insurance

A surety bond is very different from an insurance policy, with the surety company assuming a much higher level of risk.

Insurance is based on creating a pool of money by collecting premiums from a broad, diverse base of clients on a regular basis. The insurer assumes that there will be losses every year, projects what it thinks these losses will be and includes them when premiums are calculated. If the insurance company does a good job of forecasting, the premiums cover the losses and leave a profit for the insurer.

A surety bond is more comparable to co-signing a loan. When a surety company issues a bond, it is backed by the surety company's own resources. The bond is really an extension of credit, with the assumption that there will be no losses. If there is a loss because a contractor fails to meet the terms of an agreement, the surety company must use its own funds to complete the project.

The bond premium is primarily intended to cover the underwriting expenses of the surety company.

Needless to say, surety companies must have a high level of confidence in every contractor they choose to bond.

	10 Reasons Contractors Succeed
1.	**strong accounting and financial management** that tracks costs, uses bank financing prudently and follows *Generally Accepted Accounting Principles (GAPP) for Contractors*;
2.	**a comprehensive business plan** that includes goals, objectives and a "road map" to achieve them;
3.	**realistic growth and expansion** based on adequate staffing and sufficient working capital;
4.	**thorough project management** with thorough supervision, on-time completion and reasonable pricing on change-orders;
5.	**accurate estimating and job costing** that maintains profit margins and facilitates accurate, competitive bidding;
6.	**superior communication** between head office, field staff and clients;
7.	**continuity of ownership and key staff** with effective succession planning, high levels of staff retention and contingency plans in place;
8.	**a focus on areas of expertise** without repeated changes in the scope or line of the business and with any moves into new areas thoroughly researched and planned;
9.	**the ability to deal with uncontrollable factors** and adapt to the economic conditions, weather delays, labour difficulties, material shortages and other challenges no contractor can control; and
10.	**a loyal customer base** retained and expanded through high service and delivery standards.

Types of Surety Bonds

Contract Surety Bonds

There are three basic types of contract surety bonds.

The **bid bond** provides financial assurance that a bid has been submitted in good faith, that the contractor intends to enter into the contract at the price bid, and that the contractor will provide the required performance bonds, as well as labour and materials bonds.

The **performance bond** is the best-known surety bond. This bond assures that the contractor will perform the contract as specified. If the contractor fails to meet the obligations of the contract, the surety company will see that the work is completed.

The **labour and materials bond** guarantees that the contractor will pay specific subcontractors, labourers, and material suppliers associated with the project.

Commercial Surety Bonds

Commercial surety bonds assure performance in a broad range of business relationships. The most common forms of commercial bonds include:

- **License and Permit Bonds**, typically required by a government that is issuing a license to assure that specific license or permit conditions will be carried out;
- **Lost Document Bonds** which cover costs associated with lost business documents;
- **Administration, Property Guardianship Bonds** which commonly deal with estate and trust matters; and
- **Customs and Excise Bonds**, relating to the import and export of goods.

Qualified Insurance Brokers Add Value

Established surety providers work through qualified insurance brokers.

The broker is much more than a sales agent. Good brokers are experts in insurance and surety. They know the strengths of their contractor clients and they are familiar with various sectors of the construction industry.

The broker matches contractors and surety providers. He or she can ensure that the surety company has the complete, personal picture of the contractor's business that the facts and figures cannot provide. The broker can advise the contractor on the best form of surety for the project at hand, guide their client through the bonding process and help build a productive relationship between the contractor and the bonding company.

Getting a Bond Takes Time

A common misconception is that obtaining a bond is based on a superficial review of the applicant and the payment of a premium. As a result, bond applications are sometimes left until the last minute.

Without adequate lead time, acquiring a bond can be difficult and may prove impossible.

The underwriting or pre-qualification process uses a combination of information compiled by the broker and the surety company's own assessment. Surety underwriters evaluate risk in much the same way as banks evaluate loan applications. Business and personal financial statements, credit reports, credit references, experience, management skills, track record, and character are all important considerations.

The process involves a complete analysis of the business and its principals, including the contractor's:

- capacity to perform;
- financial strength;
- banking relationship;
- track record;
- company history;
- organizational structure and reporting;
- business continuation plans; and
- trade references.

A thorough analysis of all projects in progress is also part of the process.

The reason for this exhaustive process is simple. Once the surety company has qualified the contractor, it will commit its own resources because it believes the contractor will be able to meet the terms of a contract. The risk for the surety company may well involve millions of dollars of its own funds. If a default occurs, it can have a significant negative impact on the surety provider.

Surety Company Checklist

Surety companies look for a well-managed, profitable business that deals fairly and meets its obligations.

- Good character;
- Experience matching contract requirements;
- Solid track record;
- Financial strength;
- Excellent credit history;
- Banking relationship;
- Ownership of, or the ability to obtain, necessary equipment; and
- Skilled labour force.

Building Lasting Relationships

While the pre-qualification process takes time and effort on the part of all concerned, it also pays long term dividends.

Once a contractor is known to a surety provider, it becomes much easier to evaluate projects and issue appropriate bonds. Many successful contractors view their brokers and bonding companies as important business partners, involving them early on in the bid decision and development process.

The “bonding team” can even offer suggestions and input that helps contractors strengthen their bids – and their businesses.

Bonding Benefits Project Owners

For those instigating a project, bonding ensures that all bidders are capable, competent and serious. Unqualified or irresponsible bidders are eliminated.

Project owners can be confident that the contractors they select have the necessary skills and resources to complete work on budget and to specified standards. In the rare cases where unforeseen circumstances create problems, the surety company will provide the resources to complete the work.

Bonding can assure that specific standards are met and that appropriate payments to subcontractors and suppliers will be made. This virtually eliminates the filing of liens, making the transfer on completion a far smoother process.

Bonding Benefits Contractors

Obtaining a bond tells the world that a business is successful, well managed and reliable. Bonds are commonly required to bid on substantial contracts. Even when a bond is not mandatory, the security a bond provides can be a distinct competitive advantage.

In the course of the pre-qualification examination of a company, it is not uncommon for the surety company to make suggestions for internal changes that will make the contractor easier to bond. These changes usually lead to operational improvements, more efficient management or both. The end result can be a more profitable, competitive business for the contractor.

Bonding Benefits All of Us

When the project owner is a public entity or if significant levels of public funding are involved in a project, we all benefit from the security bonding provides.

As taxpayers, we are all owners of these major public projects. Surety bonds protect our money and ensure that the work we are all paying for is done properly.

Talk to a Qualified Broker

An experienced insurance broker can answer all your questions about surety bonding, connect you with the right surety company and help you build a profitable, productive and lasting business relationship.

Scott Donald
President

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Disclaimer:

[This publication is provided by Western Surety Company to qualified insurance brokers. It is intended to provide a general overview of the surety industry. If you have questions or would like to investigate obtaining or qualifying for a surety bond, please contact the broker who provided this publication.]

Please visit www.westernsurety.ca for further information.

Glossary of Surety Terms

The following are some of the more commonly used terms in the surety industry. Your broker can answer all your questions about the meaning of surety terminology, so don't be afraid to ask.

A

Administrator - Person with a legal right to act on behalf of an estate.

Attachment - Legally taking a defendant's property.

B

Beneficiary - A person who is entitled, by law or bond language, to claim against a bond even though not specifically named as an Obligee.

Bid Bond - Guarantees a contractor will execute a proposal for the amount bid and with appropriate performance bonds.

C

Capacity - The size of a bond or aggregate work program a surety is able to cover.

Collateral - Reduces the risk a surety company assumes when issuing a bond for high risk principals or unusual obligations. There are many forms in which collateral may be provided, including certified cheques, certificates of deposit or irrevocable letters of credit.

D

Damages - Damages are monetary fines.

E

Estimated Earnings Remaining - Estimated profits remaining on a job.

F

Fiduciary - Person appointed by a court to act on behalf of another, including the administration of an estate and the management of a trust or ward. Fiduciaries are often asked to post bonds guaranteeing their performance.

Fiduciary Bond - Guarantees the performance of a fiduciary.

I

Indemnity - Protection or security against loss or damage.

Indemnification - Guarantees a second party repayment in the event of a loss or judgment against the first party.

L

Labour and Materials Bond - Guarantees payment by a contractor to subcontractors, labourers and suppliers involved in a project. Where liens cannot be placed, a payment bond is an excellent assurance that all parties associated with a contract will be paid.

License and Permit Bond - These bonds may be required by a unit of government as a prerequisite for obtaining a license or permit. They guarantee that those government provisions will be carried out by the license- or permit-holder.

Lost Document Bond - These bonds cover specific costs in the event that specific business documents are lost.

M

Maintenance Bond - Guarantees that a completed project will meet its requirements for workmanship or materials for a specified period.

O

Obligee - Person or organization to whom a service will be provided. A surety guarantees the service provider will perform for the obligee as expected.

P

Penalty - The monetary size of the level of risk, and potential payment, associated with a bond.

Performance Bond - Guarantees the performance of a person or organization in fulfilling the terms of a contract. Most of these contracts are for construction, and the contractor must meet pre-qualification standards before being approved for the bond.

Plaintiff - Person or organization who initiates a legal proceeding.

Premium - The payment to have a bond.

Principal - Bonded person, company or organization.

R

Rate - Premium paid for each $1,000 of coverage.

Reclamation Bond - Guarantees an organization will restore land after a project to its original state.

S

Surety - Person or organization guaranteeing the actions of another.

Surety Bond - Guarantees a principal party will fulfill an obligation to an obligee.

T

Total Billings Excess - Billings less costs at a specific point of a job.

Total Project Loss Recognized - A loss recorded in full at the time it is recognized, based on CICA accounting standards.

Trustee - Person selected to manage an organization's funds and cooperate with creditors.

W

Work-on-Hand (WOH) Report - A summary of a contractor's work in progress, including contract prices, costs, billings and profits.

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Supporting Your Broker