Surety bonds are part of construction culture in Canada. As economic uncertainties bite, is it time to consider the real value in a time-tested solution? By Raymond Bassett, vice-president, underwriting services, Travelers Guarantee Company of Canada.

Sure shot

Often, the most serious risks to the success of the construction phase of a project are not found on the construction site, nor in the hundreds of pages of contract documentation, nor in the make-up of the project management team. Often, the most serious risks to a project can come from events and stresses affecting a contractor that are unrelated to this project; risks from outside the project fence.

In its May 2007 survey of 161 bankers, construction contractors, procuring agencies, technical and financial advisors, insurers and project companies from 22 countries, Standard & Poor's asked respondents to list the main reasons for problems with construction budgets and schedules on PPP projects. Among the top 10 reasons was "inexperienced or weak contractors." While S&P noted that participation in PPP projects is usually limited to larger, more established companies with good financial standing and reputations to protect, they also reported that: "A number of those surveyed state that they had little insight into a contractor's responsibilities beyond the PPP project until external workflow commitments started to affect the contractor's performance."

How do you get a good view, beyond the project fence, of the enormous hub of energy and activity that is a construction organisation? How do you get comfort that the contractor that is about to undertake the critical construction phase of your project is in good health and is able to stay healthy and keep any problems that it may experience from creeping inside your project fence? These are challenges that go beyond transaction-specific performance security instruments or simple risk transfer contracts. These are challenges that are uniquely met by the construction surety underwriting process and by the robust structure of a 2-page surety bond.

The surety's view

A significant programme of surety credit involves an underwriting process that goes well beyond short- and even mid-term transactional considerations and opportunities. Construction organisations work with and develop relationships with surety companies that are long-term, often spanning decades and sometimes generations. A surety's due diligence is ongoing over long periods of time, and includes a focus on a construction organisation's long-term business strategy and management, capitalisation, disciplined risk management and project execution spanning its entire work program.

A surety company has a clear view of a contractor's entire enterprise, and has a clear view of how a construction organisation assesses risk and restocks its work program to keep its capital working efficiently, but without stretching beyond its capacity to perform and to absorb the inevitable shocks along the way.

Surety culture in Canada

In Canada, the added value of the surety underwriting process and the value of the surety bond itself has long been recognised. In fact, from a Canadian perspective, surety bonds are embedded in construction culture. While the use of performance and payment bonds on publicly-funded work in the United States at both federal and state levels has been mandated by legislation since the mid-1930s, in Canada surety bonds have remained central to construction risk management on publicly funded infrastructure work without legislation or regulation. Why?

In Canada, as in many other jurisdictions, there is a strong culture of accountability on publicly-funded work, and the market functions within a commercial and legislative framework that provides some recourse and level of comfort for subcontractors and suppliers in assessing their credit risk.

In an article published in 1996 following the last severe downturn in the Canadian construction economy, and following a period of significant losses for surety companies in Canada, Bruce Reynolds, a partner in the Canadian law firm Borden, Ladner, Gervais, and head of that firm's international construction projects group, observed: "In policy terms, Canadian governments long ago accepted the proposition that both legislative and administrative steps must be taken to manage the heightened risk of insolvency which is inherent in the construction industry, and implemented a safety net of such mechanisms. The major protective mechanisms are liens, hypothecs, statutory trusts, surety bonds, and restructurings. This safety net of protective measures has, in fact, been enhanced over the years, and, although it is less than a perfect preventative, has undoubtedly had the effect of minimising insolvency in the industry, particularly during the major Canadian recessions of the early 1980s and the early to mid-1990s."

Every province in Canada has its version of construction lien legislation providing layers of safeguards, including statutory holdbacks and, in some instances, trusts that to some degree mitigate credit risk throughout the construction chain. And while there is no statutory requirement that surety bonds be used on publicly funded work, in their administrative approach governments at the federal, provincial and municipal levels in Canada continue to show strong demand for the use of surety bonds on institutional and

infrastructure projects, and the demand from the construction and project lending community for surety bonds on larger private projects is strong and has shown a marked increase with recent economic uncertainties.

Value for the project sponsor

Public and private project owners in Canada can have confidence that surety companies in Canada handle claims well. As contractors work off their backlog it can take a year or two for the effects of an economic downturn to work through the construction economy. During the last recession in the early 1990s the Canadian economy shrank significantly, and from 1990 to 1991 real GDP went down by more than 1% while the unemployment rate rose beyond 10% in both of those years.

The impact this had on the Canadian construction industry was registered in surety industry results, with surety loss ratios of 106% in 1991, 113% in 1992 and 125% in 1993. There are a few stories from that time of disputes with surety bonding companies, but the stories don't change the loss ratio. Sureties in Canada pay claims.

Value for contractors

From the perspective of construction organisations in Canada, surety credit enables Canadian contractors to put capital to work very efficiently. Most surety credit is provided on an uncollateralised basis – surety bonds are on-default instruments that promote accountability and performance on both sides of a construction contract. This means that in addition to credit quality, a surety's decisions about the size and scope of a surety credit facility can allow a factor for a contractor's ability to perform, to manage and execute on a program of work over time. Capital is not locked up supporting letters of credit but is available to support sound opportunities, and to apply to solve construction problems inside the project fence.

According to Gerry Russ, managing partner and senior vice-president of construction services for Aon Construction and Infrastructure Services: "There are a lot of factors that drive the surety credit model, so these assumptions won't work for every situation, but let's just take a simple model to illustrate the point. Assume that a large general contractor can leverage C$10 million in working capital to obtain surety support for a C$150 million work program, and assume a 6% margin on that work. That's a C$9 million opportunity. It makes you think twice when you are working out the real cost of the same C$10 million tied up as a letter of credit as part of the performance support package on a P3 project."

For contractors, and for other financial stakeholders in large projects, the real cost of a performance support package that does not include surety bonds may go beyond the fee charged for the letter of credit.

Due diligence throughout the construction chain

There are other benefits that contribute to the strong Canadian surety culture, even though they may not be quite as visible. The use of performance bonds for key subcontracts and specialty trade contracts, as well as at the prime contract level, ensures a level of consistency and third-party due diligence throughout the construction chain. While surety companies differ on their emphasis or weighting of some factors over others, there is generally a good degree of consistency, scrutiny and discipline inherent in the surety process that reduces construction risk at whatever level it is applied. The least disruptive default – anywhere in the construction chain – is the default that never happens.

Throughout the construction chain, credit risk is a key driver of pricing and participation by trade contractors and suppliers on infrastructure projects. Key subcontractors and suppliers on large infrastructure projects extend significant credit in material and labour on these projects and take on a very serious credit risk. While this credit risk at the ground-level of the construction pyramid may not register in the high-level financial modelling that is done on a large infrastructure project, the risks of non-payment and an unraveling of schedule commitments, project teams and specialised warranties because of non-payment of trade and supplier accounts is a very significant risk.

Labour and material payment bonds, typically issued in tandem with performance bonds, provide dedicated, project-specific funding for trade, supplier and labour accounts that are unpaid because of a contractor default.

Infrastructure Ontario (IO), the provincial Crown corporation with a mandate to manage a very significant amount of public infrastructure procurement for the province under its Alternative Finance and Procurement process, pointed out the value of surety bonds in its build-finance model: "Although an alternative security package that does not include a labour and materials (L&M) bond may be accepted, it is IO's opinion, and that of many co-sponsors such as hospitals, that the L&M bond is a valuable companion to the performance bond as it provides [the] owner with the comfort that the surety will make available a pool of funds to settle subcontractor claims for unpaid amounts owing under their subcontracts. Arguably, this will assist the owner and the lender to retain key subcontractors performing under their original subcontracts while a solution or replacement general contractor is sought. In addition, IO has been advised that the existence of the L&M bonds provides comfort to subcontractors when they participate in IO projects."

The risks of rapid growth

In their 2007 study, "Why Contractors Fail: A Causal Analysis of Large Contractor Bankruptcies", Hugh Rice and Arthur Heimbach, PhD observe that:"Recent history has shown that construction firms are not too big to fail even though they may have annual revenues ranging from hundreds of millions to several billions of dollars. During the past few decades, there have been dozens of large contractors who, after many years of growth and apparent prosperity, experienced notable financial disasters, resulting in bankruptcy or a reincarnation of the business in a much different form."

Growth in a construction organisation is one of the many things going on beyond the project fence. The opportunities for well-managed and well-capitalised construction organisations to grow by taking on new infrastructure work and to grow programs of work at good margins are abundant. And with published government commitments for further investment in public infrastructure over the next 5 to 10 years in nearly every region of the country, indications are that this infrastructure surge is strong enough to last through any modest slowdown in the Canadian economy.

At the same time, one of the most significant risks from outside the project fence is rapid growth. For many well-managed construction companies the toughest challenge in times like these may be seeing too many opportunities – the challenge of saying no. For example, while an overheated construction market in Western Canada over the last couple of years may be starting to level off at a level that is merely excellent, contractors continue to report challenges in finding enough good senior and mid-level people to execute on opportunities. There has been some strain on capacity among key trade and specialty contractors, and there have been some challenges related to a limited capacity in the design, engineering and consulting areas. And there have been some recent construction failures in Canada, during some of the best construction market conditions ever.

At present, there is also uncertainty about the state of the credit markets, and the impact on Canada's construction economy of economic downturns in the US and Europe. Growth cycles in Canada are often regional, and usually plateau and then tail off over time. The ability of a large construction organisation to manage through and to thrive during these transitions is critical to its long term health. Good strategic performance is also a key part of keeping these sorts of distractions from creeping inside the project fence.

In considering the way in which construction organisations approach opportunities for growth, Terry Lukow, head of the construction services unit of the bond and financial products group of The Travelers Companies, Inc. made the following observations: "Now more than ever, the industry is focused on managing both opportunities and growth. Contractors should ask themselves: 'Where can I capitalise in a given market considering my organisation, my capabilities and my experience in a way that will allow me to gain the highest and best economic returns?' For an organisation to be successful in today's marketplace, contractors should approach the construction industry with a strategic view rather than a transactional view. It's more than a strategic financial structure; it's a view composed of a business plan structure, risk appetite and relationships. Contractors must manage for the long term, not the short term, because long-term management will keep them in business while short-term management will only increase their risks. A surety company looks for more than just a contractor's financial structure. It asks, 'What is the strategic business plan?' and 'How will contractors manage this economic boom in the marketplace?' "

Surety bonds on PPP projects

Infrastructure projects in Canada are becoming larger and more complex, with longer procurement and construction schedules. There are more moving parts that need to keep moving properly over longer periods of time, and with very significant amounts of money at stake. And while it may be true that on a PPP project, for example, public funds are not at risk until project completion, there are very significant financial, social and political risks associated with a failed PPP project. Learning from Australian and UK experiences, Canadian approaches to PPP procurement are focusing on best practices and standardised structures that, it is hoped, will lead to long-term success on Canadian projects. It is still relatively early, though, in the evolution of these models, and it is yet to be seen how projects in the PPP market will perform during an economic downturn.

In developing its internal credit and risk modelling for its contract surety business, Travelers studied the detailed financial, operational and claims data on hundreds of contractor defaults. One strong correlation that is clear in the data is that the probability of contractor failure increases dramatically with increases in project duration.

The surety industry in Canada has underwritten and managed through many turns of the economic cycle and the long-term diligence of the surety underwriting process is, perhaps, one of the best early warning systems available to ensure construction performance as the economic cycle oscillates during the extended life of a PPP project. It may be that setting some requirements for the use of surety credit as part of the performance support on PPP and other infrastructure projects in Canada is a reasonable step for government sponsors to expect and one that is not an obstacle to the innovation and entrepreneurial drive in which the true value of the PPP model can be found.

For PPP projects, where liquidity in the performance support package can be critical, Travelers Guarantee Company of Canada has developed a new solution for its clients working on PPP projects in Canada. Combining the risk reduction value and well known asset completion strengths of the conventional on-default performance bond, the **Travelers Guarantee P3 Performance Bond** provides an advance loss payment feature that provides a significant shot of liquidity within a very short time frame after a contractor default. This new surety solution addresses the two primary objections sometimes raised by project stakeholders: that there is uncertainty in how long the claim adjusting process will take, and that there is uncertainty around settlement value. This new product makes available a specific amount within a specific time-frame.

This is innovation, but with a view to reinforcing and enhancing the value inherent in the surety products that have become part of the landscape in Canadian infrastructure development for more than 100 years. As we all enjoy this surge of development in public infrastructure supported by new stakeholders and broader participation, and as the market tests newer ways to find value in project delivery models, we may do well to keep one foot planted firmly on familiar ground. ■

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