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Performance Bonds - Factsheet

What is a Performance Bond?

A Performance Bond is a form of security provided by a contractor to a developer. It consists of an undertaking by a bank or insurance company to make a payment to the employer in circumstances where the contractor has defaulted under the contract.

There are two types of performance bond: "On Demand" and "Conditional".

On Demand Bonds are rarely used in the UK construction industry, but they are a standard requirement in many international contracts, as well as in the petroleum and power industries within the UK. **On Demand Bonds** are usually provided by banks and, as the title suggests, the bank is required to make a payment under the bond whenever this is demanded.

A Conditional Bond, by contrast, is common within the UK construction industry. Such a bond is usually issued by an insurance company, and payment is usually conditional upon the employer who makes the call proving the amount of loss which he has suffered.

In practice, therefore, **a Conditional Bond** may require litigation before any payment can be obtained.

The value of a performance bond is usually expressed as a percentage of the contract price, usually between five and twenty per cent of the contract price, with ten per cent by far the most common figure.

A bond issued under English law is usually executed as a deed.

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Banks vs Surety Companies

When discussing Performance Bonds with clients, it is important to note that this type of product is not an insurance product. Premiums therefore are not subject to IPT. It is common for clients to use their bank for this type of financial surety. Banks, however, generally take 100% cash collateral security for the duration of the contract.

If clients have that amount of cash in credit, that's great, because they can pay interest on it and that will probably pay for the bond.

The downside is that this arrangement could have a serious affect on the client’s cash flow for the duration of the contract as they will not be able to access it.

The Bank can offer to extend overdraft facilities and probably secure that with personal guarantees or charges over property etc.

If this is the case, the cost of taking the bond from the bank will be much more than the initial rate will indicate.

Overall, it is very possible that the bank option could well end up more expensive and prohibitive than using a Surety Company.

Bonds and Surety are strange worlds and firms often find that it is not until they are about to sign up with banks that they are told about the cash collateral.

The best advice would be to check with them before signing anything.

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Counter Indemnity

A Surety or Guarantor may seek reimbursement from its client for any claim paid under a Bond issued on the client's behalf.

This is an established concept, supported by common law, which is formalised by the counter indemnification of the Surety or Guarantor by the client. Such a Counter Indemnity takes the form of a legally binding undertaking by the client, to indemnify the Surety or Guarantor against any claims, costs and expenses that may arise whilst acting as Surety or Guarantor.

If the client is part of a wider group of companies, then the Surety or Guarantor will also generally require the Counter Indemnity of the ultimate holding company. Specimen copies of our Counter Indemnities are available if required – please email: sales@focus-insurance.com

Of course, the risk of Surety or Guarantor is that the client will be unable to make good its promise under the Counter Indemnity. Most calls on Bonds taking place under circumstances where the client has become insolvent.

Types of Bonds

Advance Payment Bonds – A bond to cover any advance a client may receive from their employer. Usually the advance is used to buy materials to get prepared for a job. These bonds will be 100% of the advance payment made.

Performance Bonds – A bond to ensure the client performs as per the conditions of the contract. These are usually 10% of the contract sum but some employers require 15%.

Retention Bonds – A bond the client can give to their employer in lieu of them holding retention monies against them, frees up cash to assist cash flow. Usually 2.5% or 5% of the contract value.

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Current marketing opportunities

1. Retention Bonds - These allow the client to get retention monies back off their employer which can assist with cash flow and offer peace of mind if your client believes their employer may be in financial difficulty.

2. Banks – Banks are historically where clients get their bonds. However, banks require 100% cash collateral as security and thus, in these difficult times, cash is not always available and banks are not willing to extend overdrafts to cater for larger bond facilities thus clients are looking for alternatives.

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