

# **GUIDE FOR THE ACCEPTANCE OF PERFORMANCE BONDS BY PUBLIC SECTOR ENTITIES**

This Guide provides recommended prudential criteria and documentary requirements to be considered by a public sector entity prior to its acceptance of a performance bond from an issuer, where the public sector entity has determined that a performance bond is required.

This Guide does not set out the circumstances in which a performance bond would be required, or, when a performance bond is required, the value of the bond. These decisions are the responsibility of the public sector entity and need to be determined by reference to its risk tolerance and taking into account the risks inherent in the project.

The recommendations are not mandatory and are solely intended to provide guidance to public sector entities. A public sector entity should consider the relevance of the recommendations in this Guide in light of their risk tolerance, their business needs and the standards of the industry they operate in. The entity should be able to explain its position regarding their acceptance of performance bonds, particularly where it accepts bonds of a lower standard than recommended in this Guide.

‘Performance bond’ is a general term referring to an undertaking from an entity guaranteeing the performance of a third party’s obligation. For the purposes of this document, the term ‘performance bond’ only encompasses bank guarantees and insurance bonds (also called surety bonds) and any equivalent bonds offered by financial institutions. Performance bonds can be conditional or unconditional.

## **Recommended Criteria for Acceptance of Issuer of Performance Bond**

The following matters should be taken into consideration when evaluating an issuer.

### ***Credit rating and APRA supervision***

In order to provide public sector entities with a sufficient level of comfort that the issuer is capable of meeting its obligations, it is recommended that a performance bond be accepted from an issuer that:

- is regulated by APRA, or, if not regulated by APRA, if they are domiciled in a country that APRA has determined comparable prudential regulation<sup>1</sup>; and
- has a credit rating at or above a Minimum Credit Rating (MCR), or the issuer has a guarantee from a parent that has a rating at or above the MCR. The MCR is defined as a long-term credit rating (or financial strength rating for insurance companies) of A- (Standard & Poor’s) or A3 (Moody’s).

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<sup>1</sup> A list of institutions regulated by APRA can be found on the APRA website ([www.apra.gov.au](http://www.apra.gov.au)).

An issuer's credit rating provides an indication of the likelihood that it will default on its obligations. The higher the credit rating, the more certainty that the issuer of the performance bond will be able to meet its obligations. The recommended minimum credit rating is set at a level that balances the possibility of recovery against the need to have a reasonable pool of eligible issuers so that concentration risk is minimised.

APRA is the prudential regulator of the Australian financial services industry. APRA's prudential standards, which include capital adequacy and liquidity requirements for banks and insurance companies, together with its over-sighting and supervisory activities, provide comfort that the financial promises made by institutions it supervises will be met within a stable and efficient financial system.

### ***Monitoring credit ratings***

Consistent with the public sector entity's overall responsibility for managing the risks of the project, the entity should confirm the credit rating of the issuer before accepting a performance bond, and monitor the issuer's credit rating over the life of the bond.

Credit ratings by agencies such as Standard & Poor's and Moody's are publicly available and can be accessed through their websites:

[www.moodys.com.au](http://www.moodys.com.au)

[www.standardandpoors.com](http://www.standardandpoors.com)

To assist public sector entities in this process, DTF will publish and update from time to time a list of APRA regulated issuers. The onus is on the public sector entity to satisfy themselves that the issuer fulfils the recommended criteria. Inclusion of an issuer in the listing does not reduce the need for the public sector entity to manage the risks associated with performance bonds (including through appropriate documentation and other criteria relating to the issuer as set out in this Guide). Given the large number of APRA regulated entities, DTF will only monitor banks/insurance companies which it is aware have, or are in the business of, providing performance bonds to public sector entities.

### ***Local office***

It is essential that the issuer of the performance bond has a local office in Victoria. This would facilitate presentation of the bond for payment or the serving of proceedings for legal disputes.

### ***Change of ownership of the issuer***

It is recommended that the public sector entity has a 'right of review' in the event that there is a change in the ownership of the issuer. This right of review is important to assist in ensuring that the MCR requirement is met, and as a possible mechanism to prevent undue concentration risk (discussed below).

### ***Concentration risk***

It is recommended that the public sector entity, where possible, avoids an undue concentration of risk with any one issuer. This can arise from significant aggregate exposures to individual issuers (including their related companies), or the large size of

individual contracts, or exposures, relative to the size of the issuer. A public sector entity can mitigate concentration risk by accepting performance bonds from a range of different issuers that meet the MCR and which are supervised by APRA.

## **Documentation**

### ***Rating downgrades to be covered in the document requiring a bond***

It is strongly recommended that the document requiring the bond should contain a 'ratings trigger', whereby in the event that the issuer's long-term credit rating falls below the MCR, the contractor is required to replace the performance bond with a bond from an alternative issuer acceptable to the public sector entity within a set time period or, failing that, with a monetary deposit<sup>2</sup>. At a minimum, this should be done within 60 working days of the rating falling below the MCR.

Where an agency considers that the risks are significant, a stricter approach could be considered, such as immediate replacement of the performance bond with a monetary deposit, or through specifying a shorter time period for replacement of the bond (for example, 14 working days rather than 60 working days).

It should be stated that failure to meet the requirements of the ratings trigger will lead to payment of the existing bond being demanded.

The longer the term of the bond, the greater is the need for such an obligation on the contractor. Over the short term, the risk of deterioration in an issuer's financial strength is lower than over the longer term. Therefore, it is prudent to monitor the credit rating of the issuer during the term of the bond and to have mechanisms in place to deal with a rating downgrade.

### ***Documentation of the performance bond***

It is recommended that performance bonds should:

- A. be documented in a form that is legally binding;
- B. be clear and unambiguous in intent;
- C. be irrevocable and unconditional. Specifically, they should:
  - i. not be conditional on the public sector entity proving that a demand has been made;
  - ii. not be contingent on any other right or obligation appearing in another document;
  - iii. be free of any requirement for the public sector entity to establish default by the contractor or prove the demand;
  - iv. contain nothing that can release the issuer from any obligation except as specified by the public sector entity;

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<sup>2</sup> That is, a deposit of funds that is immediately available in the form of: cash, a bank cheque, direct deposit, and/or electronic transfer. Where a monetary deposit is made, the public sector entity should enter into a written agreement with the security provider that covers the conditions on which the monetary deposit is held (which should be similar to the documentation requirements for performance bonds (see *Documentation*) and entitlement to interest.

In circumstances where it is not possible to obtain an unconditional performance bond and a conditional performance bond is sought, the conditions should be clearly and unambiguously stated;

- D. be payable, in part or whole, immediately on demand without reference to any other person (including the contractor), document or notice (except that given by the public sector entity), including any agreement between the public sector entity and the contractor;
- E. confer the benefit of the bond on the public sector entity until the requirement for the bond has been released;
- F. specify that it is governed by the laws of Victoria and be under the jurisdiction of the courts of Victoria (or, at the least, the laws and jurisdiction of another state or territory of Australia) to avoid enforcing it overseas under foreign laws; and
- G. require the issuer to maintain an office in Victoria where the bond can be presented.

For an acceptable unconditional performance bond, AS2124 provides a template. When documenting the terms and conditions of performance bonds, it is important that commercial and legal advice is obtained.

#### *Maturity of the bond (lapse date)*

Preferably the bond should not contain an expiry or 'lapse' date, as the term to maturity of the bond must be long enough to cover the length of the exposure to the contractor. If an expiry date is specified, the public sector entity should ensure that the bond remains valid for the whole period of the project (including any defects liability period or extended period required for variations) plus some time for 'running late'.

### **Document security and maintaining of a register**

Performance bonds are effectively cash in the hands of the public sector entity and should be held securely by the public sector entity under lock and key. The public sector entity should maintain strict custody of performance bonds directly and not rely on project managers or other third parties to store them.

The public sector entity should maintain a register of all performance bonds held by that entity. A register would assist the public sector entity in monitoring the risks associated with holding performance bonds, including monitoring of credit ratings and concentration risk.

As a minimum, the register should include the following information:

- name of the issuer of the bond;
- name of the contractor whose obligations the bond is security for;
- value of the bond;
- special conditions in the bond or on the contractor (e.g. a ratings trigger); and
- expiry date (if any) of the bond.

Department of Treasury and Finance  
December 2006