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The Power of Optionality in Performance Security

By David Bowcott

Economic uncertainty, driven by inflation, rising interest rates, and geopolitical instability, is increasing tension between construction contractors and project owners over performance security structures. When contractors have ample resources, project owners may demand less security. However, in today's climate—marked by limited contractor availability and rising material costs—demand for more robust performance security packages is growing.

Project owners must consider that asking for larger security packages often results in contractors raising their construction prices. This is because performance securities, such as letters of credit or larger bonds, affect contractors' balance sheets and limit their ability to secure future work. Consequently, contractors factor these lost opportunities into their pricing. To prevent inflated costs, both owners and contractors should be familiar with the various performance security options available. This allows them to strike a balance between ensuring strong security and minimizing the financial strain on contractors.

The following page provides a high-level overview of performance security options that help achieve this balance. The list is not exhaustive, but it highlights key options available in the market. Both project owners and contractors must collaborate to determine the best performance security structure—one that satisfies the owner's need for security without significantly impacting the contractor's ability to pursue future work. Understanding the available options is crucial to achieving this balance.

Performance Security Option	Nature of Coverage	Impact on Contractor's Balance Sheet	Security Robustness Level (Liquidity and Size)
Parental Guarantee	• Contractor is a subsidiary of a larger company • Guarantee provided by larger company • More powerful when parent is rated by respected rating agency, and that rating is strong	Low	Low (can be higher with strong parent rating)
Performance Bond (North America)	• Conditional coverage for contractual default of contractor	Low-Medium	Medium
Adjudication Bond (often used in UK)	• Coverage for contractual default of contractor • Remedy is subject to adjudication process (often rapid adjudication process – 40 to 60 days)	Medium	Medium-High
Subcontractor Default Insurance (SDI)	• Coverage for contractual default of subcontractors • SDI is used most often in buildings contractors • Protection from subcontractor and supply chain defaults • Financial interest endorsement needed for project owner	Low	High
Letter of Credit	• Often contracts will require this only be triggered for default of the contractor • Payment on-demand • Stringent security requirements on contractor	High	High
Surety-backed Letter of Credit	• Surety bond secures bank-issued letter of credit • Surety bond secured through unsecured indemnity agreement • Cost includes surety premium and bank fee for LC front	Medium	High
Demand Bond or Liquid Surety	• Coverage for contractual default of contractor • Payment on-demand (0 to 15 days)	Medium	High
Hybrid Demand Bond-Traditional Bond	• Coverage for contractual default of contractor • Portion of payment on-demand (0 to 15 days) • Portion of security is conditional coverage for contractor default (provides large security amount) • Sometimes is accompanied by labour and material payment bond	Medium	High (on-demand portion) /Medium (conditional portion)

Questions? Contact:

David Bowcott, Executive Vice President
Construction Industry Group
dbowcott@platforminsurance.com
416-566-5973

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info@platforminsurance.com

416-434-4322

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