SURETY BONDS VS.
BANK LETTERS OF CREDIT

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www.surety.org
Contract surety bonds and LOCs provide similar financial protection; however, contract surety bonds have an edge when compared to LOCs and their effect on borrowing capacity, duration, coverage, cost, and claims and contractor prequalification.

**Definitions**

**Surety Bonds**
- A three-party agreement among the surety, the obligee (the project owner), and principal (the contractor).
- A performance bond protects the owner from non-performance and financial exposures should the contractor default.
- A payment bond (a.k.a. labor bond and material bond) protects certain subcontractors, laborers, and material suppliers against non-payment by the contractor.

**Bank Letters of Credit**
- A bank LOC is a cash guarantee to the owner, who can call on the LOC on demand. The LOC converts to a payment to the owner and an interest-bearing loan for the contractor.
- The performance of the contract has no bearing on the bank's obligation to pay on the LOC.

**Claims**

The manner in which the claims process is handled by sureties and banks also differs greatly.

**Surety Bonds**
- If the owner declares the contractor in default, the surety investigates.
- If the contractor defaults, the surety's options are to:
  - Finance the original contractor or provide support;
  - Take over responsibility for completion (up to the penal sum of the bond);
  - Tender a new contractor; or
  - Pay the penal sum of the bond.
- With payment bonds, the surety pays the rightful claims of certain subcontractors, laborers, and suppliers up to the penal sum of the bond.

**Bank Letters of Credit**
- The bank will pay on an LOC upon demand of the holder if made prior to the expiration date.
- There is no completion clause in an LOC. The task of administering completion of the contract is left to the owner.
- The owner must determine the validity of claims by subcontractors, laborers, and materials suppliers. If there is not enough money from the LOC to pay all of the claims, then the owner has to decide which claims will be paid and which will be rejected.
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<th><strong>Surety Bond</strong></th>
<th><strong>Letter of Credit</strong></th>
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<td><strong>Borrowing Capacity</strong></td>
<td>Performance and payment bonds usually are issued on an unsecured basis and usually are provided on the construction company's financial strength, experience, and corporate and personal indemnity. The issuance of bonds <strong>does not diminish the contractor's borrowing capacity</strong> and may be viewed as a credit enhancement.</td>
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<td><strong>Prequalification</strong></td>
<td>A surety company assesses the contractor's business operations, financial resources, experience, organization, existing workload and its profitability, and management capability to verify that the contractor is capable of performing the contract. The purpose is to avoid default.</td>
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<td><strong>Duration</strong></td>
<td>Surety bonds remain in force <strong>for the duration of the contract</strong> plus a maintenance period, subject to the terms and conditions of the bond, the contract documents, and underlying statutes</td>
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<td><strong>How to Obtain</strong></td>
<td>The contractor obtains the bond through a surety bond producer. A list of surety bond producers is available through the National Association of Surety Bond Producers (NASBP) at <a href="http://www.nasbp.org">www.nasbp.org</a></td>
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<td><strong>Cost</strong></td>
<td>Generally 0.5% - 3% of the contract price (closer to 3% if the SBA Bond Guarantee Program is used). The bond is project-specific and covers the duration of the contract. The cost is included in the contractor's bid price.</td>
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<td><strong>Coverage</strong></td>
<td><strong>Performance bond – 100% of the contract amount</strong> for project completion</td>
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<td><strong>Payment bond – 100% of contract amount</strong> protects certain subcontractors, laborers, and materials suppliers and protects private owner against liens.</td>
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<td>At least 10% coverage for maintenance of defects the first year after completion.</td>
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SURETY AND FIDELITY BONDS:  

PROTECTING CONSUMERS, 
TAXPAYERS AND BUSINESSES

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