

The economic value of surety bonds

*Prepared for The Surety &
Fidelity Association of America*

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Executive Summary



THE SURETY &
FIDELITY ASSOCIATION
OF AMERICA



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The economic value of surety bonds – executive summary

The Surety and Fidelity Association of America (SFAA) commissioned EY to analyze the economic value of surety bonding. At a simple level, surety bonds protect public and private construction projects by guaranteeing contract performance when a contractor defaults and by paying subcontractors and suppliers, many of which are small businesses, where the contractor cannot or does not. Surety bonds also provide other benefits that may help construction projects succeed and reduce costs.

The focus of this analysis was to evaluate the benefits of surety bonds for a portfolio of public and private construction projects and develop estimates of the benefits of surety bonding throughout the lifecycle of those projects and including benefits extending beyond the financial protection surety companies provide when contractors default. This analysis is based on an assessment of project portfolios using a survey of public and private developers and interviews with experts on construction project defaults.

Key finding: *This analysis found that bonded portfolios of projects generally outperform non-bonded portfolios of projects, even under conservative estimated savings associated with key benefits such as lower default rates and average completion costs upon contract default for bonded projects, and improved contractor pricing for bonded projects.*

Three primary areas of economic value from surety identified

This analysis identified three areas where surety bonds have a significant impact on public and private construction projects (see Figures ES-1 and ES-2):

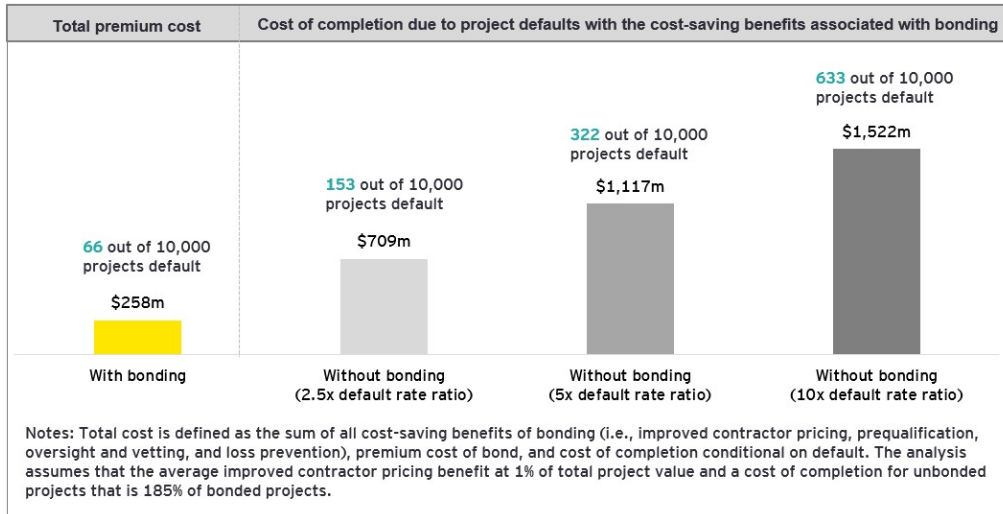
- **Lower cost of completion upon default and necessary completion expertise** – Unbonded construction projects on which the contractor defaults were found to have a cost of completion 85% higher than projects protected by surety bonds. Experts on construction project defaults also indicated the surety is generally more able to provide the expertise and resources needed in promoting a successful transition or re-procurement process, compared to an owner. Over 90% of these experts reported public or private owners/developers generally do not have the expertise and resources to complete the project, whereas the surety has the necessary expertise and resources.
- **Lower rate or likelihood of default** – Unbonded projects are more likely to default than bonded projects, perhaps by as much as ten times.ⁱ This analysis assessed portfolio performance assuming a default rate of 2.5 times, 5.0 times, and 10 times a bonded portfolio's default rate, and generally found unbonded projects are more likely to default than bonded projects, in large part, because they lack the various types of support bonding provides to projects (e.g., prequalification of a contractor's expertise and financial strength, greater project oversight).

ⁱ For example, see Canadian Center for Economic Analysis, "The Economic Value of Surety Bonding in Canada: A networked agent-based economic assessment," August 2017, p.28.

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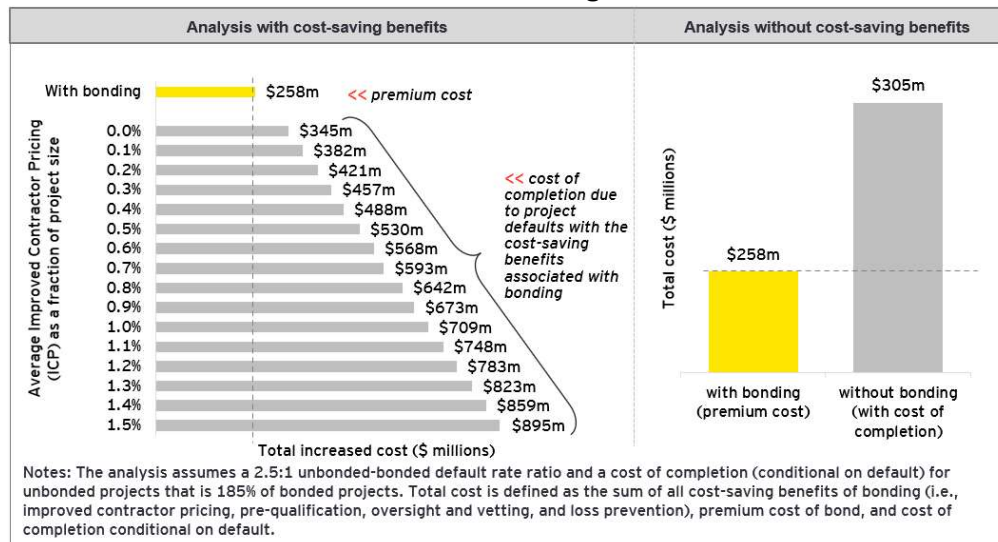
- **Improved or lower contractor pricing** – 75% of owners/developers surveyed reported that surety bonding reduces contractor pricing. Respondents cited increased confidence in the general contractor to complete the project and pay subcontractors and payment protections for subcontractors as some of the factors that impact contractor pricing.

Figure ES-1. Total portfolio cost faced by owner, by default rate ratio



Source: EY analysis.

Figure ES-2. Total portfolio cost faced by owner, by improved contractor pricing and other cost-saving benefits



Source: EY analysis.

Surety bonds were also found to benefit construction projects in several other ways:

- **More rigorous prequalification and review** – Prior to construction, prequalification was more likely to occur for bonded projects (96% of respondents reported that pre-qualification was performed for bonded projects as compared to 61% for non-bonded), and during construction, contractors provided more information for bonded projects -

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general contractors were nearly twice as likely to share more than one financial update for bonded projects as for non-bonded projects.

- **Higher priority on bonded projects/greater project oversight** – Respondents reported that contractors prioritize bonded projects when experiencing financial challenges. Nearly 5-times as many respondents indicated that contractors place a higher priority on bonded projects as compared to unbonded projects when facing financial difficulty. Greater project oversight with more involvement by construction managers is likely to help prevent losses.
- **Greater timeliness of completion** – 5-times as many public and private owners reported, bonded projects are more likely to be completed on time or ahead of schedule than non-bonded projects. And when a project does default, an unbonded project will take nearly 2-times longer to complete than a bonded project.
- **Necessary experience and resources when defaults occur** – 100% of construction default experts surveyed/interviewed for this analysis said sureties have the expertise, tools and resources necessary to complete a project in the most cost and time-effective manner as compared to an owner who does not have the same expertise and experience as a surety.

This report includes the potential cost savings and other benefits of surety bonds that go beyond the financial protection when contractors default on a construction project. It is important to note some of these services and benefits services may already be provided by some owners and developers, particularly those that are larger and/or more sophisticated.ⁱⁱ

ⁱⁱ Some self-selection may be associated with the types of projects in which bonding is used in the private sector, such as with, for example, riskier projects facing greater difficulty in attaining surety bonding. Neither of these factors is reflected in this analysis.