Using a Retention Bond

One of the objectives of the Fair Payment Campaign, launched to improve payment practices in the construction industry, is the removal of retentions.

Cash retentions are an outdated practice and there are now better ways of guaranteeing quality of workmanship including providing retention bonds.

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FAIR PAYMENT Campaign

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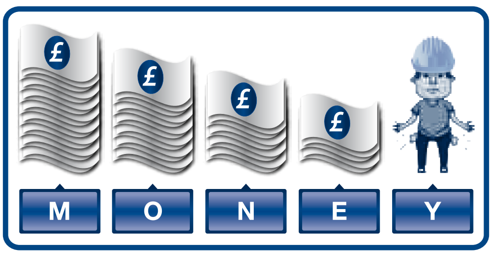
1. What is a Retention Bond?

A retention bond is an agreement between a contractor, its client, and a third party known as a surety provider, which acts as a guarantor between the two parties.

The bond agreement states that in return for the client not holding cash retention, the surety provider will undertake to pay the client up to the amount that they would have had by way of cash retention should the contractor fail to carry out the works or remedy defects.

A retention bond is a win-win: the client has the monetary protection it requires and the contractor keeps hold of its cash.



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2. Why use a Retention Bond?

Offering a retention bond in place of cash retention can result in substantial cost savings for the contractor. The money that would have been held in cash retention remains in the cash flow of the contractor improving its financial position. In addition, the retention bond will normally contain a fixed expiry date so there is no confusion about when the contractor has been released from his obligations. There is also no chasing for the release of cash retention at the end of the works.

There are two types of retention bond: conditional or default and on demand. This guidance relates to conditional bonds where the surety is provided by an insurance company. Contractors should beware of on demand bonds (where their bank acts as the surety provider and sets the bonded amount against their borrowing capacity) which allow the client to demand payment under the bond without having to prove default by the contractor.

Case Study

In the last two years, a Specialist Contractor has put in place retention bonds on over £4.5 million worth of orders with a further £1 million worth negotiated with no retention withheld at all. Assuming 5% retention, this effectively helped the Specialist Contractor to retain £275,000 in its ‘own’ cash flow, allowing it to expand its operational base and offers its clients better value.

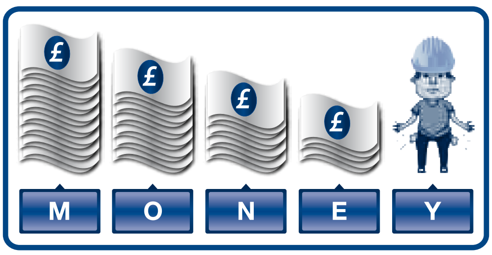
3. How much does a Retention Bond cost?

The cost of a retention bond is non-refundable and will depend on the financial performance of the contractor applying for it. However, the cost is usually between 2% and 8% of the bond value subject to a minimum charge of around £750. The level of security required from the contractor will depend on its financial standing versus the value of the bond.

A retention bond is usually offered at the beginning of a project in place of cash retention; however, it is also possible to introduce it during the course of a project to release retention monies which have previously been withheld.

Case Study

A Specialist Contractor had approximately £22,000 (10% retention) withheld on a project for the duration of the build and 2-year defects period which it wanted to release. It obtained a retention bond for the Specialist Contractor for a cost of approximately 4% (£900) for the duration, allowing it to free up its retention and put the money back into its cash flow.



4. Why should a contractor accept a Retention Bond?

A retention bond provides a client with the equivalent level of security as cash retention whilst improving the financial stability of its contractor by making the cash retention available.

The client also has the additional benefit of knowing that a contractor that is able to offer a retention bond has had its financial standing vetted by the surety provider.

There is no reason for a client not to accept a retention bond.

5. What happens if the Retention Bond is called?

The retention bond will generally provide for the contractor to be notified of the alleged defect and offered the opportunity to rectify it within a fixed period of time. If the client is not satisfied, he can 'call' the bond by providing evidence of default to the surety provider. If the surety provider is satisfied that the alleged default is proven, it will pay out and then seek recovery from the contractor.

Once a bond has been called, it is likely to affect the premium of future bonds and/ or the ability of the contractor to obtain them at all.