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ARAŞTIRMA MAKALESİ / RESEARCH ARTICLE

A NEW INSTRUMENT IN TURKISH FINANCIAL MARKET: SURETY BONDS

TÜRKİYE FİNANS PİYASALARI İÇİN YENİ BİR ENSTRÜMAN: KEFALAT SİGORTASI

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Abstract

A surety bond is a three-party agreement between the contractor, the employer, and the surety in which surety ensures the contractor can fulfill the obligations regarding the contract against the employer. However, the usage of surety bonds in Turkey are quite different from USA and Europe. They are utilized in the place of letter of guarantee. Especially for the contractors with collateral shortage, the surety bond is much more advantageous than the bank letter of guarantee for the contractors since the surety bond does not reduce their credit limits within the banks. Thus, this paper aims to reveal the benefits of surety and targets increasing the awareness of surety bonds in Turkey.

Keywords: Surety Bond, Letter of Guarantee, Collateral

JEL Codes: G20, G21, G22

Öz

Kefalet senedi, yüklenicinin/ satıcının, işveren ya da alıcı makama yönelik olarak sözleşmeden doğan yükümlülüklerini yerine getireceğinin sigorta şirketi tarafından kefil olunmasını ifade etmektedir. Türkiye finansal piyasasında yeni bir enstrüman olan kefalet senedi, yüklenici firmanın işverene karşı sözleşmeden doğan yükümlülüğünü yerine getireceğini garanti eden bir finansal enstrümandır. Kefalet senedi başta inşaat, enerji ve altyapı olmak üzere her sektörde kullanılabilecek bir finansal enstrümandır. Öyle ki özellikle, GSYİH'nin yaklaşık yüzde dokuzunu oluşturan ve yaklaşık 2 milyon kişiye istihdam sağlayan ve Türkiye'nin ekonomik kalkınmasında önemli bir rol oynamakta olan inşaat sektörü için önemli bir enstrümandır. İnşaat, enerji ve altyapı gibi taahhüt işlerinde yüklenici tarafından işverene sunulan teminat mektubuna alternatif olan bir enstrümandır.

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Hazine Müsteşarlığı tarafından 2014 yılında yayımlanan "Kefalet Sigortası Genel Şartları" ile kefalet senedinin Türkiye finansal kesiminde kullanımının yasal altyapısı oluşturulmuştur. Bu çerçevede bu çalışma dâhilinde kefalet sigortasının tanımı, türleri ve oluşturulma süreci değerlendirilmektedir. Yine bu çalışma çerçevesinde teminat mektuplarına alternatif oluşturan kefalet senedinin riskleri, fayda ve avantajları açıklanmakta ve böylelikle bilinirliliğin artırılması ve kullanımının yaygınlaşması amaçlanmaktadır.

Anahtar Kelimeler: Kefalet Sigortası, Teminat Mektubu, Teminat

JEL Kodları: G20, G21, G22

Introduction

Changing market conditions and increasing risks lead to many new instruments in the financial sector. One of the latest tools in Tukey is the "surety bonds". Surety is concept that has been going on for thousands of years. In the 1890s, the idea of surety emerged when it was presented by individuals or groups such as Lloyd's of London (Russell, 2000). American Surety Company was the first company to issue surety bonds for construction contracts in 1887 (Kangari & Bakheet, 2001). Industries such as hard rock and coal mining, oil and gas industries are among the sectors that need surety as required by legislation (Kirschner & Grandy, 2003). The surety, issued by insurance companies, is an alternative instrument to the "letter of guarantee" provided by banks and financial institutions (Barru, 2005). Surety bonds are primarily related to construction, manufacturing, construction-repair, energy, and infrastructure projects but can be used in any industry (Euler Hermes, 2018).

A surety bond is an agreement that provides claims to the employer (beneficiary) if the contractor (principal) fails to perform his obligations regarding the related contract. In general, the contractor (principal) who undertakes a business has to provide a "guarantee" to the employer (beneficiary), stating that he can fulfill the obligation defined within the agreement. However, the usage of surety bonds in Turkey are quite different from USA and Europe. In Turkey, the contractor companies used to utilize the "letter of guarantee" to meet this requirement.

However, the letters of guarantee, primarily used in construction projects, put pressure on the bank credit limits of the contractor companies, since they are issued over non-cash credit limits (within the banks) of those companies. While issuing a letter of guarantee, the banks ask the contractor companies to submit guarantees (like deposit, pledge, security, fixed assets collateral, personal guarantee, third-party guarantee, mortgage and bail). Nevertheless the contractor companies have difficulties in submitting this kind of collaterals. On the other hand, since the surety bonds are classified as "off-balance-sheet", they do not reduce the credit limits of the contractor companies in the banks. Thanks to the advantages it provides within its body, the surety allows the contractor companies not to use their non-cash credit limits and collaterals. In this context, the Turkey Undersecretariat of Treasury has published the "Surety Bond General Terms" in 2014, so the "Surety Bond" – that is widely used in America, Europe, and Asia-Pacific countries – has also become applicable in Turkey.

Contractor companies in Turkey face difficulties in reaching finance. While having a loan or letter of guarantee, the banks asks the contractor companies to issue guarantees (like deposit, pledge, security, fixed assets collateral, personal guarantee, third-party guarantee, mortgage and bail). The banks issue a limited cash or non-cash “credit limits”, based on the collateral the contractor companies provide. While having a loan or letter of guarantee, the banks take these as collateral. Besides, their cash or non-cash credit limits are reducing. The reason for the contractors to prefer the surety bond is the letter of guarantee’s putting pressure on those companies’ bank credit limits, whereas the surety bonds are classified as “off-boff-balance-sheet” they do not reduce the credit limits of the firms in the banks.

In this paper, the definition of the parties and guaranty types of the surety bond is examined, and the risks, benefits, and advantages of sureties in Turkey are discussed. Nevertheless there is not any paper regarding the sureties focusing merely on Turkish market. For this reason, this paper aims to contribute by filling the literature gap, primarily focusing on the utilization of sureties in the Turkish market. Within this context, within the first and the second part of the paper, risk assessment, premium and claims of surety bonds and the difference from insurance and surety bonds practices in Turkey are reported, respectively. In the third part of the paper, the findings are discussed.

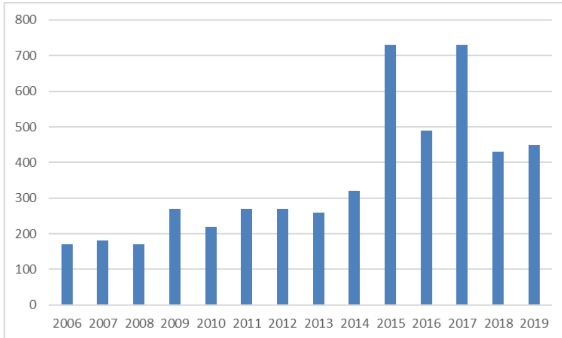
1. Surety Bond

Surety, which was first started to be used in developed countries, especially in the USA, in the 19th century, is referred to as “surety bond” in the USA and “bonding” in Europe in international terminology. The surety is an alternative instrument to the “letter of guarantee”. While insurance companies meet the entire letter of guarantee requirement in the US market, this rate is around 95 percent in South America, 25 percent in Europe, and 50 percent in the Asia Pacific (Aon, 2019). The first insurance company in Turkey that offers the surety bond – in the form of a typical letter of guarantee – 2017 is Euler Hermes, and Anadolu Sigorta, Magdeburger Sigorta, and Quick Sigorta follow this company. Many export credit agencies (ECAs) and private insurance companies issue surety bonds in many countries. Almost all the insurance agencies (Euler Hermes, Credendo, CEB, Finnvera, Atradius, CESCE, SACE, K-EXIM) issue sureties as “advance payment,” “bid,” and “performance” bonds.

More than 400 billion dollars of surety was issued in 2018 and 2019 by the members of ICISA (ICISA, 2021). In Figure 1, the utilization of surety bonds can be seen in America, Europe, Asian economies.

Figure 1: Surety Exposure of ICISA [1]

1 The premiums, claims and the claims ratios of the ICISA members can be seen SURETY-OVERVIEW-PREMIUM-CLAIMS-CLAIMS-RATIO-2006-2019.pdf (icisa.org) (23.04.2021).



Reference: ICISA, 2021 (ICISA Members)

A surety bond is a three-party agreement between the contractor, the beneficiary , and the surety in which the surety agrees to uphold, for the benefit of the beneficiary , the contractual obligations of the contractor if the contractor fails (Reynolds, 2021:1). A surety bond relationship is a three-party relationship (beneficiary, insurance company and the principal). A "surety" is a tool that ensures that the contractor can fulfill the obligations regarding the contract against the employer. The insurance company provides the beneficiary (employer) with a payment guarantee for the risk of the contractor's failure to fulfill the contractual obligation. In other words, the insurance company covers the loss of the beneficiary (employer) in the event of a loss under the insurance contract. Besides, the insurance company (depending on the type of the surety) ensures that any other contractor completes the contractual work (concluded between the employer and the contractor).

Issuing a bond, the surety company reveals that the contractor has good references and reputation, meets obligations, and has relevant experience that matches the contract requirements and the necessary equipment to do the work. Issuing a bond, the surety company ensures that the contractor has the financial strength to carry and the project work and good credit history (McIntyre & Strischek, 2005:47). A "surety bond" is a three-party contract issued by a surety company, mostly in connection with a construction project (Seifert, 2008:47). The three parties are i. the surety company (insurer/guarantor), ii. beneficiary, (the employer), iii. the principal (owner /contractor) (Beg, 2019).

Principal; (contractor/risk-posing party; insurant): The party agrees with the beneficiary (employer) about the execution of a business. Conditional credit is allocated in favor of the insurant (contractor) by signing a guarantee agreement with the surety (i.e., the guarantor/insurance company).

Surety; (risk bearer, insurer/insurance company/guarantor): An insurance company who is authorized to issue surety bonds.

The beneficiary (Obligee/employer/ insurance claiming party): The entity that requires the bond and is protected if there is a loss or default (SFAA, 2017a). The beneficiary enters into the agreement with the contractor and is the recipient of the obligations (e.g. the governmental unit on a construction Project) (Reynolds, 2021:1)

1.1. Risk Assessment, Premium and Claims

The surety underwriting decision is exceptionally complex. As part of the underwriting process, the Surety assesses the contractor's financial health, including a review of cash flow, cost control mechanisms, working capital, and the contractor's relationship with its financial institution (W-T, 2020). The Surety examines whether the contractor has sufficient personnel, equipment, working capital, and expertise to complete a particular contract, given the demands of the other projects in which the contractor is involved and the project's nature under consideration (W-T, 2020). The surety bond risks are analyzed according to the type of surety, the characteristics of the party for whom the Surety is issued, and other risk parameters. Again, risks are evaluated with approaches, such as credit valuation and rating systems used in banking (Bachrach, 1998). The following factors are of great importance in analyzing the risks of the surety bonds: features of surety: type, amount and currency type, expiry, risk exposure profile (country risk, market risk, are considered part of risk exposure profile) are regarded as features of surety. The "character," "capital," and "capacity" of the insured (contractor) are essential. The "character" is to evaluate whether the contractor can fulfill the terms of the contract. In other words, whether the contractor has these capabilities in terms of management and organization. The "capital" criterion questions financial adequacy from the beginning to the end of the bond. The "capacity" evaluates whether the required skills are available in terms of employees, technique, machinery and equipment. Besides, other risk elements (6C) are evaluated. (These include other risk elements such as "cedent", "contract", "credit", "collateral", "country," and "conditions" of ESG (environmental, social, and governmental). Each of these conditions is deepened with detailed analysis and specific questions, and a detailed analysis is carried out. Table 1 presents the underwriting process:

Table 1: Data Requested by Surety Company

Information Needed	Description
audited financial reports for the last (three) years	to examine the current and future financial strength of the principal
current and past work on hand schedules for the last years	to track profits and billings and to see what principals have done historically
current personal financial statements on owners of the principal	to examine the personnel financial strength of all owners involved for personal indemnity purposes
list of largest projects completed in the past.	historical information for tracking the construction record of the principal
summary of stock ownership and details of company's continuity program	to judge what kind of planning has been done to protect the principal's interest
organizational chart of the principal, including all key employees.	to see their potential capabilities with their present personnel
contemplated program; largest single job and work backlog	to plan their future needs
past program; largest single job and work backlog	to see their past capabilities to help estimate the current capabilities of the principal

Reference: Russell, 2000:58

Premium

The surety insurance premium is settled according to the type of bond. One of the most critical factors that distinguish surety bonds from other bonds is the determination of the premium. There is an assumption in the surety bond that there will be no claims, unlike the premium method in different insurance types. Bonding usually costs 1 percent of the contract amount or cost of the project (SFAA, 2017b). The cost of a performance bond, for example, is a one-time premium between 0.5 percent and 3 percent of the contract amount. The premium is paid by the contractor, typically in the first demand. However, the insurance company can lower the premium amount for well-established, experienced and financially strong contractors. Though premiums may be higher for less capitalized or newer contractors and sustainable small businesses with an established track record also can get lower rates. For example, if the contract amount is 10 million dollars, a premium of between 57 thousand dollars and 81 thousand dollars could pay for a performance bond (SFAA, 2017b).

Claims

If a default occurs, the insurance company assumes the responsibility of completing the contract (SFAA, 2017b). However if the employer (beneficiary) applies to the insurance company with a claim, payment is made immediately (by the insurance company) following the claim's application. The claim cannot be rejected by presenting the plea of the contractor. The cause for the settlement and the accuracy of the reason is not inquired. Payment is made without seeking any additional evidence based on the claim request. Namely, under surety, the payment is made by the insurance company , following the claim, if some of the following terms and conditions are met; i. contractor's (principle) failure to fulfill his obligation, ii. contractor's (principle) inability to persuade the insurance company about the inaccuracy of the evidence presented, iii. the court decision submitted by the employer (beneficiary). The insurance company can only reject the claim by presenting its pleas, such as fraud.

1.2. Surety Bond vs. Insurance

Although insurance companies underwrite "surety" as a line of insurance, there are important distinctions between the "insurance" and the "surety". Insurance is a loss funding mechanism designed to compensate the insured against unforeseen adverse events. In contrast with insurance, surety is a loss avoidance mechanism designed to prequalify individuals based on their credit strength and construction expertise (Russell, 2000:25).

Employers retain the risk of contract default by signing an indemnity agreement that, in essence, protects the underwriter from incurring losses. While suretyship and insurance differ, both are risk transfer mechanisms. The employer transfers the risk to the insurance company that might result from contractor failure. The insurance company protects the employer from losses due to default by the contractor, but unlike insurance, all parties enter into the agreement assuming "no one will incur losses". Table 2 compares surety bonds and insurance (Russell, 2000:25).

Table 2: Comparison: Suretyship versus Insurance Surety Bond

Surety bonds	Insurance
guaranty agreement (three parties)	indemnity agreement (two parties)
no losses assumed	losses taken for granted
premium-fee for extension of credit	premium-based on actuarial likelihood of loss
principal retains risk	insured risk of loss transferred to insurer
non-cancelable	cancelable
agreement must be in writing	agreement may or may not be in writing
nonpayment of premium-doesn't affect surety liability of bond	nonpayment of premium-grounds for cancellation
if bond is fraudulently obtained, surety is still liable	policies often contain warranties as condition precedent to recovery

Reference: Russell, 2000:25

2. Surety Bonds Practices in Turkey

The construction industry plays a vital role in Turkey's development, accounting for nearly 8-9 percent of GDP and employing almost 2 million people (TCA, 2020). According to the report issued by TCA, the continually growing global competitiveness of the Turkish contractors and building materials producers contribute significantly to the balance of payments of Turkey (TCA, 2020). According to the report issued by TCA in 2019, forty-four Turkish contracting companies, ranked among the "Top 250 International Contractors" announced by the leading industry magazine Engineering News-Record, 2019.

Since there is a massive potential for surety bonds in Turkey, the market is growing vastly. The market share and total premium income of the top 5 insurance companies in February, 2021 in Turkey are shown in Table 3. Examining the data provided by the Turkish Insurance Union, we see that the premium income of Quick Sigorta was 2 million TRY in February, 2020. Comparing the figures with February, 2020, we see that the premium income in February, 2021 increased by almost 500 percent. On the other hand, we see that the premium income of Euler Hermes, in February, 2021 increased by almost 1,200 percent comparing February, 2020. Likewise the premium income of Gulf Sigorta in February, 2021 has increased by almost 1,545 percent comparing February, 2020.

Table 3: Market Share and Total Premium Income

Company Name	Total Premium Income (TRY)	Market Share %
Quick Sigorta AŞ	12,160,451	37.96
Euler Hermes Sigorta AŞ	8,981,236	28.04
Gulf Sigorta AŞ	2,907,937	9.08
Chubb European Group SE	1,720,587	5.37
Zurich Sigorta AŞ	1,403,793	4.38

Reference: Turkish Insurance Union, 2021

Since there is a massive potential for surety bonds, especially for Turkish contractors, the surety bonds' legal base has been developed [2] by the Undersecretariat of Treasury [3]. Therefore the contractors have been able to present the surety bonds, to the employer, in all tenders, including the public tenders [4]. Turkey Undersecretariat of Treasury (2014) has also determined the types of bonds. The types of bonds specified in the "General Conditions" are shown in Table 4. As can be seen, types of surety bonds can be arranged in many different areas, and some of them must be submitted as a requirement of specific legal regulations.

Table 4: Types of Surety Bonds in Turkey

Bond Type	Definition
Advance Payment Bond	provides surety against the risk that the party receiving an advance payment does not fulfill its obligations towards the beneficiary – within the scope of a tender, project or trade of goods and services
Manufacturing / Maintenance / Repair Bond	provides surety for damages after the delivery/ completion of the trade / business
Breach of Trust Bond	provides surety for the damage of the employer due to cheating, fraud, etc.
Customs and Court Bond	provided in favor of tax offices, customs administrations and courts to open a case, to withdraw the goods from the customs
Bid Bond (Temporary Guarantee)	provides surety against the risk of the contractor's withdrawing from the tender prior to the completion of the tender
Public Claims Bond	an unconditional, precise, absolute, indefinite, type of surety which includes the payment record in the first claim, against the risk that the insured does not pay the public receivable in accordance with the Law on the Procedure for the Collection of Public Receivables No. 6183
Payment Bond	provides surety in case of non-payment to subcontractors and workers
Performance Bond	provides surety against the risk that the contractor fails to fulfill its obligation, (the insurance company can also agree with a new contractor and complete the work.
Contract Bond	provides surety against the debtor's failure to properly fulfill the contractual obligations
Public Tender Bonds	a type of surety that includes the payment record in the first request, unconditionally, precisely, independently of the insured's obligation against the risks of the surety to be recorded as revenue in the tenders subject to Public Procurement Law No. 4734 and other regulations. This surety is given within the attached clauses

Reference: Undersecretariat of Treasury, 2014

2 Surety Bond General Terms" published by Turkey Undersecretariat of Treasury (2014)

3 "Communique No 2007/01 on Insurance Branches" and "The Law on the Amendment of Some Tax Laws and Other Laws" have been published in Official Gazette No. 30261 (2017).

4 A change has been made in the 4th and 34th articles of the Public Procurement Law No. 4734. The statement "Letter of Guarantee: letters of guarantee issued by banks and surety bonds held as part of the surety insurance built by insurance companies in Turkey," has been added on the 4th article of the Law and "b)Letters of guarantee" to item (b) of the first paragraph of Article 34 of the Law has been added.

The contractors have been able to present the surety bonds in all tenders, including public tenders, by the change made in the third and fourth articles of the Public Procurement Law No. 4734. The statement "Letter of Guarantee: letters of guarantee issued by banks and surety bonds held as part of the surety insurance built by insurance companies in Turkey," has been added on the 4th article of the Law and "b) Letters of guarantee" to item (b) of the first paragraph of "Article 34" of the Law has been added the mentioned change has been made. It should be noted that, in Turkey, the surety bonds only under the bids done under Public Procurement Law No. 4734 are accepted as of today. In other words, the contractors can present surety to the bids done under Public Procurement Law No. 4734. That is to say; as of today, the insurance companies cannot issue sureties, as collateral, in favor of the companies for them to present to the customs or courts. It is crucial to make the necessary arrangements in the related laws in order to widen the use of surety bonds in Turkey.

As stated above, there is a huge potential for surety bonds in Turkey. However, both the issuance and the usage of surety bonds in Turkey are quite different from the USA and Europe. They are utilized in the place of the letter of guarantee. While establishing surety bonds in Turkey, the insurance company considers the contractor's credibility (i.e., the contractor has substantial collateral, like pledge, security, fixed assets collateral, personal guarantee, and third-party guarantee). Such that the contractor firm should have high credibility and can be able to offer substantial collateral. While establishing a surety bond, the insurance company also analyzes the contractor's experience in similar projects and determination in this field. Especially with collateral shortage, the surety bond is much more advantageous than the bank letter of guarantee, since the surety bond does not reduce the banks' credit limits. While issuing letter of guarantee, the contractor companies' credit limits are reduced within the banks, whereas the surety bonds are not reducing the credit limits of the contractor companies within the banks.

2.1. Surety Bond & Letter of Guarantee Terms

With the letter of guarantee, it is undertaken by the bank that if a specific job/service is not performed under certain conditions and within particular periods by the contractor (principal), the payment is made by the bank unconditional (irrevocable) to the beneficiary. In other words, it is a type of warranty that guarantees the contractor's (principal) commitment to the beneficiary. In fact, in cases where the contractor (principal) does not fulfill its obligation, it is the type of guarantee that obliges the bank to pay unconditionally to the beneficiary in a guarantor's capacity. The bank can only reject the claim by presenting its pleas, such as fraud. The most significant difference of the "surety bond" from the "letter of guarantee" is that the "surety bond" guarantees the project/job to be given to the competent company. In other words, the surety guarantees that the warrantee (contractor) has done the project/job well in the past, and the contractor will do the same again. Since the contractor firm (which builds an airport, railway, bridge) cannot provide collateral as much as the whole project, it is vital in surety bonds to measure the contractor firm's competence and experience that will redo the project/job. While establishing a letter of guarantee, the bank mainly considers the contractor's credibility (i.e., the contractor has substantial collateral, like deposit, pledge, security etc.). Such that the contractor firm should have high credibility and can be able to offer substantial collateral. In the surety bond, the experience and desire to complete the project/job are essential rather than the contractor's financial data and guarantees. In other words, insurance companies provide surety bonds by analyzing the contractor's experience in similar projects and determination in this field. Since the surety bond is an insurance type given for a high volume project, claims to be paid affect the insurance company's net loss ratio negatively. For this reason, in order to work "without loss" principle, each project/job must be passed through a detailed analysis process (financial analysis, performance analysis, objective / subjective evaluation criteria). Because in all cases, the employer authority (beneficiary) prefers the completion of the contractor's work rather than cash compensation. In this context, the one advantage of surety bonds against letters of guarantee is the difference in the risk assessment approach of banks and insurers. In case the work cannot be done, the banks anticipate to cash compensation (namely claims), where the insurance companies take a method to ensure that the work is completed (Grath, 2008).

Above all, as stated above, for contractors with collateral shortage, a surety bond is more advantageous than the letter of guarantee. Since the surety bonds does not reduce the credit limits of the contractors in the banks, it can strengthen the cash financing capacities of the firms. Besides, there is an opportunity for the surety bonds to reinsure (share the risk with reinsurance companies) in the international markets. As in the surety, if the employer applies to the bank with a claim (under the letter of guarantee), the claim cannot be rejected by presenting the contractor's plea. The cause for the settlement and the accuracy of the reason is not inquired. However, although both instruments have collateral features, there are differences in their legal qualities in Turkey. These differences are included in Table 5.

Table 5: Differences between Surety Bond and Letter of Guarantee

Surety bonds	Letter of Guarantee
subject to Law no. 5684 and subject to supervision and control of Undersecretariat of Treasury in Turkey usually applied by insurance companies	regulated within the context of the Banking Law No. 5411 and BRSA [5] control and supervision and considered as non-cash loans usually applied by banks
bears performance risk	bears financial risk
payment is made if the contractor does not meet the terms of the contract	payment is made upon request. (there may be exceptions where only provisional junctions are received from the courts)
provides an additional assurance to the employer to finish the contractual work	does not reflect to finish the contractual work
upon a claim, the beneficiary has to prove that the contract has been violated (the burden of proof is on beneficiary)	upon a claim the beneficiary does not have to prove the violation

Source: Author's own elaboration

As stated in Table 5, the debtor must indemnify without asking any deeds and objections in the letter of guarantee when the bank receives the claim request. In the surety bond, the insurer has the right to examine whether the risk has been realized or not, according to the terms of the insurance

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agreement. However, the surety bonds are mostly implemented in Turkey as a first demand. In other words, surety bonds are mostly implemented in Turkey, like a letter of guarantee. For this reason, the letter of guarantee is preferred by the employer, especially in large projects, since they are more advantageous.

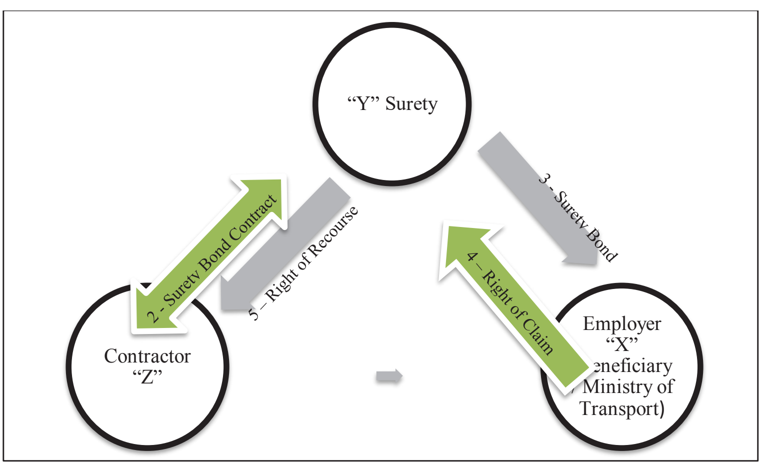
In the surety bond, the insurer has the right to review the situation when the risk occurs. Due to this feature (instead of being obliged to pay by the bank at the first demand, the insurer has the opportunity to examine), the premium to be paid to the surety insurance is lower than the bank letter of guarantee. It is one of the essential advantages of surety bonds that the insurer has the right to complete the project. In other words, if the risk occurs, the project is completed by the insurer i. by providing financial support to the current contractor or ii. by finding another contractor without entering the tender again.

2.2. Case Study

An infrastructure project can be used as an example of a surety bond. The steps to be taken and processes are summarized below:

i. The contractor "Z" in Turkey signs a contract – amount of 100 million dollars – including a 10 percent advance payment condition with the employer "X" in Saudi Arabia. The contractor "Z" has to submit a surety bond to participate in the tender according to the terms and conditions of the contract. (Alternatively, the contractor "Z" participates in the tender, initiated by the Ministry of Transport of Saudi Arabia, to construct some plants of the Medina Airport. The contractor "Z" has to submit a surety bond in order to participate in the tender according to the terms and conditions of the tender, issued by the Ministry of Transport.)

Figure 1: Surety Insurance Example (Medina Airport Infrastructure Work)



Reference: created by the author

ii. The contractor "Z" applies to the insurance company "Y Surety" for the guaranty – the 10 million dollars advance surety bond – required by the beneficiary, according to the terms and conditions of the contract.

iii. The insurance company "Y Surety" obtains financial statements/balance sheets (audited financials) of the contractor "Z" in order to assess the risk. "Y Surety" makes the necessary financial analysis based on subjective criteria by the underwriters. The risk assessment (of surety bond) processes are similar to credit risk monitoring and valuation processes in banking. "Y Surety" assesses the contractor's financial status and examines his current and future financial strength. "Y Surety" examines the current and past work on hand schedules for the last years in order to find out if the contractor "Z" has sufficient personnel, equipment, working capital, and expertise to complete the contract. "Y Surety" examines the current and past work on hand schedules also to track profits and billings and to see what contractors have done historically.

iv. "Y Surety" may ask the contractor "Z" to issue guarantees (like deposit, pledge, security, fixed assets collateral, personal guarantee, third-party guarantee, mortgage and bail) depending on the credit rating of contractor "Z".

v. During the underwriting process, "Y Surety" reviews the financials of contractor "Z", cash flow, tax returns, liquidity and debts, and may ask for letters of recommendation and references. Through this process "Y Surety" is vetting the contractor "Z" . When "Y Surety" issues a bond to contractor "Z", this signals to employer "X" that contractor "Z" is competent and qualified to do the work — and that the risk of the contractor "Z" defaulting is low. (SFAA, 2017b).

vi. As a result of the analysis, if the "Y Surety" decides to allocate a limit, the insured and the insurance company sign a revocable insurance agreement that includes the agreed "Surety Bond Limit" and "the Special Conditions" of the insurance company. Within this context "Y surety" agrees to indemnify employer "X" from loss it may experience, as a result of the failure of the contractor "Z to perform its contractual obligation.

vii. Since surety bonds are classified as "off-balance-sheet they do not reduce the credit limits of the contractor "Z" in the financial markets/ banks. Besides the surety will allow the banks to use their non-cash credit limits and collaterals in other areas and provide instrument diversity for their collateral needs. Thus the contractor "Z" can reduce his need for letters of guarantee and obtain surety bonds at lower costs.

viii. "Y Surety" decides on the premium amount that the principal has to pay. The amount of premium is determined according to the economic cycle, interest rates on the market, expected developments on the markets for labor and construction materials, the construction site, etc.

ix. The premium has to be paid by the contractor "Z" typically in the first request.

x. The contractor "Z" has an obligation to perform in accordance with the requirements of the construction contract. However, if a default occurs, the surety company assumes the responsibility of completing the contract (SFAA, 2017b). If contractor "Z" fulfills its contractual obligations, the obligation of the "Y Surety" is invalid (Reynolds, 2021:1).

xi. However, if contractor "Z" defaults on the underlying contract, employer "X" has right to make a claim against the surety under the surety bond. In other words, if there is a claim, the employer "X" applies to the "Y Surety" with a claim application. If contractor "Z" fails to fulfill his obligation, claims payment is made by the "Y Surety" following the claim application. Namely following the application, the "Y Surety" has to make the payment to the employer "X" immediately, without seeking any additional evidence based on the claim request. "Y Surety" can only reject the claim by presenting its pleas, such as fraud, etc.

xii. Upon claims payment "Y Surety" initiates a legal follow-up process (legal proceedings to recourse) against the contractor "Z" and tries to collect the amount paid.

Outcome

A surety bond is a three-party agreement between the contractor, the beneficiary, and the surety in which the insurance company agrees to uphold, for the benefit of the employer, the contractual obligations of the contractor if the contractor fails to do. Namely, a surety is a tool that ensures that the contractor can fulfill the obligations regarding the contract against the employer. The insurance company provides the beneficiary with a payment guarantee for the risk of the contractor's failure to meet the contractual obligation.

In Turkey, the contractor companies used to utilize the "letter of guarantee" to meet this requirement. However, the letters of guarantee, primarily used in construction projects, put pressure on the bank credit limits of the contractor companies, since they are issued over non-cash credit limits – within the banks – of those companies. Besides, while having a letter of guarantee, the banks ask the contractor companies to give guarantees (like deposit, pledge, security, fixed assets collateral, personal guarantee, third-party guarantee, mortgage, and bail). Nevertheless, the contractor companies have difficulties in submitting this kind of collaterals.

On the other hand, while establishing the surety bonds, the insurance companies still ask the contractor companies to issue guarantees, but the surety bonds are classified as "off-balance-sheet," and they do not reduce the credit limits of the contractor companies in the banks. To put it another way, surety bonds are utilized in the place of a typical letter of guarantee. Thanks to the advantages it provides within its body, the surety allows the contractor companies not to use their non-cash credit limits and collaterals.

Since there is a massive potential for financial instruments, which are not reducing the credit limits – especially for Turkish contractors operating domestically and internationally – the surety bonds play a significant role for the Turkish contractors to open up to new markets and contribute to the strengthening of the Turkish financial markets. Turkish contractors reduce their need for letters of guarantee that are riskier and obtain surety bonds at lower costs. Expanding the surety bond usage will support contractor companies in reaching finance easier. Therefore, the surety bond increases foreign contracting services, increasing the foreign currency inflow and decreasing Turkey's current account deficit.

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