

Acceptance of Performance Bonds or Unconditional Undertakings by Government Agencies

This circular outlines the conditions under which a Performance Bond or Unconditional Undertaking covering contracts entered into by NSW Government agencies are acceptable. This Circular is issued as a Treasurer's Direction to all agencies under section 9 of the *Public Finance and Audit Act 1983*.

Summary:

This Circular applies to the acceptance of Performance Bonds and Unconditional Undertakings from a financial institution in relation to contracts entered into by NSW Government agencies (i.e. as purchasers of goods or services).

Agencies may accept a Performance Bond or Unconditional Undertaking from financial institutions regulated by the Australian Prudential Regulatory Authority (APRA). Where the financial institution is not subject to prudential oversight by APRA, specific requirements must be met, including that the financial institution must meet a specified credit rating threshold as assessed by an independent credit rating agency, e.g. Standard and Poors, Moody's Investors Service or Fitch Ratings.

The credit rating threshold is also recommended (although not mandatory) as an additional benchmark for institutions subject to APRA oversight. Agencies should also ensure that procedures are in place to avoid an undue concentration of risks with a single third party.

This Circular does not apply to situations where an agency is requested to provide a Performance Bond covering work contracted to be carried out for another party.

This Circular withdraws and supersedes the previous NSWTC 08/01 *Eligible Financial Institutions – Issue of Performance Bonds or Unconditional Undertakings Obtained for Government Contracts or Private Finance Projects*. There are no substantive changes to these requirements compared to NSWTC 08/01.

This Circular is issued as a Treasurer's Direction to all agencies under section 9 of the *Public Finance and Audit Act 1983*.

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for Secretary

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Performance Bonds are guarantees or undertakings that may be provided by a financial institution in relation to a contract with a Government agency. In cases where a contractor fails to fulfil its contractual obligations, a Government agency can immediately call on the guarantee or undertaking. The financial risk of contractual failure is therefore transferred from the agency to the financial institution which issues the Performance Bond.

This Direction also applies:

- To Unconditional Undertakings (to pay on demand) which require a security from a financial institution covering part or all of the obligation of a contractor; and
- Private finance projects where Performance Bonds or the like are sought to cover obligations between a design and construction company and its owner consortium.

For the purposes of this Circular, the term financial institution may include a bank, a non-bank financial institution (i.e. building society or credit union), an investment bank or an insurance company.

Australian-owned banks, foreign subsidiary banks, branches of foreign banks, building societies and credit unions operating in Australia as “Authorised Deposit-taking Institutions” under the *Banking Act 1959* are all prudentially supervised by the Australian Prudential Regulatory Authority (APRA). Insurers authorised under the *Insurance Act 1973* are also subject to prudential supervision by APRA. Investment banks are not subject to APRA supervision.

Agencies may accept a Performance Bond or Unconditional Undertaking from any of the above APRA regulated financial institutions (agencies should formally confirm that the financial institution they are dealing with is subject to APRA supervision – see APRA website: www.apra.gov.au).

Where a financial institution is not subject to prudential oversight by APRA (e.g. investment banks), the following minimum requirements must be met:

- The financial institution must have a credit rating of “A” or above (as assessed by Standard and Poors) or “A2” or above (as assessed by Moody’s Investors Service) or “A” or above (as assessed by Fitch Ratings).
- The total value of Performance Bonds held by an agency with that institution must not exceed 10 per cent of the institution’s net assets.

In cases where institutions are a local branch or subsidiary of an overseas parent company, agencies should also ensure the branch operation is covered by a parental company “Deed of Guarantee” which covers all financial obligations including both primary and contingent liabilities.

Agencies are not encouraged to approve a contractor obtaining a Performance Bond or Unconditional Undertaking from a financial institution that does not operate in Australia. Where special circumstances arise, agencies (excluding State-owned Corporations) are required to seek Treasury approval. State-owned corporations are advised to have special regard to any material risks arising from this type of arrangement.

While a credit rating test is not mandatory for institutions subject to prudential oversight by APRA, it is recommended that agencies use these requirements as an additional benchmark to reduce potential risks of default.

This Circular does not apply to situations where an agency is requested to provide a Performance Bond covering work it contracts to carry out for another party.