AUSTRALIAN SURETY SOCIETY - SUBMISSION

The Secretary
Parliamentary Joint Statutory Committee on Corporations and Securities
Parliament House
CANBERRA ACT 2600

corporations.joint@aph.gov.au

20th April, 2001

Dear Sir,

Inquiry into the Financial Services Reform Bill 2001

This submission has been prepared by the FSR Bill Sub-Committee of the Australian Surety Association on behalf of its members and is signed by the members of that Sub Committee pursuant to authority granted by full members of the Australian Surety Association.

ASA has previously made submissions to both Treasury and ASIC requesting that surety bonds be specifically noted as excluded from the provisions of the Financial Services Reform Bill.

The status of surety bonds is unclear in the Bill as presented to Parliament on the 5th April and ASA's submission seeks to have the wording of the Bill amended so that :

a) Surety bonds are noted in Section 765A(1) of the FSR Bill as a specific thing that is not a financial product.

b) In the alternative surety bonds are defined as credit for the purposes of Section 765A(1)(h)(1) of the FSR Bill as a specific thing that is not a financial product.

c) Surety bonds and bank guarantees are treated in an identical manner for the purposes of the FSR Bill.

d) If surety bonds are to be regarded as a financial product, all existing surety bond providers be given the benefit of the transitional licensing provisions

Yours sincerely

Signed on behalf of the Australian Surety Association

Submission authorised by the FSR Bill Sub Committee of ASA

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SUBMISSION

BY

THE AUSTRALIAN SURETY ASSOCIATION

TO

PARLIAMENTARY JOINT COMMITTEE ON

CORPORATIONS AND SECURITIES

THE FINANCIAL SERVICES REFORM BILL

1. EXECUTIVE SUMMARY

1.1 The Minister for Financial Services and Regulation, Mr Joe Hockey MP, tabled the Financial Services Reform Bill into Parliament on the 6th April 2001. The Bill proposes the introduction of a single licensing and consumer protection regime for financial sales, advice and dealings in financial products and a consistent approach to financial product disclosure.

1.2 The proposed definition of a financial product is a functional one which focuses on what financial products provide:

(i) making a financial investment;

(ii) managing a financial risk; and

(iii) making a non cash payment

1.3 The Australian Surety Association (ASA) represents the organisations issuing surety bonds in the Australian market.

1.4 A surety bond is a written agreement where a surety company allows its financial resources to be used to effectively guarantee performance of obligations by another party.

1.5 There are normally three parties to a surety arrangement:

(i) the surety's customer who undertakes certain obligations to a third party;

(ii) the surety guaranteeing to the third party the performance of those obligations; and

(iii) the obligee (ie. the third party to whom those obligations are owed) who receives the benefit of the surety bond.

1.6 The surety bond is used to secure the performance of certain activities. Characteristics of surety bonds include:

(a) there is no risk transfer to the equivalent of the insurance company (see comments at (c) below). The risk remains with the principal and the protection of the bond goes to the obligee;

(b) there is no payment of a premium based on the concept of payment for losses incurred by the principal. The surety company charges a service fee for the use of its resources as financial backing and guarantee for the principal;

(c) surety bond obligations are secured by means of a deed of indemnity given in favour of the surety taken from the company being bonded.

1.7 Surety bonds clearly fall outside the definition of an investment product and guarantees are expressly excluded from the definition of a non-cash product. ASA submits that surety bonds also fall outside the definition of a product by which a person manages financial risk as the concept of a risk product encompasses arrangements where financial risk exposure is transferred, hedged, adjusted or where cash flow or price certainty is provided. Surety bonds do not share this characteristic. The risk remains with the individual with the contractual obligations.

1.8 Neither the Financial Services Reform Bill 2001 (FSR Bill) nor the Explanatory Memorandum provides any further discussion on the approach taken to what constitutes the management of risk. The FSR Bill relies on the simple definition that a person manages financial risk if they manage the financial consequences to them of particular circumstances happening.

1.9 Surety bonds are more akin to a credit product as the primary relationship between the parties is the extension of an indemnity (in the form of money or the performance of activities) contingent upon the performance of certain contractual obligations. However, the lack of a definition for credit in the FSR Bill means that the position of surety bonds remains unclear.

1.10 After the release of the draft Bill ASA sought clarification on the status of surety bonds by making a submission to Treasury seeking:

(a) a clear exemption from the operation of the Bill in the same way that traditional credit has been excluded; and

(b) a clear statement that the licensing and disclosure requirements will not apply to surety products.

1.11 ASA believes that the status of surety bonds remains unclear in the FSR Bill and seeks a clear statement in the FSR Bill that

(a) Surety bonds be noted in Section 765A(1) of the FSR Bill as a specific thing that is not a financial product.

(b) In the alternative surety bonds be defined as credit for the purposes of Section 765A(1)(h)(1) of the FSR Bill as a specific thing that is not a financial product.

(c) Surety bonds and bank guarantees should be treated in an identical manner for the purposes of the FSR Bill.

(d) If surety bonds are to be regarded as a financial product then all existing surety bond providers should be given the benefit of the transitional licensing provisions

2. BACKGROUND

2.1 The Australian Surety Association Limited (ASA) was formed in early 1999 as an industry association representing the interests of organisations issuing surety bonds and to provide a forum for providers of surety bonds to share views and experiences.

2.2 The International Surety Association (ISA) which is domiciled in Zurich represents the international industry. Founding members of ISA are The Surety Association of America, the International Credit Insurance Association and the Surety Association of Canada. ASA became a member of ISA in early 2000.

2.3 In 1978, The International Chamber of Commerce (ICC) adopted a set of Uniform Rules (Rules) to deal with "Contract Guarantees". These Rules deal with the provision of bonds where the guarantor is obliged to pay when demand is made on the basis that certain conditions had been fulfilled.

2.4 In 1993, in response to changing international business practice, the ICC adopted a set of Rules to regulate contract guarantee forms where a beneficiary of such an instrument could obtain payment without having to prove any breach of contract. In such cases there was no requirement for the contractor to establish that it had suffered any damage. The intention was to facilitate prompt payment where there was no substantial dispute in relation to the existence of the default by a contractor. These Rules are known as the "Uniform Rules for Contract Bonds".

2.5 The Rules have already been adopted by the Government of Japan, the International Federation of Consulting Engineers (FIDIC), the Institution of Electrical Engineers (IEE), the International Credit Association (ICIA), the Association of International French Contractors (SEFI) and the Panamerican Surety Association (PASA).

2.6 The ICC has indicated that it is seeking similar endorsements from the World Bank, EU and the Inter-American Development Bank.

2.7 In May 2000, the United Nations Commission on International Trade Law (UNCITRAL) was to consider an application by the ICC to formally recognise and endorse the Rules as a global framework for uniformity in the domain of security bonds.

2.8 ASA has indicated to the Insurance Council of Australia and through it, the Commonwealth Attorney General's Department, that it has no objections to Australia supporting the ICC proposal, which is designed to facilitate the capability of contracting worldwide.

2.9 The emergence of the surety bond market within Australia has been relatively recent with most growth occurring during the 1990's. Increasingly, surety bonds are being used as an alternative, especially in the construction industry, to the more traditional products such as a bank guarantee. A description of the various types of surety bonds is provided in Annexure A.

3. TYPES OF BONDS

3.1 What is a surety bond?

3.1.1 The definitive characteristics of a surety product are:

(a) In essence a surety bond is a promise or undertaking by a person ("**the surety**") to pay another person ("**the obligee**") an agreed amount in the circumstances agreed upon or to perform some specified obligation for that person ('**the obligee").** This promise or undertaking is referred to as "**the bond**".

(b) The surety, at the request of its customer ("**the customer**") issues the bond, to secure certain obligations owed by the customer to the obligee under separate contractual arrangements. It is a primary obligation assumed by the surety in favour of the obligee rather than a secondary obligation that would be the case under a guarantee.

(c) The bond is issued on the basis that the customer gives the surety a legal right to recover full reimbursement from them for any loss, expenses or other liabilities arising or incurred in connection with the Bond (for ease of reference, this is referred to as a "**loss**"). This occurs when the obligee makes a claim on the bond.

(d) The customer gives the surety a document to evidence the contractual relationship. This is known as the "**Indemnity**".

3.1.2 Surety bond providers regard banks providing guarantee facilities, either alone or as part of the traditional suit of credit facilities, as major competitors.

3.2 Conditional and unconditional bonds

3.2.1 In general terms, surety bonds fall into two categories. They are either "conditional bonds" or "unconditional bonds".

3.2.2 A conditional bond is where the surety is only liable to pay or perform where it is satisfied that the contractor has breached its obligations to the obligee under the underlying contract (ie an event of default must have occurred under the underlying contract). Default and sometimes loss must be proved by the obligee before the surety is required to pay or perform.

3.2.3 An unconditional surety bond will typically require a statement or demand for payment to be accompanied by a declaration which:

(a) states that the contractor is in default;

(b) outlines the nature of that default; and

(c) in some cases, attaches a copy of a notice from the obligee to the contractor notifying the contractor of the default and/or requesting the contractor to remedy that default.

3.2.4 There is no requirement that the obligee actually prove that the contractor has defaulted under the underlying contract or that it has suffered loss before the surety must pay or perform. The bond will usually specify that the surety must pay or perform notwithstanding any direction given by the contractor to the contrary.

3.2.5 When the Bond is issued strictly as an unconditional surety bond, then the surety must make the payment or the performance without anything more. The Bond operates in similar terms to an unconditional bank guarantee. The significant difference is that the surety bond is issued usually by an insurance company or a specialist surety company (which is typically owned by an insurance company).

3.3 No transfer of risk

3.3.1 Unlike insurance products, there is no risk transfer from the customer to the surety. The existence of the indemnity means the surety only takes on a credit risk. The credit risk is, in the case of default, the risk that the customer will be unable to indemnify the surety in full.

3.3.2 If the indemnity allows for a full right of recourse to or reimbursement for the customer of any or all of its financial exposure, then the bond is simply a form of financial accommodation securing the credit risk of the customer's obligations to others.

3.4 Bonding is a method simply of providing a person or the obligee with comfort in relation to the performance of the obligations owed by another person (usually the contractor).

3.5 Each bonding transaction is structured in a way that a bond is issued at the request of the contractor for the benefit of the obligee. Under the bond, the surety agrees to pay to the obligee upon demand or upon occurrence of a specified event up to an agree sum. The cost of the bond will be borne by the contractor. Counter-indemnity will be entered into between the surety and the contractor under which the contractor agrees to indemnify the surety in respect of any moneys paid by the surety to the obligee under the bond.

3.6 The bond is generally entered into at the request of the contractor pursuant to the terms of a contract between that contractor and the obligee. In deciding whether or not to issue the bond, the surety will make an assessment of the contractor's financial position, performance history and exposure upon contracts at any one time.

3.7 Historically, the law has always distinguished performance bonds and guarantee contracts from contracts of insurance.

3.7.1 *"Contracts of guarantee are between persons who are in the position of creditor, debtor and surety. The surety assumes the obligation to make good the default of the principal debtor either for a fee or without a fee …There is usually no bargaining between the guarantor and the creditor; nor is there a payment made by the creditor. On the other hand an insurer engages to pay a loss incurred by the insured in the event of a certain contingency occurring'* Scottish Amicable Heritable Securities Assn Ltd V Northern Assurance Co (1883) 11 R (Ct Sess) 287

3.8 Discussions in the past with various institutions, such as APRA and the ATO, have held that surety bonding business is not characterised as being insurance business for the purposes of the Insurance Act 1973.

4. FINANCIAL SERVICES REFORM BILL 2001

4.1 The FSR Bill has, as its premise, the fact that an AFS licence will be required to carry on a financial services business. There are exemptions to this requirement for representatives of licensees.

4.2 A person provides a financial service if they:

(a) provide financial product advice;

(b) deal in a financial product;

(c) make a market for a financial product;

(d) operate a registered scheme;

(e) provide a custodial deposit service; or

(f) engage in conduct of a kind prescribed by the regulations made for the purposes of Section 766A.

4.3 The FSR Bill takes a three part approach to the definition of financial products:

(a) a broad general definition of a financial product and the statement that a facility is a financial product if it falls within the definition;

(b) facilities deemed to be within the definition of a financial product; and

(c) facilities deemed to be excluded from the definition of a financial product.

4.4 Section 763A defines a financial product as a facility through which or through the acquisition of which a person:

(a) makes a financial investment;

(b) manages a financial risk; and

(c) makes non cash payments.

5. The Status of Surety Bonds

Makes a financial investment

5.1 Surety bond arrangements clearly do not fall into Section 763B of the FSR Bill that defines a product "when a person makes a financial investment". Investment products require a contribution of funds to another person for the purposes of generating a financial return.

Manages a financial risk

5.2 Managing risk for the purposes of the FSR Bill is defined as "a person managing the financial consequences to them of particular circumstances happening or avoiding or limiting the financial consequences of fluctuations in,or in the values of, receipts or costs(including prices and interest rates)"

5.3 Section 765A(1)(h)(i) of the FSR Bill deems a credit facility within the meaning of the regulations to be excluded from the definition of a financial product. The Explanatory Memorandum notes that credit facilities are not covered by the definition of a financial product as they are regulated by the state based Consumer Credit Code regimes. It is noted that the general consumer protection provisions in Division 2 of part 2 of the new ASIC Act will apply to all credit.

5.4 Surety bonds operate on the same basis as a credit facility in that there is an ability to call upon the surety, up to the facility limit, should the relevant triggering event occur. In this way surety bonds are akin to bank facilities as the surety bond provider "lends" its balance sheet capacity. If a claim on the surety bond is made then the contractor is in debit to the surety bond provider in the same way that a bank customer is indebted to the bank if a call is made on a bank guarantee.

5.5 The FSR Bill specifically excludes credit facilities from the definition of a financial product managing risk. On this basis products, which provide similar services such as surety bonds, should also be excluded for the sake of competitive neutrality.

5.6 The Commentary to the draft Bill noted that a warranty or guarantee in a term of contract for the sale of goods was excluded from the definition of a financial product. The Commentary noted that the definition of a financial product would exclude an arrangement with a term which might be regarded:

(a) as managing a financial risk (eg. a warranty);

(b) as a term with a dominant purpose as a whole of something other than managing a financial risk;

(c) as a whole is not commonly acquired to manage a financial risk; and

(d) with no identifiable amount to be paid for the term.

5.7 The FSR Bill deals with this issue of warranties and product guarantees by the addition of Section 763E which notes that a product that is incidental to a facility will not be a financial product. The Explanatory Memorandum notes that this section was designed to cover the range of consumer transactions that had an element of managing financial risk such as warranty periods or guarantee for the sale of goods. Surety bonds do not fall within this type of incidental facility.

Makes a non –cash payment

5.8 The Corporations Law presently defines "providing finance" to include "giving guarantees or security for loans made by someone else." No definition is provided in either the Corporations Law or the FSR Bill of "finance" or a "guarantee".

5.9 For the purposes of Chapter 7, Section 763D(b)(iii) excludes making payments by way of a guarantee given by a financial institution from the definition of a financial product in the form of a non cash payment

6. SUBMISSIONS

Submission 1: That surety bonds be noted in Section 765A(1) of the FSR Bill as a specific thing that is not a financial product.

6.1 It is the submission of ASA that a surety bond is simply used as a form of financial accommodation securing the credit risk of the contractor's obligations to others. There is no risk transfer and no underwriting occurs. There is an assessment of the financial capability of persons whose activities are to be the subject of the product.

6.2 Surety bonds involve a three way relationship between the contractor acquiring the bond, the obligee requiring the bond and the surety bond provider. Although the acquirer of the bond, the contractor does not have the power to trigger the bond nor does the trigger of the bond allow the contractor to avoid the risk. For this reason ASA submits that a surety bond is not a facility that allows the contractor to avoid the financial consequences to it of risk. There is no clear statement to this effect contained in the FSR Bill.

6.3 The Explanatory Memorandum to the FSR Bill clearly indicates in paragraph 6.37 that Treasury intentionally adopted a very general definition of a financial product. It is "intended to provide significant flexibility in defining the financial products that are to come within the regime and it will be able to cater for emerging products without the need to amend the legislation." The difficulty with this approach is that it leaves service providers subject to an ASIC interpretation of who requires a licence.

6.4 Surety bond providers will be disadvantaged if they are included in the licensing regime as they operate very differently from banks and insurance companies. The competencies and training required for surety bonds are quite different to those required by the more traditional financial service providers. However they are very similar to the skills required for credit products.

6.5 Because credit products have been excluded from the licensing requirements of the FSR Bill ASA has not been consulted to assist ASIC in the development of the appropriate licensing requirements for surety bond providers. There have been no competencies developed for surety bonds and no consultation process has occurred with ASA to identify the skills sets and level of industry knowledge required for licensing purposes.

6.6 For this reason surety bonds should be expressly stated in the FSR Bill to be a product that falls within the provisions of Section 765A(1) as an excluded product for the purposes of Chapter 7 of the Corporations Law**.**

Alternative Submission 1: **That surety bonds be defined as credit for the purposes of Section 765A(1)(h)(1) of the FSR Bill as a specific thing that is not a financial product**

6.7 Credit facilities are clearly excluded from the FSR Bill but the definition of what constitutes credit will be unavailable until the regulations are issued. This means that the position of surety bonds is left unclear at a time when surety bonds have emerged as a viable alternative to bank guarantees. This uncertainty will create operational difficulties for surety bond providers who are faced with the prospect of increased compliance and licensing costs that will not be incurred by their competitors. This situation would create the very situation that the FSR Bill seeks to avoid – two products with similar services and functions but one regulated while the other is exempt.

6.8 For this reason surety bonds should be treated on the same basis as a credit product and expressly included in the definition of credit for the purposes of Section 765A(1)(h)(1)

Submission 3: Surety bonds and bank guarantees should be treated in an identical manner for the purposes of the FSR Bill

6.9 Surety bond providers are in direct competition with providers of bank guarantees and on the basis of competitive neutrality they should be treated on an equal basis for the purposes of the FSR Bill.

Submission 4: If surety bonds are to be regarded as a financial product then all existing surety bond providers should be given the benefit of the transitional licensing provisions

6.3 The new regime anticipates further legislation later in 2001 to deal with the transitional period. The Minister has indicated that there will be a two-year period for this to occur. However, ASIC is due to release its first round of draft policy statements on April 26.

6.10 Industry briefings by ASIC indicate that entities which are not regulated or licensed at the time of the commencement of the FSR Bill will not qualify for the streamlined licensing process or the transitioning provisions. This means that well established surety bond providers will be regarded as new entrants for the purposes of licensing. ASA believes that this would be unnecessarily disruptive in a new industry that is playing a vital role in major construction and infrastructure projects. It would also disrupt competition by removing a number of existing surety bond providers from the market place while they apply for licenses.

6.11 If surety bonds are caught by the licensing requirements then in the period prior to 1st October 2001 each surety bond provider will need to assess their business operations and determine:

(a) what type of licence will be required

  (i) to provide product advice;

  (ii) to deal in a financial product;

(b) the impact of licensing on distribution channels;

  (i) the need to appoint authorised representatives;

  (ii) any issues with sub agencies which are prohibited; and

(c) the need to restructure business operations to maximise transitional opportunities, if any.

6.12 If treated as new entrants for licensing purposes the existing surety providers will be required to file full licensing applications and they will not be able to trade legally until their licence is processed and approved. ASIC has indicated that this could take some time given the number of licensing applications it will have to process at the commencement of the FSR Bill.

6.13 Given the nature of the surety bond industry and the number of providers within Australia, ASA submits that that the existing industry participants should be provided with the same opportunity to transition over the two-year period that is to be afforded to other industry participants.

ANNEXURE A

1. SURETY BONDS

Surety Bonds are used in a wide variety of situations in the modern commercial world. The type of bond issued will reflect the situation for which it is required. Examples of the types of bonds that can be issued within the above categories include:

1.1 Contract Performance and Maintenance Bonds

Contractors in the engineering and construction industries require contracts bonds. In addition, businesses tendering for large construction projects and work with Federal, State and Local governments will generally require contract bonds. These types of bonds represent approximately 90% of the Australian market.

The performance bond shields the project owner or government department from financial loss should the contractor fail to meet the contract's terms and conditions.

The bond would normally be for a monetary value equivalent to, for example, 10% of the total contract price, reducing to 5% on practical completion. The balance of the bond would be held for retention during the defects liability period and would guarantee the due performance of the works in accordance with the contract until final completion.

Where major construction projects are involved, it would be common for the main contractor to engage sub-contractors for which a separate contract will exist. A bond will then be required from the sub–contractor in favour of the main contractor and so on down the line.

1.2 Performance Completion Bonds

A performance completion bond is commonly used in the construction industry to provide a 100% guarantee in case of contractor default. The surety may decide to partner with the contractor to prevent a default or in the case of a default pay the cost of subcontractors, material and labour supplies and arrange for the completion of the work

1.3 Bid/Tender Bonds

A Bid Bond guarantees that the contractor has the ability to proceed with the contract if the contractor is successful with the bid.

The bid bond provides financial assurance to the principal that the bid has been submitted in good faith and that the contractor intends to enter into the contract at the bid price and will provide the necessary Performance and Payment bonds.

1.4 Advance Payment Bonds

This type of bond serves to secure funds advanced by the principal where they are required for the mobilisation of plant and equipment, pre-purchase of materials etc.

1.5 Retention Release Bonds

These bonds are required in the engineering and construction industries to allow release of retention monies during the defects liability period of the contract.

1.6 Maintenance/Warranty Bonds

Are used where service contracts are entered into between a principal and a contractor for the maintenance of equipment, machinery, engineering plants etc.

Maintenance bonds may also be used to cover defects arising in the period (usually 12 months) after a building has been completed or an item of machinery installed.

1.7 Off-Site material Bonds

These types of bonds are required where material and/or equipment are held offsite on behalf of the purchaser.

1.8 Rental/lease Bonds

Lease or rental bonds are issued on behalf of tenants in favour of lessors, owners or principals.

Generally, the value of the bond represents between three and six months worth of rental obligations. The bond is also issued as security to ensure that the lessee abides by the terms and conditions of the lease and does not break the lease.

1.9 Mine rehabilitation bond

Mine rehabilitation bonds are generally required by governments under various mining acts to secure the obligations of a mining company to rehabilitate the land once the mining activities have ceased.

1.10 Mining lease bond

Such a bond is often a condition of the granting of a mining lease to ensure compliance with the lease terms.

1.11 Farm Produce Bonds

Required by operators at markets to guarantee payment for produce.

1.12 Liquidators bonds

Required by registered liquidators for orders placed in their own name.

1.13 ASIC Bonds

Required by certain companies involved in broking operations that are required to provide a bond to the Australian Securities and Investment Commission (ASIC) to protect investors should the company fail to adhere to defined guidelines. These bonds are mainly required in Western Australia.

1.14 Fidelity Bond

A type of surety bond required by clerks of the court to enable them to carry out their duties where they are handling money on behalf of others.