



## ELIGIBLE FINANCIAL INSTITUTIONS – ISSUE OF PERFORMANCE BONDS OR UNCONDITIONAL UNDERTAKINGS OBTAINED FOR GOVERNMENT CONTRACTS OR PRIVATE FINANCE PROJECTS

**Advice on the type and status of financial institutions that may be used to provide performance bonds or unconditional undertakings to cover contracts entered into by NSW Government agencies (i.e. as purchasers of goods or services). The recommended financial institution benchmarks are designed to reduce the potential risks of default**

### Summary:

This Circular is issued as part of the review of Treasury Circulars due for automatic lapsing. The Circular withdraws and supersedes NSWTC 02/18; however it does not represent a substantive change to the previous policy. This Circular is issued as a Treasurer's Direction to all agencies under section 9 of the *Public Finance and Audit Act 1983*.

This Circular applies to performance bonds and unconditional undertakings, where guarantees or undertakings are provided by a financial institution in relation to contracts entered into by NSW Government agencies (i.e. as purchasers of goods or services). In cases where a contractor fails to fulfil its contractual obligations, a Government agency can immediately call on the guarantee or undertaking.

Agencies may approve a performance bond or unconditional undertaking from financial institutions regulated by the Australian Prudential Regulatory Authority (APRA). However where a financial institution is not subject to prudential oversight by APRA, to reduce the potential risks of default, certain specified requirements must be met, including meeting a specified credit rating threshold as assessed by 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.

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.

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for Secretary

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## **ELIGIBLE FINANCIAL INSTITUTIONS – ISSUE OF PERFORMANCE BONDS OR UNCONDITIONAL UNDERTAKINGS OBTAINED FOR GOVERNMENT CONTRACTS OR PRIVATE FINANCE PROJECTS**

Performance bonds are guarantees or undertakings provided by a financial institution in relation to a contract struck between a contractor and 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), a merchant 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. Merchant Banks are not subject to APRA supervision.

Agencies may approve a performance bond or unconditional undertaking from any of the above financial institutions regulated by APRA [agencies should formally confirm that the financial institution they are dealing with is subject to APRA supervision – see APRA website: [www.apra.gov.au](http://www.apra.gov.au)].

Where a financial institution is not subject to prudential oversight by APRA (e.g. merchant banks) then 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); and
- 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 such institutions may be local branches or subsidiaries of overseas parent companies, agencies should also ensure that 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 for such a proposal, such 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 it as an additional benchmark in order to reduce potential risks of default.

Agencies should also ensure that procedures are in place to avoid an undue concentration of risks. Overall risks of default may arise where:

- There are significant aggregate exposures to individual financial institutions; or
- . The size of the contract/s exposure/s is/are large relative to the size of the financial institution issuing the performance bond.

Please note that 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.