



# Surety-Backed Letters of Credit – The Right Solution for the Times

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Over the last several years, we've all gotten used to uncertainty in the macroeconomic environment. However, one factor has felt certain — it seems that each time central bankers meet, the federal funds rate increases another 25 – 50 basis points.

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We're currently experiencing interest rates that are higher than we've seen since the 1990s. Many effects, like higher prices at the pump, increased borrowing costs and the cooling of the housing market are immediately apparent to consumers. But these interest rate hikes affect businesses too.

Borrowing costs are on the rise for businesses. This means that business owners need to pay more to borrow money. The most commonly used form of credit North American banks issue to their clients is a line of credit facility.

**The surety-backed letter of credit allows a contractor access to a letter of credit facility with lower pricing than a traditional line of credit while maintaining the liquidity benefits of a traditional surety facility.**

Amid the interest rate rise, commercial banks have begun to charge their clients more in order to maintain their lines of credit. This has led to significant pressure in various industries, like construction, where performance guarantees, especially letters of credit, are essential. Many contractors can no longer access the same amount of performance security from their bank.

Traditional performance and labor and material payment surety bonds have served as a letter of credit alternative for over a century, and surety bonds offer significant benefits:

- Surety does not negatively affect working capital (cash and bank facility).
- Surety is a partner (not an insurer) and will assist a contractor in defending a claim.
- Surety rates are almost always lower than what a bank charges for a line of credit.

Despite these obvious benefits, some project owners still refuse to accept surety bonds as performance security. But the surety market is adaptable, and a hybrid product called a “surety-backed letter of credit” is currently in use. This product allows a contractor access to a letter of credit facility with lower pricing than a traditional line of credit while maintaining the liquidity benefits of a traditional surety facility.

NFP has existing relationships with multiple sureties that provide this product in order to help contractors secure their own surety-backed letter of credit facility. The following demonstrates a typical process for securing a surety-backed letter of credit facility:

- NFP will work with its surety partners to find the best match based on the contractor’s specific needs.
- NFP and its surety partner will utilize existing relationships with reputable banks that are comfortable with these types of instruments.

- Bank will issue the letter of credit with the surety, rather than the contractor, guaranteeing the letter of credit to the bank.
- Surety-backed letter of credit satisfies the project financier’s need for liquid performance security while allowing the contractor to experience the benefits of a surety bond.

Since the surety guarantees the letter of credit to the bank, the contractor does not need to keep cash with its financial institution as security. The contractor is free to reinvest that new-found liquidity. In the current interest rate environment, with the cost to borrow money so high, freeing up capital that would otherwise be used as security is quite beneficial. The contractor does need to pay a nominal fronting fee to the bank in order to issue a surety-backed letter of credit, but the combined surety bond premium and bank fronting fee is almost always lower than the cost of a letter of credit facility.

The surety-backed letter of credit market is growing rapidly. Just a few years ago, most capacity for this product came from European banks. While there can be benefits to North American contractors using European banking support, placing surety-backed letters of credit through European banks does require some extra steps. Fortunately, we’ve seen more entrants providing local North American facilities, allowing for lower fronting fees and smoother processes.





As the popularity of surety-backed letters of credit increases, we expect the number of new entrants providing North American facilities to grow.

Surety-backed letters of credit don't just provide value to contractors. A growing number of commercial surety obligations can be secured with a surety-backed letter of credit. There are many industries where the use of surety-backed letters of credit is increasing, but some of the major industries include:

- Mining (reclamation)
- Oil and Gas (environmental, financial security obligations)
- Renewable Energy (supply, interconnection)
- Finance/Insurance (deductible reimbursement)

It's important to a business's success to reduce uncertainty and maintain flexibility. Both are more difficult to achieve in a high interest rate environment. The surety-backed letter of credit solution provides an appealing alternative to free up capital and reduce fees. But this is a hybrid product that requires knowledge of both banking and surety. NFP can help you secure a surety-backed letter of credit that fits your needs, letting your business experience the benefits of combating the high cost of borrowing money in a cost-efficient and secure way.



## Questions? Contact:

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