MODERN SURETY BONDS AS FINANCIAL SECURITY FOR MUNICIPALITIES

Ontario Home Builders' Association

SURETY ASSOCIATION OF CANADA | ASSOCIATION CANADIENNE DE CAUTION

BACKGROUND INFORMATION

When approving a development proposal, such as subdivision or site plan, municipalities seek assurance that the necessary site improvements will be made in a timely manner as required by the developer. This includes the installation of common services which are specified by the developer's consulting engineers as reviewed and approved by the municipality's engineers. Development agreements typically contain details on the satisfactory completion of the services being installed and the required guarantee and maintenance period as they will eventually be owned by the municipality. These agreements also contain a financial security provision (payable to the municipality) to ensure that the developer's obligations are completed on time and function properly according to municipal standards and the requirements of the development agreement.

Throughout the 1950's, 60's and 70's it was common practice that Ontario municipalities accepted surety bonds as financial security for subdivision agreements and site plans. These bonds provided the required security while not tying up capital that could be used for investment in additional development projects. Since the 1980's, municipalities have moved away from accepting surety bonds as a form of financial security and today almost exclusively require letters of Credit (LOC) from a chartered bank.

PROBLEM WITH LETTER OF CREDIT VS MODERN SURETY BONDS

In many cases developers are required to collateralize LOC, dollar for dollar against the value of the municipal works. Every LOC directly reduces the financing capacity the developer has available to finance potential projects. An LOC on one project that occupies all the financial capacity of a developer means that other projects in the developer's portfolio are delayed until the LOC is cleared or new financing is secured. Put bluntly, the developer can only afford to finance one housing project at a time because of the LOC requirements.

Modern Surety Bonds (MSB) can be designed to provide municipalities with the financial security tool they need to move infrastructure forward, including timely compensation if required, while permitting the financing capacity of the developer to fund additional projects. MSB gives the municipality the protection they need, without undercutting the financing capacity of the developer to bring additional projects and housing supply forward at the same time.

PROPOSAL

The Ontario Home Builders' Association proposes that the Provincial Government require municipalities to accept MSB as an acceptable alternative financial tool to secure the obligations in municipal agreements. This change would continue to provide the municipality with the financial security they require to guarantee the installation, performance, and warranty period of municipal services.

MODERN SURETY BONDS AS FINANCIAL SECURITY FOR MUNICIPALITIES

RATIONALE

MSB will unlock millions of dollars of financing liquidity that can fund infrastructure and create thousands of new housing units across Ontario. These investments will produce additional employment opportunities for the trades and suppliers in the home building industry which in turn will provide positive economic stimulus for the Ontario economy through the COVID-19 pandemic. With 444 municipalities in Ontario and only a select few accepting surety bonds as financial security, it creates an uneven footing for developers and depending on which municipality they are building in, it places most at a disadvantage with capital unnecessarily tied up securing a LOC.

WHAT ARE MODERN SURETY BONDS?

Modern surety bonds are proven to provide the same benefits and security as a letter of credit. Municipalities get all the features of a LOC while enjoying the added benefit of professional underwriting, carried out by licensed bonding companies, ensuring that the developer is qualified to fulfill its obligations under the municipal agreement.

Finally, MSB are a safe and reliable form of financial security which are professionally supported through the Surety Association of Canada and regulated by the Office of the Superintendent of Financial Institutions.

CITY OF PICKERING - MUNICIPALITIES WHO HAVE ACCEPTED MSB WHERE THE DEVELOPER QUALIFIED

The City of Pickering only accepted MSB after a long and extensive Council approval process. It is unrealistic to have the acceptance of MSB by all 444 municipalities done through a piecemeal approach. Therefore, there is a need for provincial leadership to cut red tape, have an open for business approach, while ensuring that the municipal financial security provision is fulfilled.

COST

Requiring municipalities in Ontario to accept MSB would have no impact on provincial or municipal revenues or expenditures. It is a policy option which has no impact on the treasury.

IMPACT - MUNICIPAL AND ECONOMIC

For municipalities, MSB function as liquid financial instruments that can provide the funds immediately on demand without the requirement for the municipality to prove default, essentially they function just like a LOC. The municipal acceptance of MSB provides a clear signal to development industry that they are open to modern and innovative financial opportunities which

MODERN SURETY BONDS AS FINANCIAL SECURITY FOR MUNICIPALITIES

Ontario Home Builders' Association

SURETY ASSOCIATION OF CANADA | ASSOCIATION CANADIENNE DE CAUTION

help them achieve provincial growth targets, create additional housing supply, as well as provide local employment opportunities.

This proposed change would unlock billions of dollars of private sector financial liquidity for investment in new infrastructure and housing projects, provide for more units per development and accelerate the delivery of housing of all types to deliver on the government's More Homes, More Choice: Ontario's Housing Supply Action Plan and the province's Jobs and Economic Recovery Plan.

PROVINCIAL ACTION

An Amendment to the Planning Act that would permit the use of performance bonds in all development applications in Ontario, at the option of the owner of the land.

ADDENDUM

Addendum A: Amendment to the Planning Act - Performance Guarantees

Addendum B: Masters Insurance

Addendum C: Surety Bond Usage in Alberta

AMENDMENT TO THE PLANNING ACT - PERFORMANCE GUARANTEES

69.3 (1) In the event that the council of a municipality, a planning board, a committee of adjustment or a land division committee, in processing an application related to development or redevelopment, requires the posting of financial or other security to ensure the performance of any obligation pursuant to a condition of development or redevelopment approval or pursuant to the provision of any agreement, the owner, in addition to any form of security ordinarily permitted by the municipality, planning board, committee of adjustment or land division committee, shall be permitted to post security in the form of a surety bond, that includes any of the following requirements imposed by the municipality, by condition of approval or by agreement:

(a) is from an insurer licensed under the Insurance Act to write surety and fidelity insurance;
(b) has a coverage limit of at least 100 per cent of the required security amount, or such other percentage of the secured amount as may be prescribed;
(c) has an obligation to pay that is on demand, without regard to the equities between the parties and the payout is in cash up to the aggregate amount of the bond;
(d) is automatically renewed after one year and stays in effect unless the Surety provides notice that it will not renew (in which case the municipality is given the right to draw on the entire bond);

MODERN SURETY BONDS AS FINANCIAL SECURITY FOR MUNICIPALITIES

Ontario Home Builders' Association

SURETY ASSOCIATION OF CANADA | ASSOCIATION CANADIENNE DE CAUTION

(e) permits partial drawings;
(f) is standby, irrevocable and permits drawings on its face upon presentation of a sight draft;
(g) references the specific agreement or condition of approval for the construction that is secured;
(h) permits partial reductions in the bond amount; and
(i) contains any other prescribed conditions as may be required

NO LIMITATION ON OTHER BONDS OR SECURITY

(2) For greater certainty, this section does not limit the ability of the municipality, planning board, committee of adjustment or land division committee to permit the contractor to provide other types of bonds or security. 2017, c. 24, s. 56.

MODERN SURETY BONDS AS FINANCIAL SECURITY FOR MUNICIPALITIES

1. Subdivision Bonds vs Letters of Credit

Ontario Home Builders' Association

masters INSURANCE FINANCIAL for generations

OVERVIEW

SURETY BONDS V. IRREVOCABLE STANDBY LETTERS OF CREDIT

When approving a proposal to develop real estate, municipalities look for assurance that the necessary site improvements will be delivered in a timely fashion and warranted by the developer. To ensure that the developer has the necessary financial resources to deliver and pay for the required site improvements, municipalities typically require financial security from the developer.

The obligation to build is most typically found in either a subdivision agreement, a site plan agreement or some other form of development agreement (in Ontario). The agreement will describe the services to be constructed by reference to plans and specifications prepared by the developer's consulting engineer and reviewed and approved by the municipality's engineers. The services are typically designed according to engineering design criteria prepared by the municipality and adopted by council. This ensures that services will be constructed to an acceptable and common standard.

The development agreement governing the construction will contain clauses respecting the satisfactory completion of the services because ultimately, the services will be owned by the municipality and therefore the municipality will be responsible for the continued maintenance, repair and replacement of the services and will be responsible for any liability resulting from the operation and use of the services by members of the public. During the maintenance period described above (usually 2 years or more), the developer is responsible to make all repairs to any part of the system that does not perform to a satisfactory standard.

The agreement will also contain certain financial provisions which are intended to guaranty to the municipality that the services will be completed to the approved specifications and that they will function appropriately.

In Ontario, the most common form of security has historically been limited to a very narrow range of instruments. Most typically, municipalities will require the posting of cash, a certified cheque or an irrevocable standby letter of credit. Bonds have been an acceptable form of municipal subdivision services security in the US for many years. Several Canadian municipalities have now adopted policies to allow bonds to be accepted. Notably, the City of Pickering has adopted such a policy. The City of Calgary, the City of Grand Prairie, The Regional Municipality of Durham and the City of Greater Sudbury have all accepted some form of surety bond for the construction of municipal services.

MODERN SURETY BONDS AS FINANCIAL SECURITY FOR MUNICIPALITIES

1. Subdivision Bonds vs Letters of Credit

Ontario Home Builders' Association

masters INSURANCE FINANCIAL for generations

CASE STUDY - FRIDAY HARBOUR IN THE TOWN OF INNISFIL

The Town of Innisfil launched a pilot project to test the usefulness of bonds as security for the completion of municipal services in a project called "Friday Harbour" on Lake Simcoe. The Town of Innisfil (as do most municipalities) had plenty of previous experience using Performance Bonds in projects that it tendered on its own for the construction of municipal services. Historically Performance Bonds have been accepted by municipalities in the context of the construction of tendered municipal services, but there has been a reluctance to accept them for works constructed within a development plan. In the case of Innisfil and the Friday Harbour Project the municipal staff reviewed the legal basis for bonds vs letters of credit and concluded, in a report to council, that bonds would be acceptable, on a trial basis, for the completion of works which w re external to the subdivision. The report identified the following as reasons supporting this decision:

The Surety in this case was prepared to amend its standard form of Performance Bond so that it contained most, if not all of the protections contained in Uniform Custom and Practice ("UCP 600") and

Contains the following important clauses;

a. The obligation to pay is on demand, without regard to the equities between the parties and the payout is in cash up to the aggregate amount of the bond;
b. The Bond is automatically renewed after one year and stays in effect unless the Surety provides notice that it will not renew (in which case the municipality is given the right to draw on the entire bond);
c. Partial Drawings are permitted;
d. It is standby;
e. It is irrevocable;
f. Drawings are permitted upon presentation of a sight draft;
g. The Bond references the specific agreement for the construction of the municipal services; and
h. Partial reductions are permitted in the bond amount, and:

in the agreement and as a condition of accepting the bond, the municipality has stipulated that the Town is permitted to require a replacement security if the credit rating of the Surety falls below a level that is unacceptable to the municipality. This is to ensure that the security for the service will continue even if the financial stability of the Surety changes.

MODERN SURETY BONDS AS FINANCIAL SECURITY FOR MUNICIPALITIES

1. Subdivision Bonds vs Letters of Credit

Ontario Home Builders' Association

masters INSURANCE FINANCIAL for generations

CONCLUSION

As the example from Friday Harbour demonstrates, in cases where a surety company is open to such arrangements, incorporating terms and language that is typical of letters of credit into the surety contract can offer significant advantages to all parties involved.

On the one hand, the municipality gets the flexibility and peace of mind offered by an Irrevocable Standby Letter of Credit ("ISLOC"). For example, if the developer defaults on its obligations it is unnecessary for the municipality to go through a drawn out negotiation with the surety company and the risk of non-performance is thereby drastically mitigated. As well, with amended language, the modified bond provides just as much protection to a municipality as an ISLOC.

Meanwhile, the developer benefits, because although the modified bond now operates in many ways the same as an ISLOC would, the developer's liability with respect to the surety remains in the nature of an indemnity. Under an ISLOC the developer would be required to provide dollar for dollar direct security and potentially tie up resources in the form of its line of credit with the issuing bank thereby decreasing the cash available to complete construction. This potentially reduces the risk of default which is an advantage for both the developer and the municipality. As well, the overall cost of borrowing for the developer is lower. Where the parties involved are open to more flexible and creative arrangements we believe that we will see more and more municipalities accept Surety Bonds as security for subdivision services in future.

MODERN SURETY BONDS AS FINANCIAL SECURITY FOR MUNICIPALITIES

1. Subdivision Bonds vs Letters of Credit

Ontario Home Builders' Association

masters INSURANCE FINANCIAL for generations

BENEFITS OF SUBDIVISION BONDS

For Municipalities

i. **Liquid.** A subdivision bond is comparable to a letter of credit in that it represents a very liquid instrument that provides the municipality with the funds required to correct a default by the developer.

ii. **Responsive.** The trigger to making a claim under a subdivision bond mirrors that of a letter of credit, in that the municipality provides written notice to the surety that the developer has defaulted under its development agreement. The municipality is not bound to take any action or proceedings, or to exhaust its recourse against the developer or any other security, before turning to the subdivision bond for payment.

iii. **Customized Solution.** The specific terms of the subdivision bond can be tailored to each municipality, providing financial protection in line with its specific form of development agreement.

iv. **Prequalification.** To obtain a subdivision bond, a developer must demonstrate not only the financial means to complete the development project, but also the expertise, resources and operational controls to bring it to a successful conclusion.

v. **Performance.** Should a claim be filed against the bond, the developer is required to repay the surety all amounts paid under the subdivision bond. The bond keeps the developer responsible, accountable and motivated to fully perform all of its obligations to the municipality.

vi. **Promotes Growth.** Accepting an alternate form of financial security that is of benefit to developers sends a clear message to the development industry that a municipality is innovative, responsive to the needs of developers and growth-oriented. Attracting development opportunities - at no additional risk to the municipality - helps ensure the continued growth of the municipality and its economy.

For the Developer

i. **Off-Balance Sheet Security.** Subdivision bonds are considered "off-balance sheet" security, meaning they do not encumber a developer's balance sheet as a letter of credit would. Using this form of security maximizes the financial resources available to the developer to complete the proposed development.

MODERN SURETY BONDS AS FINANCIAL SECURITY FOR MUNICIPALITIES

1. Subdivision Bonds vs Letters of Credit

ii. **Access to Unproductive Cash.** Since a subdivision bond allows the developer to access the substantial amounts of idle cash that usually secures the letter of credit, the developer is much better positioned to satisfy the cash-flow requirements of the development project.

iii. **Greater Credit Availability.** By using a subdivision bond instead of a letter of credit, the developer makes available bank financing that can be used to grow the company's business and improve its liquidity

MUNICIPALITY/REGION APPROVAL PROCESS

Treasurer	Legal	Council	Resolution and By-Laws	Agreements
Step 1. Treasurer/CFO in agreement on the use of a Bond in lieu of a letter of credit	**Step 2.** Review Bond Wording for remarks and approval	**Step 3.** Vote on recommendation	**Step 4.** Pass resolution and incorporate into By-Laws	**Step 5.** Update Developments agreement(s)

MODERN SURETY BONDS AS FINANCIAL SECURITY FOR MUNICIPALITIES

1. Subdivision Bonds vs Letters of Credit

Ontario Home Builders' Association

masters INSURANCE FINANCIAL for generations

SURETY BONDS vs LETTER OF CREDIT- COMPARISON

	Letters of Credit	Subdivision Bond
Issuer	Chartered bank or financial institution	Licensed insurance company.
Regulation	Banks in Canada are regulated by the Office of the Superintendent of Financial Institutions	Insurance companies in Canada are regulated by the Office of the Superintendent of Financial Institutions
Financial Ratings	Standard & Poor's, Moody's and DBRS rate the major banks in Canada	Standard & Poor's provides ratings for a number of insurers in Canada. AM Best is the industry standard rating agency for insurance companies
Cancellation	Letters of credit typically include the option for cancellation upon 30-60 days' written notice. Instrument renews automatically if not cancelled	Subdivision bonds include a 60 day cancellation provision and renews automatically if not cancelled.
Proof of Loss	Many letters of credit require the signing of a certificate confirming the amount to be claimed.	The principal must be declared in default under the subdivision agreement. Obligee is not required to prove the default
Loss Documentation	Certificate as above is all that is required. The developer will want an accounting of expense for which the funds are used	One page notice of claim. Subsequent to a claim, the surety requires and accounting of expenses with any excess funds returned
Payment Timeline	While most letters or credit are silent on payment terms, once a claim has been made, payment is received typically within 1-5 business days	On demand, payment is received within 7 business days.
Prequalification	No prequalification provided and the provision of a letter of credit provides no insight as to the capabilities of the developer	A Surety will review not only the financial position of the developer, but the experience and resources that they have to deliver on their obligations.
Amendments	A letter of credit can be readily increased or decreased at any time through an endorsement/amendment	A letter of credit can be readily increased or decreased at any time through an endorsement/amendment
Cost of Instrument	Average of 100 bps to 150 bps	Average of 75bps to 100 bps

MODERN SURETY BONDS AS FINANCIAL SECURITY FOR MUNICIPALITIES

2. Alberta Developers can Ante Bonds, Not Cash

ALBERTA DEVELOPERS CAN ANTE BONDS, NOT CASH - WESTERN INVESTOR

Surety bonds allow developers to finance a project without facing borrowing limits or cash reserves in an idea that started in Calgary

By: Brittany Gervais St. Albert Gazette & WI Staff St. Albert Gazette
September 2, 2020

Last year, the City of Calgary was the first large municipality in Canada to provide real estate developer surety bonds, in an effort to promote construction in a city hard hit by the downturn in oil prices. This year, as the COVID-19 pandemic further slowed Alberta's economy, the City of Edmonton began accepting development bonds for select servicing agreements.

The concept is now migrating to smaller Alberta municipalities.

Instead of being backed by cash, development bonds are more like an insurance policy, explained John Reid, city manager of development engineering in St. Albert, an Edmonton satellite community which is considering the idea.

Reid said the development bonds could be a "win-win" initiative for developers and the city. It allows the developer to pay a fee to a surety bond company that will give funds to the city if the developer defaults

This will mean developers do not have to provide the full value up front for security, leaving more capital for them to work with for further developments, Reid explained. The City of St. Albert is looking to start accepting surety bonds as an alternative to letters of credit as a way to spur more development in the city.
Currently, the city either uses cash, a certified cheque or a letter of credit through an accredited bank to withdraw funds to execute work for a project in the case a developer defaults on their contractual obligations Even though this is a widespread practice, Reid said there's been a recent push for municipalities to use another form of security.

New agreements require more up-front capital every time, he said, which reduces the amount the developers have to reinvest because the capital is tied up in a letter of credit.

"There is a definite attractiveness for developers to not have to have their cash flow tied up with letters of credit, as this will allow less requirement up front for capital to get their developments done," Reid said.

MODERN SURETY BONDS AS FINANCIAL SECURITY FOR MUNICIPALITIES

2. Alberta Developers can Ante Bonds, Not Cash

"With developments being built, the city's tax rate increases. This could be seen as a win-win situation for developers and the city."

Developers with existing letters of credit can swap those out for bonds as well Surety bond companies with an A- rating will do a full review of the company that's applying to see if they're financially viable.

The risk to the city would be if the developer defaults at the same time a surety bond company defaults, but that's a "highly unlikely" scenario, Reid said,

St. Albert's competitiveness in the region is threatened as more municipalities turn to development bonds, Reid said

Strathcona County administration is also considering following suit, according to a release from the Urban Development Institute (UDI) Edmonton Region.

The UDI committee for St. Albert formally requested to follow the City of Edmonton's footsteps, Reid said. A recommendation for more administrative flexibility around the development agreement template for unique situations would also be welcomed by developers, he said.

"It's critical that the city move quickly to adopt a similar policy so developers see they are not being significantly impacted by working in the city of St, Albert," Reid said, noting the uncertainty around development due to the COVID-19 pandemic,

On September 1 the city's community growth and infrastructure standing committee passed a motion recommending city council include the option of development bonds and allow for more flexibility in the agreement.

Link to article can be found here.