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REPORT TO THE CONGRESS

Use Of Surety Bonds In Federal Construction Should Be Improved

Multiagency

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

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COMPTROLLER GENERAL OF THE UNITED STATES
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To the Speaker of the House of Representatives
and the President pro tempore of the Senate

This is our report on why the use of surety bonds in Federal construction should be improved.

We made our review pursuant to the Budget and Accounting Act, 1921 (31 U.S.C. 53), and the Accounting and Auditing Act of 1950 (31 U.S.C. 67).

Copies of this report are being sent to the Director, Office of Management and Budget; the Secretaries of Defense, the Army, the Navy, and the Air Force; the Administrator of General Services; the Secretary of Transportation; the Administrator, Federal Aviation Administration; the Administrator of Veterans Affairs; the Secretary of the Treasury; the Administrator, Small Business Administration; the Secretary of Health, Education and Welfare; the Administrator, National Aeronautics and Space Administration; and the Chairman, Atomic Energy Commission.

Elmer B. Staats

Comptroller General
of the United States

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ABBREVIATIONS

AEC	Atomic Energy Commission
ASPR	Armed Services Procurement Regulation
DOD	Department of Defense
DOT	Department of Transportation
FPR	Federal Procurement Regulations
GAO	General Accounting Office
GSA	General Services Administration
HEW	Department of Health, Education, and Welfare
NASA	National Aeronautics and Space Administration
SBA	Small Business Administration
VA	Veterans Administration

COMPTROLLER GENERAL'S REPORT TO THE CONGRESS

USE OF SURETY BONDS IN FEDERAL CONSTRUCTION SHOULD BE IMPROVED
Multiagency

D I G E S T

WHY THE STUDY WAS MADE

GAO made this study to determine the adequacy and effectiveness of payment and performance bonds (surety bonds) on Federal construction contracts, which cost about $24 million annually.

In addition, the recent Commission on Government Procurement raised the question of whether or not the Federal Government should become a self-insurer for such bonds.

This is the second GAO report on this subject; the first was issued June 14, 1972.

FINDINGS AND CONCLUSIONS

GAO does not recommend eliminating the current bonding system but proposes improvements, as follows.

The primary purpose of payment and performance bonds is to:

--Provide assurance to Federal agencies that a contract will be properly completed.

--Protect those who supply labor and material to a contractor or subcontractor under contract with a Federal agency. (See p. 1.)

Surety companies perform various services and functions, including:

--Handling claims submitted by subcontractors, suppliers, and laborers.

--Providing financial aid to contractors.

--Conducting prequalification surveys to determine a contractor's acceptability to perform the contract.

--Monitoring the progress of bonded projects.

--Assuming responsibility for completing defaulted contracts. (See pp. 8 to 10.)

GAO was unable to reduce the issue of self-insurance to a strictly quantitative basis because:

--The costs related to the various surety services could not be isolated.

--The Federal agencies' lack of experience in performing certain surety-type services prevented the agencies from estimating the cost if the Government assumed such services.

In the absence of comparable quantitative data, we could not develop measurable evidence supporting either elimination or retention of the current bonding system.

Factors arguing against the Government's

becoming a self-insurer are the Federal construction agencies' lack of legal means, administrative machinery, and in-house expertise for handling claims submitted by contractors, suppliers, and laborers and for providing financial aid to contractors. (See pp. 14 to 20.)

However, the agencies are not benefiting from bonds as much as they could. In particular:

--Most of the preaward survey work done by agencies to determine a contractor's responsibility is an unnecessary duplication of the underwriting work done by surety companies. (See pp. 21 to 24.)

--Most Federal construction agencies generally are not seeking reimbursements from surety companies for administrative expenses incurred in handling defaults. (See pp. 25 and 26.)

--Current legal limitations on the size of payment bonds to be obtained by the agencies are producing reduced protection without any savings in bond costs. (See pp. 27 to 29.)

Bond guarantee program

GAO also examined the bond guarantee program of the Small Business Administration (SBA). The program is designed to

--provide bonds for small and minority contractors who cannot obtain bonds in the open market and

--increase the viability of these contractors so that they can make the transition ("graduate") to the regular bonding system.

The program would be more effective and its goals more readily attainable if SBA provided formal guidelines and improved procedures for graduating guaranteed contractors. (See pp. 33 to 36.)

RECOMMENDATIONS

To increase the effectiveness of the Federal construction agencies' participation in the current bonding system, the Armed Services Procurement Regulation and the Federal Procurement Regulations should be amended to:

1. Allow the contracting officer to determine responsibility on the basis of the contractor's ability to obtain performance and payment bonds from surety companies on the Treasury's approved list, except

--when the project involves unique construction expertise, or

--the contracting officer has information indicating the low bidder may not be responsible. (See p. 24.)

2. Require the Federal construction agencies to seek reimbursement from sureties for administrative costs incurred in handling defaults and identify what factors the agencies should consider in determining such administrative costs. (See p. 27.)

To improve SBA's bond guarantee program, the Administrator of SBA should direct that formal criteria be developed for graduating participating contractors into the regular bonding system and a monitoring system be established to insure that sureties are complying with such criteria. (See p. 36.)

AGENCY ACTIONS AND UNRESOLVED ISSUES

Federal construction agencies generally agreed with GAO's:

--Conclusion that the current bonding system should not be eliminated. (See pp. 19 and 20.)

--Recommendation for collecting administrative expenses. (See p. 27.)

--Conclusion that the Miller Act should be amended with respect to 100-percent payment bonds. (See p. 29.)

Some of the agencies expressed reservations that the recommendation relating to determining contractor responsibility would divest contracting officers of their discretion in determining contractor responsibility.

All but one of the agencies, however, acknowledged that agencies' preaward surveys duplicated the sureties' efforts to a degree.

GAO believes the action recommended could facilitate the contracting officer's award of contracts and eliminate the duplication. The exceptions provided for in the recommendations give the contracting officer the discretion he needs to require complete preaward surveys. (See pp. 24 and 25.)

In an informative response, SBA disagreed with GAO's findings, conclusions, and recommendations on the bond guarantee program. Although GAO carefully considered SBA's comments, GAO still believes that improvements to the program are needed. The Federal construction agencies and the surety industry stated that GAO's report was an accurate description of the program and its current operations. (See pp. 36 and 37.)

MATTERS FOR CONSIDERATION BY THE CONGRESS

The Congress should amend the Miller Act to permit Federal construction agencies to require contractors to furnish 100-percent payment bonds. (See p. 30.)

CHAPTER 1

INTRODUCTION

Currently, Federal construction agencies spend an estimated $24 million annually for payment and performance bonds (surety bonds) on direct Federal construction projects. The payment bond secures payment to persons supplying labor and material for work under contract. The performance bond secures performance and fulfillment of all obligations in the contract.

The Miller Act (40 U.S.C. 270a etc.) requires that Federal contracts over $2,000 awarded for the construction, alteration, or repair of any public building or public work be covered by a performance bond and a payment bond furnished by the contractor.

The protection of these bonds is provided through suretyship, a three-party relationship in which a surety (an individual or corporation) becomes obligated to an owner (in this instance the Federal Government) for the contractor's faithful performance and payment to those supplying labor and material.

Our study was concerned primarily with evaluating the adequacy of the current bonding system. We also explored the feasibility of the Government's becoming a self-insurer with respect to the risks currently covered by performance and payment bonds.

SCOPE OF REVIEW

We examined bonding activities, policies, and procedures at the Federal Aviation Administration; Department of Health, Education, and Welfare (HEW); Department of the Air Force; Department of the Navy; Department of the Army; General Services Administration (GSA); Atomic Energy Commission (AEC); National Aeronautics and Space Administration (NASA); Veterans Administration (VA); and Small Business Administration (SBA). We did our work primarily at the agencies' headquarters offices and at selected field offices. We interviewed agency officials and examined applicable documents and records.

We also examined the bonding practices of selected State and local government agencies. In addition, we met with several private owner-builders to discuss their bonding practices.

We reviewed the activities of selected surety companies, particularly in the area of defaults. We also discussed all aspects of the bonding system with representatives of surety companies and the two major surety associations--the Surety Association of America and the American Insurance Association.

Meetings and discussions were also held with companies and associations representing contractors, subcontractors, suppliers, laborers, minority contractors and subcontractors, bond producers, underwriters, and reinsurers.

CHAPTER 2

BONDING SYSTEM

Contractors buy surety bonds to provide certain types of protection for work undertaken. For a stated premium, the issuers (sureties) of these bonds accept obligations that are collateral or secondary to the contract obligations assumed by the contractor.

Sureties guarantee financial protection to the owners, subcontractors, suppliers, and laborers. If sureties have to pay these persons under the terms of the bonds, then the sureties demand reimbursement from the contractors for all obligations paid plus administrative costs. Thus the sureties' fees are charges for the services they perform.

EVOLUTION OF BONDING REQUIREMENTS

The forerunner of the Miller Act, the Heard Act of 1894 (28 Stat. 278), was intended mainly as a substitute for the mechanics' or materialmen's lien laws. These lien laws provided security of payment to persons supplying labor and material for private construction projects. No lien, however, could be attached to Federal property, and the mechanics and materialmen had no right of action in their favor on any bond which the Federal Government might extract from a contractor. The Heard Act compensated for this situation by providing that the performance bonds, obtained for the Government's protection, also contain a condition for the payment of labor and material claims.

The Heard Act stood unchanged until 1905, when it was amended to provide that there could be only one suit, that the Government could bring suit on performance at any time within its discretion, but that the subcontractors and materialmen had to wait until 6 months after final contract settlement and interplead with the Government. If there was no Government suit, the subcontractors and materialmen had to wait 6 months after final contract settlement and had to have all suits joined.

The new provisions lessened the protection for subcon-

tractors and materialmen and precipitated the need for the Miller Act of 1935. This act corrected the inequities of the Heard Act by replacing the one bond, which protected those supplying labor and material as well as the Government, with two bonds: a performance bond for the Government's protection and a payment bond for payment of labor and material claims.

Under the Miller Act, a person supplying labor or materials to a prime contractor can institute collection procedures 90 days after the last materials or labor have been furnished but no later than one year after the last materials or labor have been supplied. The same requirements apply to persons supplying labor or material to a subcontractor, with the exception that those persons must give notice to the prime contractor within 90 days of the last performed labor or supplied material.

CURRRENT BONDING REQUIREMENTS FOR CONSTRUCTION

The Miller Act, as amended, provides that, before a contract exceeding $2,000 for the construction, alteration, or repair of any public building or public work of the United States can be awarded to any person (contractor), the contractor must furnish the following bonds.

1. A performance bond with a surety or sureties satisfactory to the officer awarding the contract and in an amount the awarding officer deems adequate for protecting the United States.

2. A payment bond with a surety or sureties satisfactory to the contract-awarding officer for protecting all persons supplying labor and material under the contract. The payment bond penal sum (dollar amount of surety liability) shall equal 50 percent of each contract not exceeding $1,000,000; 40 percent of each contract that is more than $1,000,000 but not more than $5,000,000; and $2,500,000 for contracts exceeding $5,000,000.

The Miller Act authorized the contracting officer to waive the requirements for performance and payment bonds for contract work in a foreign country if he finds that it is impractical for the contractor to furnish such bonds.

Agencies' policies and procedures for implementing the

Miller Act bonding requirements are contained in the Armed Services Procurement Regulation (ASPR) and the Federal Procurement Regulations (FPR). These regulations contain the bonding requirements specified by the Miller Act as well as requirements for bid bonds and procedures for contractor evaluation. A bid bond, the cost of which is nominal, provides assurance that the bidder (contractor) will sign the contract and be able to furnish performance and payment bonds if awarded the contract.

Agencies require bid bonds when performance and payment bonds are required. The penal sum of the bid bond is normally 20 percent of the bid price, with the maximum penalty being $3 million.

BONDING ACTIVITIES OF FEDERAL CONSTRUCTION AGENCIES

The expenditures for direct Federal construction in fiscal year 1972 totaled about $4.7 billion. We studied the bonding activities of nine Federal construction agencies. Together these nine agencies accounted for about 63 percent ($2.95 billion) of the total direct Federal construction expenditures for fiscal year 1972, as follows:

Agency	Fiscal year 1972 direct Federal construction expenditures (000,000 omitted)
Department of the Army	$1,434
Department of the Navy	344
Department of the Air Force	331
HEW	28
Federal Aviation Administration	231
GSA	206
NASA	50
VA	105
AEC	222
Total	$2,951

Federal construction process

Generally, the Federal construction agencies follow similar procedures and practices in awarding and administering construction contracts. For competitively bid contracts, the cognizant agency receives and evaluates contractor bids and then determines the lowest qualified bidder.

Both FPR and ASPR provide that contracts be awarded only to responsible contractors. An agency, in theory, generally determines the lowest responsible bidder by making a preaward survey, in which a contractor's past performance, financial position, and technical capability are examined. As part of this survey, the agencies generally review confidential Government lists, such as the "Joint Consolidated List of Debarred, Ineligible and Suspended Contractors."

Once an agency satisfies itself that a contractor is responsible and meets all contract stipulations, it can award the contract when the contractor furnishes a performance bond and a payment bond.

Following contract award, the agency is responsible for administering the contract and managing the project. One method the agencies use to monitor the contractor's progress is onsite inspections. The amount of inspection and supervision is generally determined by the project's size and importance.

Monitoring is also done through the use of the progress payment system. Contractors submit monthly estimates of their progress on contracts, and, if accepted by the agency, they become the basis for periodic payments during construction.

An agency may terminate a contractor's right to proceed with the work if the contractor (1) does not carry out the work required by the contract with enough diligence to insure its completion or (2) fails to complete the work in the time specified in the contract or any extension thereof. If a contractor's right to proceed is terminated for default, the agency may take over and complete the work or have it

completed through other arrangements. In either case, the contractor and its surety are liable to the Government for any additional cost incurred in obtaining contract completion. Furthermore, the contractor and its surety are liable for liquidated damages--penalties for delays in contract completion--if provided for in the contract or for actual damages if liquidated damages are not provided for.

CHAPTER 3

THE SURETY INDUSTRY

The surety industry is composed of approximately 400 companies licensed in the various States to write surety bonds, including construction bonds. Some of these licensed companies are not actively competing for the surety bond business, and many of the companies are grouped under common management. Over two-thirds of the surety bond business is handled by 15 separately managed groups, with no one management group controlling more than 9 percent of the total business.

Although there are several different types of surety bonds, about two-thirds of all bonds written are construction bonds. According to industry statistics, in 1970 sureties received about $232 million in premiums from construction bonds, of which about $19 million was derived from direct Federal construction projects.

Sureties are licensed and regulated by the various State governments. Sureties that wish to write bonds for Federal construction projects have to be approved by the Department of the Treasury.

The Surety Association of America is licensed by most of the States as the statistics-gathering and rate-making or rate advisory bureau for the surety industry. The license permits the Association to file rates for all member companies licensed in a State.

SURETY BONDING PROCESS

The surety bonding process starts with a contractor applying for a construction bond. If the surety's evaluation of the contractor's acceptability to perform the contract is favorable, the surety underwrites the contractor. A surety follows the contractor's progress and, if problems arise, the surety may try to aid the contractor to prevent a default. When a default occurs on a Federal construction project, the surety generally has the option of deciding how it will arrange for completing the construction contract.

Underwriting bonds

The underwriting process, which is similar to a credit examination made by a bank, attempts to measure the contractor's ability to undertake and complete the job. In screening an applicant for a bond, the surety goes somewhat beyond strictly financial considerations and analyzes a contractor's management and organization, expertise for the kind of work involved, and equipment and present capacity to finish the contract in the required time.

The surety attempts to verify and evaluate the contractor's financial data, reviews other work being done by the contractor, and examines the legal terms and payment provisions of the contract for which the bond is sought. The surety may also attempt to determine whether the owner has sufficient funds to meet the payment schedule provided for in the contract.

Monitoring of bonded contractors

A surety follows the progress of a bonded project by periodically asking the Federal agency (or private owner) or architect to determine project status. In addition, the surety periodically evaluates details of a contractor's work under both bonded and nonbonded contracts to determine the status and profitability of the work.

Although sureties are not obligated to avoid contractor defaults, they may try to do so by (1) providing financial assistance, (2) providing engineering, accounting, consulting, and other technical services, and (3) paying claims to those supplying labor and materials.

When a default occurs, the surety generally can:

1. Enter into a takeover agreement with the agency whereby the surety agrees to carry out the contract and the agency agrees to pay all contract proceeds, earned and to be earned, to the surety without reduction or setoff. The surety then completes the project under contract with another contractor acceptable to the agency.

2. Secure another contractor, acceptable to the agency, which the agency will contract with to complete the project.

   The surety pays the difference between the remaining original contract moneys available and the cost to the agency of completing the contract using the substitute contractor.

3. Decide not to act at the time of default and thus allow the agency to determine how to complete the project. After the project is finished, the agency submits its claims to the surety for costs incurred in excess of the original contract amount.

REGULATION OF SURETIES

There is no Federal control over the rates and premiums charged by surety companies. By Public Law 79-15 (15 U.S.C. 1011, 1012), the Congress declared in 1945 that the States' continued regulation and taxation of the insurance industry was in the public interest. All States have departments of insurance to carry out regulations.

To regulate rates charged for bonds, the States have adopted either "file and use" or "file and approval" laws. File and use means rates can be used once they have been reported to the State; file and approval means rates become effective only after a State approves them. Both laws have the following similar requirements: rates (1) cannot be discriminatory, (2) should not produce unreasonable profit margins for the industry, and (3) should not be excessively high. Most States have adopted file and approval laws.

At 5-year intervals the Surety Association of America's rates and statistics are audited by personnel from several State insurance departments; these audits include evaluations of the reasonableness of the industry's profit margin.

Treasury list

Federal regulation of surety companies is limited to

Treasury approval for underwriting bonds on Federal construction projects. Sureties seeking to write Federal construction bonds must submit requests to the Treasury, along with detailed information on their charter and articles of incorporation, State insurance commission licenses, officers, holders of more than 5 percent of their stock, financial position, and methods of operation.

If approved, the surety company is authorized to underwrite bonds on Federal construction projects up to a stated limit for any one bond.

PREMIUMS AND RATE SCHEDULES

The premiums charged for surety bonds are based on the industry's experience. The current premium rates have not changed since 1955.

Premiums

The surety industry has devised the premium rates so that it is to the obligee's disadvantage if it obtains less than 100-percent performance and 100-percent payment bonds. Premiums are based on either the contract's dollar amount or the bond's penal sum, as follows:

1. If the bond's penal sum is 20 percent or more of the contract's dollar amount, the premiums ae based on the contract amount, regardless of the bond's penal sum.

2. If the bond's penal sum is less than 20 percent of the contract's dollar amount, the premiums are based on the bond's penal sum.

Under this rate structure, a purchaser of a bond that has a penal sum equal to 20 percent of the contract amount incurs the same premium cost as the purchaser of a 100-percent bond. Therefore, buying any bond having a penal sum of 20 percent or more but less than 100 percent results in a reduction in protection without any reduction in cost.

Further, the industry has substantially negated the incentive to purchase bonds having less than a 20-percent penal sum by making them financially unattractive. Bonds based on the penal sum have a much higher premium structure than bonds based on contract amount. For example, on a $100,000 contract, a 10-percent bond would cost $500 and a 100-percent bond would cost $1,000. Thus, the buyer of the 10-percent bond gets his premium cost reduced to only one-half, while his protection is reduced to one-tenth.

Because of the way the rate tables are structured, the disparity between protection and cost gets more pronounced as the contracts get larger. For example, a 10-percent bond on a $10 million dollar contract would cost $50,000. A 100-percent bond on this size contract would cost $53,975.

The sureties generally sell payment and performance bonds as a package. It costs the same for a performance bond alone as it does for a combined performance and payment bond. Accordingly, there is no cost advantage in buying only a performance bond.

There is a cost advantage to buying an individual payment bond, up to a certain point. However, as the amount of the contract increases, the relative cost savings decrease. Eventually, an individual payment bond actually becomes more costly than a combined performance and payment bond. Sureties maintain that performance and payment bonds are packaged because sureties define performance to include payments for subcontractors' and suppliers' claims.

Rate tables

For rating purposes, construction contracts are divided into two broad classes. Class B contracts include architectural building construction, related subtrade construction, and most engineering construction. Class A contracts include construction of a generally lighter nature than that in class B.

The standard rates, as detailed in the table below, are graduated in relation to contract size. For example, the premium for a 100-percent performance and payment bond on a $10 million class A or B contract would be $41,500 or $53,975, respectively.

Contract price		Premium rate per $1,000 Class A	Class B
First $	100,000	$7.50	$10.00
Next	2,400,000	5.00	6.50
Next	2,500,000	4.00	5.25
Next	2,500,000	3.90	5.00
Over	7,500,000	3.60	4.70

CHAPTER 4

ELIMINATING CURRENT BONDING SYSTEM

DOES NOT APPEAR WARRANTED

We evaluated (1) the effectiveness of the current bonding system and (2) the economic and administrative feasibility of eliminating bonds and having the Government become a self-insurer.

In general, surety bonds and the surety companies provide:

1. Financial protection to Government agencies against losses resulting from defaults.

2. Financial recourse for subcontractors, suppliers, and laborers.

3. Financial and technical aid for contractors.

The lack of cost data and the lack of Federal experience, particularly with respect to the latter two functions, prevented us from reducing the issue of self-insurance to a strictly quantitative determination. The monetary value of the individual services provided by sureties could not be isolated. Because the Federal agencies have had no experience in providing these services, they could not state what the cost would be if the Government assumed such services.

In the absence of comparable quantitative data, we could not develop measurable evidence supporting either elimination or retention of the current bonding system. The major participants in the system--Federal construction agencies, contractors, subcontractors, suppliers, etc.--generally voiced opinions that surety bonds were needed and that the current system was effective and should be continued.

As discussed below, Federal construction agencies do not, at this time, have the ability to duplicate some of the services provided by sureties. Particular factors arguing against the Government's becoming a self-insurer are the lack of legal means, administrative machinery, and in-house expertise for handling claims of subcontractors, suppliers,

and laborers and for providing financial aid to contractors in trouble. Most Federal agencies stated that, even if they could develop the necessary capabilities, it would probably prove costly to the Government.

Although we do not recommend eliminating the current bonding system, we feel that the Government is not benefiting as much as it could from surety bonds. Chapter 5 discusses those areas where the Federal construction agencies can improve their participation in the system.

CLAIMS OF SUBCONTRACTORS, SUPPLIERS, AND LABORERS

The basic purpose of the Miller Act is to provide a means of recourse for subcontractors, suppliers, and laborers on Federal construction projects. Payment bonds provide the means by which subcontractors, suppliers, and laborers can submit claims against contractors, even in the absence of defaults.

We examined selected project files at 9 Federal construction agencies, including files relating to 75 defaulted contracts. For 17 of the defaults, we examined the project files at both the Federal agency and the cognizant surety company. In many instances, subcontractors, suppliers, or laborers submitted claims or voiced complaints directly to the Federal agencies. Because these projects were bonded, the Federal agencies simply referred the complaints to the appropriate surety company. The fact that sureties handled the claims removed potentially major legal and administrative problems from the Federal construction agencies.

The surety industry has said that it does not keep overall statistics on the amount of claims submitted and paid on Federal construction projects. To ascertain the prevalence of claims, we reviewed selected surety companies. Presented below are examples of the situations we found.

Example 1

On a $36,000 Navy contract, a subcontractor submitted a claim for $29,000 to the surety company, citing nonpayment by the contractor. The surety maintains that,

as a result of paying the claim, it incurred a loss of $10,130. The surety also noted that its attempts to recover its loss from the contractor had so far proved unsuccessful.

Example 2

The contractor got into difficulty simultaneously on three multimillion dollar Federal projects. The surety allowed the contractor to complete all three projects and funded settlements with subcontractors and material suppliers. The surety cited payments on such claims of over $540,000, plus incurred expenses of over $20,000 and said that, so far, it had recovered only about $85,000 from the contractor.

However, in other instances the sureties contested subcontractors' and suppliers' claims. It is apparent that the sureties do not automatically pay all claims submitted under payment bonds. Rather, the sureties make certain determinations regarding the validity of the claims and the effect that payment or nonpayment will have on the sureties' financial exposure and on contract completion.

If bonds were eliminated, some other system for protecting subcontractors, suppliers, and laborers would have to be devised. Most Federal construction agencies believe that a workable system cannot be developed. The agencies feel that, even if a system could be developed, the administrative cost to the Government to operate the system likely would be high.

FINANCIAL AID TO CONTRACTORS

The surety keeps a bonded contractor's work program under surveillance to guard against the contractor overextending its total resources and thus subjecting the surety to potential financial losses. Should the contractor get into difficulty, the surety may be able to arrange for the loan of supervisory personnel, skilled technicians, or special equipment from other contractor clients of the surety. In addition, a surety sometimes provides or arranges for financial assistance to a contractor in trouble.

It may be feasible for Federal construction agencies to provide in-house technical assistance to a contractor. However, the agencies currently have no legal means, administrative machinery, or resources to provide financial aid to contractors in trouble.

As shown in the following examples, the surety companies can and do provide financial assistance to contractors.

Example 1

A contractor involved in a Federal dam project for the Corps of Engineers, Department of the Army, experienced a serious cash shortage that threatened its ability to continue operations. The surety elected to support the contractor and secured a $1 million line of credit for the contractor at a commercial bank. The surety guaranteed advances under the line of credit. As a result of the surety's aid, the contractor avoided default and completed the project.

Example 2

The contractor exhausted its capital at the time it was involved with nine bonded projects, including eight Federal jobs. The surety provided the contractor with enough capital to pay construction costs and to satisfy outstanding bonded job obligations. Surety payments on the Federal jobs totaled $138,500, plus legal and other expenses of over $5,000. The surety eventually was reimbursed.

It was evident from our study that the decision to provide financial aid to contractors was generally based strictly on sureties' concern for minimizing potential losses. If the surety determined that immediate financial aid would be less costly than the loss from default, the aid was provided. However, if the surety felt that it would be potentially less costly to take over the contract, the contractor was allowed to default.

DEFAULTS ON FEDERAL CONSTRUCTION

From the nine Federal agencies reviewed, we tried to obtain detailed data on the default history for a 10-year

period and the relationship of defaults to total construction activities. Only one of the nine agencies was able to provide complete information.

An analysis of the limited information available indicates that (1) most agencies experienced very few defaults and (2) the value of the defaulted contracts represented a very small portion of the total value of all construction contracts. For example, for the period 1963-72, AEC, NASA, and HEW were able to identify only five, two, and six defaults, respectively.

The Corps of Engineers was the only agency able to provide complete data comparing defaults to total construction activities. For the 10-year period, the Corps had 73 defaulted contracts having a total contract award value of about $30 million. During the period, the Corps awarded about 20,000 contracts valued at about $11.7 billion. The number of defaulted contracts represented less than one-half of 1 percent of total contract awards. On the basis of the total value of all contract awards, the value of the defaulted contracts was also less than one-half of 1 percent.

Generally, the cost of performance and payment bonds represents about one-half of 1 percent to three-quarters of 1 percent of the total contract price. Accordingly, it appears that sureties' losses on the Corps' defaulted contracts were considerably less than the bond premiums earned from such contracts. Surety figures show that, for all Federal contracts, the direct losses incurred averaged 51 percent for the period 1959-70--total premiums of about $241 million versus direct losses of about $123 million.

In comparing these figures to the total premiums paid on direct Federal construction (about $24 million annually), it appears that the Government could self-insure against losses from defaults if Federal construction agencies could keep losses from defaults, including the administrative cost of handling defaults, below $24 million annually. The agencies could not determine what their administrative costs would be if they had to assume the responsibility for handling defaults.

The above approach does not consider:

1. The costs related to the other services provided by sureties, particularly paying claims and providing financial aid to contractors.

2. What the default ratio would be if surety bonds were eliminated.

If bonds were eliminated, these two issues would become particularly important. Unless some substitute method was devised to handle claims and provide contractors with financial aid, defaults would increase.

Other factors affect the ratio of losses to premiums earned. When a default occurs, sureties try to minimize their losses through various legal sanctions against the defaulting contractor, such as attachment and subsequent liquidation of the contractor's equipment and personal assets. If the Government became a self-insurer, it would have to take similar actions or face the prospect of higher loss ratios.

Most agencies expressed satisfaction with sureties' efforts on defaulted contracts. Our review of defaulted contracts at both the Federal agencies and the surety companies generally supported the agencies' observations. Sureties were usually prompt in attempting to reach agreements with the agencies regarding arrangements for completing the projects. Generally the sureties (1) cooperated with the agencies in completing the projects and (2) honored the agencies' claims for reimbursement of additional contract costs incurred in completing the projects. As discussed in chapter 5, we believe the agencies, besides being reimbursed for increased contract costs, should also be reimbursed for the administrative costs incurred in handling defaults.

CONCLUSIONS

Because of the unavailability of cost data and the Government's inexperience in providing certain surety-type services, we could not quantitatively determine:

1. The value of the services provided by sureties, particularly the value of handling claims of subcontractors, suppliers, and laborers and providing financial aid to contractors in trouble.

2. Whether it would be economically feasible for Federal construction agencies to assume these services and have the Government become a self-insurer.

Therefore we do not recommend eliminating the current bonding system. Factors arguing against the Government's becoming a self-insurer are its lack of legal means, administrative machinery, and in-house expertise for handling claims and providing financial aid to contractors.

AGENCY COMMENTS AND OUR EVALUATION

The Federal construction agencies supported our conclusion that there was no basis for recommending elimination of the current bonding system. For example, the Department of Defense (DOD) stated that it strongly supported our "conclusion that the present basic system of performance and payment bonds in construction should be retained."

The Office of Management and Budget expressed the opinion that we might review the issues in greater detail. On the basis of factors cited in this chapter, however, we do not believe that additional review effort would produce enough meaningful data to make a definitive decision on the Government's becoming a self-insurer.

CHAPTER 5

IMPROVING GOVERNMENT PARTICIPATION IN BONDING SYSTEM

The first three sections of this chapter cover changes recommended to alleviate the agencies' administrative workload, provide for recoupment of administrative expenses, and increase the protection the agencies receive from bonds. Specifically, we believe Federal construction agencies should:

1. Discontinue most of their preaward survey work.

2. Seek reimbursement for administrative expenses they incur in handling defaults.

3. Obtain 100-percent protection under performance and payment bonds.

The last section of this chapter discusses a concept currently being tested by two agencies that could reduce the cost of Federal construction. The agencies believe the Government can save in construction costs by discontinuing the practice of withholding a portion of the progress payments to contractors.

ELIMINATION OF AGENCY PREAWARD SURVEY WORK

In our opinion, the Federal construction agencies should be allowed to discontinue most of their preaward survey work of the low bidders because:

1. The survey efforts, to a large extent, duplicate the underwriting activities performed by sureties before bond awards.

2. The agencies are already paying the sureties for this service.

Contractor evaluations

As discussed in chapter 2, an agency, before awarding a construction contract to a low bidder, must determine that the bidder is responsible. Pursuant to FPR and ASPR provisions, the determination should be based on the contractor's past performance, financial position, and technical capability.

In carrying out their underwriting functions, sureties also evaluate the responsibility of a contractor applying for a bond. In making this prequalification survey, a surety examines the contractor's financial ability, technical expertise, and capability to finish the contract in the required time.

We evaluated the preaward survey activities at nine Federal construction agencies and found that the amount of preaward survey work varied greatly. Some agencies made very formalized evaluations based on all the items cited in either FPR or ASPR, particularly for contractors which were unfamiliar to the agencies. In other instances, when the contractors were already known to the agencies, there was little or no preaward survey work done.

In general, the amount of preaward survey work depended on an agency's available manpower and knowledge of the contractors. The one constant element we found in all contract awards was the emphasis the agencies placed on bonds. Both ASPR and FPR provide that a contractor's ability to provide payment and performance bonds does not, by itself, denote responsibility. However, during our fieldwork, we could not identify a single instance when a bonded contractor was declared nonresponsible. In our opinion, agencies are hesitant to do so because of possible contractor protests.

We evaluated the underwriting practices at 15 separate surety companies. Generally, the sureties did all the preaward work done by the agencies, except for reviewing confidential Government lists. (See ch. 2.)

In our opinion, the sureties' underwriting surveys are at least equal to the agencies' preaward surveys, for two basic reasons.

1. The sureties thoroughly evaluate the contractor to minimize their exposure to financial risk; the sureties satisfy themselves that a contractor is financially and technically capable of fulfilling a contract.

2. The surety may be more familiar than the agency with a contractor's work program, particularly if the surety has been bonding the contractor for a number of years. A particular surety generally handles all bonds for an individual contractor.

A surety company considers the administrative costs incurred in underwriting bonds, including the costs related to prequalification surveys, as overhead costs. These costs are recovered through the premiums collected from all awarded bonds. Accordingly, Government projects bear part of the overhead costs related to a surety's prequalification surveys.

Conclusions

Federal construction agencies' preaward survey work, except for the reviews of confidential Government lists, generally represent an unnecessary expenditure of time and money. In our opinion, the contracting officer should be allowed to determine responsibility on the basis of the contractor's ability to obtain performance and payment bonds from surety companies on the Treasury's approved list. We believe the only exceptions should be

--when a project involves unique construction expertise or

--when the contracting officer has information indicating the low bidder may not be responsible.

The agencies are already paying the sureties to (1) provide protection against the possibility that a contractor is nonresponsible and (2) perform such services. Further, the agencies' surveys duplicate the sureties' efforts.

The basic purpose of a performance bond is to protect the Government against financial losses resulting from a contractor's failure to perform pursuant to contract specifications. Since the Government is paying through bond premiums for this protection, it appears unreasonable for the agencies to spend their own time and money just to reassure themselves that they, in theory, don't need this protection.

We were unable to quantify any dollar savings that would result from discontinuing preaward surveys, since such activities represent only part of the duties performed by various individuals in an agency. However, if such discontinuance did not reduce an agency's manpower requirements, it would at least enable those individuals previously involved in preaward surveys to concentrate more on other duties.

Recommendation

We recommend that the Secretary of Defense and the Administrator of General Services direct that ASPR and FPR be amended to allow the contracting officer to determine responsibility on the basis of the contractor's ability to obtain performance and payment bonds from surety companies on the Treasury's approved list, except

--when the project involves unique construction expertise or

--when the contracting officer has information indicating the low bidder may not be responsible.

Agency comments and our evaluation

One agency--VA--unequivocally endorsed our recommendation regarding preaward surveys. Three other agencies--HEW, SBA, and Treasury--made no comment on the recommendation. The other five agencies--GSA, DOD, NASA, AEC, and the Department of Transportation--expressed reservations that the recommendation would divest contracting officers of their discretion in determining contractor responsibility. For example, both GSA and NASA were concerned about the legal propriety of relying on a contractor's ability to obtain a bond as the sole criterion for determining responsibility.

This is not the intent of the recommendation. Rather, it is directed at (1) facilitating the award of contracts by enabling the contracting officer to take advantage of existing indicators--bonding capabilities--in making his decision and (2) avoiding unnecessary duplication of effort by the Federal construction agencies. He will still be responsible for determining contractor responsibility, including performing complete preaward surveys when necessary.

Transportation was concerned that the contracting officer could not rely solely on a surety investigation to fully determine a contractor's responsibility because he must ascertain that the contractor complies with Government requirements, such as minority employment practices. The example cited by Transportation, as is the case with most Government requirements of this nature, involves compliance with contract provisions, not preaward survey determinations.

Of the five agencies expressing reservations, four-DOD, Transportation, AEC, and NASA--acknowledged that the agencies' preaward surveys duplicate the sureties' efforts to some degree. DOD stated that it agreed with the thrust of the recommendation, which is to eliminate unnecessary duplicative effort, and would look into the matter further.

COLLECTION OF ADMINISTRATIVE EXPENSES RESULTING FROM DEFAULTS

When a contract is defaulted, whether the cognizant Federal agency or the surety assumes the responsibility for completion, an additional administrative burden is usually placed upon the Government. The Government may have to (1) measure the amount of work completed by the original contractor, (2) determine if damages or excess costs are to be assessed, (3) locate a contractor to complete the contract, which includes the award and administration of a completion contract, (4) deal with claimants against the defaulted contractor, (5) handle transactions with the surety, and (6) face possible litigation proceedings.

We reviewed 75 defaulted contracts involving 9 Federal construction agencies. In only three cases, involving the field offices of two agencies, were attempts made to obtain reimbursement from contractors or their sureties for administrative costs. In one case, an agency's field office estimated that it had incurred administrative expenses of about $3,200 in awarding a completion contract for a defaulted project. The surety reimbursed the agency for the claim.

The other two cases involved two field offices of another agency. In both cases, the field offices sued the sureties for both the actual cost of completing the contracts and the related administrative expenses. Both cases were settled out of court by lump-sum payments from the sureties.

In attempting to determine why the agencies generally did not seek reimbursement for such costs, we noted two major factors.

1. ASPR is somewhat vague on the subject.
2. The agencies are reluctant to seek recovery.

ASPR provides that a defaulted contractor and its surety are liable for damages caused by a termination, but the regulations do not specifically mention added administrative costs.

FPR does provide that the surety and contractor are liable for the added administrative costs resulting from a default. However, we found that those agencies that follow FPR generally absorb such costs. Agency officials said two reasons for absorbing the costs were (1) to expedite contract completion and (2) it was easier than trying to collect from a defaulted contractor or its surety.

Another contributing factor, in our opinion, is the fact that neither ASPR nor FPR describe what constitutes administrative expenses. Such a description would enable the agencies to identify and seek reimbursement for specific costs incurred in handling defaults.

Conclusions

One of the benefits of a performance bond is that the Government is obtaining protection against possible financial losses resulting from the completion of a defaulted contract. Sureties are liable for such Government losses up to the penal amount of the bond. Any additional administrative costs incurred by a Federal agency as a result of a default qualify as this kind of financial loss. Accordingly, Federal construction agencies should seek reimbursement from sureties for such administrative costs.

Recommendations

We recommend that the Secretary of Defense direct that ASPR be amended to require that Federal construction agencies seek reimbursement from sureties for administrative costs incurred in handling defaults.

We also recommend that the Secretary of Defense and the Administrator of General Services direct that ASPR and FPR be amended to state what expenditures are to be considered as administrative costs.

Agency comments and our evaluation

The agencies generally agreed with our recommendation relating to the collection of administrative expenses. Only AEC had any reservations, recommending that further study be made before action is taken.

GSA stated that it fully agreed with the recommendation. DOD stated that it would pursue the matter, in consultation with other agencies, to determine the appropriate action.

100-PERCENT PAYMENT BONDS

The Miller Act requires a 50-percent payment bond for contracts up to $1 million, a 40-percent payment bond on contracts between $1 million and $5 million, and a $2.5 million payment bond when the contract price is over $5 million. Regardless of the amount of the payment bond, Government agencies generally require a 100-percent performance bond.

We believe the Miller Act should be amended to permit Federal agencies to require contractors to furnish 100-percent payment bonds. Under the present rate structure, this change would provide increased protection without any increased cost, except on contracts exceeding about $25 million.

As discussed in chapter 3, performance and payment bonds are generally sold as a package. The surety industry has structured the rates so that premiums for the combined performance and payment bonds are usually based on contract amounts, not on the penal sums of the bonds. As long as the performance half of the combined bond is for 100 percent, the bond premiums will be based on the contract amount, regardless of whether the payment bond is for a lesser amount (50 or 40 percent). Further, even a combined bond of 50 or 40 percent would not produce any premium savings, since the premiums for combined bonds of 20 percent or more are also based on the contract amount.

Due to the nature of the rate structure, the Miller Act's limitations on payment bonds result in reduced protection without any cost savings. Even the $2.5 million payment bond limitation will not produce any premium savings as long as the agencies require a companion 100-percent performance bond.

Under the rate schedules, a combined bond of $2.5 million will result in premium savings only if the contract amount exceeds $25,111,702. However, the savings in premium cost are minimal in comparison to the degree of reduced protection. For example, on a $30 million contract, a combined $2.5 million bond would cost $125,000, and a 100-percent combined bond would cost about $148,000. Although the premiums would be reduced by only about $22,500, the overall protection would be reduced from $30 million to $2.5 million.

The Government awards very few construction contracts exceeding $25 million. In addition, the increased cost from requiring 100-percent performance and payment bonds on any such contracts would be minimal. Accordingly, we believe the $2.5 million payment bond limitation should be eliminated.

Officials of some of the agencies reviewed were unaware of the fact that bond premiums are based on the contract amount, not on the penal sum of the bond. We found that most agencies followed ASPR and FPR requirements for payment bonds, even though this meant a reduction in the amount of protection without any corresponding reduction in bond cost.

Only one Federal agency required 100-percent payment bonds. Although the agency generally follows the FPR bonding requirements, its instructions to bidders require 100-percent payment bonds. Agency officials stated that, since a 100-percent payment bond costs the same as a 50-percent payment bond, they intend to continue requiring 100-percent coverage.

We discussed the concept of 100-percent payment bonds on Federal construction projects with surety industry representatives, and they said that premium rates would not increase because:

1. Federal construction projects represent only 10 percent of the industries' premium income.

2. With the current rate structure based on total construction costs, the Federal Government is already paying for a 100-percent payment bond.

3. Most State and local government laws, as well as private industry policy, currently permit 100-percent payment bonds.

Conclusions

The Miller Act should be amended to permit Federal agencies to require contractors to furnish 100-percent payment bonds as long as rate schedules provide no appreciable reduction for less than 100-percent coverage. The current restrictions on payment bonds produce reduced protection with little or no savings in premium costs.

Under the current rate structure, requiring 100-percent payment bonds on Federal construction projects would increase protection without increasing bond costs on contracts of less than about $25 million. For contracts exceeding that amount, 100-percent payment bonds would significantly increase protection with only a minimal increase in bond costs.

Agency comments and our evaluation

The Federal construction agencies supported our conclusion that the Miller Act should be amended to permit

Federal construction agencies to require contractors to furnish 100-percent payment bonds.

Matters for consideration
by the Congress

The Congress should amend the Miller Act to permit Federal construction agencies to require contractors to furnish 100-percent payment bonds.

RETAINAGE

During our study, certain agencies indicated that the Government was unnecessarily increasing the cost of construction projects because it was withholding a portion of the progress payments to contractors. This procedure also appears to duplicate, to a degree, the protection provided by surety bonds.

Through the use of periodic progress payments, agencies pay contractors for work completed on a contract. The agencies monitor a project's progress to insure that this payment is for work done.

To protect agencies against paying for more than the actual amount of work completed, ASPR and FPR require that agencies generally withhold a certain percentage (retainage—usually 10 percent) of each progress payment up to the 50-percent completion stage. After 50-percent completion, an agency may retain a smaller percentage or, if the contracting officer is satisfied with the progress being made, authorize any of the remaining payments to be made in full.

Certain agencies believe that the primary effect of the retainage system is an increase in the cost of Federal construction projects. Progress payments aid a contractor's cash flow by providing it with incremental payments for work it does. Retaining a portion of the progress payments reduces a contractor's cash flow and thus requires it to finance moneys to compensate for the withheld funds. The interest costs of financing the additional moneys are ultimately reflected in a contractor's bid price.

A nationwide association of construction contractors has expressed similar views. A recent survey of its members reportedly showed that construction bids could be greatly reduced if retainage requirements were eliminated.

At the time of our fieldwork, two agencies were testing the feasibility of eliminating the retainage system. In our opinion, these two tests, which are discussed in detail below, should provide useful information on whether eliminating retainage will produce savings in Federal construction costs without negatively affecting the Government's interests.

GSA test program

GSA will conduct its program on an alternative-bid basis with projects currently on the market. Contractors will be able to submit one bid with the retainage feature still in the contract and one bid without the retainage feature.

GSA feels that savings up to 1 percent of the contract price may be possible and plans to issue a position paper on the results of its test program.

Department of the Interior's pilot program

Interior is running a pilot program under which construction contractors are permitted to post interest-bearing securities instead of retainage. Interior feels that, if a contractor can receive interest on these securities, it will represent a tangible source of income and will improve the contractor's cash flow. This gain in working funds is of greater competitive value to the contractor than to the Government. Hopefully, this source of funds will produce lower bid proposals and broaden competition. More contractors will be able to compete for the project because of the reduction in the need for available funds.

The program, begun in 1970, is now scheduled to expire in 1975. It is designed to allow the contractor to earn a return on money that rightfully belongs to it, while still providing a means of protection against paying the contractor for more than the actual amount of work done.

Interior also believes that retainage is a duplication of coverage provided by performance bonds.

Conclusions

The two test programs should provide definitive data on the effect of retainage on Federal construction projects. If these tests show that eliminating retainage will produce significant savings without negatively affecting project monitoring, the other construction agencies should also evaluate the feasibility of eliminating retainage.

Agency comments and our evaluation

Only two of the agencies specifically commented on this section of our report. Transportation endorsed our position that any decision in this area should depend on the results of the two test programs. VA expressed the opinion that some form of retainage should be maintained as a form of leverage.

We believe that the results of the two test programs will provide useful information on whether retainage can be eliminated without negatively affecting the Government's interests. If the results are favorable, the construction agencies should give futher consideration to eliminating or modifying retainage requirements.

CHAPTER 6

SBA BOND GUARANTEE PROGRAM

As part of our study, we examined SBA's bond guarantee program. The program's basic objectives are to (1) provide bonds for small and minority contractors who cannot obtain bonds in the open market and (2) increase the viability of these contractors so they can make the transition ("graduate") to the regular bonding system. We believe that the program would be more effective if SBA developed formal criteria for graduating participating contractors and established a monitoring system to insure that sureties are complying with such criteria.

PROGRAM OPERATION

The bond guarantee program, established pursuant to Public Law 91-609 (15 U.S.C. 694a-b), allows SBA to guarantee, for a fee, any surety company against up to 90 percent of its losses resulting from a small contractor's breach of the terms of a bid, performance, or payment bond. To qualify, a contractor must be a small business with annual sales under $750,000 and be able to show that a surety bond is required and could not be obtained on reasonable terms and conditions without an SBA guarantee. The guarantee is limited to surety bonds on contracts up to $500,000.

SBA stated that, as of May 20, 1974, it had guaranteed bonds on 15,093 contracts having a total value of about $1 billion. As of that date, 99 sureties were participating in the program.

To obtain a bond, a contractor applies to a bond broker of its choice. The contractor furnished the broker with the necessary financial data, work history, and other information. If the broker decides that the contractor may be bondable, he refers the application to surety companies he represents until he finds a surety willing to bond the contractor.

A surety company which is interested in the contractor's application decides whether to (1) bond the contractor without an SBA guarantee, (2) bond with an SBA guarantee, or (3) not bond under any circumstances. If the surety determines an SBA guarantee is necessary, it sends a letter with supporting data to the appropriate SBA regional office

requesting the guarantee. SBA makes its own underwriting review and, if it is favorable, completes the guarantee agreement and returns it to the surety company.

When the bond is issued, the contractor pays SBA two-tenths of 1 percent ($2 per $1,000) of the contract's face value. In the case of partial bonds (less than 100-percent bonds), the contractor pays SBA either two-tenths of 1 percent of the contract's face value or 20 percent of the total premium charged by the surety, whichever is less. The contractor must also pay the surety the total bond premium, 10 percent of which the surety pays to SBA as its fee for the guarantee.

Claims and defaults

SBA officials stated that losses resulting from defaulted contracts were 1.24 percent of total completed contracts backed by guarantees.

Initially, reserves to cover potential claims resulting from payment defaults were about $400,000, or 1 percent of the $40 million in bonds outstanding. SBA subsequently raised reserves to about 2 percent because of an increase in the number of claims.

Defaults and claims against SBA bond-guaranteed contractors are handled by the sureties. SBA gives each surety written authorization to deal with such problems in a manner which is routine for the company and conducive to mitigating losses and insuring satisfactory completion of the contract.

Sharing ratios and premiums

The SBA program is often referred to as the "90-10 program" because of the method used to distribute risk exposure to premiums earned. SBA guarantees 90 percent of the risk

for 10 percent of the bonding premiums. Consequently, sureties participating in the program incur only a 10-percent risk for 90 percent of the bond premiums collected.

The authorizing legislation stated that SBA could guarantee up to 90 percent of the penal amount of the bond in return for a reasonable portion of the permiums collected from the contractors. The disparity in the relationship of risk to premiums resulted from the uncompromising position taken by the surety industry during negotiations. According to SBA officials, the surety industry dictated the terms under which it would participate in the program. One condition the industry insisted on was that SBA had to agree to accept 90 percent of any loss for no more than 10 percent of the premiums collected. SBA agreed, and the industry indicated a willingness to reassess the adequacy of SBA's 10-percent share after 2 years of experience.

In February 1974, SBA met with surety representatives to reassess the "90-10" ratio. No change resulted from the meeting.

SBA's apparent lack of forcefulness in dealing with the industry was explained as being the result of the industry's take it or leave it proposition for SBA. SBA officials made the following observations.

--If SBA had not been willing to accept 90 percent of the risk, the industry would not have been willing to participate in the program.

--The surety's premium on the average guaranteed bond is not large and has to be shared with SBA and the broker.

--The 10-percent risk the surety faces makes it more responsible than it would be if it bore no risk whatsoever.

Sureties are allowed to charge higher premium rates for guaranteed bonds. Normally, bonds cost contractors $10 per $1,000 for contracts up to $100,000. However, for bonds issued under the SBA program, sureties were allowed to charge a rate up to $20 per $1,000. In March 1973, the rate

was changed to $15 per $1,000 for the first $5,000 and $10 per $1,000 thereafter.

NEED FOR INCREASED SBA PARTICIPATION IN PROGRAM OPERATIONS

The need for increased SBA guidance and program management is apparent. Specifically, SBA should provide formal guidelines and improved procedures for graduating guaranteed contractors.

According to SBA, the program is too new to have an adequate basis for graduation procedures, and the program operates under the assumption that a "surety will make every effort to graduate a contractor."

Because SBA does not have formal graduation procedures or a monitoring system, it does not know (1) the number of graduated contractors or (2) the number of contractors still in the program that should have been graduated. Therefore, SBA has not been able to determine the extent to which the program was accomplishing its objective.

CONCLUSIONS

It is apparent to us that, unless SBA develops adequate procedures for graduating contractors, its ability to insure that the program is accomplishing its objectives will be impaired. Accordingly, we believe SBA should develop formal criteria for graduating participating contractors into the regular bonding system and establish a monitoring system to insure that sureties are complying with such criteria.

RECOMMENDATION

We recommend that the Administrator of SBA direct that formal criteria be developed for graduating participating contractors into the regular bonding system and a monitoring system be established to insure that sureties are complying with such criteria.

AGENCY COMMENTS AND OUR EVALUATION

The Administrator, SBA, disagreed with our findings, conclusions, and recommendation regarding the bond guarantee program. With respect to our recommendation, he stated that SBA has established criteria by which its field offices will question the sureties on why a particular contractor is remaining in the program and not being graduated. SBA thinks, however, that the forces at work in the marketplace will

accomplish more than any set of rules that could be devised.

After receiving its comments, we asked SBA to provide us with a copy of the established criteria. SBA officials stated that there was no written criteria, just an understanding among SBA's field offices to review a contractor's file when a surety applies for a guarantee.

The officials acknowledged that SBA has no systematic method for determining whether a contractor has, in fact, graduated. It should be recognized that "marketplace conditions" could produce results other than graduation, such as a contractor no longer being in business or maybe being involved in projects that do not require bonds.

We still believe the program would be more effective if our recommendation were implemented. Following are comments from those Federal construction agencies--GSA, Transportation (DOT), and NASA--that discussed the SBA section of the report.

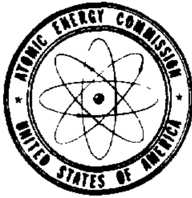
GSA--"Since the recommendations directed primarily toward SBA would generate certain benefits for the procuring agencies participating in the small business programs, we also support those recommendations."

DOT--"We do not object to the recommendations concerning the Small Business Administration's involvement in the Surety Bond Guarantee Program."

NASA--"We believe the GAO findings to be accurate and their recommendations sound."

Our report was also reviewed by representatives from the Surety Association of America, the American Insurance Association, the Reinsurance Association of America, the National Association of Surety Bond Producers, and several surety companies. All the representatives stated that the SBA section of the report was an accurate description of the SBA program and how it is currently operating.

After carefully considering SBA's informative response, we still believe our report accurately reflects the current state of the bond guarantee program, a view supported by the Federal construction agencies and the surety industry. We believe that implementation of our recommendations will make the program more effective and its goals more readily attainable.



UNITED STATES
ATOMIC ENERGY COMMISSION
WASHINGTON, D.C. 20545

JUN 14 1974

Mr. Henry Eschwege
Director, Resources and
Economic Development Division
U. S. General Accounting Office
Washington, D. C. 20548

Dear Mr. Eschwege:

This is in reply to your letter of May 16, 1974, requesting our comments to the GAO draft report titled "Surety Bonds in Federal Construction: A Study of Their Application and Effectiveness." [ii]

[24] With respect to the second recommendation on page 4, and the same recommendation on page 35, it is our opinion that the contracting officer's basis for a determination of responsibility should not be confined solely to the contractor's ability to obtain performance and payment bonds from surety companies.

Notwithstanding the fact that the sureties evaluate the contractor's financial and technical capabilities, we believe the contracting officer should have the option to perform preaward surveys. Such surveys would enable the contracting officer to satisfy himself as to questions he may have on other construction matters, such as the quality of the contractor's performance in fulfilling other Federal contracts; his ability to meet critical completion dates; his construction safety record; his labor relations record; and his record on quality assurance programs. [iii]

[27] We suggest that the third recommendation on page 4 and the recommendations on page 38 be deleted and be replaced with the following recommendation:

"GAO recommends that the Federal agencies responsible for the ASPR's and FPR's in conjunction with affected agencies should study the feasibility of obtaining refunds from sureties for administrative costs incurred in handling defaults and incorporate detailed guidance in the ASPR's and FPR's, if appropriate."

In our opinion, rather than taking immediate action to amend the ASPR's and FPR's to require the Federal agencies to seek reimbursement from sureties, this area should be studied to insure that we take appropriate action. For example, the administrative costs and time involved in accumulating and reporting the administrative costs related to handling defaults might not prove to be cost effective.

[6]

On page 12, in the second and third lines of the first paragraph, we suggest that the following words be deleted: "construction contracting award and administration"; and the following words be included: "awarding and administering construction contracts."

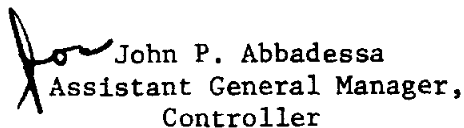
We suggest that the second sentence of the second paragraph on [6] page 12 be deleted and be replaced by the following:

> "A preaward survey may be required when the contracting officer does not possess sufficient information to satisfy himself that a prospective contractor currently meets the minimum and special standards required by regulations and the contract task."

As now worded, it appears to indicate that the preaward survey is the only process by which a contractor's responsibility is determined.

[See GAO note 1.]

Sincerely,



John P. Abbadessa
Assistant General Manager,
Controller

GAO notes:

1. The deleted comments relate to matters omitted from or modified in this report.

2. Numbers in brackets refer to page numbers in this final report.

ASSISTANT SECRETARY OF DEFENSE
WASHINGTON, D.C. 20301

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INSTALLATIONS AND LOGISTICS

12 JUL 1974

Mr. F. J. Shafer
Director, Logistics and
Communications Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Shafer:

This is in response to your letter of May 14, 1974 to the Secretary of Defense, which forwarded a draft report entitled "Surety Bonds in Federal Construction" A Study of Their Application and Effectiveness," Code 945016, (OSD Case #3834).

The study was made to evaluate the effectiveness of the bonding system currently used in construction and explore the feasibility of the government becoming a self-insurer with respect to the risks presently covered by performance and payment bonds. Your report evidences a thorough examination of the bonding system. We strongly support your conclusion that the present basic system of performance and payment bonds in construction should be retained.

There are several recommendations in the report designed to improve the effectiveness of the bonding system.

[See GAO note 1, p. 40.]

Because the contracting officer's determination of contractor responsibility precedes the obtaining of performance and payment bonds, we do not concur with the recommendation in the draft report that the ASPR and FPR be amended to allow the contracting officer to base his determination of responsibility on the contractor's ability to obtain performance and payment

bonds from surety companies. However, we are in accord with the thrust of the recommendation, which is to eliminate unnecessary duplicative effort, and we will look into this matter further.

The draft report recommends that the ASPR be revised to require that reimbursement be sought from sureties for increased administrative costs incurred in handling defaults. It was also recommended that the ASPR provide a definition of the government costs for which reimbursement would be sought. We concur with the general intent of these recommendations and will pursue this matter, in consultation with other agencies, to determine the appropriate action.

Based on a finding that the rate schedules provide no appreciable reduction in cost for less than full coverage on payment bonds, the draft report recommends that the Congress consider amending the Miller Act to permit Federal construction agencies to require contractors to furnish payment bonds in the full amount of the contract. We are not in a position to evaluate the adequacy of the protection afforded by present payment bonds to those supplying labor and materials, but we feel it would be highly unusual that unpaid obligations of a contractor would exceed the present payment bond amounts before a surety would receive complaints of nonpayment and intervene. Although the increased coverage would apparently not affect corporate sureties, it could pose difficulties for those contractors who utilize individual sureties, since a corresponding increase in demonstrated net worth would be required. However, if it is determined that there is a need to increase the protection afforded by payment bonds to those supplying labor and materials, we would not oppose the increase.

GAO also made several recommendations regarding the Bond Guarantee Program of the Small Business Administration (SBA). We defer to SBA with respect to these recommendations.

We appreciate the opportunity to review and comment upon your draft report.

Sincerely,

ARTHUR I. MENDOLIA
Assistant Secretary of Defense
(Installations & Logistics)

DEPARTMENT OF HEALTH, EDUCATION, AND WELFARE
WASHINGTON, D.C. 20201

OFFICE OF THE SECRETARY

JUN 19 1974

Mr. Gregory J. Ahart
Director, Manpower and
Welfare Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Ahart:

The Secretary has asked that I respond to your request of May 17, for our comments on your draft report entitled, "Surety Bonds In Federal Construction: A Study of Their Application and Effectiveness." We have carefully reviewed your report and have no comments.

We appreciate the opportunity to comment on this draft report before its publication.

Sincerely yours,

John D. Young
Assistant Secretary, Comptroller

OFFICE OF THE SECRETARY OF TRANSPORTATION
WASHINGTON, D.C. 20590

ASSISTANT SECRETARY
FOR ADMINISTRATION

July 29, 1974

Mr. Henry Eschwege
Director
Resources and Economic Development
Division
U. S. General Accounting Office
Washington, D. C. 20548

Dear Mr. Eschwege:

This is in response to your letter dated May 15, 1974, requesting our comments on the General Accounting Office's (GAO) draft report entitled "Surety Bonds in Federal Construction: A Study of their Application and Effectiveness." The Department concurs in the GAO recommendation that the current bonding system should not be eliminated and that the rate schedules should be examined to determine if they are reasonable. The Department does not agree that the ASPR and FPR should be amended to allow the contracting officer to determine a contractor's responsibility based on the contractor's ability to obtain performance and payment bonds from surety companies. The reason for our disagreement and an alternative are offered in our enclosed comments. We agree that contractors should furnish 100 percent performance and payment bonds rather than the reduced amounts limited by the Miller Act.

The Department believes that the withholding of a percentage of the progress payments to contractors (the retainage system) is effective in administering contracts and we recognize that retainage adds to the contract cost.

I have enclosed two copies of the Department's reply.

Sincerely,

William S. Heffelfinger

Enclosure
(2 copies)

DEPARTMENT OF TRANSPORTATION
STATEMENT ON GAO DRAFT REPORT

I. TITLE: Surety Bonds in Federal Construction: A Study of Their Application and Effectiveness (Draft), May 14, 1974

II. GAO FINDINGS AND RECOMMENDATIONS:

[See GAO note 1, p. 40.]

b. ASPR and FPR should be amended to allow the contracting officer to base the determination of responsibility on the contractor's ability to obtain performance and payment bonds from surety companies on the Treasury's approved list, except:

   o Where it is a specialized project involving unique construction expertise; or

   o The contracting officer has existing information indicating the low bidder may be nonresponsible.

c. The ASPR and FPR should require that Federal construction agencies seek reimbursement from sureties for administrative costs incurred in handling defaults; and identify what factors are to be considered in determining such administrative costs.

d. Congress should consider the need for amending the Miller Act to permit Federal construction agencies to require contractors to furnish 100 percent performance and payment bonds.

e. The two test programs currently being conducted by GSA and Interior should provide definitive data on the effect of retainage (certain percentage of progress payment withheld) on Federal construction projects. If these tests show that elimination of retainage will produce significant savings without negatively affecting the monitoring of projects, then other construction agencies should also evaluate the feasibility of eliminating retainage.

f. The Administrator of SBA should initiate actions to change the operations of the Bond Guarantee Program so that:

- o SBA assumes responsibility for determining which contractors are considered for participation in the Program.
- o The sharing ratios are adjusted to create a more equitable relationship between premiums received and risks taken.
- o Formal criteria for "graduating" participating contractors into the regular bonding system is developed, including a monitoring system to insure that sureties are complying with such criteria.

III. DOT COMMENTS ON RECOMMENDATIONS:

We agree that there is not sufficient information to indicate that the Federal Government should eliminate the requirement for surety bonds for construction work and become a self insurer. The report indicates that direct losses from defaulted contracts averaged about 51 percent of the total premiums paid on direct Federal construction for the period 1959 through 1970. However, the costs that the Government would incur to perform the services provided by sureties could not be readily estimated.

The services performed by the sureties include handling claims by subcontractors, suppliers, and laborers, providing financial aid to contractors and completing defaulted contracts. We believe the cost for the Government to provide these services would be significant and therefore it would not be economical for the Government to eliminate surety services.

[See GAO note 1, p. 40.]

We do not agree that the ASPR and FPR should be amended to allow the contracting officer to determine a contractor's responsibility based on the contractor's ability to obtain performance and payment bonds from surety companies.

A surety investigation and the Government's preaward survey could be duplicative in the determination of a contractor's financial responsibility, integrity and ability to perform. However, in addition to the responsibility requirements evaluated by sureties the contracting officer must ascertain that the contractor complies with special Government requirements such as minority employment practices. Therefore, a

contracting officer cannot rely solely on a surety investigation to fully determine a contractor's responsibility.

We recommend that the procurement regulations continue to require the contracting officer to conduct the pre-award survey to determine a contractor's responsibility. The regulations should, however, be revised to give the contracting officer the option to base the evaluation of those items pertaining to financial responsibility, integrity and ability to perform on the contractor's ability to obtain surety bonds. Notwithstanding the foregoing, we agree that the contracting officer should not rely on surety investigations when the project involves specialized construction expertise, or when there is existing information indicating the low bidder may be nonresponsible.

We concur that Federal construction agencies should seek reimbursement from sureties for administrative costs incurred in handling defaults. Last year the Federal Highway Administration was awarded administrative and engineering costs in a default case involving a surety. It would be helpful if the factors to be considered administrative costs were defined in the procurement regulations.

We agree that contractors should be required to furnish 100 percent performance and payment bonds since GAO has determined that for contracts under $25 million there would be no additional cost to the Government, i.e., no increase in premium rates. Procurement regulations now require 50% payment bond for contracts up to $1.0 million, a 40% payment bond for contracts between $1.0 million and $5.0 million and a $2.5 million payment bond for a contract over $5.0 million.

We believe that retainage is effective in construction projects not only because it assures that the Government does not pay for more than the actual amount of work completed but it also gives the Government added control over the contractor's daily performance. The added control associated with retainage is due to the fact that a contractor risks not getting paid for work already accomplished if follow-on work is not performed to the satisfaction of the Government. There is no doubt that the retainage adds to the contract cost because the

contractor must borrow money to compensate for the funds withheld and the cost of borrowing is passed on to the Government. The two test programs being conducted by GSA and Interior should provide sufficient data on the cost of using retainage in order to make a decision on whether the cost is worth the benefits obtained.

We do not object to the recommendations concerning the Small Business Administration's involvement in the Surety Bond Guarantee Program.

William B. Davis
Deputy Assistant Secretary for Administration

THE DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

FISCAL ASSISTANT SECRETARY

June 18, 1974

Dear Mr. Lowe:

This is in response to your letter of May 16 to the Secretary, transmitting for review and comment your draft report on the use and effectiveness of surety bonds in Federal construction.

The report indicates that a wide-ranging review was made of bonding activities relating to Federal construction projects. We were particularly interested in the report's conclusions that the current bonding system should be continued, with certain recommended improvements, rather than having the Government become a self-insurer for such bonds. Our comments on the specific parts of the report relating to the Treasury are attached.

We appreciate having an opportunity to review the draft report.

Very truly yours,

John K. Carlock

Mr. Victor L. Lowe
Director
General Government Division
United States General Accounting Office
Washington, D. C. 20548

Attachment

COMMENTS ON GAO DRAFT REPORT ON THE
USE AND EFFECTIVENESS OF SURETY BONDS
IN FEDERAL CONSTRUCTION.

[10]
Page 19 - - Treasury list:

By way of clarification, it is suggested that the language in the first and last sentences in this section be broadened, as follows, to indicate that surety companies on the Treasury list may also underwrite various other types of Federal bonds, in addition to those on Federal construction projects.

> "Federal regulation of surety companies is limited to approval by the Department of the Treasury for underwriting bonds on Federal construction projects and other types of bonds running in favor of the United States.....
>
> If approved, the surety company is authorized to underwrite Federal bonds, including those on Federal construction projects, up to a stated limit for any one bond."

[See GAO note 1, p. 40.]

UNITED STATES OF AMERICA
GENERAL SERVICES ADMINISTRATION
WASHINGTON, D.C. 20405

JUL 9 1974

Honorable Elmer B. Staats
Comptroller General of the
United States
General Accounting Office
Washington, DC 20548

Dear Mr. Staats:

This is in reply to the letter of May 14, 1974, from F. J. Shafer of your staff requesting our review and comments on a draft report to the Congress on surety bonds in Federal construction.

In reviewing the draft report we have found two recommendations on which we would like to offer the following comments:

[See GAO note 1, p. 40.]

2. We also have some reservations as to the legal propriety of relying on a contractor's ability to obtain bonds as the sole criterion for determining responsibility. Section 303(b) of the Federal Property and Administrative Services Act of 1949, 63 Stat. 395, as amended (41 U.S.C. 253(b)), requires that award be made to the responsible bidder whose bid is responsive and most advantageous to the Government. We believe the statute puts the responsibility for making all three determinations on the Federal procuring agency. The recommendation would have the effect of shifting one of these determinations entirely into the hands of a non-Government entity in all but two circumstances.

Further, the fact that one of the exceptions would be where the contracting officer already has information that the low bidder is not responsible recognizes that a surety's screening will not always identify bidders who do not qualify as "responsible." We are of the view that contracting officers should remain responsible for determining the extent to which they need to pursue their own inquiries as a condition for making their own determination that a bidder is responsible or not.

We are in full agreement with the recommendation for recovery of administrative costs arising out of defaults. Since the recommendations directed primarily toward SBA would generate certain benefits for the procuring agencies participating in small business programs, we also support those recommendations. To the best of our knowledge, the penal amount of a payment bond has been insufficient in only rare instances; however, if increasing the penal amount would cost little or nothing, it might be advisable to amend the Miller Act so as to provide adequate protection of workmen and subcontractors in all cases.

We are pleased to have the opportunity to present our comments on the draft report.

Sincerely,

Dwight Ink

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

AUG 15 1974

Mr. F. J. Shafer
Director
Logistics and Communications Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Shafer:

We appreciate the opportunity to comment on your draft report to the Congress on "Surety Bonds in Federal Construction: A Study of Their Application and Effectiveness."

We concur with your assessment that a careful analysis should be made to determine the effectiveness of the current construction bonding system and the feasibility of the Government becoming a self-insurer.

Your study has addressed most of the key issues involved in this question, as we perceive them. We agree with your findings as they are presented in the draft.

We would like to suggest, however, that these issues might be reviewed in greater detail.

Costs. We appreciate the difficulty in determining the cost of the various Government agencies (or a possible central agency) to assume the administrative responsibilities of self insurance. However, we believe estimates of administrative and any other additional service costs for self insurance are critical to make a sound decision in this area.

Services. We realize that sureties have the capability to provide a wide range of services in assuring that construction projects are successfully performed. However, in regard to these services, to what extent are these services actually

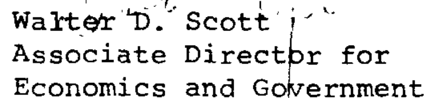
provided? For example, how frequently do sureties make loans to contractors (e.g., one loan for every 1000 bonds)? Also, since you report that some surety services are duplicated by Government agencies, it would be helpful to know the degree of duplication (e.g., does a Government pre-award survey generate the same type of data as a surety pre-qualification review, or how many defaults do Government agencies handle in relation to total defaults?).

Total Impact of Miller Act. We agree that the potential savings from self insurance must be measured on the basis of premiums generated by direct Federal construction. However, we believe it may be useful in your analysis to examine the total bonding costs generated by the Miller Act. Other Federally supported construction (e.g., FHA guaranteed) may require bonding. In addition, many States and local governments have used the Miller Act and Federal practices in bonding as a model for their own legislation.

One additional point which the study does not address is the use of alternative methods for reducing the risk of losses (e.g., letters of credit issued by banks or interest bearing securities deposited by the contractor). A discussion of these alternatives in terms of cost/benefit to be derived might provide a broader analysis on which to base decisions.

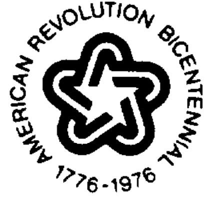
We are encouraged by your efforts to review this complex matter and we would be happy to discuss our comments further if you desire.

Sincerely,



Walter D. Scott
Associate Director for
Economics and Government

NATIONAL AERONAUTICS AND SPACE ADMINISTRATION
WASHINGTON, D.C. 20546



REPLY TO ATTN OF: BXB

JUN 17 1974

Mr. F. J. Shafer
Director
Logistics and Communications Division
United States General Accounting Office
Washington, DC 20548

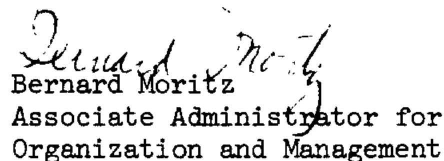
Dear Mr. Shafer:

We appreciate the opportunity to comment on the draft report "Surety Bonds in Federal Construction: A study of Their Application and Effectiveness" dated May 14, 1974. The enclosed comments set forth our observations and recommendations based on consideration of the report contents by interested NASA elements.

In summary, we are in essential agreement with the report except that we believe the GAO recommendations should be modified as indicated by the enclosed comments.

We hope that our comments will be helpful in the preparation of your final report.

Sincerely,



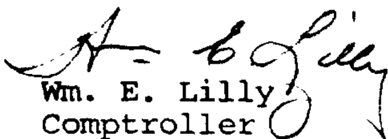
Bernard Moritz
Associate Administrator for
Organization and Management

Enclosure

responsible bidder whose bid conforms to the invitation and will be the most advantageous to the United States, price and other factors considered." Acceptance of the GAO recommendation would, in effect, delegate the authority to determine contractor responsibility to a third party outside of the government, i.e., the surety industry. We believe that such a procedure is questionable in view of the authority and responsibility vested by law in the contracting agencies. Although considerable weight could be given by contracting officers to determinations by sureties in this regard, we believe that this responsibility should remain with the contracting officials of the government who are, in the final analysis, responsible for their procurements.

With respect to Recommendation (d), as noted above, although we have no objection to the recommendation regarding the SBA Bond Guarantee Program we believe that some additional comments are appropriate. This program was authorized by Public Law 91-609. It is an SBA program, involving only the SBA, the prospective contractor and the surety bonding company. The bonding requirements in Government contracts constitute a difficult problem, especially for small minority construction firms. Such firms, which otherwise have been "unbondable", have been given the opportunity to participate in government procurement opportunities through this highly desirable program. Since the success of the program depends upon the willingness of the surety industry's participation, SBA may not be able to influence the situation as recommended by the GAO. We believe the GAO findings to be accurate and their recommendations sound. However, their enforcement on the surety industry may be difficult. If unsuccessful, consideration might be given to amending the legislation, permitting the Government (SBA) to bond its eligible contractors which are first rejected by surety companies under their normal business procedures. This would give the SBA complete control of the guarantee program by assuming the additional 10 percent of the risk. SBA would then receive the full fee for the service provided.

We appreciate the opportunity to comment on the subject GAO report.



Wm. E. Lilly
Comptroller

NASA COMMENTS ON THE GAO DRAFT REPORT TO THE CONGRESS OF THE UNITED STATES ON SURETY BONDS IN FEDERAL CONSTRUCTION: A STUDY OF THEIR APPLICATION AND EFFECTIVENESS (MAY 14, 1974)

The GAO Report recommends:

[See GAO note 1, p. 40.]

(b) The ASPR and FPR be amended to permit the contracting officer to base the determination of contractor responsibility on the contractor's ability to obtain bonds from surety companies on the Treasury's approved list, with certain exceptions

(c) The ASPR and FPR be amended to require agencies to seek reimbursement from sureties for administrative costs incurred in handling defaults, and to provide guidance to the agencies for use in determining such costs

(d) The SBA administrator initiate actions under the SBA Bond Guarantee Program designed to ensure greater SBA control over the Program

(e) The Congress consider the need to amend the Miller Act to permit agencies to require 100 percent performance and payment bonds

With respect to Recommendation

[See GAO note 1, p. 40.]

(c) and (e), except that, with respect to Recommendation (c), the NASA PR also should be included.

With respect to Recommendation (b), as noted above, the GAO has recommended that ASPR and the FPR be amended to allow the contracting officer to base his determination of responsibility on the contractor's ability to obtain performance and payment bonds from Treasury - approved surety companies with exceptions for specialized projects and bidders known to be nonresponsible. This would eliminate pre-award surveys performed by the agencies and substitute therefor underwriting surveys performed by sureties. Under Title 10 U.S.C. 2305, certain agencies, including NASA, are required to make contract award to "the

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

OFFICE OF THE ADMINISTRATOR

JULY 2, 1974

Mr. Victor L. Lowe
Director
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Lowe:

This is in response to your request for comments on the draft report entitled "Surety Bonds in Federal Construction: A Study of Their Application and Effectiveness."

[See GAO note 1, p. 40.]

Operation of the Program

Before we get into the specific areas listed, we must bear in mind that the report itself is 14 months old, and we should like to provide an update on the statistical data listed in the report as of March 31, 1973, and bring that up to May 20, 1974. The Surety Bond Guarantee Program is the fastest growing program of the SBA. Following is a table indicating levels of activity:

Fiscal Year	No. Guarantees Approved	No. Contracts Awarded	Value of Contracts
1971 (Pilot)	21	7	$ 312,252
1972	2,316	1,339	$ 94,434,157
1973	8,657	5,597	$ 351,189,011
1974 (Thru 5/20/74)	11,856	8,150	$ 571,426,269
TOTAL	22,850	15,093	$1,017,361,689

The total number of contractors that have received this assistance since the inception of the program had been 8,342. There are 99 sureties that are currently participating in the program. Approximately 35 percent of our total guarantees are for minority contractors.

Next, we should like to outline the procedures through which an applicant goes in obtaining a surety bond guarantee: (1) The contractor obtains a copy of our application form from one of our district offices or, in most cases, through a broker or agent. (2) The original application goes directly to our surety bond personnel in the regional office, a copy to the surety, and an information copy to our local district office.

If an agent or contractor is unable to locate a surety willing to participate in our program in his area or feels that the sureties are unreasonable in their underwriting standards, our offices are prepared to give him a list of the sureties which have demonstrated a responsiveness to our program. Agreement with the surety industry provides that, if a surety decides that it cannot issue a bond even with an SBA guarantee, SBA will be supplied with the reasons for decline. Three major reasons for declination are:

1. The financial package is inadequately prepared,

2. The surety feels that the contractor does not have sufficient working capital to handle the contract under consideration, or

3. There is a lack of sufficient technical and/or managerial skills to perform the contract or to handle the extra managerial and financial load of one more contract in addition to his work in progress.

SBA can and does assist the contractor to eliminate deficiencies by the following means:

1. Refers the contractor to funded organizations which specialize in assisting the contractor in putting his financial package together properly.

2. Refers the contractor to SBA loan specialists for consideration of either a working capital loan or the revocable, revolving line of credit, which was designed specifically for construction contractors.

3. Refers contractor to our management assistance personnel.

If the surety decides that a bond can be issued with our guarantee, they will forward to our office a copy of the contractor's financial statement, together with a copy of our Surety Bond Guarantee Underwriting Review, SBA Form 994-B. The SBA Form 994-B is primarily a checklist of virtually all of the normal underwriting requirements that a surety would check out prior to issuing a bond, be it with SBA or on their own. Upon receipt of the Underwriting Review, the financial statement, and the surety's recommendation, the SBA makes its own underwriting review, and, if favorable, completes the guarantee agreement and returns it to the surety.

The following is an update on our claims and defaults. We compute our loss ratios on a quarterly basis, the last of which was as of April 20, 1974. At that time we had 548 default notifications, with 393 of these that have established incurred loss of $9,260,214. The incurred loss figure included paid losses plus reserves. In computing our loss ratios, we use our average sized contract of $68,000 and prorate the contract over a 10 month period. In other words, our $68,000 contract is 50 percent completed in 5 months and 100 percent complete in 10 months. Our loss ratio, based on completed commitments, is 1.24 percent.

The sureties compute their loss ratios on an earned premium basis rather than commitments. An average contract of $68,000 would carry a 1 percent premium. Therefore, the industry loss ratio, based on earned premiums, would be 124 percent versus 1.24 percent on commitments.

We break down our loss ratio by region as well as by surety. At any given time we can determine the loss ratio of a specific surety company, either nationwide or in any region.

All claims are handled out of our Central Office. Our field office sends us a copy of the complete underwriting file. A desk audit is made on each claim submitted. In addition to normal verification and audit of claims data, we also assure that the surety made no misrepresentations, etc., as well as attempting to establish reasons for default. We have found that the reasons our contractors go into default are basically the same as those that the sureties sustain under normal programs - insufficient capitalization to carry them over when they run into trouble, and going beyond their capacity. Only about 3 percent of our contracts go into default. Therefore, we have a success rate of 97 percent.

As a matter of information, we also have broken down some other statistical data with regard to our loss ratios. A study made by us in February shows the surcharge rate companies had a 1.56 percent loss ratio versus a 1.34 percent for the standard rate companies. This includes only those companies that have one or more losses. The commitments of the other companies are not included.

Minority contractors have established a 1.8 percent loss ratio versus non-minority at a 1.1 percent loss ratio. Our four largest producers in this program have the following loss ratios: 1.58 percent, 2.3 percent, 1.67 percent, 2.38 percent. These are all smaller companies that specialize in smaller contracts. One of the major companies, which is one of the largest surety bond writers in the country, has established a loss ratio of 1.60 percent in our program. A copy of the loss ratios is enclosed with this report and, as you will note, one company has a 7.5 percent loss ratio. However, there were only two claims that were quite substantial and would be considered as shock losses in determining loss ratio. We will debar any surety that has a consistent and inordinately high unexplained loss ratio.

We have taken the position, unless Congress feels to the contrary, that a 2 percent loss ratio on commitments should be the maximum allowable in the program. This, we feel, is a reasonable loss expectation for the marginal contractor. As a comparison in loss ratios, GAO reports show that sureties have a 51 percent loss ratio on government work, based on their premiums. Converting this to our method of computation would show a .51 percent loss ratio on the "blue chip" contractors. Comparing this contractor to the marginal contractors that we are dealing with, our loss ratio of 1.24 percent would fall in line with the intent of the program.

Need for Increased Participation by SBA in Program Operations

Our position is that any contractor who meets our size standards is eligible to apply for surety bond guarantee assistance. The initial evaluation of the contractor is up to the surety. The premiums charged by sureties include efforts expended in the prequalification of contractors. This is a function that we feel should be performed by the surety itself. Our function is only reviewing what the surety has submitted to us and to see whether it falls in line with our legislative and regulatory requirements. The industry itself does not have any iron-clad formal underwriting criteria. Each case must stand on its own merits. We feel this same procedure should be followed within our own program. However, we do have our underwriting review, which is an official checklist for the industry of the information we expect them to develop in order to make an underwriting determination. As we have mentioned earlier, should a surety decide that a contractor does not qualify for a bond, even with an SBA agreement, and, if we feel that the contractor can perform, we will refer him to a more responsive surety.

APPENDIX IX

One factor which makes it difficult to establish formal underwriting guidelines for the sureties is that these guidelines can be used to turn down applicants, as well as to make them eligible. As a rule of thumb, for construction contractors, many sureties require a ratio of 1 to 10 of the contractor's net quick assets to his total work in progress. There are cases where the surety may want a 1 to 5 ratio. There are other cases where another surety may go 1 to 20 on a specific contractor. Availability of additional credit, size of the job, and the amount to be subcontracted are all elements that enter into a decision on net quick asset requirements. If we were to establish a standard of, say 1 to 15, a ratio of less would automatically trigger a decline by the surety industry. It would become too complex to establish these types of standards. The industry itself has general guidelines in their normal underwriting; we expect them to use their guidelines, consider that these are marginal contractors, and that the SBA will accept risks that the industry would normally decline. All we ask them to do is to give us the normal underwriting data with all of the facts and their opinion as to whether the contractor can perform the specific contract. Based on that analysis, SBA will further analyze the facts presented and make a subjective judgment.

We have even had cases where we have extended our guarantee where the contractor had a deficit net worth and where he performed successfully. However, we could not write a guideline that would permit the issuance of a guarantee to a contractor with a deficit net worth. Such a determination would depend upon the individual contractor and circumstances of the specific case.

A contractor has every right to appeal to SBA for assistance should he be turned down by a surety, and, as a matter of fact, frequently does. We have met with several minority contractor associations throughout the country. There is a favorable consensus among these groups.

The question of "graduation" is a difficult one. The sureties do not notify us when they take a contractor out of our program and put him into their own. The only assumption we can make is that, if there is no activity in a particular file for 6 months to a year, we can assume that the contractor, if he has not gone into claim, has gone into the surety's normal business. We do, however, have certain guidelines for our surety bond personnel in the field. As an example, a valid reason for keeping a contractor in our program after he completes several jobs could be that his financial statements show insufficient earnings to justify bonding him without SBA support. Another reason is that the contractor is increasing the size of job or total work program beyond what the surety would accept in its standard business. Again, this is a form of graduating from small contracts to larger contracts.

There is considerable room for upward mobility within the program. The average job is now $68,000. Our limit is $500,000. We also find that the marketplace itself assists in this area. We have noted that even in the cases of some surcharge rate companies, which may not write standard rate bond business, a contractor who can qualify for standard business will go with one of the major companies. The reason for this is twofold:

(1) The contractor will not pay the higher premium if he can avoid it, and

(2) There is a certain pride among contractors when they can get bonding on their own with one of the major sureties.

We must remember that the contractors in our program are considered marginal and no contractor wants to be tagged with that label for any longer than absolutely necessary. In checking with one of the large producers in the surcharge rate area, we find that they average 1-1/2 contracts before they lose a client to one of the other surety companies. Our national average is less than two contracts per contractor since the inception of the program.

When we originally discussed the prospects of this program with the industry, one of the objections of the industry in handling our type of business - the marginal contractor - was the fact that the administrative expense alone, aside from the losses, would be far greater than the normal business. Our experience so far has proven this to be the case.

In February we had a meeting with 19 surety companies, each of which write 1 percent or more of our total volume. Combined, they represented 89 percent of the total volume in our program. Also attending were representatives of the American Insurance Association, the Surety Association of America, and the Agents' Associations. The purpose of the meeting was to discuss premium sharing, percentage of guarantee, and contractors' fees.

The major companies expressed a willingness to increase the SBA share of the premium and to consider a reduced guarantee percentage. They also stated that they were losing money on the program. Our analysis of their activity would bear this out.

The smaller companies took a very strong position on maintaining the present fee and guarantee structure. They stated that they were making money on the program, that increased fees and decreased guarantees would eliminate profit, and that without profit they would not remain in the program.

There are many factors to consider. Why are the major companies willing to participate in the program at loss? Is it because their big business clients are applying subtle pressure to eliminate competition? Is it because they know that the smaller sureties cannot remain in the program at a loss?

To remain in the program with higher fees or a lesser guarantee, the smaller sureties would have to tighten up on their underwriting. What would the effect be on the minority contractor? The loss rate on his business is 1.8 percent versus 1.1 percent for nonminority. With a tightening of underwriting standards, the benefits of the program would be denied to those who need it most.

We are not prepared to adjust either the fees or percentages of guarantee at this time. We will, however, make adjustments at such a time as our continuing analyses might justify.

We are enclosing a list of all the sureties participating in our program as of May 20, 1974 (from the inception of the program). This list includes the number of contracts and the dollar values by region and total. As you will note, there are many sureties listed that are national companies but have written very few bonds through our program in the almost 3 year period since its inception.

The report also states that the maximum allowable premium rate that SBA permits was $20.00 a thousand and a change to $15.00 a thousand under contemplation. Our maximum allowable rate as of March 1973 is $15.00 per thousand for the first $50,000 and $10.00 per thousand on amounts in excess of $50,000. Therefore, we only allow the additional 1/2 percent on the first $50,000. Any surety that is using the standard 1 percent in their normal business, because of filing with the various state insurance departments, must use the same rate for the business with the SBA program. Therefore, there are very few companies charging the 1-1/2 percent rate, though it is true that a substantial amount of our volume comes from sureties which charge the higher rate. We have no quarrel with those sureties which are in the program for profit. Profit, if kept within reasonable bounds, is a perfectly legal and proper incentive.

Lack of Incentives

Our experience in the program alone seems to dispute this point.

1. For the surcharge rate companies, their records show that a contractor, on the average, has 1-1/2 contracts prior to leaving them.

2. The total number of contracts in the program versus the number of contracts guaranteed is still less than two contracts per contractor.

It is true that the surcharge rate companies would prefer to keep the contractor with them for a longer period of time, but, because of market conditions and the lower rates with the standard surety companies, the contractor automatically will go where the price is right. It must also be noted that publicly the Surety Association and American Insurance Association have indicated to us that they feel the program is getting too large. Therefore, they are encouraging their members to graduate contractors out of our program and write them in as their standard business. This philosophy of the industry is understandable. They are afraid of any government interference in the surety bond field. Total underwritings through the SBA are probably between 1 to 2 percent of the total value of construction bonds written throughout the country, and it is evident that they do not want government participation to become a much bigger factor than it now is.

We have found no instance where the surety found that it was advantageous, economically or administratively, to allow the contractor to default rather than provide financial and technical assistance. On the contrary, the sureties check with us on all claims and we work together in attempting to handle claims in the best way possible. There are many cases where the sureties have financed the contractor. When the surety finances the contractor, we do not provide any funds to the surety while they have the funds in a controlled account. However, once the funds are expended from the account, then the sureties receive their 90 percent reimbursement. This is much the same way that claims are handled between the sureties and their reinsurers. So again, we have found no cases where the surety has defaulted a contractor rather than go through additional administrative expense in trying to have the contractor himself complete the job. It is an unfortunate fact that, once a marginal contractor defaults, the chances of his survival are minimal. In a few cases, however, through the mutual efforts of SBA and the surety, we have been able to help a contractor so that he corrected his default and was able to continue in business.

Conclusions

Based on the information given herein, we feel that we have covered the three points in your recommendations:

[See GAO note 1, p. 40.]

[See GAO note 1, p. 40.]

2. The sharing ratios are adjusted to create a more equitable relationship between premiums received and risks taken.

   We are convinced that the sureties are not making excess profits on our program. We believe that higher fees will work to the disadvantage of the small contractor. We do not think that adjustments are appropriate at this time.

3. Formal criteria for graduating participating contractors into the regular bonding system is developed, including a monitoring system to insure that sureties are complying with such criteria.

   We have established criteria by which our field offices will question the sureties on why the particular contractor is remaining in the program and not being graduated. We think, however, that the forces at work in the marketplace will accomplish more than any set of rules that could be devised.

We apologize for the length of our reply, but thought it necessary to bring certain matters to your attention that were overlooked by your examiners in their rather cursory and, perhaps, premature review.

Sincerely,

Thomas S. Kleppe
Administrator

Enclosures [See GAO note.]

GAO note: The enclosures have not been included in this report.

VETERANS ADMINISTRATION
OFFICE OF THE ADMINISTRATOR OF VETERANS AFFAIRS
WASHINGTON, D.C. 20420

JUNE 27 1974

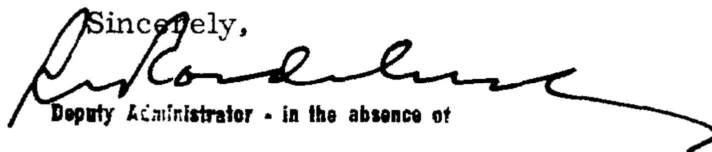
Mr. Gregory J. Ahart
Director, Manpower and
Welfare Division
U. S. General Accounting Office
Washington, D. C. 20548

Dear Mr. Ahart:

We appreciate the opportunity to review and comment on the draft report "Surety Bonds In Federal Construction: A Study of Their Application and Effectiveness."

We are in agreement with the recommendations regarding Performance and Payment Bonds. However, the implication of a possible change in the practice of retainage could reduce leverage needed in dealing with contractors. Some form of retainage should be maintained as a source of leverage in expediting progress during the various phases of the project.

Sincerely,



DONALD E. JOHNSON
Administrator

PRINCIPAL OFFICIALS RESPONSIBLE FOR ADMINISTERING THE ACTIVITIES DISCUSSED IN THIS REPORT

	Tenure of Office	
	From	To
GENERAL SERVICES ADMINISTRATION		
ADMINISTRATOR OF GENERAL SERVICES:		
Arthur F. Sampson	June 1973	Present
Arthur F. Sampson (acting)	June 1972	June 1973
COMMISSIONER, PUBLIC BUILDINGS SERVICE:		
Larry F. Roush	Aug. 1973	Present
Larry F. Roush (acting)	Jan. 1973	Aug. 1973
John F. Galuardi (acting)	July 1972	Jan. 1973
DEPARTMENT OF TRANSPORTATION		
SECRETARY OF TRANSPORTATION:		
Claude S. Brinegar	Feb. 1973	Present
John A. Volpe	Jan. 1969	Feb. 1973
ADMINISTRATOR, FEDERAL AVIATION ADMINISTRATION:		
Alexander P. Butterfield	Mar. 1973	Present
John H. Shaffer	Mar. 1969	Mar. 1973
VETERANS ADMINISTRATION		
ADMINISTRATOR OF VETERAN AFFAIRS:		
R. L. Roudebush	Oct. 1974	Present
R. L. Roudebush (acting)	June 1974	Oct. 1974
D. E. Johnson	June 1969	June 1974
ASSISTANT ADMINISTRATIOR FOR CONSTRUCTION:		
V. P. Miller	Aug. 1970	Present

	Tenure of office	
	From	To
ATOMIC ENERGY COMMISSION		
CHAIRMAN:		
Dr. Dixy Lee Ray	Feb. 1973	Present
Dr. James R. Schlesinger	Aug. 1971	Feb. 1973
DIRECTOR, DIVISION OF CONSTRUCTION:		
Samuel L. Hack	June 1972	Present
DEPARTMENT OF HEALTH, EDUCATION, AND WELFARE		
SECRETARY OF HEALTH, EDUCATION, AND WELFARE:		
Caspar W. Weinberger	Feb. 1973	Present
Elliot L. Richardson	June 1970	Jan. 1973
DIRECTOR, OFFICE OF FACILITIES ENGINEERING AND PROPERTY MANAGEMENT (note a):		
Gerritt D. Fremouw	May 1970	Present
NATIONAL AERONAUTICS AND SPACE ADMINISTRATION		
ADMINISTRATOR:		
Dr. James C. Fletcher	April 1971	Present
DIRECTOR, OFFICE OF FACILITIES:		
Robert H. Curtin	May 1968	Present
DEPARTMENT OF DEFENSE		
SECRETARY OF DEFENSE:		
James R. Schlesinger	July 1973	Present
William P. Clements, Jr. (acting)	Apr. 1973	July 1973

	Tenure of office	
	From	To
DEPARTMENT OF DEFENSE (continued)		
SECRETARY OF DEFENSE:		
Elliot L. Richardson	Jan. 1973	Apr. 1973
Melvin R. Laird	Jan. 1969	Jan. 1973
DEPARTMENT OF THE ARMY		
SECRETARY OF THE ARMY:		
Howard H. Callaway	June 1973	Present
Robert F. Froehlke	July 1971	June 1973
CHIEF OF ENGINEERS:		
Lt. Gen. W. C. Gribble, Jr.	Aug. 1973	Present
Lt. Gen. Frederick J. Clarke	Aug. 1969	July 1973
DEPARTMENT OF THE NAVY		
SECRETARY OF THE NAVY:		
J. William Middendorf	June 1974	Present
J. William Middendorf (acting)	April 1974	June 1974
John W. Warner	May 1972	April 1974
John H. Chafee	Jan. 1969	May 1972
COMMANDER, NAVAL FACILITIES ENGINEERING COMMAND:		
Rear Adm. A. R. Marschall	May 1973	Present
Rear Adm. Walter M. Enger	Aug. 1969	May 1973
DEPARTMENT OF THE AIR FORCE		
SECRETARY OF THE AIR FORCE:		
Dr. John L. McLucas	July 1973	Present
Dr. John L. McLucas (acting)	June 1973	July 1973
Dr. Robert C. Seamans, Jr.	Jan. 1969	May 1973
DEPUTY CHIEF OF STAFF (Systems and Logistics):		
Lt. Gen. William W. Snavely	Jan. 1973	Present
Lt. Gen. Harry E. Goldsworthy	Aug. 1969	Dec. 1972

	Tenure of office	
	From	To
SMALL BUSINESS ADMINISTRATION		
ADMINISTRATOR:		
Thomas S. Kleppe	Jan. 1971	Present
ASSOCIATE ADMINISTRATOR FOR FINANCE AND INVESTMENT:		
David A. Wollard	Feb. 1973	Present
Anthony S. Stasio (acting)	Jan. 1973	Feb. 1973
Jack Eachon, Jr.	Dec. 1969	Jan. 1973
DIRECTOR, OFFICE OF COMMUNITY DEVELOPMENT:		
Einar Johnson	Feb. 1971	Present
DIRECTOR, SURETY BOND GUARANTEE PROGRAM:		
Sal Lauricella	June 1972	Present

[a]Before June 1973, this office was known as the Facilities Engineering and Construction Agency.