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Bank Stability Is Crucial to Contractor Bondability

By Mike Sanders of Old Republic Surety

We dodged a bullet this spring, with the feared contagion of bank collapses having been effectively controlled. However, we may not be out of the woods yet. For example, the KBW Bank Index, a measurement of the health of the leading publicly traded U.S. banks and thrifts, shows substantial deterioration over the past year, with an 18% decline in performance in the 12 months to June 19, 2023.

Additionally, regulators and the Federal Reserve are contemplating a change that could affect contractors and, potentially, their bond qualifications.

The Changes Expected to Affect Contractors

Many contractors rely on lines of credit to ensure liquidity for making payroll and for purchasing materials and equipment before the first billing cycle of a contract. Liquidity is an important factor in qualifying for a surety bond, but liquidity may be challenging to maintain as banks respond to new demands from regulators.

Upcoming changes may put pressure on banks' ability to lend or may force them to further tighten their lending criteria. That means contractors could experience longer bank processing times, lower credit thresholds, higher costs of borrowing, or even non-renewals or withdrawals of current lines of credit. All of those could impact contractors' ability to obtain surety bonds on favorable terms.

One of the changes we are following is a set of new capital reserve rules for banks. The Fed, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency are working on new rules to increase required capital reserves for banks, reportedly by as much as 20%. This could result in strain on the amount of money banks could lend out and in some cases could possibly result in banks calling in lines of credit they've already issued.

In the meantime, banks are tightening lending criteria, which is increasing the pain already inflicted by higher interest rates. In fact, by the end of March 2023, 47% of banks had tightened standards for commercial and industrial loans to businesses with annual revenue of less than $50 million, according to the Fed's quarterly Senior Loan Officer Opinion Survey on Bank Lending Practices, the latest data available.

Already this year, small businesses have reported increased challenges finding adequate financing, loan terms have become less favorable, and limits on credit lines have decreased, according to the National Small Business Association.

Also of concern is the effect of a continuing decline in commercial real estate values, down 15% from June 2022, according to The Motley Fool, as well as a drop in home prices and a 31% decrease in the number of mortgage applications between second quarter 2022 and March 2023, according to the Mortgage Bankers Association. These decreases portend two problems for contractors. One is a reduction in work resulting in increased competition for fewer projects, which puts downward pressure on profit margins. The other is that banks may further tighten their credit underwriting standards. Additionally, any increase in contractor failures would hurt the lending banks' balance sheets.

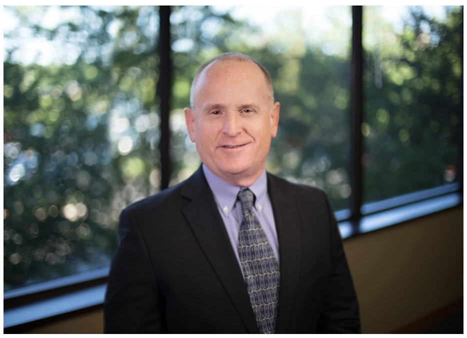
What If Your Bank Goes Under?

In the off chance that your bank has liquidity or solvency problems, you should understand the implications for your business, including the effect on your ability to obtain bonds for your projects.

The first thing to know is that your corporate/partnership/LLC cash deposits are insured by the FDIC for $250,000, so any amount up to that threshold in a failed bank that is FDIC insured will be paid out to you. The FDIC says it makes these payments within days of a bank's closure. Deposits in excess of the $250,000 insured limit might also be recoverable when bank assets are sold off, but that could be a drawn-out process and it might not restore all of the excess amounts. One possible way to secure deposits beyond the $250,000 upper limit is bank depository bonds. Understandably, in the wake of the Silicon Valley Bank collapse, bank depository bonds may be difficult or expensive to obtain. However, if your bank is on sound financial footing, this is still an avenue to pursue for contractors that regularly have large amounts of cash on deposit with a single financial institution.

The second thing to understand is the effect of your bank's failure on your company's financial statements. Obviously, if you lose cash deposits in the process, your balance sheet will reflect that. You should also expect to lose access to lines of credit and other services your bank provided, such as checking, autopay, retirement accounts, and associated payroll services. Blips in these activities may be understandable, explainable, and correctable; but you will need access to your records and ways to address the issues with your bond underwriter. It certainly will not be painless.

Bond underwriters analyze your balance sheet and income statement to assess your qualifications for a bond, and they want to see stability. They regard swings and disruptions with caution. It will be wise over the next 12 months to pay attention to the health of your bank to make sure your assets and services remain accessible. You should also have all your financial records up to date and accessible—bearing in mind that closed banks might not be able to provide documentation quickly. Taking steps to ensure your assets are with a reputable and stable institution is a smart move that can protect your company and its ability to qualify for essential surety bonds.



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