



Surety Bonds – Old is New Again

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Throughout history, surety bonds have been utilized as a vehicle to guarantee/uphold contractual obligations. By nature, a surety is promise by a guarantor to pay the obliged an *agreed* upon amount if the *principal* fails to meet some obligation, such as fulfilling the terms of a contract or performance. A premium is paid to an insurance company (by principal or the obliged) in exchange for the insurance company's financial strength. In the case of the Excess Deposit Bond, the surety bond protects the obliged against losses resulting from the principal's failure to perform.

Excess Deposit Surety Bonds (EDSB) were once common within the banking industry. They were often used in lieu of collateral, such as pledged securities and letters of credit, as an acceptable vehicle to secure deposits in excess of Federal Deposit Insurance Corporation (FDIC) and National Credit Union Association (NCUA) insured limits. Prior to the Great Recession, insurance companies recognized heightened exposure and began taking precautions to minimize risk, including higher bond underwriting standards for surety bonds. At the onset of the Great Recession, EDSBs all but vanished. The economic stress, coupled with credit instability in the banking system, created the perfect situation for massive defaults. The insurance companies immediately ceased issuing new bonds and began canceling existing bonds to minimize exposure.

The result: a void in securitization and collateral options available for financial institutions. Community banks, in particular, lost a valuable tool used in the securitization of deposits over regulatory insured limits, as larger banks had several other funding sources available. Those that navigated the unsettling times thought a revival in the EDSB market was unimaginable.

Fortunately, what is old is now new again. During this current recovery period, affordable EDSB opportunities have begun to reappear for community, regional and money center institutions. This victory is most significant for the community bank market. Insurers and reinsurers are willing to underwrite bonds for non-rated institutions at reasonable rates, which is a good indicator of opportunities to come. Now, insurers are much more comfortable with the banking sector due to the strengthened regulatory requirements.

EDSB's allow financial institutions to free up collateral that would otherwise be encumbered. Even though the new regulatory environment is heavily focused on larger institutions, there is an expectation that these rules will become best practices for the banking sector as a whole. Surety bonds can provide relief for community banks from



punitive liquidity rules attached to current collateralization techniques (i.e. pledged securities and letters of credit) that will help level an uneven playing field.

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