



RETENTION PAYMENTS IN THE CONSTRUCTION INDUSTRY

Joint Inquiry by the Economy, Infrastructure, Skills and Finance Committee

ABOUT THE SPECIALIST ENGINEERING CONTRACTORS' (SEC) GROUP WALES/CYMRU

SEC Group Wales/Cymru represents the specialist engineering sector which contributes the largest element (by value) to Welsh construction. The sector primarily comprises small businesses. The following trade associations are represented under the SEC Group Wales/Cymru umbrella:

British Constructional Steelwork Association (BCSA)
Building Engineering Services Association (BESA)
ECA - Electrotechnical and engineering services trade body
Lift and Escalator Industry Association (LEIA)
Scaffolding Association

1. Use of Retentions in Wales and UK

- 1.1 The use of retention monies is widespread across the construction industry and has been so for almost 200 years. Ostensibly the monies are deducted as security in the event that a business providing construction or engineering works fails to return to rectify non-compliant work. In practice the monies are withheld to bolster the working capital of the withholdor or, in some cases, are even used to invest in the overnight money markets.
- 1.2 Normally 5% of progress payments are deducted but in some cases the percentage may be as high as 10%. Half the total retention withheld should be returned on handover of the works but this is not always the case. The other half should be released over the next 12 months following the expiry of a period referred to by myriad terms such as the *defects liability period*. Again, in practice, the final half of the monies are not released until 2,3 or more years after handover – usually after a considerable amount of chasing from the creditor firm.
- 1.3 In October 2017 the UK Government published the results of research on retentions carried out by consultants Pye Tait. The research concluded that any benefits that might be obtained from the practice of retentions were far outweighed by the abuse associated with the practice which primarily impacts SMEs. The Pye Tait report revealed that:
 - £4.5 billion (at 2015 prices) of cash retentions was, on average, withheld annually.

- £700 million of cash retentions had been lost over a 3-year period up to 2016 as a result of upstream insolvencies (almost £1 million per working day!).
- Over a three-year period (ending 2016) £7.8 billion of cash retentions was still owing.

These are UK-wide figures.

- 1.4 The above figures did not take account of the losses arising from the Carillion collapse (it is variously estimated that firms in Carillion's supply chain would have lost between £¼ billion and £½ billion worth of retentions). The collapse of Welsh-registered construction company Dawnus in March 2019 left £39 million owing to its trade creditors; much of this would have comprised retention monies.
2. **To what extent are retentions an issue for companies based and/or operating in Wales including how issues might differ through the supply chain?**
- 2.1 Whilst cash retentions are supposed to provide a measure of performance security there is no concomitant security for the cash. Retentions are owned by the businesses from whom they were deducted since they are withheld from sums acknowledged as due. Moreover, when it comes to insolvency risk and retentions there is an inequality of distribution of such risk as one proceeds along the supply chain.
- 2.2 Where works are commissioned by public bodies such bodies do not go into insolvency. Therefore the retentions provided by a tier 1 contractor (over 90% of which are collected from its supply chain) are protected from insolvency. This does not, of course, apply along the supply chain. (Attached at **Annex 1** are suggested options which public bodies can include in their contracts with tier 1 contractors.) Even where works are procured by a private sector client a tier 1 contractor can protect itself in the event of the client's insolvency. This is achieved by inserting a pay when/if paid clause in its sub-contracts (which is permitted under section 113, Housing, Grants & Regeneration Act 1996).
- 2.3 Cash retentions are regarded by the overwhelming majority of SMEs in Welsh construction as a significant drain on their scarce resources; a retention usually represents their margin on any given contract. Retentions are never released automatically; they always have to be chased once the release date is past. According to a 2017 survey carried out by trade bodies in membership of SEC Group most respondents reported that they had to wait more than 12 months for release of their retentions with an average of almost £35,000 outstanding (the majority of respondents were small businesses). There was never any indication of the reason(s) for the delay, when the monies would actually be paid or whether the outstanding retention would be released in full. This financial uncertainty is intolerable for small firms and curbs their prospects for growth derived from investment in jobs, skills and business development. In many cases firms give up chasing the monies; this is acknowledged by HMRC in its internal Business Income Manual (updated in 2016) which states:

"In recent years, construction industry customers have become increasingly reluctant to pay retention monies, irrespective of whether there are defects to be made good. It is now common for such monies never to get paid."

3. Are there any benefits to the use of retentions?

- 3.1 Any benefits associated with the practice of retentions are often more apparent than real. Some clients believe that they are a “*comfort blanket*” providing a measure of protection in the event that a firm for whatever reason, fails to address non-compliant work. But, in many cases where there are extensive defects, the funds in the retention pot are insufficient to carry out the necessary remedial work or complete any unfinished work (often as a result of the insolvency of the firm in question). It has to be said that the prime benefit is the boost to working capital provided by retentions. Surveys carried out by SEC Group in Wales and in the rest of the UK have indicated that many local authorities are dependent on retentions to fund other works or other council activities.
- 3.2 From a macro standpoint the disbenefits outweigh the benefits. In its impact assessment prior to introducing legislation in 2017 to protect cash retentions the New Zealand Government’s Ministry of Business, Innovation & Employment stated:

“The use of retentions as working capital is the key concern for the Government; funding working capital from retentions can mask and reward poor performance and poor financial management practices. For example, undercapitalisation and low-price tendering are long standing features of the Construction market that contribute to its low productivity and innovation. The use of retentions as working capital enables those features to remain with no incentive to change and no incentive for clients or lead contractors to properly manage project risks.”

- 3.3 Far from addressing defects the retentions system and the associated abuse can, paradoxically, have a detrimental impact on quality. Dame Judith Hackitt’s report in May 2018, *Building a Safer Future*, stated:

“Payment terms within contracts (for example, retentions) can drive poor behaviours, by putting financial strain into the supply chain. For example, non-payment of invoices and consequent cash flow issues can cause subcontractors to substitute materials purely on price rather than value for money or suitability for purpose.”

We would suggest that the primary reason for the continuation of the cash retention system is that it has become embedded in the “*subconsciousness*” of a construction delivery model that is driven by poor capitalisation in the pursuit of the lowest possible price and falling standards.

4. What are the alternatives to the use of retentions and what role could the Welsh Government play in developing and delivering those alternatives?

- 4.1 The alternative to cash retentions that is often proposed is the use of retention bonds. Unfortunately, surety bonding is not an option for small firms. Assuming that they can have access in the first place to the surety market the cost of bonding will usually be prohibitive. Therefore, this is not considered to be a viable alternative for small businesses.
- 4.2 Since 2017 the SEC Group has sponsored the development of a digital platform to protect retention money. This has been led by Pay2escrow (a financial services company) as part of a proposed consortium of Willis Towers Watson (insurance broker), the University of Northumbria (for research support), and others including software developers. Underpinning the platform will be an industry-owned insurance fund to ensure retentions

are released in full and on time, even in the event of upstream insolvencies. Support for this work has come from a range of industry bodies including the Federation of Environmental Trade Associations, the National Federation of Builders and the Federation of Master Builders. Interest in this work has also been expressed by the Local Government Association in England.

- 4.3 Like online banking the platform will be easy to use. Contractors will be able to see what they are owed and when it will be paid. Retentions will be safely ring-fenced in a trust account with an industry-owned clearing house. A distributed ledger will be used to deliver a cost-effective insurance-enhanced service. The whole cost of the scheme will be roughly £230 for every £100,000 of contract value (a mere 0.23%).
- 4.4 The project is now ready for live testing. Funding is now being sought for a 12-18 month pilot. The pilot will allow industry participants to optimise the solution. **We would encourage Welsh Government to support this work and, if possible, make some funding available to help in the development of the digital platform so that it is ready for piloting.**
- 4.5 Most other jurisdictions (e.g. some Australian states, some US states, New Zealand, Germany) have legislation in place that ring-fences cash retentions by requiring that they are placed in trust or in a stakeholder account until released. The 1975 French Law of Sub-Contacting requires all tier 1 contractors to issue their sub-contractors with bank guarantees to guarantee that the funds will be available on the date(s) for release.
- 4.6 **We suggest that Welsh Government considers introducing legislation in the Welsh Assembly to protect cash retentions where they are withheld on construction operations in Wales.** Attached is the draft of a Bill which we published in 2013 as a possible Private Members' Bill. The Bill is for illustrative purposes only as developments since 2013 (such as advances in digital technology) will mean that some updating will be necessary. A useful template is the Construction (Retention Deposit Schemes) Bill which was a Private Members' Bill introduced in the House of Commons in January 2018. This outlaws cash retentions unless they are placed in a retention deposit scheme.
- 4.7 Other than legislation there is no other alternative that ensures the necessary protection for cash retentions. This has been the experience of most other jurisdictions. It is within the competence of the Welsh Assembly to pass the necessary legislation which would mean that Wales will lead the UK in delivering a transformative solution that both enhances the livelihoods of construction small businesses and addresses the Welsh Government's focus on the foundational economy.

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National Executive Officer, SEC Group Wales/Cymru

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CEO, SEC Group

27 September 2019

RETENTION MONIES (WALES) BILL 2013

[AS INTRODUCED]

An Act of the National Assembly for Wales to provide
for the protection of retention monies in the construction
industry in Wales in the event of the insolvency of
the party holding such monies

**Having been passed by the National Assembly for Wales and having received
the assent of Her Majesty, as follows:**

Interpretation

1.

1. (1) In this Act –

“adjudication” has the meaning given to it by section 108 of the Housing Grants Construction and Regeneration Act 1996 (as amended);

“construction contract” has the meaning given to it by Section 104 of the Housing Grants, Construction and Regeneration Act 1996 (as amended) but only includes construction contracts insofar as these relate to the carrying out of construction operations in Wales;

“construction operations” has the meaning given to it by Section 105 of the Housing Grants, Construction and Regeneration Act 1996 (as amended) with the exception of *subsection (2)*;

“insolvency” has the meaning given to it by Section 113 of the Housing Grants, Construction and Regeneration Act 1996 (as amended);

“month” means a calendar month;

(2) In this Act, reference to “beneficiary” or “beneficiaries” means (as the case may be) -

(a) a “tier one contractor” which has entered into a construction contract with a party procuring construction operations;

(b) a “tier two contractor” which has entered into a construction contract with a tier one contractor;

(c) a “tier three contractor” which has entered into a construction contract with a tier two contractor.

- (3) In this Act, reference to a “party procuring construction operations” means the party which has entered into a construction contract with a tier one contractor to provide such operations.
- (4) In this Act, reference to “retention monies” includes any sums withheld from payments otherwise due under a construction contract by way of security for current and future performance other than performance damages or liquidated damages;
- (5) In this Act, reference to “trustee” is the party under section 2 upon whom is placed the obligation to hold retention monies in trust.

Status of retention monies

- 2. (1) Where a party procuring construction operations under a construction contract withholds retention monies from the tier one contractor such monies shall be held in trust for the benefit of the tier one contractor and such of the tier two and tier three contractors as have had retention withheld against them under a construction contract.
- (2) Where the party procuring construction operations does not withhold retention monies under a construction contract but the tier one contractor withholds retention monies from its tier two contractors, such monies shall be held in trust for the benefit of such of the tier two contractors and their tier three contractors as have had retention monies withheld against them under a construction contract.
- (3) Where both the party procuring construction operations under a construction contract and the tier contractor do not deduct retention monies but a tier two contractor withholds retention monies from its tier three contractors, such monies shall be held in trust for the benefit of such of the tier three contractors as have had retentions withheld against them.

Duties of the trustee

- 3. (1) The trustee shall establish a trust account at a bank solely for the purpose of depositing the retention monies and shall notify the bank that the monies are held in such account in accordance with the provisions of this Act.
- (2) The trustee shall be solely liable for the cost of establishing and maintaining such account.
- (3) The trustee shall maintain a record of all amounts of the retention monies individually contributed by each beneficiary and shall issue each beneficiary details of the trust account.

Interest

4. Each beneficiary shall have an entitlement to a share of the interest earned whilst their respective retention monies are in the trust account in proportion to each of their retention monies held in the account.

Failure to comply with this Act

5. (1) Where a party designated as trustee under *section 2* fails to comply with any of the requirements of this Act it shall not be permitted to deduct any retention monies and this prohibition shall apply to all construction contracts in the supply chain as between tier one and tier two contractors, and tier two and tier three contractors.

(2) Where in contravention of any of the requirements of the Act any retention monies have been deducted they shall be refunded immediately and are recoverable under the relevant construction contract as a debt exclusive of any counterclaim.

Release of retention monies

6. Subject to *section 7* the trustee shall ensure that all outstanding retention monies are released to each beneficiary no later than the expiry of twelve months following the date the party procuring the construction operations had taken them over.

Right of recourse against trust account

7. The obligation under *section 6* to release the retention monies is without prejudice to the right of the trustee to use the monies in accordance with the purpose for which such monies have been withheld under the construction contract to which the trustee is a party.

Liability of the bank

8. This Act does not impose any liability upon a bank holding an account designated as a trust account under this Act but the bank shall have no recourse to the account to offset any claim or liability which the bank may have against the trustee.

Replenishment of trust account

9. (1) Where under *subsection 7* the trustee is the party procuring the construction operations the tier one contractor shall forthwith replenish the account to the extent of the contributions of each of its tier two contractors provided that the reason for the withdrawal by the trustee from the account was not due to their insolvency or their work and/or materials not being in

conformity with their contract and this provision shall apply *mutatis mutandis* to tier two contractors in respect of their tier three contractors.

- (2) Similarly where under *section 7* the trustee is a tier one contractor its tier two contractors shall forthwith replenish the account to the extent of the contribution of each of their tier three contractors provided that the reason for the withdrawal by the trustee from the account was not due to their insolvency or their work and/or materials not being in conformity with their contract.
- (3) Failure by the tier one contractor or tier two contractor, (as the case may be), to comply with *paragraphs (a) or (b)* shall entitle the affected beneficiaries to the immediate release by the other party under their construction contracts of any outstanding retention monies.

Conflict with provisions in the construction contract

10. The provisions of this section should prevail over any inconsistent express or implied terms of any construction contract to which this Act applies.

Disputes

11. In the event of any dispute or difference arising under or in connection with the provisions in this Act a party to the relevant construction contract shall have the right to refer such dispute or difference to adjudication in accordance with the Housing Grants, Construction and Regeneration Act 1996 (as amended) and, where applicable, in accordance with the Scheme for Construction Contracts (England and Wales) Regulations 1998 as amended by the Scheme for Construction Contracts (England and Wales) Regulations 1998 (Amendment) (Wales) Regulations 2011.

Application to the Crown

12. This Act binds the Crown to the full extent authorised or permitted by the Government of Wales Act 2006.

Commencement

13. This Act shall come into operation on such day as the Welsh Ministers may by order appoint and shall apply to construction contracts entered into on or after such day.

Short title

14. This Act may be cited as the Protection of Retention Monies Act (Wales) 2013.

SEC GROUP SUGGESTED PROCUREMENT ADVICE NOTE FOR CONTRACTING AUTHORITIES

The Carillion debacle has highlighted the lack of security for cash retentions deducted from firms in the supply chain. Whilst tier 1 suppliers' retentions are protected (public sector clients do not go into insolvency) there isn't similar protection for the supply chain. It is common for tier 1 suppliers to delay the release of supply chain retentions for 2 or more years which increases the risk of their loss from the insolvency of the tier 1.

With this in mind all contracting authorities are invited to include the following model clauses (as options) in their contract conditions when inviting bids from tier 1 suppliers¹.

- *In the event that you were to be successful in bidding for any contract let by the authority are you able to confirm that you will accept one of the following options in your contract? Please state your preferred option.*
- *Please note that in the event of failure by you to include your preferred option in your sub-contracts or to comply with the provisions in the relevant clauses will prejudice any future listing of your company on our approved lists².*

Option 1

In the event that the Contractor intends to deduct cash retentions from its sub-contractors the Contractor shall include a clause in all its sub-contracts that cash retentions shall be held in trust by the Contractor until the contractual date for their release but without prejudice to the Contractor's right to have recourse to the monies in accordance with the sub-contract. For the duration of the time that the monies are held in trust they shall be held in a segregated account that is made known to the sub-contractor which shall have the right at any time to request a statement of the account showing the amount of retention monies held on its behalf. The Contractor shall be identified to the account holder as a trustee of the monies in the account and the Sub-contractors having retention monies in the account shall be identified as the beneficiaries.

Option 2

In the event that the Contractor intends to deduct cash retentions from its sub-contractors the Contractor shall include a clause in all its sub-contracts that the

¹ In Wales, where contracting authorities propose to use these model clauses they are asked to confirm this with Value Wales.

² Some English Local Authorities do not use "Approved Lists"; instead after 'future' there should be inserted, "inclusion of your company in our tender lists".

Contractor shall obtain a bank guarantee by way of an undertaking that the issuing bank will guarantee repayment of retention monies in the event that by reason of insolvency the Contractor is unable to repay the monies on their becoming due for release. Before commencement of the sub-contract works the Contractor shall issue to the sub-contractor a copy of the bank guarantee.

NOTE: Contracting Authorities may prefer not to deduct retentions. In such case, the above advice will not be necessary, provided that the Authority was to ensure that cash retentions were not withheld along the supply chain³.

³ The Local Government Association also suggested something along the lines of: "we are not including a requirement for cash retentions in this contract, we therefore do not expect that cash will be retained from subcontractors. We would expect that subcontractors through the complete supply chain will include a clause to this effect."

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Duties of the trustee

3. (1) The trustee shall establish a trust account at a bank solely for the purpose of depositing the retention monies and shall notify the bank that the monies are held in such account in accordance with the provisions of this Act.
- (2) The trustee shall be solely liable for the cost of establishing and maintaining such account.
- (3) The trustee shall maintain a record of all amounts of the retention monies individually contributed by each beneficiary and shall issue each beneficiary details of the trust account.

Interest

4. Each beneficiary shall have an entitlement to a share of the interest earned whilst their respective retention monies are in the trust account in proportion to each of their retention monies held in the account.

Failure to comply with this Act

5. (1) Where a party designated as trustee under *section 2* fails to comply with any of the requirements of this Act it shall not be permitted to deduct any retention monies and this prohibition shall apply to all construction contracts in the supply chain as between tier one and tier two contractors, and tier two and tier three contractors.

(2) Where in contravention of any of the requirements of the Act any retention monies have been deducted they shall be refunded immediately and are recoverable under the relevant construction contract as a debt exclusive of any counterclaim.

Release of retention monies

6. Subject to *section 7* the trustee shall ensure that all outstanding retention monies are released to each beneficiary no later than the expiry of twelve months following the date the party procuring the construction operations had taken them over.

Right of recourse against trust account

7. The obligation under *section 6* to release the retention monies is without prejudice to the right of the trustee to use the monies in accordance with the purpose for which such monies have been withheld under the construction contract to which the trustee is a party.

Liability of the bank

8. This Act does not impose any liability upon a bank holding an account designated as a trust account under this Act but the bank shall have no recourse to the account to offset any claim or liability which the bank may have against the trustee.

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Conflict with provisions in the construction contract

10. The provisions of this section should prevail over any inconsistent express or implied terms of any construction contract to which this Act applies.

Disputes

11. In the event of any dispute or difference arising under or in connection with the provisions in this Act a party to the relevant construction contract shall have the right to refer such dispute or difference to adjudication in accordance with the Housing Grants, Construction and Regeneration Act 1996 (as amended) and, where applicable, in accordance with the Scheme for Construction Contracts (England and Wales) Regulations 1998 as amended by the Scheme for Construction Contracts (England and Wales) Regulations 1998 (Amendment) (Wales) Regulations 2011.

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Option 2

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