Report of the Working Group on suitability of offering of Surety Bond by Indian Insurance Industry

30th September, 2020

भारतीय बीमा विनियामक और विकास प्राधिकरण

Insurance Regulatory and Development Authority of India

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Date 30th September, 2020

Dr. Subhash C. Khuntia
Chairman
Insurance Regulatory and Development Authority of India
Hyderabad

Dear Sir,

Report of the Working Group on suitability of offering of Surety Bond by Indian Insurance Industry

The Insurance Regulatory and Development Authority of India constituted a Working Group to study the suitability of offering of Surety Bond by Indian Insurance Industry vide order IRDAI/NL/ORD/MISC/170/07/2020 dated 1st July, 2020.

We are pleased to submit the Report of the Working Group on suitability of offering of Surety Bond by Indian Insurance Industry. We thank you for entrusting this important responsibility to the Working Group. We hope that IRDAI will find the recommendations made in the report useful to develop Surety market in India.

Yours Sincerely,

G. Srinivasan
Chairman of the Working Group

Members

Smt. D. Nagalakshmi
Shri. Roopam Asthana
Shri. Neelesh Garg
Shri. Hitesh Kotak
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दिनांक 30 सितंबर, 2020

डॉ सुभाष सी खुंटिआ
अध्यक्ष
भारतीय बीमा विनियामक और विकास प्राधिकरण
हैदराबाद

महोदय,

भारतीय बीमा उद्योग द्वारा प्रतिभूति बंधपत्र की पेशकश करने की उपयुक्तता पर कार्यकारी-समूह की रिपोर्ट

भारतीय बीमा विनियामक विकास प्राधिकरण ने आदेश संदर्भ आईआरडीएआई/एनएल/ओआरडी/एमआईएससी/170/07/2020 दिनांकित 1 जुलाई, 2020 द्वारा भारतीय बीमा उद्योग द्वारा प्रतिभूति बंधपत्र की पेशकश करने की उपयुक्तता का अध्ययन करने के लिए एक कार्यकारी-समूह का गठन किया।

हमें भारतीय बीमा उद्योग द्वारा प्रतिभूति बंधपत्र की पेशकश करने की उपयुक्तता का अध्ययन करने के लिए कार्यकारी-समूह की रिपोर्ट प्रस्तुत करने में प्रसन्नता हो रही है। हम कार्यकारी-समूह को यह महत्वपूर्ण जिम्मेदारी सौंपने के लिए धन्यवाद देते हैं। हम आशा करते हैं कि आईआरडीएआई भारत में प्रतिभूति बाज़ार को विकसित करने के लिए रिपोर्ट में की गई अनुशंसाओं को उपयोगी पाएगा।

भवदीय ,
जी. श्रीनिवासन
कार्यदल के अध्यक्ष

सदस्य
श्रीमती डी नागलक्ष्मी
श्री रूपम अस्थाना
श्री नीलेश गर्ग
श्री हितेश कोटक
श्री शंकर गारिगीपार्थी
श्री एस एन जयसिम्हन
श्री सी श्रीनिवास कुमार
श्री के महिपाल रेड्डी

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Acknowledgements

The Working Group expresses its gratitude to Dr. Subhash C. Khuntia, Chairman, Insurance Regulatory and Development Authority of India (IRDAI) for entrusting this responsibility to recommend the enabling framework for underwriting surety bond business by Indian Insurance Industry. The Group is extremely grateful to the senior officials of National Highways Authority of India (NHAI), Ministry of Road Transport and Highways (MoRTH) for their valuable suggestions made during the discussions.

The Working Group has immensely benefitted from extended interactions with senior executives of General Insurers, GIC Re, Foreign Reinsurance Branches and GI Council and insights, inputs and suggestions on the subject provided by experts from Banking Sector, individual legal and surety professionals that helped in arriving at the final recommendations.

The Working Group greatly benefitted from the inputs received during the discussions held with National Highways Builders Federation(NHBF) and construction contractors. The practioners from global surety companies have made significant contributions to the deliberations of the Group.

The Working Group would also like to commend the support provided by IRDAI and its team in planning and meticulously organizing various meetings of the Group. The agenda notes and minutes prepared by them for each of the meetings of the Group had enabled the Group to have meaningful and focused discussions.

G. Srinivasan
Chairman of the Working Group

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Executive Summary

1. Introduction

1.1. Surety Bonds are proven risk management mechanisms with a long history that help ensure public and private owners execute their construction projects in accordance with the plans and specifications and ensure subcontractors and suppliers are paid. Surety bonds help provide owners of construction projects with guarantees of success and enhanced reputations.

1.2. The two basic types of surety bonds are Contract surety bond which guarantees the performance of a bonded contractor and Commercial surety bond that guarantee performance in situations that arise from other than contracts. The primary type of contract bond includes Bid bonds, Performance bonds, Payment bonds and Maintenance bonds. The other types of surety bonds include customs or tax bonds, bonds concerning concessions or licenses, judicial bonds, bonds concerning leases and bonds concerning the delivery of goods or services. But there are many types of other bonds as well.

1.3. Surety Bonds are differentiated from corporate bonds and financial guarantees. While Surety Bond refers to the performance or delivery obligations to complete the insured project, the latter refers to financial obligations to repay the debts or loans.

1.4. In large construction or infrastructure projects, bank guarantee/surety bond is a contractual requirement or precondition of the project owner for awarding an order to the contractor. In case the contract is not honoured, the bank/insurance company is called upon to pay the bond or otherwise assure the finalization of the contractual obligation. The performance bonds issued may cover up to 10-20% or sometimes guarantee 100% of the project value.

1.5. Surety Bond is an option and an alternate to Bank Guarantees. Surety bonds are typically conditional whereas bank guarantees are on demand. The difference between Surety Bond and a Bank Guarantee are given in **Chapter I** of the report.

1.6. Surety Bonds are offered as Insurance products in the Global Market. Though in many countries, originally banks issued bonds, the security provided by an insurer has proven equally acceptable. Insurance Companies in markets such as USA, Brazil, Mexico, Germany, Australia and Philippines issue surety bond and many leading companies in these countries have set up separate lines of credit and bonds with surety of insurance companies. The **Chapter IV** covers the international practices on Surety Bonds in detail.

1.7. In India, the performance guarantee bonds to specific customers were issued prior to nationalization of general insurance business and later. The Contract Guarantee Business in India is discussed in **Chapter II**.

1.8. The Surety Bond for road/civil infrastructure projects market need has been felt since the Indian Banks are now not providing any waivers on collaterals for granting Bank Guarantees. The big corporate failures resulting in the events of Non-Performing Assets have driven the Banks to exercise tighter controls in issuing Bank Guarantees.

1.9. National Highways Authority of India(NHAI) received representations from contractors, developers because obtaining Bank Guarantees are becoming very difficult. The Banks have increased two components i.e. margin money as well as the commission. Under these circumstances, an alternative option was required.

1.10. Earlier in 2016, Department of Financial Services, had written to IRDAI to explore the possibility of introducing surety bonds in favour of Central Board of Indirect Taxes and Customs (CBIC) (formerly known as Central Board of Excise and Customs (CBEC) to facilitate trade by substituting Bank Guarantees.

1.11. Due to the COVID 19 pandemic and consequent economic impact on liquidity and cash flow issues in the Indian Banking sector, the Ministry of Road Transport and Highways (MORTH), Government of India, has requested IRDAI to examine possible offering of Surety Bond being issued by general insurance companies.

2. Legal and Regulatory Framework in India:

2.1. The definitions of the "surety" find place in Section 126 of The Indian Contract Act of 1872. The various provisions in respect of contract of guarantee/surety are enshrined in the sections 126 to 147 of The Indian Contract Act of 1872.

2.2. The Rule 59 (i) of Insurance Rules, 1939 refers to Contract Performance Bonds or Guarantees as a long term category of insurance policy issued for a period of more than one year. The section 64VB (1) and (5) of The Insurance Act, 1938 read with the Rule 59 (i) of Insurance Rules, 1939 recognizes the Contract Performance Bonds or Guarantees which are also termed as Surety Bonds as insurance contracts.

2.3. The proposed Indian Accounting Standard -Ind AS 117 on Insurance Contracts (earlier as Ind AS 104) issued by the Accounting Standards Board of the Institute of Chartered Accountants of India contains examples of insurance contracts that includes surety bonds.

2.4. The then General Insurance Corporation of India issued guidelines for transaction of business including nature of guarantee permitted to be issued, limits of sum insured, underwriting and premium in respect of bonds. Under this type of guarantee bonds falls into different type of guarantee bonds like Earnest Money (Tender Deposit Bonds) Performance, Security Deposit. Advance Payment, Retention Money Bonds. These Bonds were issued on behalf of civil contractors who were awarded contracts from Public Sector organizations, big Private sector companies. The other types of bonds included Customs Bonds, Excise Bonds, Coffee Bonds.

2.5. Currently, the guidelines on product filing procedures for General Insurance products issued under the provisions of Section 14 (2) (i) of the IRDA Act 1999 provides a regulatory framework for filing of general insurance products in India. IRDAI vide circular ref: IRDA/NL/CIR/159/09/2010 dated 27th September, 2010 felt the need to have proper regulatory framework for transaction of credit and guarantee business and directed all general insurers (except ECGC) to stop selling these policies till such time the Authority comes with detailed guidelines. Subsequently, IRDAI had issued Guidelines on Trade Credit Insurance on 13th December, 2010, revised on 10th March, 2016. The Authority is revisiting these Guidelines, on a regular basis, considering the changes in economy.

2.6. The **chapter III** covers Banking Practices on issue of Bank Guarantees in India. The **chapter IV** covers product and regulatory overview of some of the key markets (ex. USA, Brazil, Mexico, Germany, Australia and Philippines) across the globe.

3. Recommendations:

3.1. The recommendations in the report consist of the various aspects of regulatory and operational framework required for reviving and developing underwriting of surety business in India.

Regulatory Framework-Guidelines on Surety Bond Insurance:

3.2. The Working Group (WG) recommends that the Authority may issue separate guidelines to regulate the business of Surety Bond Insurance.

3.3. The Authority may allow the insurers to enter into Surety Bond insurance business with solvency margin above a certain threshold as the experience of surety bond insurance is yet to develop in Indian market and the risk exposure under this business is quite significant compared to other lines of business which are reasonably mature in Indian insurance market. If the insurer`s solvency ratio falls below the specified threshold limit at any point in time, the insurer shall stop writing new surety bond business until its solvency ratio improves above the specified threshold limit.

3.4. Specific approval may be given to insurance companies for issuance of sureties' based on assessment of the capabilities to handle this business. The insurers with exposure to credit risk and engineering risk may be allowed to underwrite this risk. The insurer should get capital relief to the extent the exposure is reinsured through reinsurance structure.

3.5. The exposure of an Insurer under surety bond insurance may be regulated through a cap on its exposure under this business as a proportion of its net worth. The periodical monitoring of the surety bond products and establishing risk assessment mechanism/ risk management guidelines to evaluate technical/financial strength of contractors before and after underwriting the surety bond business are proposed. It is emphasized that regulatory framework is extremely important for encouraging the surety business with recourse mechanism.

3.6. The insurance companies can work together with banks to share risk and/or share risk information, technical expertise to monitor projects, cash flow amongst other aspects. The risk information in respect of key financial indicators, contractor's historical payment records to bankers/lenders, their experience of client, promptness of payments, losses incurred, whether working capital account is regular etc., may be shared through this partnership mechanism.

Underwriting Philosophy for Surety Business:

3.7. It is recommended that Insurance companies shall have an underwriting philosophy on surety bond business, incorporating all aspects for managing this business. It shall have the maximum limit for risk accumulation per contractor and its group companies/firms and maximum retention limit for risk accumulation. The personal guarantees of promoters of policyholders/contractors as security for issuance of sureties is to be considered.

3.8. The Board of Directors of the Insurance Companies shall assess the ability of the insurance company to retain the surety risks on their balance sheet based on financial strength of the insurance company and mandate appropriate reinsurance requirements to ensure that disproportionate surety risks are not written by the insurance company. It shall conduct review on an annual basis.

3.9. The surety insurer shall satisfy itself that, among other criteria, the contractor has good references and reputation, ability to meet current and future obligations, experience that matches the contract requirements, the necessary equipment to do the work, the financial strength to carry and support its share of the project work. The underwriting process shall include review of contractor's financials, cash flow, tax returns, liquidity and debts.

Reinsurance Capacity:

3.10. It is recommended to have reinsurers supporting surety to have minimum A rating (S&P), or equivalent besides technical capabilities on underwriting, risk assessment, claims processes and portfolio monitoring of insurers and preferably with branch in India including IFSC, GIFT City. The Reinsurers offering such capacity should also be in a position to train the insurers on underwriting, risk assessment, claims processes and portfolio monitoring.

3.11. The Insurers and locally domiciled reinsurers may be allowed to factor in full benefit of reinsurance for its solvency computations.

Additional Legal framework & Ecosystem necessary for Surety market in India:

3.12. It is recommended to introduce a robust legislation requiring surety bonds and other non- fund based guarantees as a necessary condition. Surety bonds may also be included in other Acts such as Insolvency and Bankruptcy code, 2016 and given equivalent status as bank guarantees to ensure speedy and effective resolution and enforcement of indemnity by surety providers.

3.13. The current practice of Indemnity Agreement could be modified to a specific Surety based Indemnity Agreement which facilitates tripartite contract between the surety, the principal and owners of the contracting company. Such specific provision could become a very effective tool, which gives surety bonds, more legal rights against the indemnifiers participating in such agreement.

3.14. The recourse mechanism safeguards provided in the contracts with some provisions can enable Surety market to develop in India. Every surety bond shall carry a subrogation condition and it shall be protected by agreement between Surety and Contractor and no waiver of this condition under any circumstances shall be allowed.

3.15. The surety bonds shall be accepted as an alternative form of guarantee by Reserve Bank of India (RBI) and Government Departments and accordingly reflect in the appropriate contract documents.

3.16. It is recommended that in India, Ministry of Micro, Small, and Medium Businesses runs various schemes to aid the smaller businesses in development, such as, the Credit Guarantee Scheme, where the businesses eligible for these schemes can approach approved banks and can get collateral free loans up to Rs. 50 lakhs (US$ 66000). This can be extended for issuance of surety bonds also and in such cases surety bonds and Government guarantees can work more efficiently than banks to secure and promote the MSME sector within India.

Offering of Surety Bonds to Construction Contractors:

3.17. The Surety Bonds business may be revived with offering of surety bonds to Construction Companies in India that covers road projects, housing/commercial buildings and other projects of Government/Private. The contract bonds may include: Bid Bonds, Performance Bonds, Advance Payment Bonds & Retention Money. The limit of guarantee may be limited to maximum 30 percent of Project Value.

3.18. The other types of surety bonds such as customs or tax bonds, court bonds may be permitted with counter guarantee of the parties with additional liquid securities with a margin of 30 percent and above. The insurer shall consider issuing the other types of bonds on case to case basis, depending on the available tangible securities for the parties to ensure that at least partial recovery is protected. It is felt that the surety bonds in favour of Central Board of Indirect Taxes and Customs (CBIC) will facilitate trade considerably by substituting Bank Guarantees.

Centralized Data Base:

3.19. The database of the bonds issued by all the insurance companies may be centralized at designated body as may be decided by the Authority. Every insurer shall furnish the details of clients and exposures periodically to the designated body. This will help in better understanding of the risk, improve underwriting, avoid bad risk, anti-selection issues etc.,

Registration as General/Specialist Insurance Company to carry out Surety Insurance business in India:

3.20. It is recommended that any entity/ies other than registered General Insurers with the Authority that wish to act or currently acting as some surety bond issuers on bid, performance, payment and other types of bonds shall obtain Registration as a General/Specialist Insurance Company from IRDAI. The application for registration of specialized/monoline insurer for doing surety and credit insurance business may be encouraged.

Chapter I

Introduction

A surety bond is defined as a contract, in which a surety/insurer provides a guarantee to a beneficiary or obligee that the principal will meet its contractual obligations or that a monetary compensation is paid to the obligee, if the principal fails to deliver on its promise.

1.1. Surety Bond protect the beneficiary against acts or events which impair the underlying obligations of the principal. Surety bonds guarantee the performance of a variety of obligations, from construction or service contracts, to licensing and commercial undertakings. Bonds and guarantees are normally required under the terms of a construction or engineering contract, or in accordance with legal requirements, to secure the obligations of the principal. Surety bonds play a vital part in domestic and international trade and in particular protect taxpayers against the loss of public funds.

1.2. Surety Bonds are proven risk management mechanisms, with a long history, that help ensure public and private owners execute their construction projects in accordance with the plans and specifications and make certain subcontractors and suppliers are paid. Surety bonds help provide owners of construction projects with guarantees of success and enhanced reputations.

History of Surety Contracts:

1.3. The first known account of contract suretyship was etched on a Mesopotamian clay tablet around 2750 B.C. A farmer contracted with another farmer to tend his fields and split the proceeds equally. A local merchant served as the surety and guaranteed the second farmer's compliance. A millennium later, the first known written legal code, Hammurabi's code, addressed suretyship. A Babylonian contract of financial guarantee from 670 BC is the oldest surviving written surety contract. The Roman Empire promulgated surety law around 150 AD that survives in the principles of suretyship today. The development of the concept of suretyship in the continental jurisprudence has been largely due to the doctrines established by the Roman Law.

1.4. Some of the Common Law rules relative to suretyship were, for the first time, given statutory basis through the English Statute of Frauds of 1677. Since this statute was not a comprehensive and foolproof piece of legislation, further legislation was brought in through the Statute of Frauds Amendment Act of 1828.

1.5. The trend in America appeared to have followed closely that of England. In a great leap forward aboard the surety time machine, US Congress passed the Heard Act in 1894 that required surety bonds on all federally funded projects and then updated that law with the Miller Act of 1935 requiring performance and payment bonds on federal public works contracts exceeding $100,000.

Types of Surety Bonds:

1.6. The two basic types of surety bonds are Contract surety bond which guarantees the performance of a bonded contractor and Commercial surety bond that guarantee performance in situations that arise from other than contracts. The primary type of contract bond includes Bid bonds, Performance bonds, Payment bonds and Maintenance bonds.

a. A bid bond provides financial protection to an obligee if a bidder is awarded a contract pursuant to the bid documents, but fails to sign the contract and provide any required performance and payment bonds. The bid bond also helps to screen out unqualified bidders and is necessary to the process of competitive bidding.

b. A performance bond provides assurance that the obligee will be protected if the principal fails to perform the bonded contract. If the obligee declares the principal in default and terminates the contract, it can call on the surety to meet the surety's obligations under the bond. Bonds differ in terms of the types of options available to the surety, and to the obligee, in the event of a default.

c. A payment bond provides assurance that certain labourers and material suppliers that furnish services, labour, and materials for use on the bonded contract will be paid. Payment bonds are provided primarily for the benefit of the principal's suppliers and subcontractors on a project, providing them with a remedy in the event of nonpayment. With that benefit, however, come certain obligations to notify the surety or the contractor of nonpayment in a timely manner.

d. Maintenance bonds protect the project owner against the quality of the completed project for a specific time. If there are any defects on the project within the time frame specified on the bond, the project owner can file for a claim.

1.7. Other types of surety bonds include customs or tax bonds, bonds concerning concessions or licenses, judicial bonds, bonds concerning leases and bonds concerning the delivery of goods or services. But there are many types of other bonds as well.

1.8. Surety Bonds may be differentiated from corporate bonds and financial guarantee. While Surety Bond refers to the performance or delivery obligations to complete the insured project the latter refer to financial obligations to repay the debts or loans.

1.9. In large construction or infrastructure projects, bank guarantee/surety bond is a contractual requirement or precondition of the project owner for awarding an order to the contractor. In case the contract is not honoured, the bank/insurance company is called upon to pay the bond or otherwise assure the finalization of the contractual obligation. The performance bonds issued may cover up to 10-20% or sometimes guarantee 100% of the project value.

Benefits of Surety Bonds:

1.10. The Project Owners, lenders, taxpayers, contractors, and subcontractors are protected because the contractor has undergone a rigorous prequalification process and is judged capable of fulfilling the obligations of the contract. The contractors are more likely to complete bonded projects than non-bonded projects since the surety company may require personal or corporate indemnity from the contractor. The subcontractors will have protection through the payment bond if they are not paid for the goods and services they provide. The bonding capacity can increase a contractor's or subcontractor's project opportunities.

The surety bond underwriter may be able to offer technical, financial, or management assistance to a contractor and the surety company fulfills the contract in the event of contractor default.

1.11. Other types of surety bonds ensure that the principal party meets and fulfills the requirements for a variety of tasks and operations.

Surety Bonds vs Bank Guarantees:

Surety Bond is an option and an alternate to Bank Guarantees. Surety bonds are typically conditional whereas bank guarantees are on demand.

1.12 The difference between Surety Bond and a Bank Guarantee are as under.

Surety Bonds	Bank Guarantees
Document Format	
A contract surety bond is a three-part agreement where the surety guarantees to the project owner that the contractor will perform the contract in accordance with the contract documents. A performance bond protects the owner from non-performance and financial	A bank guarantee may take the form of a performance bond or a form of letter of credit. A bank generally issue bank guarantees which take form of a performance bond include a clause to pay when the bank guarantee is invoked by the beneficiary.

exposures should the contractor default on the contract. It is directly tied to the underlying contract and if the contractor is unable to perform the contract, the surety has responsibilities to the owner and contractor for project completion.	
Security	
Performance and payment bonds usually are issued on an unsecured basis. They are usually provided on the construction company's financial strength and experience and contractor's indemnity and personal guarantees from the contractor's owners. The issuing of the bonds has no effect on the contractor's bank lines of credit and in some instances, can be viewed as a credit enhancement. Unused borrowing capacity can be viewed as an off-balance sheet strength.	A bank will almost invariably require an indemnity from the contractor, personal guarantees from the owners of the contractor, and the tangible security from whoever is able to supply it. Specific liquid assets are pledged to secure Bank Guarantee. Bank Guarantees reduce existing lines of credit. It may appear on the contractor's financial statement as a contingent liability.
Prequalification	
A surety company assesses the contractor's business operations, financial resources, experience, organization, existing workload and its profitability, and management capability to verify that the contractor is capable of performing the contract. The purpose is to avoid default.	The banker examines the quality and liquidity of the collateral in case there is a demand on the letter of credit. If the banker is satisfied that the contractor can reimburse the bank if demand is made upon the letter of credit, there is no further prequalification.
Duration	
Surety bonds remain in force for the duration of the contract plus a maintenance period, subject to the terms and conditions of the bond, the contract documents, and underlying statutes.	Bank Guarantees usually is date-specific, generally for one year and may contain clauses for automatic renewal, with related fees.

Cost	
The cost of a bond varies from 1% to 3% per year, and is calculated on the face value of the bond. Once paid the premium is fixed. The premium is payable up in one lump sum absent any arrangements with surety.	The bank fees are payable at 3 or 6 month intervals and may be payable on the facility amount as opposed to the amounts actually issued. Other administration fees may be payable. Overall cost, direct and indirect is hard to assess given that hard assets are tied up with a bonding facility.
Claims	
Depending on the bond format the surety company will have a number of alternatives in the event of a call, or a threatened call, under a bond. They are: • Finance the original contractor or provide support necessary to allow it to finish the project; • Arrange for a new contractor to complete the project; • Assume the role of the contractor and subcontract out the remaining work to be completed; or • Pay the amount of the bond	While banks have the same alternatives as mentioned alongside, the reality is that given that banks will be holding security, and given also that their expertise lies in areas other than that mediating in contracting disputes, banks will be inclined to pay out and look to the contractor for re-reimbursement.

Surety Bonds offered as Insurance Product in Global Market:

1.13. Surety insurance is a form of collateral and a possible alternative of bank guarantees that is broadly used in the European Union (EU) and the rest of the world as well. Though in many countries, originally banks issued bonds, the security provided by an insurer has proven equally acceptable. The markets such as USA, Brazil, Mexico, Germany, Australia and Philippines issue surety bond as an insurance and many leading companies in these countries have set up separate lines of credit and bonds with surety of insurance companies. The **Chapter IV** covers the International practices on Surety Bonds in detail.

1.14. In the United States, almost all surety bonds are written by insurance companies regularly engaged in the business of acting as a surety. Surety companies typically are authorized and qualified to do business by the state insurance commissioner where they are domiciled and in the jurisdiction where the bond is issued. The state departments of insurance regulate surety companies, which must meet minimum capital requirements, file periodic financial reports in those jurisdictions where they are authorized to do business, and are subject to market conduct investigations, among other regulatory requirements and actions.

1.15. In Brazil, surety bond, being an insurance product, has force majeure exclusion. Insurance law in Brazil allows installment premium in performance bond and normally premium is paid in two installments.

1.16. Mexico has new Insurance and Surety Institutions Law also known as LIFS, marking, amongst other things, a new regulatory framework on insurance surety law. The new law brings into play a new surety insurance product in Mexico called Insurance Bond merging insurance and surety products and blending the legal provisions that apply to both in a relatively revolutionary way. LISF expressly provides that surety insurance shall be recognized and accepted for guaranteeing obligations assumed with the Federal and Local Governments. Insurance companies that desire to offer surety insurance must operate as mono-line insurers. The only other product that may be underwritten by mono-line surety insurance companies is credit insurance.

1.17. The German Civil Code (BGB) regulate the Surety insurance business and Sureties in Germany are permitted to exclude Force Majeure events (Political risk, Terrorism, Pandemic risks). Italian Civil code govern the surety Insurance. The Surety insurance are legally equivalent to bank guarantees The Australian Regulator, APRA, grants approval on a case by case basis, to insurers looking to offer Surety Bond contracts. APRA satisfies itself that the insurer has sufficient expertise and reinsurance support, as part of considering the application to offer surety contracts.

1.18. In China, surety bonds can be issued by banks (ie, bank guarantees) and insurers (ie, guarantee insurance). The bank guarantees are drawn from a company's credit lines on the bank's terms, whereas, an insurer issues a bond to guarantee performance, payments are made in the form of a premium. It is an insurance product governed by the Insurance Law of the People’s Republic of China.

1.19. The leading global insurance companies provide surety bonds. The International Credit Insurance & Surety Association (ICISA) brings together the world’s leading companies. ICISA plays a vital role advising and educating international and multinational authorities and organizations on issues related to credit insurance and surety bonds. Some of the leading global companies providing surety bonds are;

- Atradius is a global provider of credit insurance, surety and collection services, with a strategic presence in over 50 countries.

- Liberty Mutual Surety, a Liberty Mutual business unit, is the United States' second largest surety on a direct written basis and largest on a net written basis and a leading surety globally.
- The Lombard Group provides a portfolio of specialist insurance products to a variety of industries through its respective Short-term and Long-term Insurance licences and the Products offered include, Construction bonds, Custom and Excise bonds, Mining Rehabilitation guarantee.
- QBE Surety is a provider of contract and commercial bonds with capabilities to underwrite surety in many key markets. QBE issues a broad range of surety bonds across various sectors of industry and commerce.
- Zurich Insurance Group is a leading provider of surety bonds, guarantees, trade credit and political risk products and is serving the needs of customers worldwide.
- Chubb offers a wide variety of surety products and specializes in underwriting both commercial and contract bonds and has the capacity for bond issuance on an international basis.

Surety Market for India:

1.20. Performance guarantee bonds to specific customers were issued prior to nationalization of general insurance business and later. The issuance of guarantee bonds had not continued and slowly stopped due to the following reasons.

- It is a non-core business to many insurers and it required expertise.
- It is a risky business, causing possible solvency problems for other insurance products.
- It is a long term nature of business and capital intensive. There would be special focus required on reserving, capital and solvency requirements.
- The regulatory concerns voiced.

The Contract Guarantee Business in India is discussed in **Chapter II**.

The discussions with various stakeholders like insurance intermediaries, finance professionals, bankers handling BGs, surety topic experts revealed the following.

1.21. The Surety Bond for road/civil infrastructure projects market need has been felt since the Indian Banks are now not providing any waivers on collaterals for granting Bank Guarantees. The Banks till recently for their key clients would waive collateral requirements which made Bank Guarantee market very attractive as the main constraint of non-availability of collateral assets was not felt by contractors. However, the big corporate failures resulting in the events of Non-Performing Assets have driven the Banks to exercise tighter controls and obtaining Bank Guarantees process has become more cumbersome for contractors.

1.22. Bank Guarantees in the past was a cross-subsidized product and would often be put in for very low price in the overall bouquet of financial products. With NPA's rising, BG is now getting more and more under scrutiny and, hence, collateral free or low-priced BGs are no longer sustainable.

1.23. Moreover, the cost of BG has now gone up from 20-40 bps to 50-130 bps (and inching upwards as the market becomes tighter). The issue of cost and collateral has basically meant that contractors look for alternate options. The rise in infra projects would also mean that non availability of BGs could become a constraint for project allocation.

1.24. It is observed that a number of contractors are also becoming asset light and moving more and more to outsourcing model and, hence, they have less assets on book. There is, therefore, not enough collateral to support BG. Unlike in case of Surety wherein the sub-contractors are covered, the BG structure requires separate BG for sub-contractors.

1.25. NHAI has also more recently started to put contractors not meeting bid obligations into caution list. This phenomenon in a way replaces the need for "Bid bonds" as contractors are more focused on fulfilling their obligations towards bid/tender requirements. This would mean that BGs (and in future Sureties) would be required more for Performance bonds applicable for the performance period of the contract.

1.26. It was informed that large number of representations were received from contractors, developers by NHAI because providing Bank Guarantees are becoming very difficult. The Banks have increased two components i.e. margin money as well as the commission. Under these circumstances, an alternative option was required. Since in other jurisdictions surety bonds are issued by insurance industry, the matter was represented to the Department of Financial Services.

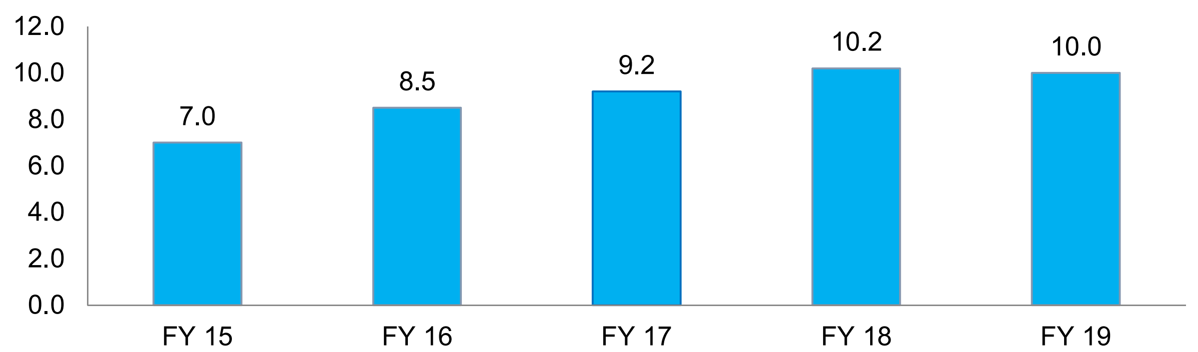
1.27. Hence, the requirement has arisen because banks are not forthcoming as they were doing earlier to provide performance securities at the same cost. Now, banks, in some cases, want 100 % margin money before issuing bank guarantees. High way sector is executing around 5 lac crores projects at the moment and performance security varies to 5 % to 10 %, which this sector requires.

1.28. The projects are now being awarded only after due care such as 90 % of land is available. Only then the Government will award the work which will reduce the risk further. The cost of bank guarantees is increasing. Secondly, as per the conditions of contracts where the defect liability period is 10 years, for which the BG has to be kept live at least for 14 / 15 years – very large time to sustain that BG by the contractors. That is why the contractors are looking for some other economical option.

1.29. NHAI has strict conditions in its bidding conditions and require initially Bid security then the performance security. As far as collaterals are concerned, the cost benefit analysis will be undertaken by contractors. The project has the inherent nature of time over runs. It will be part of the due diligence. NHAI is ensuring good project preparedness which will reduce the project delays.

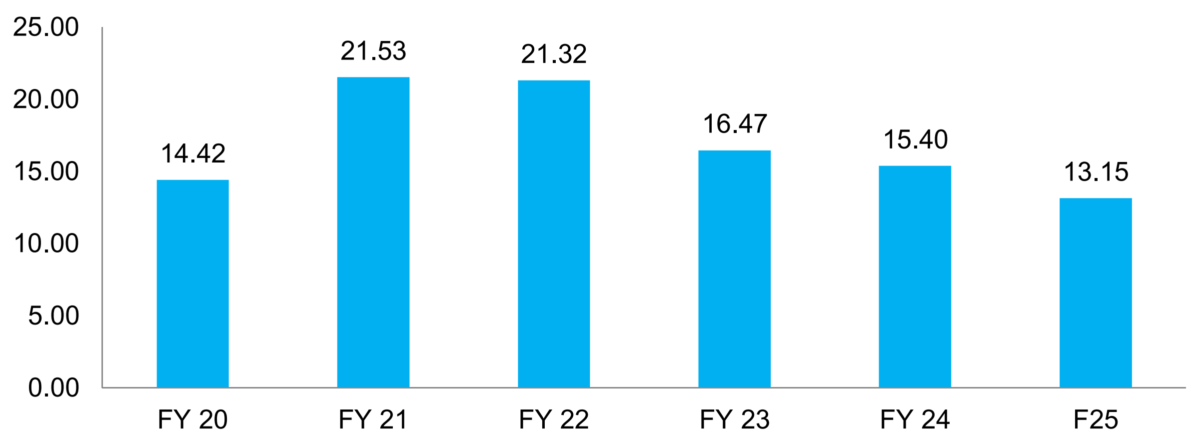
1.30. The following graphs depict the infrastructure investment in India in the last five years and estimated infrastructure investment in the next five years for all sectors and road projects in particular.

Chart 1: Infrastructure Investment in India – Last Five Years (In Rs. lacs Crore)

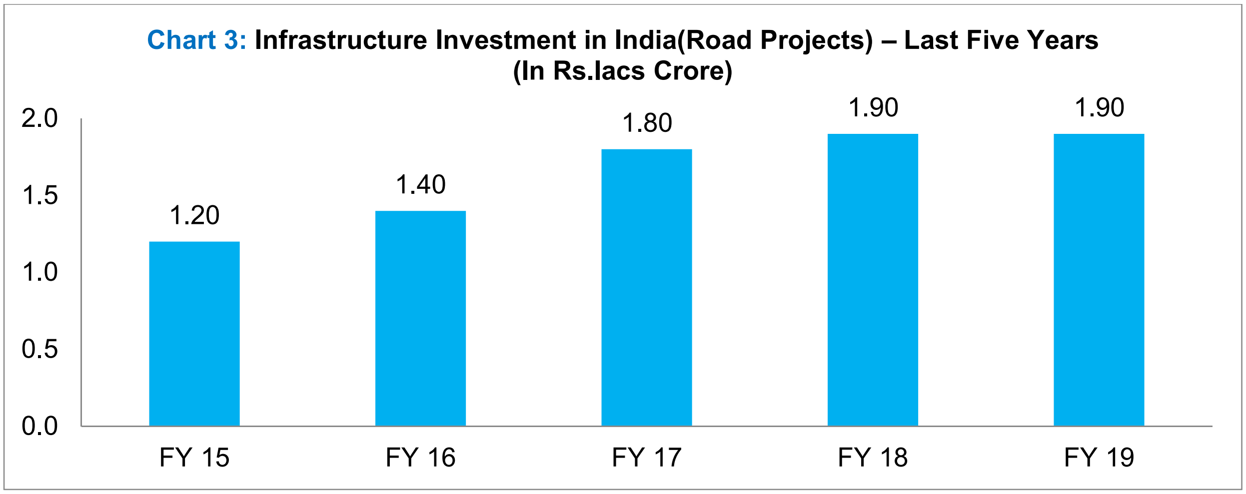


Source: Report of the Task Force National Infrastructure Pipeline (NIP) - volume-II

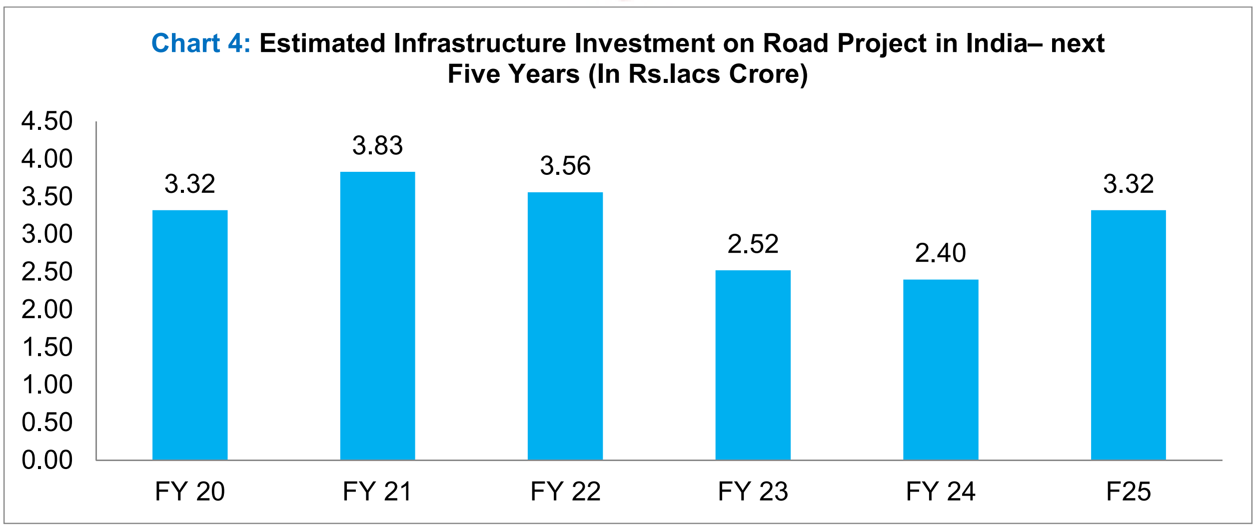
Chart 2: Estimated Infrastructure in next five years (In Rs. lacs Crore)



Source: Report of the Task Force National Infrastructure Pipeline (NIP) - Volume-I



Source: Report of the Task Force National Infrastructure Pipeline (NIP) - volume-II



Source: Report of the Task Force National Infrastructure Pipeline (NIP) - Volume-I.

1.31. Earlier in 2016, Department of Financial Services, had written to IRDAI to explore the possibility of introducing surety bonds in favour of Central Board of Indirect Taxes and Customs (CBIC) (formerly known as Central Board of Excise and Customs (CBEC) to facilitate trade in a big way by substituting Bank Guarantees.

1.32. Due to the COVID 19 pandemic and consequent economic impact on liquidity and cash flow issues in the Indian Banking sector, the Ministry of Road Transport and Highways (MORTH), Government of India, has requested IRDAI to examine possible offering of Surety Bond by the general insurance companies. In this regard, IRDAI has constituted the Working Group to;

a) To study the current Indian legal and regulatory framework with reference to Surety Bonds.

b) To assess the suitability of the Indian Insurance Industry or any other sector to offer Surety Bonds.

c) To provide justification for the recommendations being made by the group, with special reference to the legal and regulatory perspective.

d) Any other matter relevant to the subject.

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1. www.SuretyLearn.org/ www.nasbp.org ,National Association of Surety Bond Producers,
2. www.surety.org, www,sio.org
3. https://www.icisa.org/
4. Surety Bonding in Today's Construction Market: Changing Times for Contractors, Bankers, and Sureties by Marla McIntyre and Dev Strischek The RMA Journal May 2005
5. Surety insurance in China: A line of business on the rise-Kathleen Koh (https://www.peak-re.com
6. Surety bond business (basic)- Munich Re
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Chapter II

Current Legal and Regulatory Framework in India:

Terms of Reference (a)
a) To study the current Indian legal and regulatory framework with reference to Surety Bonds.

The Indian Contract Act of 1872:

The definitions of the "surety" find place in Section 126 of The Indian Contract Act of 1872. It defines the terms "contract of guarantee", "surety", "principal debtor" and "creditor".

2.1. A “contract of guarantee” is a contract to perform the promise, or discharge the liability, of a third person in case of his default. The person who gives the guarantee is called the “surety”; the person in respect of whose default the guarantee is given is called the “principal debtor”, and the person to whom the guarantee is given is called the “creditor”. A guarantee may be either oral or written.

2.2. A contract of guarantee, as the section classifies, involves three parties, namely: the creditor, the surety and the principal debtor, and a contract to which those parties are privy. Thus, the contract between the principal debtor and the creditor is primary. Then there must be a contract between the creditor and the surety by which the latter guarantees the debt. However, in order to constitute a contract of guarantee, there must be a third contract, by which the principal debtor expressly or by necessary implication, requests the surety to act as a surety.

2.3. Under Section 128 of The Indian Contract Act of 1872, the liability of the surety is co-extensive with that of the principal debtor, unless it is otherwise provided by the contract. There can be no contract of guarantee if liability does not exist. The liability of the guarantee presupposes the existence of a separate liability of the principal debtor and his liability is thus secondary, which comes into existence only in default by the principal debtor.

Contract of Guarantee and Contract of Indemnity:

2.4. As per Section 124 of The Indian Contract Act of 1872, a contract by which one party promises to save the other from loss caused to him by the contract of the promisor himself, or by the conduct of any other person, is called a “contract of indemnity”.

2.5. Contracts of guarantee are distinguished from contracts of indemnity by the fact that a guarantee is a collateral contract, that is, ancillary or subsidiary to another contract, whereas an indemnity is a contract by which the provision undertakes an original and independent obligation.

The various provisions in respect of contract of guarantee/surety are enshrined in the sections 126 to 147 of The Indian Contract Act of 1872.[1]

Indian Foreign Exchange Regulation Act, 1947:

2.6. The Indian Foreign Exchange Regulation Act, 1947[2] and the Exchange Control Manual contain several provisions dealing with export and import guarantees and special provisions governing guarantees for persons residing outside India.

2.7. The Exchange Control Manual issued by the Reserve Bank of India, permits authorized dealers, who are banks recognized as authorized dealers in foreign exchange by the Reserve Bank to furnish performance bonds or guarantees (including those in lieu of earnest money) in favour of overseas buyers on account of Indian exporters.

2.8. The Exchange Control Manual requires that applications from importers for guarantees in favour of foreign manufacturers or suppliers of goods for payments against imports into India should be referred to the Reserve Bank for prior approval. It is specifically stipulated by the Manual that such applications will be ordinarily entertained only in respect of import of machinery and heavy equipment proposed to be imported under licences authorizing deferred payments and should be supported by the necessary documents.

2.9. Under the Indian Foreign Exchange Regulation Act, 1947, Section 18 (3-c), a person, resident in India, can give a guarantee in respect of any debt or other obligation or liability of a person resident outside India, only upon the general or special permission of the Central Government or the Reserve Bank of India. The Reserve Bank of India, however, has given authorized dealers a general permission to give guarantees in favour of persons resident in India in respect of any debt or other obligation or liability of persons resident outside India subject to such instructions as the Reserve Bank may from time to time issue to them. The general permission is also given to firms and companies resident in India to give guarantees to income-tax officers and other authorities under the Income-tax Act, 1961, in respect of taxes due by nationals of foreign states in the employ of such firms or companies.

2.10. The Exchange Control Manual further authorizes dealers to give on behalf of their overseas head offices/branches/correspondents performance bonds or guarantees in favour of residents in India in support of tenders to be submitted for the due performance of contracts, or for the refund, in the event of contracts not being fulfilled of advance payments received. The requirement, however, is that the bond of the guarantee is covered by the counter-guarantee of the head office/ branch/ correspondent.

The Insurance Act, 1938 & Insurance Rules, 1939:

2.11. The Insurance Act, 1938[4] in Section 64VB. (1) mandates that no insurer shall assume any risk in India in respect of any insurance business on which premium is not ordinarily payable outside India unless and until the premium payable is received by him or is guaranteed to be paid by such person in such manner and within such time as may be prescribed or unless and until deposit of such amount as may be prescribed, is made in advance in the prescribed manner.

2.12. Under Section 64VB (5) of The Insurance Act, 1938, the Central Government may, by rules, relax the requirements of sub-section (1) In respect of particular categories in insurance policies.

2.13. The Rule 59 of Insurance Rules, 1939[5], it is mentioned that in respect of the categories of insurance policies mentioned there under the requirements of sub-section (1) of Sec. 64-VB shall stand relaxed to the extent and in the manner mentioned against each category of policy, subject to the conditions mentioned therein:

2.14. The Rule 59 (i) of Insurance Rules, 1939 refers to Contract Performance Bonds or Guarantees as a long term category of insurance policy issued for a period of more than one year.

2.15. Policies issued for a period of more than one year. In the case of policies issued for a period of more than one year, such as Contract Performance Bonds or Guarantees, Contractors' "All Risk" policies. Machinery Erection policies and the like, the premium may be staggered as necessary according to custom, over the period of the cover, provided that the first equated instalment is higher than any other instalment by at least 5 per cent of the total premiums payable and each instalment is paid in advance. Where the premiums are payable by declarations, they may be paid within fifteen days from the dates of receipt of declarations. ``

2.16. The section 64VB (1) and (5) of The Insurance Act, 1938 read with the Rule 59 (i) of Insurance Rules, 1939 recognizes the Contract Performance Bonds or Guarantees which are also termed as Surety Bonds as insurance contracts.

2.17. In terms of Section 2. (13 B) of Insurance Act, 1938, Contract Performance Bonds or Guarantees or Surety Bonds can be categorized as an insurance contracts falling under miscellaneous insurance business of general insurance business.

Framework on Contract Guarantee Business in India in pre IRDAI era:

2.18. The then General Insurance Corporation of India issued guidelines[6] for transaction of business including nature of guarantee permitted to be issued, limits of sum insured, underwriting and premium in respect of bonds. Under this type of guarantee bonds fall different type of guarantee bonds like Earnest Money (Tender Deposit Bonds) Performance, Security Deposit. Advance Payment, Retention Money Bonds. These Bonds were issued on behalf of civil contractors who are awarded contracts from Public Sector Organizations, Big Private sector companies. The other types of bonds included Customs Bonds, Excise Bonds, Coffee Bonds.

2.19. The indicative guidelines in respect of Contract Guarantee Bonds were as under.

- The party`s audited accounts for the last three years should indicate satisfactory results. The party should have adequate finances of their own or they should command good credit to enable them to obtain business credit to complete the contract successfully. The sufficiency or otherwise of the working capital in respect of contractor also would have a vital bearing on the successful performance of the contractors. This factor apart from other factors should, therefore, be closely looked into. The net worth and financial position of their Directors/partners should be satisfactory.

- The party should have the necessary capacity to perform the type of contracts which they undertake i.e, they should have the requisite experience, expertise and evidence of successful past performance of similar contracts. The list of contracts performed by the party for the last five years as also the contracts outstanding were to be obtained.

- The ratio of risk capital to liabilities should not normally exceed 1:4. As a rough measure, the guarantee limit sanctioned should not normally exceed three times the risk capital of the party. Normally, the counter guarantee of the company or firm and some of the directors/partners in their individual and joint capacities should be suffice except in some circumstances. Special care should be taken in case of sanctioning advance payment and retention money bonds.

- The price escalation clause should be included in case the period of contract exceeds more than a year. Where the contract exceeds certain value, the agreement between principal and contractor should include Force Majeure Clause.

- The duration of Bonds depends on case to case as per the period of contract. It can be extended wherever required by clients/insured.

- As a security, in addition to counter guarantee of company and their directors, some margin money in the shape of FDR of a Bank and mortgage of tangible securities from the client was to be taken.

Current Regulatory Framework in India:

2.20. Insurance Contracts have to be compliant with various laws, regulations, guidelines and directions issued by IRDAI from time to time. The insurance product shall ensure not only compliance with these legislations and guidelines, but in the process, meets larger objective of product being fair and transparent to customer and takes care of policyholders' rights and interests in an adequate manner.

2.21. Currently, the guidelines on product filing procedures for General Insurance products issued under the provisions of Section 14 (2) (i) of the IRDA Act 1999 provides a regulatory framework for general insurance products in India. These guidelines shall apply to all general insurance products whether or not governed by the erstwhile tariff and include all products those are in the market and noted by the Authority under any of the earlier File and Use guidelines.

2.22. The para 6 of guidelines on product filing procedures for General Insurance products provides guiding principles for product design and rating. One of the principle requires that the product should be a genuine insurance product covering an insurable risk with a real risk transfer. "Alternate risk transfer" or "Financial guarantee" business in any form shall not be accepted including indirect insurance products such as insurance derivatives.

2.23. As per definition in Circular Ref: IRDAI/NL/CIR/CRE/044/03/2016 dated 10th March, 2016 on Guidelines on Trade Credit Insurance, Financial Guarantee" is understood as comprising any bond, guarantee, indemnity or insurance, covering financial obligations in respect of any type of loan, personal loan and leasing facility, granted by a bank/credit institution, financial institution or financier, or issued or executed in favour of any person or legal entity in respect of the payment or repayment of borrowed money or any contract, transaction or arrangement —primary purpose of which is to raise finance or secure sums due in respect of borrowed money.

2.24. In this regard, it is noted that the financial guarantees are given for securing an outstanding financial obligation in a commercial transaction. Performance guarantees on the other hand are issued to cover risks related to the non-performance of certain terms and conditions of the underlying contract between the contractor and the Beneficiary or sponsor. Performance guarantees are essentially transaction related and given to secure the performance of a contractual obligation. The guarantees cover delays in execution of contract, substandard execution of contract and non-fulfillment of the terms and conditions of the contract by the Contractor.

2.25. Hence, the above guiding principle barring financial guarantee business will not hold for all types of Surety Bond contracts. Moreover, the relevant sections in Insurance Act, 1938, read with the rules of Insurance Rules, 1939 confirm that Contract Performance Bonds or Guarantees or Surety Bonds are insurance contracts. Accordingly, the business was carried out in the past under the guidelines of erstwhile GIC of India.

2.26. The proposed Indian Accounting Standard -Ind AS 117 on Insurance Contracts (earlier known as Ind AS 104) issued by the Accounting Standards Board of the Institute of Chartered Accountants of India contains examples of insurance contracts that includes surety bonds. As per Appendix B of B-26 (f**) surety bonds**, fidelity bonds, performance bonds and bid bonds (ie contracts that provide compensation if another party fails to perform a contractual obligation, for example an obligation to construct a building).

2.27. The equivalent and comparable insurance products to Surety Bonds would be the credit default insurance contracts. It is gathered that one of the product currently with ECGC Ltd (formerly Export Credit Guarantee Corporation of India Ltd) bearing name Export Credit Insurance for Banks–Surety Cover (earlier known as Export Performance Indemnity) was introduced during the year 1967 with approval of Government of India and since then it is being issued to Banks. This is a non-financial product and issued to the Banks covering the risk of default/insolvency of the exporter. It covers Bid Bond Guarantee, Performance Guarantee, Advance Payment Guarantee, Retention Money, Export Performance and sub-coverages thereunder.

2.28. The products namely Contract Guarantee and Performance Guarantee Insurance existing with two other general insurers covers against losses out of failure of contractor/ principal to complete the contract entered into with the beneficiary or delay in completion thereof.

2.29. However, IRDAI vide circular ref: IRDA/NL/CIR/159/09/2010 dated 27th September, 2010 on examination of credit default insurance contracts has come to the conclusion that the insurers are underwriting risks which do not have proper regulatory framework or sanction. Hence, in exercise of powers under Section 14(1) and 14(2)(i) of the IRDA Act, 1999, the Authority ordered that all general insurers (except ECGC) to stop selling these policies till such time the Authority comes with detailed guidelines in this regard.

2.30. Subsequently, IRDAI has issued Guidelines on Trade Credit Insurance on 13th December, 2010 which were later revised on 10th March, 2016 vide Circular Ref: IRDAI/NL/CIR/CRE/044/03/2016, considering the changes in economy and the enhanced need for trade credit insurance. Once again, the Authority has revisited the Guidelines on Trade Credit Insurance.

2.31. In a similar manner, the Contract/Performance Guarantee/Surety Bonds considered and marketed as insurance products shall necessarily have a different regulatory treatment. The key recommendations in the report consist of the various aspects of regulatory framework required for reviving underwriting the surety business in India.

References:

1. The Indian Contract Act, 1872
2. Reserve Bank of India, Exchange Control Manual
3. Chapter VIII The Indian Law of Guaranties and Securities- BY Vathsala Mani
4. The Insurance Act, 1938
5. Insurance Rules, 1939
6.Selected Guidelines of GIC of India reproduced in the Insurer circular

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Chapter III

Banking Practices on issue of Bank Guarantees in India

Bank Guarantee

Definition:

A Bank Guarantee (**BG**) is a commercial instrument, in the nature of a contract, issued by a bank (**Guarantor**) on behalf of its customer (**Applicant**) favoring a third party (**Beneficiary**) under which the guarantor undertakes to pay to the beneficiary in case of breach of contract/performance by the applicant.

3.1. Guarantee issuing bank is liable to make payment upon receipt of claim from the beneficiary subject to the conditions specified in the BG.

Types of Bank Guarantee:

3.2. Following are the types of bank guarantees issued by banks:

I. Bid Bond Guarantee

a. Issued for enabling participation in a bid by the applicant.
b. As part of the bidding process, this guarantee assures that the bidder would undertake the contract on the bidding terms if he is the winning bidder.
c. Low risk for bank since BG tenure is very short and is only valid if the applicant is successful.
d. Project assessment for issuing bid bond guarantee is generally not required.
e. Generally, companies bid for multiple projects by submitting bid bond guarantee since success ratio is low.

II. Performance Bank Guarantee (PBG)

a. PBGs are generally issued as a specific % of the total contract value.
b. PBGs are transaction related contingencies that involve an irrevocable undertaking to pay a third party in the event the counterparty fails to fulfil or perform a contractual non-financial obligation.
c. In such transactions, the risk of loss depends on the event which need not be related to the creditworthiness of the counterparty involved.
d. Tenure of the bank guarantee is linked to the execution period of the contract.
e. High risk product wherein status of project needs to be continuously monitored.

III. **Advance Payment Guarantee**

a. Supports performance of a contract or payment obligation for which advance payment has been received by the applicant from beneficiary.
b. Risk on the guarantee reduces gradually on progress of the project since the advance paid by the beneficiary is adjusted on each bill raised by the contractor.

IV. **Retention Bank Guarantees**

a. Retention money is a part of the amount payable to the contractor, which is retained and payable at the end after successful completion of the contract.
b. Retention Money guarantee is issued to ensure that retention money withheld by the beneficiary is released to the applicant (contractor) so that he gets sufficient working capital to complete the contract.
c. Low risk since the guarantee is generally issued at the fag end of the contract where majority of the work is complete and banks are in a better position to assess the project.

V. **Others**

There are other types of BGs issued by banks which include guarantee for income tax, GST, customs payments and other statutory requirements.

Market size:

3.3. The total bank guarantee outstanding is about ` 10,000.00 billion and considering average commission of 0.75% on the outstanding amount being charged by banks, guarantee commission income could be about ` 75.00 billion on an annual basis.

3.4. Bank guarantee exposure as a percentage of total banking system advances is about 10%. The following graphs show the Bank guarantees issued by Indian banks for infrastructure in last five years and road projects in particular (In Crore).

Chart 5: Bank guarantees issued by Indian banks for infrastructure in last five years
(Rs. In lacs Crore)

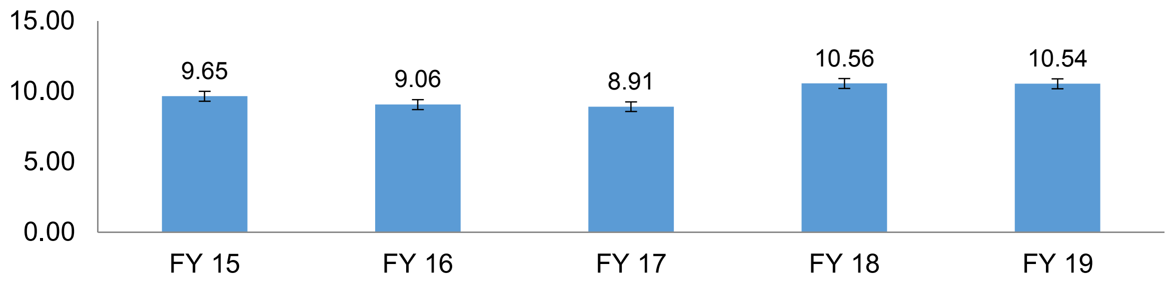
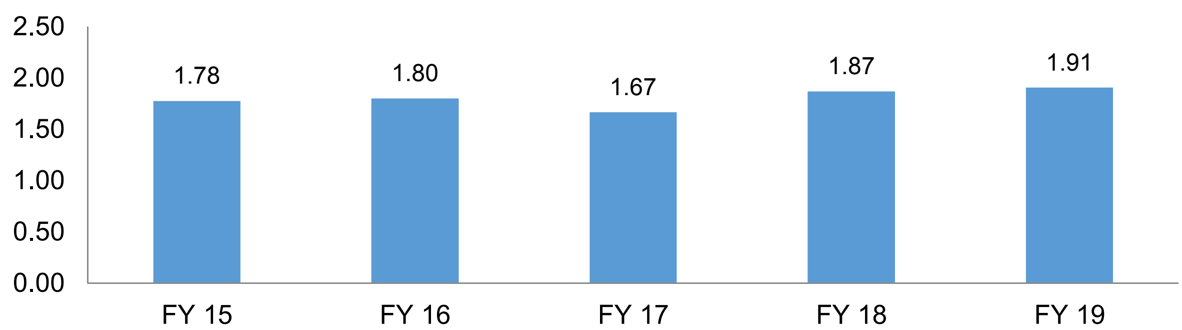


Chart 6: Bank guarantees issued by Indian banks for road in last five years
(Rs.In lacs Crore)



Source: https://m.rbi.org.in/scripts/bs_viewbulletin.aspx/searchnew/BS_ViewBulletin.aspx

Rationalisation of Bank Guarantee exposure by Banks:

1. Various alternate products (term loan, demand loan, export credit, etc.) are available with banks.
2. BGs are typically low on yield and long in tenure.
3. Bank guarantees issued for a project generally gets extended beyond the original tenure due to delay in project completion and subsequent release also takes time.
    - Release of BGs even after completion of project gets delayed in some cases.
4. Security available with banks for BGs in most cases is charge over current assets of the Company resulting in limited recovery in case of invocation and subsequent legal proceedings.
5. Invocation of BGs have increased significantly over the last 5 years where loss given default for banks is high.
6. Banks have thus started focusing on higher yielding products having lower risk profile compared to BGs.

References:1.Criteria for a contractor for being offered Surety Bond.
https://cdn.ymaws.com/www.surety.org/resource/resmgr/learnaboutsurety

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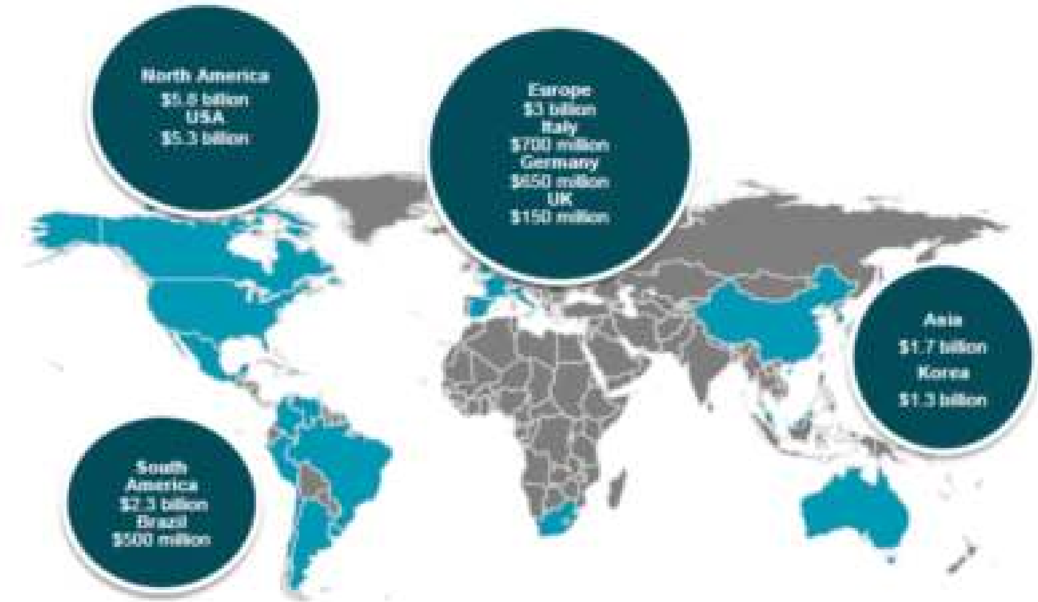
Chapter IV

International practices on Surety Bonds

Global Context for Surety Bonds



This chapter covers product and regulatory overview of some of the key markets (ex. USA, Brazil, Mexico, Germany, Australia and Philippines) representing key markets across the globe. Subsequent to the country overview, the WG has suggested recommendations based on best practices observed in context to the Indian market.

4.1. The global surety industry had a **premium volume of US$ 13 billion** (2013, Swiss Re's Sigma Report) up from US$ 7.4 billion in 2003 increasing nearly **76%** in a decade. In terms of the global market, the market penetration rate as a percentage of GDP for all the countries combined stayed at 0.022% mirroring the figure from 2003. Average growth rate for the global market stayed at 6% for the entire decade.

4.2. As of 2013, USA had the largest share of surety premium placed at 40% of total global premium valued at US$ 5.3 billion. Additionally, South Korea followed suit at 11% of the total premium valued at US$ 1.4 billion. In the decade from 2003 to 2013, Latin America registered the most expansion in surety. Overall the Latin American market grew from 7% premium volume in 2003 to 17% premium volume in 2013.

4.3. Brazil grew on average by 28% per annum between 2003 and 2013, Chile by 20% and Colombia by 17%. Since 2003, the region's premiums increased four-fold, while the rate of surety insurance as a percentage of GDP (penetration) doubled to 0.044%, or 30% above the rate of North America at 0.033%.

4.4. Europe's market share over this period remained largely stable at roughly 23%. The most dynamic market was Germany, almost tripling its premiums in the past ten years, while Italy, historically Europe's largest surety market, grew by just 20% in the same period.

North America (US, Canada):

4.5. The North American market, inclusive of USA and Canada, has the biggest surety market in the world in terms of surety premium placed. Sureties in North America exist since mid-1800 with USA being one of the first countries to have a legislation requiring surety bonds for infrastructure construction projects.

History of Surety in North America:

4.6. In 1853, New York State enacted the first law authorizing creation of corporate surety firms, however, the first surety company in North America was founded in 1865 named the **Fidelity Insurance Company (FIC).** The FIC bought ideas about surety from old world to the new.

4.7. The first surety company in Canada was **Citizens Insurance Company** and was founded in 1868. Citizens Insurance Company did not last though, as in 1881 it was discontinued and merged with **Canadian Guarantee Company** to assume risks.

4.8. The years from 1883 to 1898 saw nearly 25 new surety companies as the market progressed. American Surety Company, Inc. founded in New York in 1884 was the first successful company in the USA that was committed to underwriting and drew even more attention to the rising surety industry in the country.

4.9. Surety bonds had become so prominent and proved so useful that the United States Congress began requiring them. Congress used them to fix the problem the US Government had with private construction firms not completing government contracts for public works projects. In 1894, Congress passed the **Heard Act** which required corporate surety bonds on all federally funded projects to ensure project completion and decrease the amount of tax payer dollars wasted on unfinished projects.

4.10. Prior to the Heard Act, bonds with USA as the obligee were issued by individuals. The government found it difficult to collect on surety bonds issued by individuals and saw corporate surety companies as a major improvement.

4.11. Loose regulations and active corporate and private markets led to frauds and insolvencies. Surety companies running into losses was an everyday affair and hence to tackle this commotion, in 1908, 14 corporate sureties formed The Surety Association of America which promoted fairer trade.

4.12. In 1935, Heard Act was replaced by the **Miller Act** of 1935, which made more rigid guidelines for the kind of bonds contractors had to obtain for federally funded projects. Miller Act required **performance bonds** on public works projects greater than **$100,000** and **payment bonds** for contracts greater than **$25,000.**

4.13. The Miller Act proved to be so effective that many states, counties and municipalities adopted Little Millers Act. Because of these laws, it is almost impossible, even today, to do any kind of public works project and not have bid, payment and performance bonds in place.

4.14. In late 2017 the **Ontario Construction Act of Canada** was amended to include surety bonds requiring contractors, who enter into a contract with an owner that is the Crown, a municipality or a broader public sector organization, to furnish the owner with a labour and material payment bond, and with a performance bond, if the contract price is above the amount set out in the regulations.

4.15. Following USA's suit, the Construction Act of Ontario requires any contractor who enters into a public contract in the amount of $500,000 or greater to provide 50% performance and payment bonds using the prescribed forms.

Market overview:

4.16. According to Surety and Fidelity Association of America (SFAA), the overall surety premium placed in the market by all surety writers was US$ 6.2 billion in 2017 which increased to US$ 6.5 billion at the end of calendar year 2018. From there on the surety premium increased to **US$ 6.9 billion** by the end of calendar year 2019.

4.17. The surety premium has increased two folds in the last couple of decades from **US$ 2.9 billion in 1998 to US$ 6.9 billion in 2019**. Historic legislation, dynamic market encompassing contractors from small to mega projects and acceptance of surety bonds by the state has led to this growth.

4.18. Figure hereunder shows the graph for total premium earned and the loss ratios from the year 2017 to the year 2019. In 2017, the loss ratio stood at 16% and decreased to 13% in 2018 leading to a higher premium earned in total by all the companies. The loss ratio rose to 19% in 2019 due to the hardening construction market in the country.

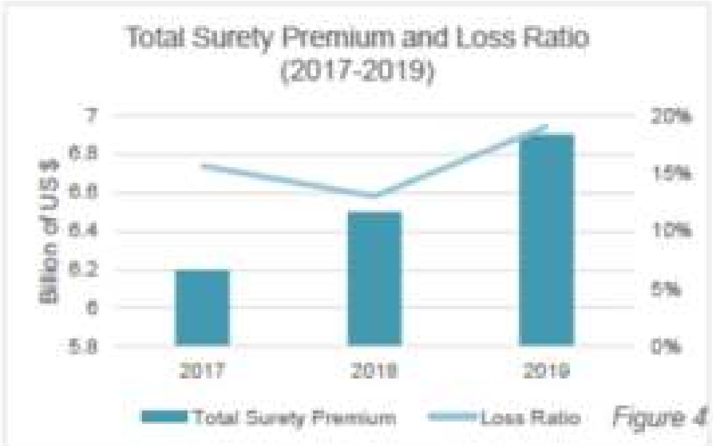


Chart 7:

4.19. For large projects (US$ 100 million-US$ 250 million) there is abundant capacity in sectors such as oil and gas and healthcare where the amount of work is increasing, and the larger contractors are taking advantage of the same.

4.20. The capacity for medium and smaller projects has been on the rise and is considered as a sweet spot for majority of surety providers. However, a large number of surety providers are marketing for small and medium-size accounts. The providers are challenged to remain disciplined, as contractors in the middle market may have interest in expanding outside of their normal geographical area or pursue projects that are much larger or more complex than their typical projects.

Credit Enhancement for Small and Emerging Contractors:

The large capacity for small projects is supported by Government sponsored Small Business Administration's (SBA) **Surety Bond Guarantee Program**.

4.21. For more than 40 years, the Surety Bond Guarantee (SBG) program has helped small and emerging contractors who have the knowledge and skills necessary for success but lack the combination of experience and financial strength to obtain bonds through regular commercial channels. **The SBA guarantees** bid, performance, and payment bonds issued by surety companies to **small and emerging contractors** and reimburses the surety a percentage of loss if the contractor defaults.

4.22. This government guarantee allows sureties to write bonds for contractors who otherwise would not meet their minimum standards—thus providing small and emerging contractors with contracting opportunities for which they would not otherwise qualify.

4.23. In order to be eligible for the program, the contractor must be listed as a small business under North American Industry Classification System code. The contracts that the contractor is bidding for should be less than US$ 6.5 million. SBA can give guarantees on projects up to US$ 10 million if a federal contracting officer certifies that SBA's guarantee is necessary in order for the small business to obtain bonding.

4.24. Under the Prior Approval Program, SBA must approve each bond guarantee individually, based on information submitted by the surety. The SBA's guarantee percentage is 90% if the contract is $100,000 or less, or if it is awarded to a socially or economically disadvantaged or veteran- owned or service-disabled- owned firm. Otherwise, the SBA's guarantee is 80%. The surety bond producer reviews the application package and recommends it to the surety company for approval.

4.25. If the surety company agrees to issue a bond with the SBA guarantee, the package is forwarded to the appropriate SBA/SBG Area Office for evaluation. If the SBA determines that the applicant is eligible, the SBA may issue a guarantee to the surety company. The surety then issues the bond to the contractor. The SBA's guarantee agreement is with the surety company on behalf of the small business contractor.

4.26. In India, Ministry of Micro, Small, and Medium Businesses runs various schemes to aid the smaller businesses in development such as the Credit Guarantee Scheme where the businesses eligible for these schemes can approach approved banks and can get collateral free loans up to **Rs. 50 lakhs (US$ 66000). This can be extended for issuance of surety bonds also and in such** cases surety bonds and government guarantees can work more efficiently than banks to **secure and promote the MSME sector within India.**

Regulatory environment - Protection for Surety Providers:

The United States is one of the countries to have laws and acts in place for specifically protecting surety providers issuing bonds for public work contracts.

4.27. The **Right of Subrogation** is one such act. It states that if the surety is required to pay or perform due to the principal's failure to do so, the law will usually give the surety a right of subrogation, allowing the surety to **"step into the shoes of"** the principal and use the surety's contractual rights to recover the cost of making payment or performing on the principal's behalf, even in the absence of an express agreement to that effect between the surety and the principal.

4.28. Due to the specific nature of surety bond providers, this act has important implications as when a principal defaults, the surety will step into their shoes to complete the project or subcontract the remaining work rather than allowing the project owner to unfairly call a surety bond.

4.29. In case of a surety bond being called and the surety provider has to step in and complete the work/make payments for the rest of the project duration, The General

Agreement of Indemnity (GAI) provides the surety with a means to be reimbursed in the event that it incurs costs and losses under the bonds it issues to the contractor.

4.30. If a surety reviews a claim and finds that the principal is in default, the surety will typically first give the principal the opportunity to pay the claim amount. This is usually a preferable option for principals who are able to pay. If the principal does not pay when given the opportunity, the surety will then pay the claim amount up to the penalty sum. The principal will then be legally required to pay the surety back.

4.31. A GAI gives a surety several different powerful legal tools for enforcing the provisions of a surety bond. These typically include requirements such as principal indemnifying and holding surety harmless from any liabilities, the principal cooperating with the surety in investigation of the claim, the surety provider has the final right to either reject or accept a claim.

4.32. The GAI is usually signed as a separate document and serves as an important reminder for the principal to complete their obligations to the project owner and at the same time assures the surety provider that they're protected in case of a default.

Underwriting, Pricing and Claims:

Underwriting

While taking underwriting and pricing decisions, the surety/insurer takes the following main factors into account:

4.33. Capital (Analysis of Financial Statements) – Here the Surety takes into considerations the financial position of the contractor on whose behalf the surety bond is to be issued. Some of the inputs that are required are assessment of profitability and cash flow from operations, liquidity, leverage and net worth of the contractor.

4.34. Capacity (Analysis of Work History) – Here the surety attempts to assess the ability of the contractor to fulfill the contract for which the surety bond is sought. The surety looks at the past performance of the contractor, large jobs conducted and fulfilled previously, the projects currently under implementation and operational capability of the contractor to take on future projects.

4.35. Character (Analysis of Contractor Reputation) – Here the surety looks at factors like market feedback on the contractor and seeks external third party references to determine the market reputation of the contractor.

Surety takes these factors into account and while evaluating bond requests and provides approval or pre-qualification for select chosen contractors.

4.36. Prequalification is preliminary approval of a prospective bond principal (contractor) based on factors such as credit strength, competence, and character. Only qualified bond applicants (contractors) receive a bid bond and a performance bond and pay the appropriate premium.

Pricing

4.37. Surety pricing is primarily market driven, however analytics from internal data and Industry organizations has emerged to supplement underwriting and the industry is slowly moving toward data driven decision making

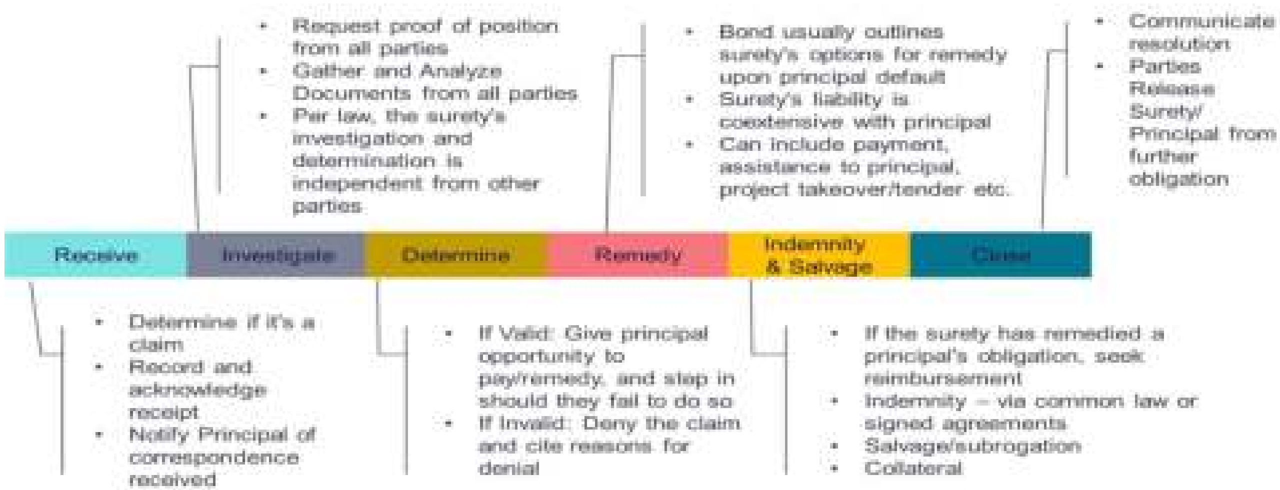
Market Driven Pricing: surety bond prices are typically market driven and varies basis underwriter's assessment of risk of individual accounts based on financial statements and work in process documents.

Rates: While degree of regulation of surety bond rates varies by country; capital requirements are a more effective way to safeguard against insolvency

Actuarial Analysis/Analytics: Traditional actuarial methods like rate level indications are not used due to low data credibility. Analytics are emerging in the industry to supplement traditional underwriting and loss cost determination. Analytics coupled with actuarial techniques can advise on whether proposed rate covers account expected losses and costs of business.

Claims

4.38. Given below is a pictorial representation of the usual claims cycle in Surety Bonds:



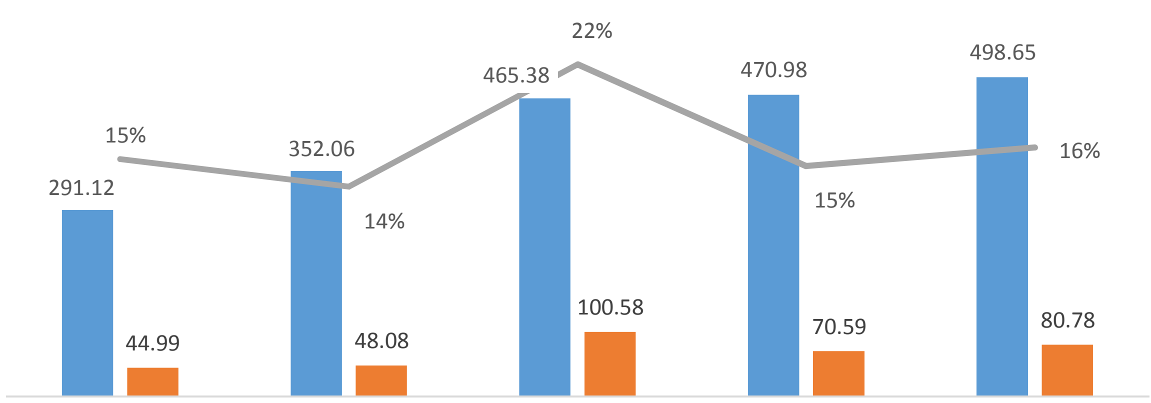
Brazil

Market overview:

4.39. Amongst Latin America market which itself is a vibrant Surety market, Brazil places the highest amount of surety premium. Brazil undertook one of the most important steps towards the creation of a more robust legal framework applicable to surety bonds in 1994, when the Federal Law number 8.883 expressly included Surety Bonds in the list of guarantees which can be bought by the contractor. This law ensured that Surety Bonds to be a reliable and acceptable guarantee for public contracts, at the same level of the existing ones.

4.40. In Brazil, surety bonds are divided into two major categories: Public and Private Surety Bonds. Therefore, surety bonds can be used in all, public and private contractual relationships, as well as in all governmental and tax procedures. Surety market in Brazil though is dominated by Judicial Bond (80% market) which are of course slightly different than the surety bonds WG is discussing and the remaining being the infrastructure related surety bonds. As at 2019, the total Surety bond market in Brazil was close to USD 500 Mln, growing by 6% per year.

4.41. In Brazil, Surety and Bank guarantee co-exist side by side and slowly surety is taking more prominent role in public projects. Surety Providers in Brazil and in Latin America are also active beyond construction sector and in some parts, surety providers are cooperating with banks to provide back-to-back cover for risk that increase bank's capacity or business interest.



Product framework (Pricing, Markets):

4.42. Surety premiums represents 0.03% of GDP & 0.16% of Public Expense as of December 2016. Due to higher competitive intensity, Brazil Surety insurance market is interpreted as "soft" and average rate on line is close to 0.5%. The major Surety players in the market are Pottencial, Junto (Travelers), BTG, Fairfax and key reinsurers operating in the market are IRB, Munich Re, Swiss Re, Hannover Re and Everest.

4.43. Average Duration of the performance bond is limited to 5 years. Performance bond can be equivalent to 10% of the contact value, however a bill has been recently introduced in Brazilian Senate to increase to 30% of the contract value.

4.44. Surety bond being an insurance product excludes acts generated by the beneficiary and also have force majeure exclusion.

4.45. Indemnity agreement is executed as separate contract along with surety mandate and it is mandatory to have indemnity agreement.

4.46. Indemnity agreement is linked to principal's contractual obligation and triggered with non-execution of the contract.

Regulatory Environment:

4.47. Performance bond is regulated by Bidding law which is law no 8666/1993 which was amended through a new bill (559/2013) approved by the Senate.

4.48. The bill is awaiting review by the Chamber of Deputies, where it is identified by number 6,814/2017.

4.49. Major changes proposed in the new bill:

a) Increase the limit of the guarantee which is currently limited to 10% to 30% - 100%

b) Brazilian performance bond law is inspired by US model (Heard/Miller Act)

c) Up-to 100% performance guarantee for major projects (project size of BRL 100Mn)

d) the insurer shall sign the contract, including the additives, as intervening party, and may:

i. have free access to the premises where the main contract is carried out;

ii. supervise the execution of the main contract and attest to the conformity of the services and materials employed in the execution of the agreed terms;
iii. perform technical and accounting audits;
iv. request clarification from the technical responsible for the work or the supply

e) the insurer may subcontract the conclusion of the contract, in whole or in part.

f) Brazilian Civil Code regulate the Force Majeure (including political risk, terrorism and pandemic risks etc.)

g) Insurance law in Brazil allow installment premium in performance bond and normally premium is paid in two installments.

Mexican Surety Market:

4.50. Surety bonds have been an important concept for over a century in Mexico. The bonds have been an important guarantee tool due to the reason that the Mexican Government requires to guarantee the contractual obligations through bonds, which prevail over other type of guarantees such as standby letter of credit.

4.51. Due to the fact that surety bonds are trustworthy guarantees, they are being used by private entities. The bonds are regulated by the Federal Act of Bonds in Mexico, which divides them into five distinct divisions.

4.52. As opposed to other surety markets in Latin America, the Mexico market has seen a different pattern in terms of surety premium growth. There was a 5% growth in from the year 2007 to the year2008 from US$ 427.1 million to US$ 448.5 million. Surety premium saw a dip in the year 2009 to a mere US$ 353.5 million and saw a steady increase till 2014 which accounted for the highest premium in a decade to US$ 570.3 million.

4.53. Surety corresponds to 1.70% of the total insurance portfolio in Mexico and represented 20.5% of the total premium placed in Latin America as of 2016. Surety premiums in 2016 represented 0.04% of the total Mexican GDP and 0.32% of the total public expense.

Market overview:

The Federal Bonds Act divide the surety bonds into five distinctive divisions known as Ramo.

4.54. Ramo 1/ Division 1 consists of Fidelity Bonds also known as *Fidelidad*. Fidelity bond guarantees possible material or financial resources loss committed by the employees against the company's patrimony such as robbery, fraud and breach of trust. The validity for this bond is usually 12 months or before if the bond is called for.

4.55. Ramo 2/ Division 2 consists of Judicial Bonds which are further divided into Penal and Non-Penal bonds. The judicial bonds in Mexico function similar to their counterparts in Brazil. The bond amount is usually 100% of the penalty as established by the court.

4.56. Ramo 3/ Division 3 consists of Performance bonds, Advance payment bonds, Hidden defects bonds, Labour contingency bonds, Lease bonds, Concession bonds, and Tax appeal bonds.

4.57. Ramo 4/ Division 4 covers Credit bonds for oil and energy supply. These bonds usually guarantee the payment on time, mainly for gas, electricity, oil, or other type of goods. The bonding amount is 100% of the service to be provided and is valid for a period of 12 months.

4.58. Ramo 5/ Division 5 consists of bonds to cover Trust Funds. Mexico has authorized the Bonding Companies are authorized by the to create and manage Trust funds, in fact, there is only one bonding company specialized for this business line bonds required by the Tax Authority to ensure the payment or the result of a procedure derived from a disagreement with any arrears of taxes, fees, fines, etc.

Mexico's new Surety Law and Product:

4.59. In 2015, Mexico set in motion its new Insurance and Surety Institutions Law (Ley de Instituciones de Seguros y Fianzas) also known as LIFS, marking, amongst other things, a new regulatory framework on insurance surety law.

4.60. The new law brings into play a new surety insurance product in Mexico called the "seguro de caución" (Insurance Bond), merging insurance and surety products and blending the legal provisions that apply to both in a relatively revolutionary way. The result should make for a more agile guarantee, sitting independently of its related agreement in a stand-alone insurance policy that documents its own legal and contractual obligations (unlike a surety bond which cannot exist alone as it operates alongside and collateral to the main agreement).

4.61. Under the Insurance Bond the Insurer is bound up to the insured amount that is stipulated in the policy itself rather than the norm of a surety bond which is for the value of the main collateral agreement, and a claim would be triggered by a breach of the provisions of the terms of the policy with recovery of a claim through the courts, as opposed to a breach of the main agreement.

4.62. Recovery is also different under an Insurance Bond as the party bound to perform must return the amounts paid by the company to the Insured, and it is then up to the party to recover any amounts it considers wrongfully paid. With a Surety Bond, the principal has discretion to make payment only of what is necessary or required under law. Guarantees are also optional under an Insurance Bond as opposed to binding for a Surety Bond.

4.63. LISF expressly provides that surety insurance shall be recognized and accepted for guaranteeing obligations assumed with the Federal and Local Governments.

4.64. This change, that would apparently open the door to unrestricted competition in the surety bond market, is curtailed by the LISF in one essential respect: **insurance companies that desire to offer surety insurance must operate as mono-line insurers. The only other product that may be underwritten by mono-line surety insurance companies is credit insurance.**

4.65. On the other hand, the LISF created an incentive for surety companies to convert into mono-line insurers. In order for a surety company to offer surety insurance in addition to surety bond products, the LISF requires that it converts into an insurance company that will receive an authorization to underwrite both types of products (i.e., surety bonds and surety insurance). Also, there may be a more favourable tax treatment with respect to certain operational aspects of surety insurance companies as compared with the tax treatment afforded such operational aspects in surety bond companies.

Regulatory overview:

Capital Requirements

4.66. The Law requires a minimum paid capital for each operation or branch, or branch or sub-branch, as the case may be. Such capital is determined annually by the National Insurance and Bond Commission (the "Commission"), with the agreement of its Governance Board.

4.67. The annual capital is announced no later than June 30 of each year. This amount will remain in effect until it is modified by the same Commission. On June 29, 2020, the Commission published the minimum paid capital that Insurance Institutions shall have. In the case of Surety Insurance, the approximate amounts in United States dollars are the following:

- ~$1.5 mn when the insurance company only operates Surety Insurance; and
- ~$2.0 mn when the insurance company operates Surety Insurance and Credit Insurance at the same time

4.68. By determining the minimum capital, the Commission expects that Insurance Institutions have a solid financial position that allows them to respond to the obligations and responsibilities they assume in the exercise of their activity.

Caps on the amount of premium and exposure

4.69. Insurance Institutions authorized to operate Surety Insurance shall specifically determine the following limits:

- Maximum limit of accumulation of risks per contractor: This limit refers to the amount of the insured amount that the carrier is willing to assume in Surety Insurance contracts with the same contractor.
- Board of Directors of the carrier shall approve the methodology and procedures to set the maximum limit of accumulation of risks per contractor.

Maximum retention limit due to accumulation of risks.

4.70. This is the maximum risk retention limit for insurance, reinsurance, bonding or re-bonding operations carried out by the Insurance Institution.

Some Forms of Security Taken by Surety Companies in Mexico

- Pledge consisting in cash or securities issued or guaranteed by the Federal Government, or issued by the Bank of Mexico;
- Performance risk coverages granted by development bank institutions;
- Pledge consisting in rated securities issued by credit or securities targeted for investment institutions
- Pledge consisting in cash deposits in credit institutions;
- Pledge consisting in loans and credits in credit institutions;
- Guarantee or contingent letter of credit of credit institutions;
- Stand-by letter of credit or guarantee or contingent letter of credit of qualified foreign credit institutions
- Counter-guarantee of Institutions;

European Union – Germany

Market overview:

4.71. Germany is one of the leading markets in Surety business and in 2018, German surety premium was close to Euro 600Mn. Banks are competing with surety insurance but surety insurance is the dominant player in construction projects. In Germany short projects are profitable as the loss ratio is as low as "5%" but large project have high loss ratio in tune of 40%.

Product framework:

4.72. Germany surety market is very mature and represented by local players such as R+V, Euler Hermes, VHV, Zürich, AXA and Coface and their underwriting quality is very high as most of the companies have to prepare extensive financial information; the frequency is at least annually, for riskier bonds types and higher amounts also in shorter intervals. Insurance companies have digital platform to evaluate the risk and they maintain data base.

Reinsurer capacity is available from Munich Re, Hannover Re and R+V.

4.73. Some sureties can take collaterals if the financials are poor or deteriorating and Premium is annual payable.

4.74. Mainly construction sector buys performance bonds, advance payment and maintenance bonds with average duration of 2-3 yrs (max go upto 7-8 yrs). Performance bonds are equal to 10% of the contract value.

4.75. In Germany, also due to the low percentage of the bond, the surety generally does not step into the contractor's rights to finish the obligation / project.

Regulatory environment:

4.76. German Civil Code (BGB) regulate the Surety insurance business and premium are determined by market forces and they are not tariffed driven. Retention of Sureties are regulated by Solvency regulations. The Bond duration can be disconnected from the underlying duration obligation.

4.77. Sureties in Germany are permitted to exclude Force Majeure events (Political risk, Terrorism, Pandemic risks). In Germany the prescription period for accessory surety bonds (Bürgschaften) typically is 3 years from the date of the emergence of the bond receivable/claim (§§195, 199 I Nr. 1 BGB). Prescription period starts according to the ruling of the high court (BGH) typically at the due date of the underlying obligation. The prescription is on the one hand independent from the prescription of the underlying obligation (can be earlier), on the other hand the Surety has the right to oppose the prescription of the underlying obligation.

4.78. Indemnity Agreement is must for any surety contract and indemnity agreement gives the right of recourse to the principle; the right to ask for further collateral; the right to cancel the line. Indemnity agreement is part of surety mandate. The beneficiary has to prove that the principal has defaulted on the underlying obligation. The situation is different in case of the accessory/conditional bond (explained in next section) on first demand.

4.79. In case of accessory/conditional bond on first demand, the beneficiary here can call without having to proof the default of the principal, however due to the accessory/conditional character of the bond the surety has the right to claim back the amount unduly paid back from the beneficiary. In principle, the surety can oppose all defences which the principal has against the beneficiary (§768 BGB) Additionally he can object to pay out in cause the principal has a right to refute the underlying contract or is able to offset the debt against another receivable due to him (§770 BGB).

4.80. The right of the surety to object the pay-out until the principal has tried unsuccessfully to execute his title (§771 BGB) is typically excluded/waived via the "selbstschuldnerische Bürgschaft" (§773 I Nr. 1 BGB) or in case of declared insolvency (§773 I Nr. 3).

4.81. The Surety bond follow changes of the underlying obligations without limitations however with the exception of increase of underlying obligation by a voluntary new transaction. This also applies in particular if the main liability is changed through negligence or default on the part of the main debtor. The obligation of the surety is not extended by a legal transaction that the main debtor undertakes after taking over the guarantee."

Accessoriness Principal: German civil code recognise accessoriness principal:

4.82. The purpose of a security right is to improve the chances of a creditor recovering a debt. This may be by means of a cautionary obligation (guarantee) from a third party (personal security), or by encumbering an asset, typically belonging to the debtor, which can be sold if the debtor defaults (real security). In either case the right in security depends on there being a debt. This is the “accessoriness principle” of security rights. The accessoriness principle can be traced back to the Roman law of personal security and real security. There are five rules arising from the accessoriness principle in its strict or strong form:

a) There must be a present debt for the security to be constituted
b) Debt must be specific
c) If the debt is transferred, the security follows it
d) If the debt is extinguished, so too is the security
e) There must be actual indebtedness for the security to be enforced

European Union – Italy

Market overview:

4.83. In Italy, both surety and bank surety are seen as "proportional"; the market is shared 50/50 among sureties and banks. Amongst EU markets, Italy is one market where Sureties are more popular than Bank guarantees. Italy is hence, among the biggest surety markets in Europe having an premium of approximately USD 600 mn as at 2018.

4.84. The Italian surety market though is quite fragmented and has more than 40 surety providers with the largest player having market share in single digit nos. representing the wide spread of players. The top 10 surety providers have a combined market share of 70%, with the rest 30 players having 30% share of market.

4.85. The major chunk of the premium originates from the public works and acquirement contracts (48%), where, in addition the infrastructure division (railroads, national streets, and so forth.) and mostly in the public private partnership space.

Product framework:

4.86. Italy is a "low penalty" framework, which implies that only a percentage of the agreement must be reinforced. This percentage can differ on the discount offered during the tender: the lower the bid, the higher the performance bond, with a calculation that occasionally is tricky in any event, for surety specialists to make. On an average the performance bond is somewhere in the range of 5 and 20%, and an advance payment bond is generally required for 20% of the agreement value. A bid bond equivalent to 1-2% is normally required.

Regulatory environment:

4.87. The Surety insurance are legally equivalent to bank guarantees (at least for public administrations, intended as public bodies, government departments, regions, municipalities, and so on); and on the other hand, the Italian jurisprudence is starting to consider surety bonds as "unconditional" and "independent" guarantees.

4.88. Italian Civil code govern the surety Insurance. Italy also follow "**Accessoriness Principal"** like the other European markets. An Indemnity Agreement is must for any surety contract. Surety right of recourse is protected by law.

AUSTRALIA

Market Overview:

4.89. The Australasian surety bond market is currently witnessing a welcome period of growth. There is now a wider acceptance of surety bonds both within the Government as well as within the private sector, as a form of security, and as a result this is giving rise to new market entrants.

4.90. Surety Bonds, which include Contract Bonds, have been part of the Australian market for over 60 years and are widely accepted by the private sector and Commonwealth, State and Local Government Authorities and Agencies.

4.91. In the fragmented world of Suretyship, Australia has a fair stake of Surety activities going on. Australia understood that the camaraderie between the Banks and the Insurance company is key and this led to a subtle inclusion of suretyship using bank fronting process. The procedure of credit capacity check in the case of Deposit bonds, paving the way to a robust system, thereby eliminating the trivial notions about Insurance backed guarantees. The country has also calibrated surety bonds efficiently in the environmental bonds where the contract also protects the ecosystem.

4.92. Australian surety market has co-existed with bank guarantees and is moving to a full surety market such as the US. Deposit bonds are a unique form of surety bonds offered in Australia.

4.93. One key aspect often overlooked is that Surety Bonds fall outside the Bankruptcy Act in Australia, therefore, in the event of the liquidation of a contractor, the principal/project owners aren't impacted as their call is against the insurer and not as an unsecured creditor as is the case with a bank guarantee.

Product and Pricing overview:

4.94. Typically, contractors are involved with an ongoing number of existing and new projects, so we establish a 'multi-bond facility'. Not dissimilar to an approved line of credit with a financial institution that can be drawn down/used/reused as required.

4.95. The pricing of Contract Bonds depends upon the risk profile of the contractor; the Contract Bond amount required; the duration of the particular project; specialist aspects of the particular project; and any other relevant information. The determined premium must be paid in full prior to the Contract Bond being released to the nominated party.

Regulatory framework:

4.96. The Australian Regulator, APRA, grants approval on a case by case basis, to insurers looking to offer Surety Bond contracts. APRA satisfies itself that the insurer has sufficient expertise and reinsurance support, as part of considering the application to offer Surety contracts.

4.97. The regulated institution has the choice of either:

(a) treating any surety bonds the regulated institution has issued as a type of direct credit substitute. In this case, 25 per cent of the value of the asset over which the surety has been written must be included in the assets at risk for the Asset Risk Charge. The type of underlying asset will determine which asset risk stresses are to be applied; or

(b) seeking written approval from APRA to treat any surety bonds the regulated institution has issued as if they were an insurance risk (for the purposes of meeting the requirements of the **GI Prudential Standards** only). This would require the regulated institution to include surety bond exposures within the insurer's assessment of insurance liabilities, as determined under GPS 320, and to apply the relevant capital factors specified in *Prudential Standard GPS 115 Capital Adequacy: Insurance Risk Charge*. For the purposes of calculating net outstanding claims liabilities and net premiums liabilities (as determined under GPS 320), the regulated institution may treat any risk mitigation arrangement as if it were reinsurance. A regulated institution seeking APRA's approval for this approach would need to include with its application a written confirmation from the regulated institution's **Appointed Actuary** that that person is able to appropriately measure the risk of the surety bond business within the regulated institution's insurance liabilities.

4.98. The regulated institution must use the same approach for all surety bonds issued by it and apply that approach consistently over time.

4.99. Australia is seeing broader acceptance of surety bonds by industry. Most banks and financial institutions, both domestically and internationally, now accept surety bonds as security. With government, an increasing number of federal, state and local departments and agencies are now also accepting surety bonds.

4.100. As a case in point, the Victorian & New South Wales State Governments have issued Treasury Guidelines on acceptance of contract security, which do not differentiate between Bank Guarantees and Surety Bonds provided the undertaking meets the following criteria.

Victoria:

- Unconditional, irrevocable and payable on demand;
- APRA approved; and
- Issuer has a Standard & Poor's rating of A- or better.

New South Wales:

- Issuer is either APRA approved or has a Standard & Poor's rating of A- or better.

Philippines

Market Overview:

4.101. In Philippines, surety premium rates are subject to minimum tariffs. Surety bonds were first tariffed in 1960, when the schedule of rates previously approved by the secretary of finance in 1954, went into effect. The implementation was ordered by then-Insurance Commissioner Francisco Mandanas. Prior to tariffication, there were no standard premium rates. Hence, every surety company was free to charge any rate based on the risk to be guaranteed, the counter guarantee given, and the need of the applicant. In other words, it was based purely on market forces. It was then that the Insurance and Surety Association of the Philippines proposed a Schedule of Rates to be adopted by all nonlife insurance companies.

4.102. Subsequently, the tariffs were amended in 1985 when Insurance Commission approved the request of the Philippine Association of Surety Underwriters Inc. (Philasurers). The revised bond tariff took effect in April 1985. Under this amendment, the minimum premium rate was increased from P10 to P100 for all bonds except firearms bonds, which was fixed at P50. The minimum amount in the graduated scale was increased from P5,000 to P15,000.

4.103 Finally, in 1995 the tariffs were again adjusted upon the request of the Philasurers through the Philippine Insurance Rating Association (Pira). Insurance Commission approved the amendment to the rules of rating on bonds in a letter to Pira Inc. dated August 28, 1995. The Amended Bond Rules and Rates took effect on September 1, 1995. This Amended Rules on Bonds was circularized by Pira in Circular Pira-1070/95 dated September 18, 1995. This circular includes a schedule of Rates for Bonds up to P15,000 (Schedule I) and Rates for Bonds over P15,000 (Schedule II). It also includes a General Classification of Bonds, classified into five classes; as well as a list of abbreviated symbols or codes with prefixed serial numbers to be printed in the bond forms.

Regulatory Framework:

4.104. The latest circular issued by the Insurance Commission is 2018-47, dated 13th September 2018. Some of the key General Rules and Regulations for the issuance of bonds are as follows:

Bond Forms - Bond forms and the series to be issued by the company must be duly approved by the Insurance Commission.

Spoiled or Cancelled Bonds - Any bond form which will be spoiled or cancelled shall be plainly marked with the word "SPOILED" or "CANCELLED' and shall be preserved and placed in a separate file by the insurance company concerned.

Bond Registry-Every insurance company authorized to issue bonds in the Philippines shall maintain a bond registry books which shall be open to the public and to duly authorized representatives of the Insurance Commission during all reasonable business hours.

Liability Register- Every insurance company must maintain a liability register wherein all the bonds issued by the company are recorded. In addition, a subsidiary liability register for each type of bond falling under any of the general classifications must be maintained where every bond issued shall be entered and recorded in numerical and chronological order.

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8. The Ontario Construction Act: https://www.singleton.com/2018/09/a-bargain-struck-surety-bonds- under-ontarios-new-construction-act/
9. Liberty Mutual Insurance Group – Surety Business – Presentation on Surety Business
   Marsh and Mclennan Companies – Suretyship the time has arrived for India Report

Chapter V

Recommendations

Terms of Reference (b) & (c)
b) To assess the suitability of the Indian Insurance Industry or any other sector to offer Surety Bonds. c) To provide justification for the recommendations being made by the group, with special reference to the legal and regulatory perspective.

As part of above cited terms of reference given to the Committee, and after considering the existing legal and regulatory framework on contract performance bonds in India, surety bond product structure, best practices in various jurisdictions, views expressed during meetings held with insurers, reinsurers, National Highways Authority of India, Ministry of Road Transport and Highways officials, Legal and surety professionals, experts from Banking Sector, construction contractors and the practitioners from global surety companies, we make the following Recommendations 1 to 9.

Recommendation 1: **Regulatory framework-Guidelines on Surety Bond Insurance**
Separate guidelines to regulate the business of Surety Bond Insurance may be put in place by the Authority. The Guidelines at minimum may cover the following: **Capital Requirement:** a) The Authority may allow the insurers to enter into Surety bond insurance business with Solvency margin above a certain threshold as the experience of surety bond insurance is yet to develop in Indian market and the risk exposure under this business is quite significant compared to other lines of business which are reasonably mature in the Indian insurance market. If the insurer`s solvency ratio falls below the specified threshold limit at any point in time, the insurer shall stop writing new surety bond business until its solvency ratio is improves above the specified threshold limit. b) The Authority to provide specific approval to insurance companies for issuance

of sureties' based on assessment of the insurers' capabilities to handle this business.

c) In addition to (a) above, only insurers with exposure to credit risk and engineering risk may be allowed to underwrite this risk.

d) The insurer should get capital relief to the extent the exposure is reinsured through an appropriate reinsurance structure.

Limitation On Exposure:

The exposure of an Insurer under Surety bond insurance may be regulated through a cap on its exposure under this business as a proportion of its net worth.

Monitoring of Surety business:

The Authority may need to closely monitor the business under this line to ensure an orderly growth. It is recommended to have:

a) Monthly report, detailing the business written
b) Underwriting capability development
c) Solvency monitoring and Capital adequacy frame work
d) Claims mechanism with legal capabilities

Risk Assessment Mechanism:

The Insurer shall establish risk assessment mechanism/ Risk Management Guidelines to evaluate technical/financial strength of contractors before and after underwriting the surety bond business. The insurer may outsource the risk evaluation to an external agency. The services of Indian Banks may be engaged provided the arm's length is maintained in case Bank is promoter/group company of Insurer.

The technical committee may be formed with all the partners – banks, insurer and reinsurers whoever is providing capacity and manage the risk for assessment of risk.

Reasons:

- Regulatory framework is extremely important for encouraging the surety business with recourse mechanism. It defines rights and obligations of stakeholders.

- The strongest comfort for the underwriter is the recourse on the contractors subsequent to the claim. The Indian contract law in its current form needs to be strengthened to make some amendments to improve the recourse mechanism.

- For the General Insurance Industry, most of the revenues are generally short term. The industry has to look at an exposure which runs into many years.

  Predominantly, a) skill-set- Specialist underwriters are required. b) solvency and c) how to manage the exposure need to be in guidelines.

- Considering it is a specialized product and insurance companies have limited knowledge in handling this product, monitoring periodical performance of the insurance product is required.

- When assessing these long term risks, Bankers, because of their continuous relationship and also the transactional accounts, still have lot of information on the customers. So, they are in better position to understand this risk. Banks and insurance companies can work together where banks can monitor projects cash flow.

- Instead of Insurance industry handling alone, a mechanism is required wherein the banking sector and the insurance sector could collaborate for sharing of customer information since banks have more experience in managing these types of risks.

Recommendation 2:

Underwriting Philosophy for Surety Business

The underwriting Philosophy for Surety insurance business shall include the following:

a) The maximum limit for risk accumulation per contractor and its group companies/firms, and

b) The maximum retention limit for risk accumulation.

c) Surety insurers may consider taking personal guarantees of promoters of policyholders/contractors as security for issuance of sureties.

d) Sureties are issued only to specific projects and not clubbed for multiple projects.

e) May appoint a bank which can monitor cash flows and technical experts for project progress.

f) The Board of Directors of the Insurance Companies shall approve the methodology and the mechanisms to set the maximum limit for risk accumulation per policyholder/group and overall accumulation at any given time, and it shall communicate such methodology and mechanisms to the Authority.

g) The Board of Directors of the Insurance Companies shall assess the ability of the insurance company to retain the surety risks on their balance sheet based on the financial strength of the insurance company and mandate appropriate reinsurance requirements to ensure that disproportionate surety risks are not written by the insurance company. This is especially relevant in case of surety bonds that are written for long tenures (like in the case of performance bonds for major infrastructure projects).

h) The Board of Directors shall review on an annual basis, within the twelve months following the approval or last revision thereof, the methodology and the mechanisms to set the maximum limit for risk accumulation per policyholder/ group and overall accumulation at any given time and if applicable, it shall communicate any amendments made by it to the Authority.

i) In the case of an on-demand bank guarantee, banks usually do not ascertain whether the contractor in question has committed any breach of the contracted terms at the time of the call on the guarantee or in case if the guarantee is being called by the project owner by unfair means. Hence, the contractor has no recourse in the event of a project owner improperly calling on his guarantee other than proceeding legally which can be not only time consuming but cumbersome as well.

   A surety provider on other hand must first ascertain whether the principal or contractor is in the breach of the contract and then disburse the payment to the concerned project owner, after which, the surety provider will turn towards the contractor for reimbursement, thus protecting both their and contractor's interest. The surety bond wordings must take this major factor into account while finalizing the same and filing with the Authority for approval.

j) Before issuing a bond, the surety insurer satisfies itself that, among other criteria, the contractor has:

- Good references and reputation.
- The ability to meet current and future obligations.
- Experience that matches the contract requirements.
- The necessary equipment to do the work or the ability to obtain it.
- The financial strength to carry and support its share of the project work.
- An excellent credit history.
- An established bank relationship and line of credit.

During the underwriting process, an insurance company will review:

- contractor's financials
- cash flow
- tax returns
- liquidity and debts
- ask for letters of recommendation and references.

Reasons:

- The maximum limit for risk accumulation per contractor and its group companies/firms refers to the gross risk accumulation per policyholder that is, to the amount of the insured amount that the Insurance Company is willing to assume in those surety insurance agreements with the same policyholder.

- The maximum limit for risk accumulation is a factor of net worth.

- The risk limits will ensure that no single risk and aggregate risk is disproportionate to the capital of the insurer.

- Being a specialized insurance that requires technical expertise in underwriting, controlling the quality of the portfolio is very important. Insurance company with higher than prescribed threshold solvency margin may only be allowed in the initial phase. This will help earmark certain capital allocation for underwriting this business. It will also help potentially other lines of business.

- The surety insurer examines a contractor much the way a banker does. Before issuing a bond or extending credit, both the bond issuing insurer and the commercial lender must be satisfied that the contractor runs a well-managed, profitable enterprise, keeps promises, deals fairly, and meets obligations on time—as agreed and in full.

- These will act as underwriting safeguards for minimizing exposure for high risk.

Recommendation 3: **Reinsurance Capacity** a) Reinsurers play a significant role in this line of business and it will be in the interest of the market that we attract reinsurers, which have experience in this field, strong financials and having long terms plan in India. It is, hence, recommended to have reinsurers supporting Surety business, to have minimum A rating (S&P), or equivalent besides technical capabilities to impart training and skill building of insurers and preferably with a branch in India including IFSC, GIFT City. b) It is recommended that Reinsurers offering such capacity are also in position to train the insurers on underwriting, risk assessment, claims processes and portfolio monitoring. c) It is also recommended that Insurers and locally domiciled reinsurers be allowed to factor in full benefit of reinsurance for its solvency computations.
Reason: Surety being high severity LOB, it is pertinent to ensure sound, sustainable reinsurance capacity in place in advance.

Recommendation 4: **Additional Legal framework and Ecosystem necessary for Surety market in India** a) In the Indian Context, currently the contract of guarantee and indemnity along with the other sections in the Indian Contract Act, 1872 (Section 124, 125) would be the underlying law for Sureties. For Surety market to develop in India and keeping in mind best practices observed in other markets, a robust legislation requiring surety bonds and other non- fund based guarantees would be a necessary condition. Some impositions like the Millers Act or Mexican framework (as discussed in **Chapter IV)** are required in the legislation so that the rights of the vendors and subcontractors will be safeguarded and also the payments will be secured. b) It is essential to provide stronger legal recourse mechanism to avoid elongated civil recourses (under Contract's Act). In order to tackle this prolonged civil

suits, it is imperative to include surety bonds in other acts such as Insolvency and Bankruptcy code, 2016, to ensure speedy and effective resolution and enforcement of indemnity by surety providers.

The surety bonds risk should be given equivalent status as bank guarantees in front of the IBC (Insolvency and Bankruptcy Code) and, hence, appropriate changes be made to include them in the settlement process.

c) Implementation of **The General Agreement of Indemnity (GAI)**; GAI gives a surety several different powerful legal tools for enforcing the provisions of a surety bond. These typically include requirements such as principal indemnifying and holding surety harmless from any liabilities, the principal cooperating with the surety in investigation of the claim, the surety provider has the final right to either reject or accept a claim. The GAI is usually signed as a separate document and serves as an important reminder for the principal to complete their obligations to the project owner and at the same time assures the surety provider that they're protected in case of a default.

   The current practice of Indemnity Agreement could be modified to a specific Surety based Indemnity Agreement which facilitates tripartite contract between the surety, the principal and owners of the contracting company. Such specific provision could become a very effective tool, which gives surety bonds, more legal rights against the indemnifiers participating in such agreement.

d) Development of Accessoriness Principal and recognition (referred to in previous section **4.82 in chapter IV**) of the same in Indian Law.

e) The Right of Subrogation and its applicability. If the Surety is required to pay or perform due to the principal's failure to do so, the law should provide the Surety a right of subrogation, allowing the surety to "step into the shoes of" the principal and use the surety's contractual rights to recover the cost of making payment or performing on the principal's behalf, even in the absence of an express agreement to that effect between the surety and the principal.

f) The surety bonds shall be accepted as an alternative form of guarantee by Reserve Bank of India (RBI) and Government Departments and accordingly reflect in the appropriate contract documents.

g) A credit enhancement arrangement like USA's Surety Bond Guarantee Program administered by Small Business Administration may be considered for Small and Medium Sized Contractors. In India, Ministry of Micro, Small, and

Medium Businesses runs various schemes to aid the smaller businesses in development such as the Credit Guarantee Scheme where the businesses eligible for these schemes can approach approved banks and can get collateral free loans up to Rs. 50 lakhs (US$ 66000). This can be extended for issuance of surety bonds also and in such cases surety bonds and government guarantees can work more efficiently than banks to secure and promote the MSME sector within India.
Reasons: • In USA, Miller Act, the federal law is used to protect subcontractors and laborers. It is mandatory to issue a payment and performance bond in the US under the Miller act if the amount exceeds $100,000 (INR 75 Lacs equivalent), while bidding for a public works project. A vendor or a subcontractor who doesn't get paid within 90 days from their last day of their working has a civil right to file a lawsuit against the contractor under the Miller Act. Introduction of this Act has been the key reason for success of Sureties in USA. • The recourse mechanism safeguards provided in the contracts with some provisions can enable Surety market to develop in India. Every Surety Bond shall carry a subrogation condition and it shall be protected by agreement between Surety and Contractor and no waiver of this condition under any circumstances shall be allowed. • Due to the specific nature of surety bond providers, the Right of Subrogation has important implications as when a principal defaults, the surety will step into their shoes to complete the project or subcontract the remaining work rather than allowing the project owner to unfairly call a surety bond. • The right of subrogation for insurers after a claim payment is vital for the sustainability of this portfolio. • Surety based Indemnity Agreement used as a standard document in construction and surety industries in many markets such as USA, Germany. This agreement purely safeguards the rights of the surety company. Example: If the principle fails to honor the agreement, the surety will then pay the principal's subcontractors and suppliers for any dues. In turn, the principal, under such agreement would indemnify the surety against any loss incurred due to the contract.

- Under the 'Bank Guarantees Scheme of Government of India', RBI has allowed the various government departments to accept guarantees from scheduled commercial banks in lieu of security deposit to be submitted by the contractors to the government departments. In order for surety bonds to be used by government departments to secure their projects, either in lieu of bank guarantees or simultaneously with them, RBI would need to accept surety bonds as an alternative form of non-fund based guarantee instrument and surety bonds in bank fronted guarantees.

- This will enable the project owners to choose surety bonds option as an alternative to bank guarantees.

Recommendation 5:

Partnership approach with Banks for sharing of risk and/or for sharing risk information

It is recommended that Insurers may explore a collaborative approach with leading banks for sharing of risk and/or for sharing risk information in respect of key financial indicators, contractors historical payment records to bankers/lenders, their experience of client, prompteness of payments, losses incurred, whether working capital account is regular etc.,

Reasons:

- The sharing of risk information will provide strong framework for the appraisal of projects that allows for optimal risk identification.

- The mechanism for sharing credit information between banks and insurance companies will enable both to take better credit/underwriting decisions.

Terms of Reference (d)
d) Any other matter relevant to the subject.
Recommendation 6: **Offering of Surety Bonds to Construction Contractors** a) The Surety Bonds business may be revived with offering of surety bonds initially to Construction Companies in India. The Construction includes road projects, housing/commercial buildings and other projects of Government/Private.The contract bonds may include: Bid Bonds, Performance Bonds, Advance Payment Bonds & Retention Money. b) The limit of guarantee may be limited to maximum 30 percent of Project Value.
Reason: The surety bonds to the projects undertaken by construction contractors may be the major focus of the business in the initial phase.

Recommendation 7:
Issue of Other types of Surety Bonds The other types of surety bonds such as customs or tax bonds, court bonds may be permitted with counter guarantee of the parties with additional liquid securities with a margin of 30 percent and above.
Reasons: • The insurer shall consider issuing the other types of bonds on case to case basis, depending on the available tangible securities for the parties to ensure that at least partial recovery is protected. • The surety bonds in favour of Central Board of Indirect Taxes and Customs (CBIC) will facilitate trade considerably by substituting Bank Guarantees.

Recommendation 8:

Centralized Data Base:

The database of the bonds issued by all the insurance companies may be centralized at designated body as may be decided by the Authority. Every insurer shall furnish the details of clients and exposures periodically to the designated body.

Reason:

Maintaining a central database enables to analyze total porffolio exposure according to product types, transaction structure and a variety of other factors, the ability to anticipate and correct concerns to protect the participating insurers. This will help in better understanding of the risk, improve underwriting, avoid bad risk, anti-selection issues etc.,

Recommendation 9:

Registration as General/Specialist Insurance Company to carry out Surety Insurance business in India

a) It is recommended that any entity/ies other than registered General insurers with the Authority that wish to act or are currently acting as some surety bond issuers on bid, performance, payment and other types of bonds shall obtain Registration as a General/Specialist Insurance Company from IRDAI.

b) The application for registration of specialized/monoline insurer for doing surety and credit insurance business may be encouraged.

Reasons:

- Without such registration, the entities will engage in unregulated surety issuance activity.

- There are examples of leading global insurers who are monoline insurers, undertaking only surety and credit insurance business.

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Annexure:

Summary of Views/Comments of Stakeholders

The Working Group had discussions with the representatives of selected General Insurers, GIC Re, Foreign Reinsurance Branches, GI Council, senior officials of NHAI, MORTH, Indian legal and surety professionals, experts from Banking Sector, representatives of NHBF, construction contractors and the practioners from global surety companies. The stakeholders' comments/suggestions were discussed and taken into consideration while preparing the report. The following summary presents the divergent views received from the stakeholders.

- Indian insurance companies have issued performance guarantee and surety bonds at some point of time during 1970s to specific customers. Guarantees are permitted contracts in India and most of the guarantees are 'on call' documents and there is no recourse to the contractors.

- Later on, after nationalization of general insurance, the issuance of guarantee bonds was not favoured and slowly stopped. After IRDAI came into existence, the Authority directed that financial guarantee products should not be offered.

- Large number of representations were received from contractors, developers by NHAI, because at some point of time Bank Guarantees are becoming very problematic. The Banks have increased two components i.e. margin money as well as the commission. Under such circumstances, an alternative option is required. Since in other jurisdictions surety bonds are issued by insurance industry, the matter was represented to the Department of Financial Services. Generally, NHAI awards Rs. 50000 to 1 lac crores work contracts. It comes into two stages i.e. Bid security – for shorter period and Performance security for longer period.

- In case of Banks, surety providers require the security over the company's assets and NHAI require bonds to be supported by cash or collaterals. With Surety bonds product, contractor will be freed up from the bank obligations and free up their funds. In India it is high time to provide this sort of product subject to Regulatory provisions.

- The requirement has arisen because banks are not forthcoming as they were doing earlier to provide performance securities at the same cost. Now, banks in some cases want 100 % margin money before issuing bank guarantees. Highway sector is executing around 5 lac crores projects at the moment and performance security varies to 5 % to 10 %, which this sector requires. The failure rate is less than 1 %. It is in very rare cases where we have encashed performance security.

- Taking into consideration the above, there is a huge market for issuing surety bonds by Insurance sector. If it can be done in a manner so that it benefits contractors, developers, in turn, it also beneficial to NHAI. To start with, bid security can be offered as it is less risky, less costly and of shorter duration. Further, encashment of bid security level is very less. Performance security can be taken up in second stage.

- RBI Governor clarified that infrastructure industry should not depend on banks. From this point of view, if another avenue is open, it would help the construction industry. In case of pandemics like current situation, it is becoming difficult to getting finances. It will be a good avenue for revenue generation for the Insurers although risk is present.

- Projects are now being awarded only after due care such as at 90 % of land has to be available only then we will award the work which will reduce the risk further. The cost of bank guarantees is increasing. Secondly, as per the conditions of contracts where the defect liability period is 10 years, the BG has to be kept live at least for 14 / 15 years – very large time to sustain that BG by the contractors. That is why the contractors are requesting for another economical option. As regards project delay, because of the awarding authority`s default, certainly no action will be taken against the contractor. In case of contractors' default, he will be debarred or declared as non-performer for next two years.

- The option of Surety Bond can definitely be there in the market in addition to the BG and bidder has a choice. With all the modified conditions, we can enter into the market. Initially, bid security product can immediately be taken up. In case, it is not found economical by the bidder, obviously he can still prefer the banks.

- NHAI has strict conditions in its bidding conditions and require initially Bid security then the performance security. As far as collaterals, the cost benefit analysis will be undertaken by contractors. The project has the inherent nature of the time over runs. It will be part of the due diligence. NHAI is ensuring good project preparedness which will reduce the project delays.

- In India, Banking sector took the load of issuing 'Guarantees' to provide surety services to contractors. The Banking sector has been going through some challenges viz., high risk, capital challenges etc. Hence, getting guarantees from Banking sector has become difficult. The cost of bank guarantees has increased and banks ask for collaterals. Especially after COVID scenario, contractors are finding it very difficult to get bank guarantees. From macro perspective, banks today are having issues with their balance sheets because of NPAs or other conditions. In comparison with banking guarantee, insurance product does not have collaterals and even it comes with certain caveats in terms of policy wordings which are project specific.

- Even for the banking sector, monitoring and managing these non-fund based exposures are very complex. In fund based exposure, the exposure and its behavior is known upfront. The non-fund based exposures need not be triggered immediately as in fund based exposures and can be very long term in nature and knowing chances of getting invoked are not known. So, credit assessment and credit management is very critical.

- Banks have learnt to manage exposures in terms of term loans and working capital loans, but ,non-fund based limits, especially bank guarantees, are difficult as letter of credit still moves within the production cycle but these non-fund based exposures moves far beyond production cycle.

- As per RBI guidelines, banks have to make payments immediately on invoking the guarantees as per terms. For some contractor's, bank guarantee limits are blocked and, hence, they cannot bid for future projects.

- Bank guarantees are unconditional and the projects authority designs the format of bank guarantees. Banks have no role in designing the formats. In terms of performance guarantees, till the completion of 100% of the work, the performance guarantee will not be released. Some of the central government agencies are following the performance guarantee gets limited only to the extent of the balance of work proportionately.

- Surety Bonds are available in other developed markets but the conditions are not comparable with Indian context in view of different kinds of projects. When somebody lodges an insurance claim, Insurers examine the claim and claim is admitted but in bank guarantees the payment has to be made immediately.

- In terms of monitoring, banks have mechanism to look at all the BGs that have been given in the past, what extent work has been completed, has the BGs have been returned or not. In case BGs gets invoked, it becomes funded limit with banks and existing securities whatever is available to other funded projects also available to these invoked bank guarantees.

- Generally, the contractors are not manufacturing outlets so they do not have stock, factory, land etc which they can provide for bank as collateral security. The requirement for bank guarantees is very large. Most of the contractors have now adopted asset light model – they are disowning more stuff and most of the equipment's are owned by sub-contracts and, hence, contractors are not able to provide collaterals with the banks. Perhaps these would be the trigger points to explore an alternative product for bank guarantees.

- Most of the construction companies are suffering for surety. Indian infrastructure has to grow for the country to grow. The Government is looking for other sources of revenue or other players to come in who could play important role in the surety bonds.

- Globally Insurance companies are doing surety. The key issue would be whether the insurance industry would want to develop a new line of business with global partner's support. Systems and process to be set up. Banks and insurance companies can work together where banks can monitor projects cash flow.

- There could be other benefits that could happen to the insurance industry. Most of the construction companies apart from surety bonds also needs insurance for other areas as well. The key issue would be whether the insurance industry would want to develop a new line of business with global partner's support. Systems and process to be set up. It has a potential to become very large revenue pool for the Insurance industry in future.

- The Contract Bonds include Bid, Performance and Payment bonds that provide assurance to the public entity, developers, subcontractors, suppliers that the principal will fulfil its contractual obligation when undertaking the project. The surety provides the benefit of protection and pre-qualification to the beneficiary and enhances the principal's track record and cash flow requirement.

- The Surety Bonds is a viable alternative risk product to Bank Guarantees with an assurance to an owner that its award of a contract to a contractor is supported by the backing of a third party. Although it is an insurance product, it has three parties viz. contractor, principal and of course the Insurance company.

- Insurance policies will always have some terms and conditions unlike bank guarantees. Insurance market is always used to exclusions and underwrite certain things to figure out mechanism to minimize the loss or at the same time pay the loss. But when it comes to surety, it is a different situation and it has to be match to the contract. For example, in Insurance pandemic is an exclusion but in surety it cannot be excluded. Need to strengthen the regulations or act to enhance recourse mechanism. The definition of 'force majeure' has to be clearly match to the original contract. The recourse mechanism safeguards can be provided in the contracts with some provisions.

- A special purpose vehicle may be formed for the purpose of issuing surety bonds as the current regulatory framework does not allow Insurance companies to issue surety bonds. The recourse mechanism safeguards can be provided in the contracts with some provisions.

- The Pricing is a challenge for issuing surety bonds for the insurance industry as insurance is the only product where pricing is pre-determined. The accounting would also be a challenge in view of long tail business. If at all it is to be implemented, a standalone company like Health Insurance Co., with separate solvency requirement, separate premium deficiency requirement option to be reviewed.

- As of now, the acceptance of surety insurance along with bank guarantee is very low and it is a big challenge. Some projects are now accepting in some parts of the country. There is no regulation for surety. Regulation from the Government will boost surety. Regulatory framework is extremely important for encouraging the surety with recourse mechanism.

- We require regulations which enhance acceptance. It would be clearly distinct from insurance companies as well as from the banking. A separate legal regulatory frame work for surety which defines rights and obligations of stakeholders should be important. It should be in line with other Regulations.

- A very sizeable market for this product is not immediately envisaged, particularly because of the underwriting ability of the Insurance Company. It will be examined as step by step process and clearly some time away before it fully develops as surety bond market. But it is not to say that it will not happen but it can happen and purely it is a product of how we appraise it.

- The Surety bonds by insurance companies will provide an alternative option to bank guarantees which can free contractor's capital as they may not require 'collateral'. Bank Guarantee is a big market which is totally controlled by banks today and from the insurer point of view this will be a new market in India. Surety, per se, is definitely not going to compete with banks but it will help as an additional facility.

From costing perspective, the contractor can look at what is the more beneficial , BG or surety, based on his own analysis.

- Banks have their aversions on extending facilities to any infrastructure company but good companies having good track record are not facing difficulty in getting bank guarantees. Contractors with a good track record have no problem in getting banking facility but the small and medium contractors may have problem in getting bank guarantees due to current situation, RBI circulars, NPAs, their own balance sheet issues. If the market expands and more players come in, it is better for the customers.

- Surety bonds will be preferred based on cost and tenure of the bonds. Further, if the contractor can utilize the current existing non-fund based limits to fund-based limits and for non-fund based limits, contractor may look for insurance surety bonds. If the companies are not able to do business due to constraint on banking limits, they would certainly not mind to pay little extra for surety market. But the difference should not be significant.

- The performance bank guarantee could be invoked in case the contractors could not complete the project on time, probably due to liquidity or quality issues. The terms and conditions are almost similar for BGs and surety bonds in other jurisdictions as the conditions are decided by the principal.

- In case the insurance company has decided to exit the particular line of business after issuing surety bond for 5 years, the contractor during the notice period has to replace the surety with other bond or to replace it with BG. Most of the terms of the contracts are common but banks or insurance companies do due diligence before issuing surety bonds.

- Generally, in the project finance contractors get a credit limit and there is a mortgage of that project to be given to the bank and against that there is fund or non-fund based facility available. Out of non-fund facility available, contractors issue the bank guarantee without depositing margin money with the bank. These BGs are generally issued to different authorities.

- Contractors are facing problem in getting bank guarantees as they need to provide collaterals or deposit money with the bank. They need to block their working capital for availing this facility. Preference to surety bonds issued by insurance sector will be based on the cost. Cost of the surety bonds plays a very critical role in selection.

Global Practices:

- American market is the largest market in terms of large engineering / construction projects and it is successful to a great extent because of Miller Act which stipulates all public funded projects are to be done under performance guarantee has to be done through suretyship rather than bank guarantee.

- Globally surety market is of three types;

  (1) Surety defined market - In US it is 100 % surety bond market. No banking product is available. (2) Markets where Surety and bank guarantee compete with each other. (3) Markets where banking sector has not matured and insurance sector takes over sureties like in Africa.

- We can classify India in the 2nd category where Bank Guarantee and Surety will co-exist like in Mexico and Brazil. There the biggest driver for the Insurance sector to open for surety has been the reforms in the Law or Act. The strongest comfort for the underwriter is the recourse on the contractors post the claim. Currently, Indian contract law is not very strong and perhaps to look for some amendments to strengthen recourse mechanism.

- Surety bond market is more active in the markets where generally banking sector is weak like in Africa and Caribbean where banking sector is not well robust or as well regularized. That could be the reason for insurance product precedence in these markets.

- The practice followed in Australia and UK jurisdictions are on Risk Based Supervision. The Insurers are permitted to write surety business on case by cases basis where Insurers shall demonstrate requisite underwriting expertise and capacity.

- Lloyd's allow syndicates to write this business as reinsurance support only, and not as direct insurance business. Concerns are on how to capitalize Insurance or Reinsurance company whether it is 90 % or 95% as we don't have a risk based capital mechanism currently.

- In some jurisdictions like Australia, they are done on a case by case basis where they fully evaluate what expertise will insurers bring in; will they have an understanding of what they are getting and what is reinsurance backing. In some jurisdictions it is almost a tariffed market.

- Insurers have to manage solvency and the capital charge on surety business. RBI has given certain formulae to calculate risk based average and capital adequacy thereof, so the entire work on provision of capital and its calculation of solvency is to be taken in to account. For the General Insurance Industry, most of the revenues are generally short term. Can the industry really look at an exposure which runs into 10 years where no visibility and many of them are unrated in public. The information on the public domain is little and the level of disclosure to protect our exposure are yet to be put in place.

- Predominantly, a) skill-set b) solvency and c) how to manage the exposure are to be examined. These will be in large of balance-sheet because each of these contracts will be large infrastructural contracts. The Reinsurers support to surety bonds is key, if at all Indian insurance industry to go for surety bonds.

- Insurance industry can work in conjunction with the banks and lend capacities rather than become the primary driver of the risk. Even today, people with right credentials and right track records are getting credit with reasonable rates as the rates are function of MCLR. Methodology of having data in the public domain and to have access by anyone is required.

- Instead of Insurance industry to issue alone, a mechanism to be found out with the banking sector and the insurance sector collaborating for sharing of customer information since banks are more experienced in managing the risks. Subrogation and Reinsurance support have to be examined.

- A tightly controlled technical committee may be formed with all the partners – banks, insurer and reinsurers whoever is providing capacity and manage the risk for assessment of risk, in case insurance industry is to go for surety bonds. Information on customers like CIBIL rating kind of information to be strengthened.

- Performance bonds and surety bonds is a separate line of business and contractual obligations and performance of the policy have to be tightly controlled. It cannot be open ended policy wordings like the open-ended bank guarantee which is as good as encashment of cheque.

- Swiss Re will be involved in the surety bonds as a separate line of business with certain projections and regarding capacity obviously whatever capital allocated by the head office for Indian branch is available and may ask for additional support if required. It is a three party agreement and still it will be treated as an Insurance product.

- Because of long tail nature, it is advantageous to insurance industry as insurance industry does long tail project in the engineering book – one part of the underwriting about that project itself and contractor underwriting is partially done in their books. But the credit analysis part that is the concern as it is a new environment for which adequate mechanism will be put in place by Reinsurer like strict wordings related to performance bonds and have to have monitoring mechanism for project as well as contractors.

- The credit appraisal mechanism in Non-life industry, including GIC Re, is rather scanty. Practically, the credit appraisal mechanism is almost nil. When assessing this product, the involvement of bankers is to be ensured. This product should not be a sole insurance product. It should be part of insurance operations and it should not be put in under the investment portfolio. It should be part of pure underwriting operations.

- If the insurance industry need to enter into this market, we need to have certain precautions such as developing underwriting guidelines and data of the bonds issued by all the companies to be centralized. Every insurer shall furnish the details of clients and the data on customer wise and exposure limit and should be maintained to keep track.

- It may be limited to only for performance guarantee i.e., project execution only. Maintenance aspects (for highways) which will come after completion of the project shall be treated as a separate annual contract with separate premium. To start with performance bonds / surety bonds can be issued limited to the projects of NHAIs only and not for all the contractors. The rate should be determined by a market agreement.

- Specialist underwriters are required. However, it may not be a challenge for Indian context as Engineering underwriters with financial knowledge can be trained as focus on assessing risk is largely on contractor's profile, moral hazard, credibility and past performance. Current Reinsurance trend for bonds is more as facultative than treaty Insurance.

- The Underwriting consideration shall include evaluation of the principal's past performance and how well it fulfills the obligation, License & Track record, Bid practice, Reputation of the Beneficiary, principal's technical resources necessary to complete the project successfully, Technical resources (Equipment/ Labor/Material/

Technology), Core business and business mix (residential/ commercial/industrial/ engineering),Existing commitment (on-going projects), principal's financial ability to undertake the project and to cope with unforeseen situations and ability to access financing (Shareholder's fund/Capital markets/Debt).

- The factors used to assess and price a risk are; analysis of financial statements, analysis of work history, analysis of contractor reputations, Capital-Profitability & CFFO, Liquidity, Leverage and Net worth, Capacity-Single largest job, total work program and Prior experience and Character- External references, external reports.

- Surety pricing is primarily market driven and underwriters assess risk of individual accounts based on financial statements and work in process documents. However, analytics from internal data and industry organizations has emerged to supplement underwriting moving toward data driven decision making. Analysis are emerging in the industry to supplement traditional underwriting and loss cost determination. Analytics coupled with actuarial techniques can advise on whether proposed rate covers account expected losses and costs of business.

- Amount of capital held is determined by requirements of rating agencies, regulator and internal economic capital models. Overall capital needs for a company largely depends on business written. Insurance companies working many lines in addition to surety see a diversification on capital need. The reserving is using traditional reserving techniques supplemented with consideration for large loss.

End of the Report