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Surety Bonds

Evaluation of these instruments for diversifying risk in infrastructure financing

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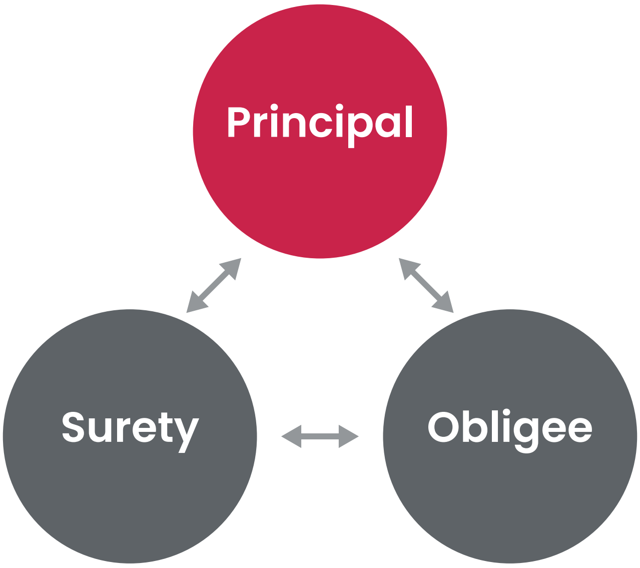
Introduction[1]

A Surety Bond is a legally binding contract entered into by three parties—the Principal, the Obligee, and the Surety. Surety guarantees the payment obligations of the Principal. Surety provides a financial guarantee to the Obligee that the Principal will fulfil their obligations. Most Surety Bonds are issued for a set term (usually 1, 2, or 3 years). The different types of Surety Bonds



PRINCIPAL

- Usually a business owner or contractor
- The party required to obtain the surety bond.
- Purchases the bond and agrees to perform the work in a compliant manner.
- Responsible for performance and financial aspects of the contract.

OBLIGEE

- Usually a government entity
- The party requiring the Principal to obtain the surety bond.
- If the Principal fails to deliver on the terms of the contract entered into with the Obligee, the Obligee has the right to file a claim against the bond to recover any damage/losses incurred. If the claim is valid, the Surety will pay reparation up to the bond amount.

SURETY

- The guarantor
- A neutral party that guarantees the Principal's obligations.
- Insurance Company that guarantees the work of the Principal and is liable for claims against the Principal up to the bond amount.
- If the Principal fails to perform the act as promised, the Surety is liable for the claims made.

[1] This is a brief overview of Surety Bonds. A detailed note on Surety Bonds is available as part of the Working Group Note which can be accessed from the link: https://taxguru.in/wp-content/uploads/2020/10/Report-of-Working-Group-on-Surety-Bond.pdf

as prescribed in the IRDA Guidelines are as follows:

Advance Bond It is a promise by the Surety to pay the outstanding balance of the advance payment in case the Principal fails to complete the contract as per specifications or fails to adhere to the scope of the contract.
Bid Bond It provides financial protection to the Obligee if a Principal is awarded a contract but fails to sign the contract or provide the required performance and payment bonds.
Contract Bond It provides assurance to the Obligee (public entity, developers, subcontractors and suppliers) that the Principal will fulfil its contractual obligation when undertaking the project. If the Principal defaults, the Surety company is obligated to find another Principal to complete the contract or compensate the project owner for the financial loss incurred.
Customs and Court Bond This is a type of guarantee where the Obligee is a public office such as tax office, customs administration or the court, and it guarantees the payment of a public receivable incurred from opening a court case,clearing goods from customs or losses due to incorrect customs procedures.
Performance Bond It provides an Obligee with a guarantee that, in the event of a Principal's default, the surety will complete or cause to be completed the contract.
Retention Money Similar to maintenance bonds. It guarantees the owner that any workmanship and material defects found in the original construction will be repaired during the warranty period. It is a part of the amount payable to the Principal, which is retained and payable at the end after successful completion of the contract.

Honourable Finance Minister made an announcement in Budget 2022, introducing Surety Bonds as an Insurance product in India. Through this report, we have conducted a background study of Surety Bonds and evaluated their relevance in the context of Indian markets. We have looked at various technical aspects of Surety Bonds, the probable market size and implementation of Surety Bonds with respect to the Indian context. This report will cover the following sections:

1. **Market Sizing:** This section outlines the scale and size of the Surety Bond Market in India.
2. **International Practices:** This section gives a detailed study of how Surety Bond markets operate globally.
3. **Regulatory Landscape:** This section discusses the laws and regulations related to the Indian Insurance market and examines the extent to which Surety Bonds can be readily implemented in India. We have also attempted to identify the potential issues that can arise and probable solutions while implementing Surety Bonds issuance in India.
4. **Pricing:** This section assesses the pricing models associated with Surety Bonds.

1. Market Sizing

The Government of India has allowed contractors to use Surety Bonds as a substitute for BGs for Government procurements, which could be a shot in the arm for the infrastructure sector. Hence to determine the scope of Surety Bond market, it is important to closely look at growth of the Infrastructure Sector. We begin by taking an overview of the size and scale of the Infrastructure Sector in India.

Infrastructure sector can be identified as one of the most important drivers of economic growth in India. According to RBI, Infrastructure Sector comprises roads, power, water and railways.

1.1 Present Scenario of the Infrastructure Sector in India

According to a report published by Groww, Budget 2022 has rightly emphasized accelerating infrastructure development, in both its physical and digital avatars, as a component of the stockpile upgrade initiatives for delivering a booster dose to revive economic growth. India's infrastructure output increased 12.7% year over year in June 2022, flagging the second month of double-digit economic expansion.

Some of the key budgetary announcements and allocations with respect to the infrastructure sector are as follows:

Allocations

- In Union Budget 2022-23, the government has given a massive push to the infrastructure sector by allocating INR 10 lakh crore to enhance the infrastructure sector.

Spending

- India plans to spend INR 114.8 lakh crore (USD 1.4 trillion) on infrastructure through 'National Infrastructure Pipeline' in the next five years.
- It is estimated that India would need to spend INR 369 lakh crore (USD 4.5 trillion) on infrastructure by 2030.

Global Competition

- India is estimated to become the third-largest construction market globally very soon. Indian logistics market is estimated to touch INR 26.2 lakh crore (USD 320) billion by 2025.

NIP

- The government expanded the 'National Infrastructure Pipeline (NIP)' to 9,335 projects. 217 projects worth INR 1.10 lakh crore were completed as of 2020.

The National Infrastructure Pipeline (NIP) envisaged a projected infrastructure investment of INR 111 lakh crores during FY 2020 to FY 2025.

Source: IBEF Report, Infrastructure June 2022[2]

[2] The exchange rate is considered to be 1 USD=82 INR

1.2 Determining the Market Sizing of Surety Bonds in India

In order to determine the market size of Surety Bonds in India, we have looked at two aspects:

Table 1. Demand for BGs

Demand	
BGs issued by banks for infrastructure in FY 19	INR 10.5 lakh crores[3]
Infrastructure spending in FY 19	INR 12.7 lakh crores[4]
Bank Guarantees coverage	
(BGs issued as a percentage of infrastructure spending)	82.6%[5]
Infra spending over the next 5 years	USD 1.4 trillion ≈ ~INR 115 lakh crores[6]
Requirement of BGs over the next 5 years	INR 95 lakh crores

Note: Projected demand of BGs in next 5 years is calculated by multiplying BG coverage with Infra spending in next 5 years. (Note. Exchange Rate is taken to be 1 USD= 82 INR approx.)

Demand and Supply. Lets see the demand side which evaluates the requirement for BGs over the next 5 years (till FY25).

In order to determine the supply, let's look at the possible supply of BGs over the next 5 years.

Forward Looking Market Sizing:

In order to determine the possible supply of BGs, we take the historic growth rate in issuance of BGs as a base to make future projections. The Working Group Report by IRDA on Surety Bonds depicts the data for BGs issued by Indian Banks for infrastructure in last five years (FY 15 to FY 19). On the basis of this data, we have projected the bank guarantees up to FY 25. This can be

FY	Year	BGs issued (in lakh crores)	CAGR
FY15	2014-15	9.65	
FY16	2015-16	9.06	-6.1%
FY17	2016-17	8.91	-1.7%
FY18	2017-18	10.56	18.5%
FY19	2018-19	10.54[7]	0.2%
FY20	2019-20	10.78	2.2%
FY21	2020-21	11.25	2.2%
FY22	2021-22	11.93	2.2%
FY23	2022-23	12.30	2.2%
FY24	2023-24	12.78	2.2%
FY25	2024-25	13.34	2.2%

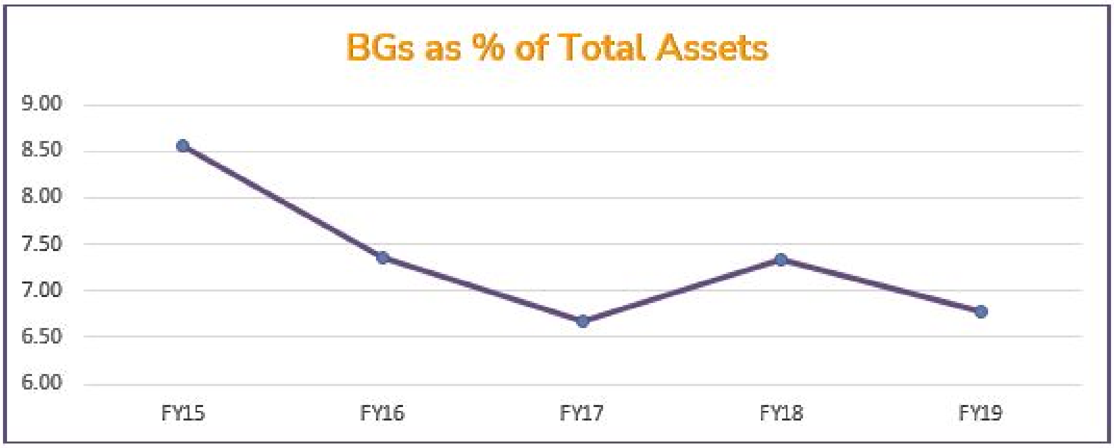
[3] Source: IBEF Report- Infrastructure June 2022
[4] Source: IBEF Report- Infrastructure June 2022
[5] Calculated as the ratio of BGs issued in FY 19 to infra spend in FY 19
[6] Source: IBEF Report- Infrastructure June 2022 (expressed in Rupees considering the Exchange Rate as 1USD=82INR)
[7] Source: Report of Working Group, IRDA, https://taxguru.in/wp-content/uploads/2020/10/Report-of-Working-Group-on Surety-Bond.pdf

depicted as follows:

Table 2: Estimated Supply of BGs

We first computed the CAGR (Computed Annual Growth Rates) as depicted in the rightmost column. Based on these CAGRs, we see a figure of 2.2 % for FY 20. Since there are huge fluctuations in the issuance of BGs from FY 15 to FY 19, we have kept a constant CAGR of 2.2 % to project the issuance of BGs in the next 5 years. We conclude that based on the trends of how BGs have been issued from FY 15 to FY 19, the projected BGs issued by the banks by FY 25 will be about INR13.34 lakh cr.

Graph 1. Bank Guarantees issued as percentage of Total Assets



Based on the issuances of BGs from FY 15 to FY 19, we plotted the issuances of BGs as a percentage of total assets. This depiction looks as follows:

From the above graph, we see that Bank Guarantees as percentage to total assets[8] have decreased in 2014-15 to 2016-17 and then again in 2018-19. The trend of bank guarantees shows a lot of fluctuations from a period of 2014-15 to 2018-19.

Table 3. Projections of BGs (in lakh cr) based on different CAGRs

FY	Year	Projected BGs (With CAGR 2.2%)	Projected BGs (With CAGR 4.4%)	Projected BGs (With CAGR 11%)	Projected BGs (With CAGR 22%)
FY20	2019-20	10.78	11.00	11.70	12.86
FY21	2020-21	11.25	11.49	12.99	15.69
FY22	2021-22	11.93	11.99	14.41	19.14
FY23	2022-23	12.30	12.52	16.00	23.35
FY24	2023-24	12.78	13.07	17.76	28.49
FY25	2024-25	13.34	**13.65**	**19.71**	**34.75**

[8] The figures of total Assets have been taken from DBIE Database- Statistical Tables- Liabilities and Assets of Scheduled Commercial Banks (excluding Foreign Banks)

Based on the projections of Bank Guarantees till FY 25, we can have conducted a further analysis. The table below shows the projected Bank Guarantees by FY 25, when CAGR IS 2.2% (with respect to our earlier calculations), when CAGR is 4.4% (2x of 2.2%), 11% (5x of 2.2%) and 22% (10x of 2.2%).

Looking at these figures, it is evident that **there exists a huge gap between the BGs required and the expected supply of BGs from the banking system**. Even if we assume the CAGR of BGs to be 10x, the projected BGs in FY 25 would come to INR 34.75 lakh crore, while the requirement of Bank Guarantees by FY 25 is about INR 95 lakh cr. **It is evident that the limit of Bank Guarantees is getting exhausted and there is a need for an alternative to Bank Guarantees**. The alternative to Bank Guarantees can thus be SURETY BONDS.

If we take the CAGR of BGs to be 10x (of 2.2%) which is 22%, then the approx. Market Size of Surety Bonds in India would be around INR 60.25[9] lakh cr. According to our projections, the gap between the demand and supply and hence the market size of Surety Bonds in India is about **INR 60 lakh crores**[10].

Since the Surety Bonds are going to be introduced as an Insurance product, it is important to

MARKET SIZING

- Indian insurance market stands at USD131 billion as of FY22.
- The Indian insurance industry grew at a CAGR of 17% over the last two decades and is expected to continue its commendable growth trajectory in the future years.

INCREASING INVESTMENTS

- In February 2021, the Finance Ministry announced to infuse INR 3,000 crores (USD 413.13 million) into state-owned general insurance companies to improve the overall financial health of companies.
- The government has made FDI laws easier for the insurance sector, raising the FDI limit from 49% to 74%.

POLICY SUPPORT

- As of April 2022, the Indian government intends to raise INR 50,000 crores (USD 6.6 billion) through the LIC IPO.
- In September 2021, the Union Cabinet approved an investment of INR 6,000 crores (~USD 805 million) into entities, offering export insurance cover to facilitate additional exports worth INR 5.6 lakh crore (~USD 75 billion) over the next five years.

have an overview of growth in the Insurance Sector. In order to assess the growth trends and performance of the Insurance Sector, we have looked at the Market Sizing and CAGR of the Insurance Sector. The present scenario of the Insurance Sector with respect to its market size and budgetary allocations[11] is as follows:

According to BFSI-Analysis of the Insurance Sector 2022, India is ranked 11th in global insurance business. India's share in global market was 1.72 % during 2020 and the total insurance premium volume in India has increased by 0.1 %. Overall insurance penetration (premiums as % of GDP)

[9] Calculated as the gap (95 lakh cr minus 34.75 lakh cr)
[10] If we take the CAGR of BGs to be 22%, 95 lakh cr minus 34.75 lakh cr is around 60 lakh crore
[11] Source: IBEF Insurance Industry Report- August 2022

was 3.76 % in FY 20[12], while that of US[13] was around 12 %. US serves as the largest Surety Bond Market. According to the IBEF Insurance Industry Report June 2022, Insurance reach is still low in India and it provides a huge underserved market. In other words, looking at growth trends and global ranking of the insurance business in India, it shows some signs that the Insurance sector in India may have the potential of entering into the Surety Bond Market space.

1.3 Surety Bond Issuances in India

Recently while addressing the Confederation of Indian Industry's Global Economic Policy Summit, Union Minister Nitin Gadkari announced that the Road Transport and Highways Ministry will launch the first Surety Bond by general insurance companies on December 19, 2022. Bajaj Allianz General is set to be the first company to launch this product. SBI General Insurance and Tata AIG General Insurance are also said to be looking at launching a surety insurance product soon. However, India's largest private sector general insurer-ICICI Lombard General Insurance is still evaluating the contours of the product, given the recovery process in case of a default is still a vexed issue for a number of companies in the industry. The government believes that the surety bonds will help in boosting the liquidity in the infrastructure sector by freeing the contractors working capital stuck in bank guarantees. Thus Surety Bonds is a potential alternative for bank guarantees. There are a variety of implementation and legal issues that may arise and that ought to be looked at closely which are important for the successful implementation of this product in India.

[12] IBEF Insurance Industry Analysis Report Mar 2021
[13] Source: Swiss Re Survey Report on Insurance 2020

2. International Practices

2.1 Global Market Overview

The trends with respect to the market size and growth of Global Surety Bond Market are as follows:

Table 4. Global Surety Bond Market trends

Country	Market value (2019)	Market value (est. 2027)	CAGR from 2020-2027
Global	USD 16.07 Billion	USD 25.18 Billion	6.40%
US	USD 8.57 Billion	USD 13.50 Billion	6.40%
Europe	USD 3.61 Billion	USD 5.40 Billion	5.80%

With a current total Global Market value of ~ USD 20 Billion and growing CAGR of ~6%, Surety Bonds are extensively used to support Infrastructure building across the world Surety Bonds have healthy markets extending from advanced economies like US, Canada, EMEA, South Korea, to emerging economies of South Africa, Brazil and Latin America.

Surety Premiums: The Report by Swiss Re on Trade Credit Insurance and Surety Premiums, October 2014 talks about the Surety Premiums for various countries for the time period of 2003-2013.

Table 5. Global Surety Premiums

Country	Premium volume		Share of world market		Average growth rate
	2003	2013	2003	2013	2003-2013
North America	4150	5840	56%	45%	3%
US	3963	5317	53%	41%	3%
Canada	186	523	3%	4%	11%
Latin America	540	2210	7%	17%	15%
Brazil	45	508	1%	4%	28%
Mexico	308	603	4%	5%	7%
Advanced EMEA	1569	2936	21%	23%	6%
France	238	588	3%	5%	9%
Germany	233	639	3%	5%	11%
Italy	551	658	7%	5%	2%
Advanced Asia	1005	1726	14%	13%	6%
South Korea	790	1377	11%	11%	6%

Since the latest data pertaining to 2022 was not available, we have cited the above data which shows market growth during 10-year period from 2003 to 2013. This is to give an idea and represent those countries which are amongst the top surety bond market players who have achieved remarkable growth in the surety insurance space by 2013. At present, the global surety market is dominated by the developed regions, such as North America and Europe, accounting for more than 75% of the global surety market collectively. Factors such as aging infrastructure in developed countries, need for massive restoration investment, and acceptance of P3[14] models are contributing significant market share consolidation of the surety market companies in North America and Europe.

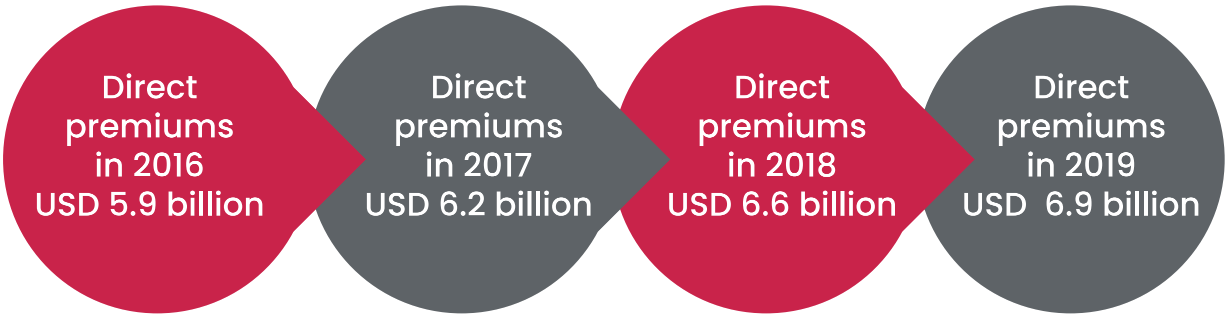
According to the Report by the Insight Partners on Surety Market Forecast 2027- published in July 2020, there exists a fragmented Global Surety Market. This fragmentation can be attributed to a huge number of market players operating in the Surety Bond space. The Travelers Indemnity Company, Liberty Mutual Insurance Company, The Hartford, Chubb, and CNA Financial Corporation are some prominent market players with the considerable customer base and strong market position.

We now look at individual surety bond market in specific countries.

2.2 Surety Bond Market: US

2.2.A Overview and Market Size:

- According to The Surety and Fidelity Association of America (SFAA) Direct premiums witnessed considerable growth in US since 2016. Historic legislation, dynamic market encompassing contractors from small to mega projects and acceptance of Surety Bonds by the State has led to this growth.



- According to the Report by the Working Group, IRDA the Surety Market penetration rates in North America region are higher than any other markets across the globe. This is attributed to laws that mandate Surety Bonds. Both the US and Canada Surety markets are dominated by insurers, and banks play only a minor role.

[14] P3 Projects are public private partnerships with the aim of procuring public infrastructure where the private sector assumes a major share of the risks in terms of financing and construction, from design and planning, to long-term maintenance.

Table 6. Surety Premiums

Parameter	2017	2018	Expectations for 2027
Direct premiums in North America	USD 7.73 billion	USD 8.17 billion	USD 15.27 billion
Contract Surety Bond segment	USD 7.27 billion	USD 7.67 billion	USD 14.78 billion
Commercial Surety Bond segment	USD 4.46 billion	USD 4.67 billion	USD 8.36 billion

Source: 2019 Surety Market Global Analysis published by The Insight Partner

2.2.B Legislative Support:

- In 2019, SFAA partnered with other industry organizations to advocate for bonding on P3[15] projects to state legislators. Through advocacy and education, the Indiana Finance Authority (IFA) and the Indiana Dept. of Transportation both agreed to 100% Payment Bonds and Performance Bonds of at least 50% for P3s for road and transportation projects.
- Colorado signed Senate Bill 19-38 into law in April 2019, clarifying that Surety Bonds are required on P3 construction projects. Recent North Dakota legislation amends all three of the State’s P3 laws to require a 100% payment bond and a 50% performance bond.

2.2.C The U.S. Small Business Administration’s (SBA) Surety Bond Guarantee Program:

- 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 the loss if the contractor defaults. 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.
- Detailed guidelines with respect to the overview of the program, eligibility criteria, structure has been formalised and implemented by SFAA.

2.2.D Surety Losses:

- In terms of Surety losses, in 2017, the loss ratio stood at 16% and decreased to 13% in 2018 leading to a higher net 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.
- By the late 1990s, after more than a dozen years of profitability, the Surety industry suffered record losses in 2000 and was especially hard hit in 2001 by a series of high-profile corporate failures.

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[14] P3 Projects are public private partnerships with the aim of procuring public infrastructure where the private sector assumes a major share of the risks in terms of financing and construction, from design and planning, to long-term maintenance.

- There can be several reasons for the surety industry to face losses, be it the macroeconomic conditions, loss of appetite, lower risk bearing capacities, contractual losses. One of the major causes of contract failures can be attributed to contractor failures.

2.2.E Contractor Failure trends in US:

- In some cases, contract failures can also be due to the failure of the construction contractors. Construction is a risk-filled enterprise and even capable and well-established contractors can ultimately fail.
- Some trends observed in the US market with respect to Building, Heavy/Highway, and Specialty Trade Contractors in US are as follows:

Table 7. Trends depicted Failure of Contractor in US

In Business		Survivors		Failure Rate
in 2002	8,53,372	in 2004	6,10,357	28.50%
in 2004	8,50,029	in 2006	6,49,602	23.60%
in 2006	11,55,245	in 2008	9,19,848	20.40%
in 2009	8,97,602	in 2011	7,02,618	21.70%
in 2011	9,86,057	in 2013	7,35,159	25.40%
in 2014	10,21,350	in 2016	7,22,281	29.30%

- As is evident from the above data, the average failure rate of contractors since 2002 has been around 25%. In the unfortunate event that a bonded contractor does default, the surety has legal obligations to the project owner and the contractor. First, the owner must formally declare the contractor in default. Then the surety company conducts an impartial investigation before settling any claim. This protects the contractor's ability to pursue legal recourse in the event that the owner improperly declares the contractor in default.
- Several reinsurers left the surety market in such hard times. Those that have chosen to remain have refocused their strategies and continue to support well managed surety companies; at a price. The refocusing has meant renegotiated treaties with the sureties, increased prices, additional exclusions and substantially more risk retained by the primary surety company.
- Since 2019, along with strong surety capacity, contractor failure has been low. Just as importantly, profit margins seem to be on the rise thanks to the increased opportunities and increasing backlogs.
- The data pertaining to Surety losses is depicted as below:

Table 8. Surety Losses

Indicator	2017 (USD in millions)	2018 (USD in millions)
Direct Premiums Earned	6017	6303
Direct Losses incurred	938	818
Loss %	15.6 %	13.0 %

2.2.F Regulatory intervention to protect Surety providers:

- Before agreeing to bond a contractor, Sureties typically require those with a financial interest in the contractor to sign a General Agreement of Indemnity ("GAI"). The 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.
- One of the common practices followed in US in order to protect against contract failures is the Right to Subrogation. 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.

2.2.G Market Players

Since there is a huge Surety Bond Market in US, there are a variety of players and companies operating in this market. There are about 162 companies writing this line of insurance as of 2017. The top 20 surety insurers in 2022 with their market share can be listed as below:

Table 9. Top Market Players in the Surety Bond Market

Company	Direct Premiums Written (in USD thousands)	Market Share (in %)
Liberty Mutual Insurance Companies (G)	918,719	13.25
Travelers Group (G)	908,250	13.1
Zurich Insurance US PC Group (G)	549,759	7.93
CNA Insurance Companies (G)	507,160	7.32
Chubb INA Group (G)	373,920	5.39
Tokio Marine US PC Group (G)	290,444	4.19
Hartford Insurance Group (G)	225,649	3.25
Intact US Insurance Group (G)	184,373	2.66
Fairfax Financial (USA) Group (G)	181,297	2.62
IAT Insurance Group (G)	163,211	2.35

Source: Best's Ranking "Largest 30 Surety Insurers – 2022 Edition

2.3 Surety Bond Market: Brazil

OVERVIEW

- A huge contributor to the Latin American Surety Bond Market, the highest amount of premium earned in Latin America is by Brazil

BANKS VERSUS INSURERS

- In Brazil, Surety and Bank guarantee co-exist side by side and slowly surety is taking a 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.

MARKET PLAYERS

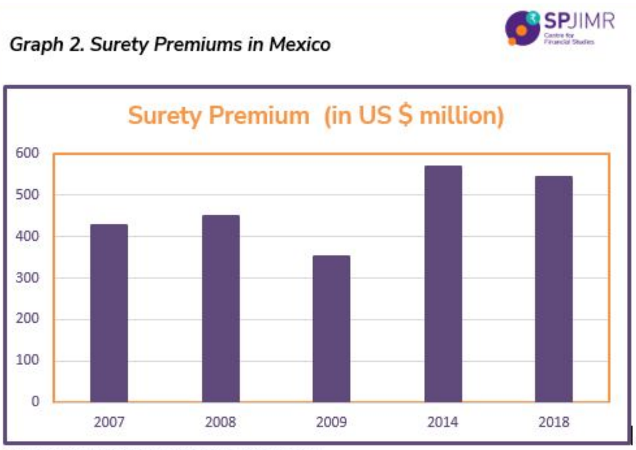
- The major Surety players in the market are Pottencial, Junto (Travelers), BTG, Fairfax and key reinsurers operating in the market are IRB, Munich Re, Swiss Re, Hannover Re and Everest.

Regulatory Framework:

- 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.
- 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. According to the changes proposed in the bill, the limit of the guarantee in now increased from 30 % to 100 %. This ensures that upto 100 % performance guarantee can be given for major projects (project size of BRL 100 million). The insurer will now be allowed to subcontract the conclusion of the contract, in whole or in part. The new law also allows the payment of instalment premium in performance bonds in two instalments.

2.4 Surety Bond Market: Mexico

- Overview: The growth trends in Surety Bond Market can be viewed as below:



Source: Working Group Report, IRDA

Surety corresponds to

- 1.7 % of the total insurance portfolio
- 20.5 % of the total premium placed in Latin America
- 0.04 % of the total Mexican GDP
- 0.32 % of the total public expense

Market Players

- The surety insurance market in Mexico is considered mature and one of the larger markets in the world. In 2018, 16 surety companies were operating in Mexico, with the five largest accounting for more than 80% of the total market and administrator surety bonds accounted for nearly two-thirds of total premiums written.

Regulated by: Surety Bonds are regulated by the Federal Act of Bonds in Mexico.

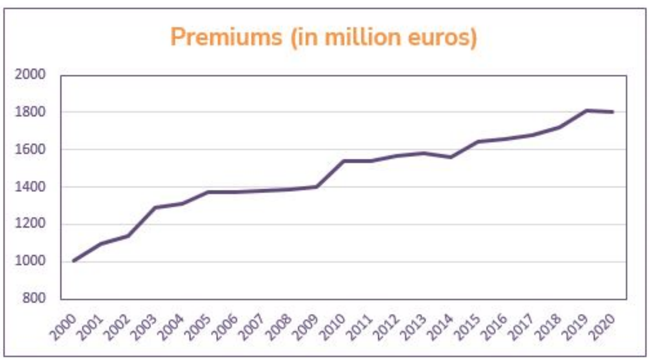
Mexico's new Insurance and Surety Institutions Law:

- On 4 April 2015, Mexico officially welcomed its new Insurance and Surety Institutions Law 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 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.
- Recovery is also different under an Insurance Bond as the Principal must return the amounts paid by the Surety to the Obligee, and it is then up to the Principal 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.
- It is believed that the benefits of the new law should include greater insurance industry transparency and better technical risk management. It may also encourage more foreign investment. It also opens up new opportunities in the insurance market.

2.5 Surety Bond Market: Germany

- Overview: The value of credit, surety, and fidelity insurance premiums in Germany since 2000 can be depicted as follows:

Graph 3. Surety Premiums in Germany



Source: GDV; BaFin, Germany September 2021

BANKS VERSUS INSURERS	MARKET PLAYERS	STRUCTURE
• Banks are competing with surety insurance but surety insurance is the dominant player in construction projects	• German Surety Bond Market is represented by local players such as R+V, Euler Hermes, VHV, Zürich, AXA and Coface.	• 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.

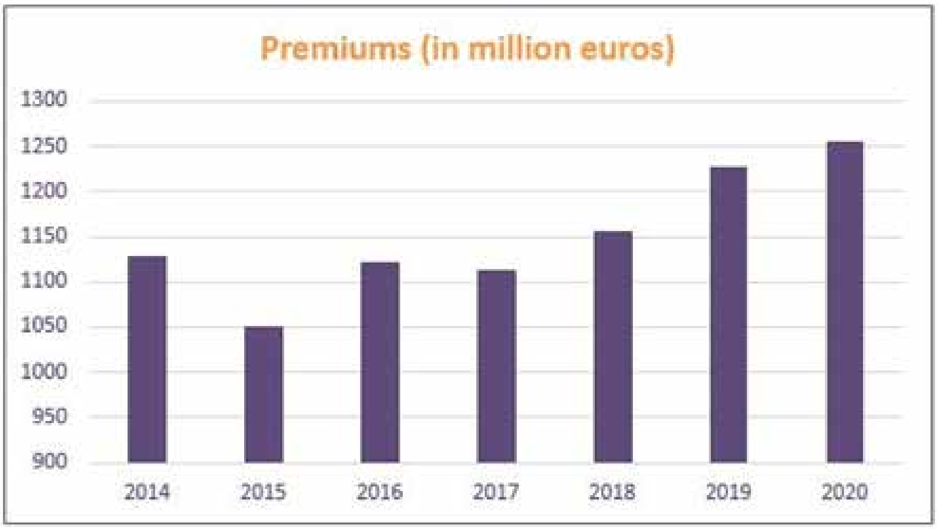
Regulatory Framework:

- German Civil Code (BGB) regulate the Surety insurance business and premium are determined by market forces and they are not tariff driven. Retention of Sureties are regulated by Solvency regulations. The Bond duration can be disconnected from the underlying duration obligation.
- Indemnity Agreement is must for any surety contract and indemnity agreement gives the right of recourse to the Principal; 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.
- In case of default, 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.

2.6 Surety Bond Market: Italy

- Overview: The Surety premiums in Italy from 2014 onwards can be depicted as follows:

Graph 4. Surety Premiums in Italy



Source: Istituto per la vigilanza sulle assicurazioni – IVASS, Italy, May 2022

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.

Banks versus Insurers

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.

Market Players

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.

Structure

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 Framework

Italian Civil code governs 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.

2.7 Takeaways from International Models

Based on the international models of the Surety Bond Market, we can summarise a general process that is followed while implementing Surety Bonds as a product. The process can be identified as follows:

Prequalification → **Underwriting** → **Default**

2.7.A Prequalification:

This is the first and an important step which enables a complete assessment of the applicant company. Before issuing a bond the surety company must be fully satisfied that the contractor has, among other criteria:

- Good references and reputation for performance delivery
- The ability to meet current and future obligations
- The experience matching the contract requirements

- The necessary equipment to do the work or the ability to obtain it
- The financial strength to support the desired work program
- An excellent credit history
- An established bank relationship and line of credit

2.7.B Underwriting:

Surety bond underwriting is the pre-approval evaluation by the surety. It undertakes an evaluation of both the bond performance requirements determined by the obligee and the principal's current financial situation to assess the risk related to the performance criteria and the principal's ability to reimburse the surety should a claim occur.

The process of underwriting considers the macroeconomic factors that could increase the risk of claims – like recession or pandemic – and the microeconomic factors – such as the financial performance of the insured contractor or the projected profitability of the contractor's backlog – to determine the rate that the contractor will pay and the bonding capacity the contractor will have.

The key underwriting criteria can be categorised as 6 Cs:

Capital

- Refers to financial strength of a principal, which a surety company assess by examining:
- Financial statements for the past 3 to 5 years, including the balance sheet income statement, statement of cash flows and statement of owners equity
- A summary of completed contracts and schedule of work in progress listing the name contract price and anticipated completion date of each job
- Credit report of the contractor
- Cost records accounting for the financial status of the contractors jobs
- A bank line of credit showing unsecured credit that can be use a short-term working capital

Capacity

- Refers to ability to perform, in which the surety company assess by reviewing:
- The resumes of the contractor and key personnel,
- The contractors history of completed works
- The adequacy of the contract as equipment and tools for the job
- A contingency plan illustrating how the company will operate their key personnel to deport
- The contractor’s future business plans goals in growth strategies

Character

- Review of references from owners, architects, sub-contractors, general contractors and suppliers with whom the contractor has worked to assess its reputation for fair, business like dealings

Conditions

- Refers to conditions of the surety transactions.
- Review of the state of the economy and industry of the principle, check if the terms and conditions of the underlying contract fair and realistic, review of the wordings of the indemnity agreement.

Collateral

- A surety company typically asks the principle to sign an indemnity agreement before a bond is issued.
- If the balance sheet of the principal is deemed to weak, the surety may in addition ask for a parental guarantee or even hard types of collateral such as cash or pledge of assets.
- Strong collateral considerably mitigates the risk for the surety company as it enhances the likelihood of recovery of a claim paid.

Confidence

- The underwiters takes an educated decision based on previous facts and experience.
- Underwriter takes the decision on the basis of a certain level of confidence in a transaction comfort a level of entering into an agreement etc

2.7.C Contract Failure or Default:

- With surety bonds, the risks of project completion are shifted from the owner to the surety company. For that reason, many private owners require surety bonds from their contractors to protect their company and shareholders from the enormous cost of contractor failure.
- In the unfortunate event that a bonded contractor does default, the surety has legal obligations to the project owner and the contractor. First, the owner must formally declare the contractor in default. Then the surety company conducts an impartial investigation before settling any claim. This protects the contractor's ability to pursue legal recourse in the event that the owner improperly declares the contractor in default.
- When there is a proper default, the surety's options often are spelled out in the bond. These options may include:
    - right to re-bid the job for completion
    - bring in a replacement contractor
    - provide financial and/or technical assistance to the existing contractor
    - pay the penal sum of the bond.

2.7.D Issues in implementations:

- According to 2019 Surety Mid-Year Update ENR Magazine Report, all those surveyed about the surety trends and challenges noted that while the contractor margins and amount of work are increasing, labour shortages, onerous contract provisions, scope changes, compressed schedules and poor owner financial metrics threaten the current market strength.
- One of the disquieting issues for construction and surety remains the lack of a long-term federal infrastructure bill, which puts considerable stress on both state and local agencies to come up with funding sources themselves.

2.7.E Bond Rates:

Surety bond premiums vary from one surety to another but can range from 0.5% to 3% of the contract amount. The premium rate depends on the size and type of the project, the contractor's creditworthiness, the level of collateral (if any) posted with the insurer, and the projects' anticipated duration.

2.7.F Primary Creditor? Comparison between Banks and Insurance Companies:

- According to a report by Marsh, Surety Bonds can be provided by banks or insurance companies. However, banks will only provide unconditional on-demand bonds that are independent instruments and do not provide any protection of the underlying contract conditions. Using banks for the provision of bonds will also impact the working capital headroom.
- The insurance market prefers to provide guarantee bonds that are conditional in nature and relate directly to the underlying contractual obligations. This type of instrument is 'off

balance sheet' and will not impact or reduce the working capital facilities. An insurer will usually take security by way of a counter indemnity from the company (or group) and will not charge an arrangement or non-utilisation fee. Bond premium is paid solely on the individual bond requirement.

Banks versus Insurers

Surety Bonds have been introduced as an alternative to bank guarantees in India. While both of these work on a common fundamental principle, it is important to understand the technical differences in their nature which are described as under:

Bank Guarantees	Surety Bonds
Basic Principle: promise a sum of money to a beneficiary if a third party fails to fulfil its contractual obligations	
Abstract in the sense that it is legally independent of the underlying contract or obligation.	Accessory to the main contractor, legal or regulatory obligations between beneficiary and principal.
	That is, the existence of the responsibility of the surety depends on the existence of an underlying obligation (resulting in the above described tripartite structure of a surety bond, involving surety beneficiary and principal)
Typically payable on demand	Often conditional

Sureties compete with banks for bonding/guarantee business in many markets. In the US, the banks role is restricted by law but in many European markets, banks act as dominant players. In Latin America banks complete also but to a lesser degree than in Europe.

Banks compete with the insurers in the surety and guarantee markets. In some markets such as US and Canada, insurers hold a dominant position due to regulations restricting banks' role. However, in many European countries, the banks market share exceeds that of insurers. The Report by Swiss Re on Trade Credit Insurance & Surety, October 2014 gives a detailed analysis of how banks and insurance companies share the surety market space. The Market share of banks and surety writers in different countries in 2013 can be depicted as follows:

Source: Report by Swiss Re on Trade Credit insurance and Surety: Taking stock after the financial crisis-2014. International Credit Insurance & Surety Association (ICSIA)

3. Regulatory Framework

Regulatory guidelines pertaining to Surety Business in India corresponds to Section 126 of the India Contract Act. According to the Act, Contract of guarantee', 'surety', 'principal debtor' and 'creditor'—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'. The IRDA Surety Guidelines defines a Surety Insurance Contract as a contract of guarantee pursuant to section 126 of the Indian Contract Act, 1872, where the Insurer (as a surety) will perform the promise or discharge the liability of a third party in the event of a default and such insurer must be registered under the Insurance Act, 1938, as a general insurer.

The IRDA Surety Guidelines provide for general requirements of underwriting of surety insurance, which includes

- Solvency Margin: maintaining a solvency margin of not below 1.25 times of the specified solvency level by IRDA
- Premium to not exceed 10% of the total gross written premium of that year, subject to a maximum of INR 500 crore
- Establishing risk assessment/internal risk management to evaluate technical/financial strength of Principal

The main considerations regarding certain legal aspects pertaining to the implementation of Surety Bonds in India are as follows:

I. Solvency Ratios:

Under the Insurance Regulatory and Development Authority of India (Assets, Liabilities, and Solvency Margin of General Insurance Business) Regulations, 2016 ("IDRAI Solvency Regulations"), there are various solvency ratios:

(A) Available Solvency Margin: Available Solvency Margin is the excess of the value of assets over the value of liabilities. Under Regulation 2 of the Solvency Regulations, every insurer at all times shall maintain its Available Solvency Margin at a level which is not less than higher of (i) 50% of the amount of minimum capital as stated under Section 6 of the Insurance Act and (ii) 100% of Required Solvency Margin. Section 6 of the Insurance Act requires INR 100 crore minimum paid up equity share capital for general and health insurers and INR 200 crore minimum paid up equity share capital for re-insurers.

(B) Required Solvency Ratio: Required Solvency Margin is based on a calculation of gross insurance premiums, net insurance premium, gross incurred claims, and net incurred claims and the solvency margins required. The required solvency margin is calculated by insurance companies on the basis of their mathematical reserves and the sum at risk.

(C) Solvency Ratio: A minimum Solvency Ratio of 150 % has to be maintained by insurance companies. The "Solvency Ratio" is the ratio of the amount of Available Solvency Margin to the amount of Required Solvency Margin as specified in the IRDAI Solvency Regulations.

According to the guidelines, it is important for insurance companies to have their solvency margins above a certain threshold. This can be attributed to the fact that this product is new in India. However, it is important to understand a fundamental aspect of Surety. Unlike other types of insurance, Surety will be reimbursed by the Principal on whose behalf the Surety bond is issued. Since Surety Bonds are significantly different in nature and as the amount paid by the insurance companies is reimbursed, there is lower risk associated with Surety Bonds. The Required Solvency Margin, Available Solvency Margin and Solvency Ratio from a capital perspective do not take into account the fact that an insurer will be re-imbursed. In order to enable insurers are clear on capital and ratios, the Solvency Regulations should take into account the fact that there is reimbursement from the assured. But considering the nascency, we would recommend that this clause can be looked at in a time frame of about 3 to 5 years, Amendments can be made and solvency regulations can be diluted once adequate track record is established. The Surety business encompasses risk based on counterparty rating and past history (invocation of bank guarantees, performance defaults, discontinued or deferred projects). Thus, solvency regulations should also take into consideration the rating of counterparties and beneficiaries.

Capital Adequacy Compliance and Ratings:

Under the RBI Master Circular- Basel III Circulations dated 1 July 2015 balance sheet assets, non-funded items and other off-balance sheet exposures are assigned prescribed risk weights and banks have to maintain unimpaired minimum capital funds equivalent to the prescribed ratio on the aggregate of the risk weighted assets and other exposures on an ongoing basis. While issuing bank guarantees, banks use credit rating mechanisms to measure credit risk. External credit rating agencies have been identified by RBI. Banks rely on the ratings assigned by these external credit rating agencies for assigning risk weights for capital adequacy purposes.

With respect to Surety Bonds, the IRDAI Surety Guidelines do not have any specific rating requirements for the counterparty on whose behalf the surety bond is issued. It only looks at qualitative parameters such as reputation of the contractor, its financial strength, past experience etc. Since the surety contract has a re-imbursement obligation, assessment of credit rating would be an important parameter to assess credit risk. Making a qualifier regulation and filtering with AAA rating would lessen the risk for insurers.

II. Indemnity Agreement:

Owing to the lack of clarity regarding Surety being treated as a financial or operational creditor, the insurance companies have sought an indemnity agreement where the Principal unconditionally indemnifies their losses. Various international examples can be cited to support this recommendation. Well-developed Global Surety Markets like US, Germany and Italy (Italian Civil Code) establish that Indemnity is a part of their Surety mandate. In US, there is a regulatory framework which establishes the existence of a GAI- General Agreement of Indemnity which provides the Surety with the means to be reimbursed when a loss is incurred. It is extremely important to incorporate the Indemnity Agreement while implementing Surety Bonds in India. Various approaches for implementing the Indemnity Agreement in context of India has been provided in detail in the Recommendations Section.

III. Right of Subrogation:

The Right of Subrogation states that 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. This right is one of the common practices followed in the US which is a well-developed Surety market. This law ensures protection to surety providers. We recommend the inclusion of the Right of subrogation while implementing Surety Bonds in India.

IV. Operational Creditor:

Under the Insolvency and Bankruptcy Code (IBC), a financial creditor is a person to whom a financial debt is owed by a corporate debtor and includes any person to whom such debt has been legally assigned or transferred. A financial debt is a debt together with interest, if any, which is disbursed against the consideration for the time value of money and includes: any counter-indemnity obligation in respect of a guarantee, indemnity, bond, documentary letter of credit or any other instrument issued by a bank or financial institution.

In India, we expect Surety to predominantly cover performance risk. Surety Bonds may also be issued to cover financial risk (advance payment guarantee). In our conversations with ZBA, one of the leading law firms, we realized that if Surety has been issued to cover financial debt, then it can be argued that Surety may be considered within the scope of IBC and insurance companies considered as a financial creditor alongside banks. According to the definition of Financial Institution under Section 45-I of the Reserve Bank of India Act, a Financial Institution includes any non-banking institution carrying on any class of insurance business. If underlying debt is a financial debt, then the guarantee and the Surety can fall under the purview of a financial creditor. Examples of a few cases to justify this argument would be Andhra Bank V. F.M Hammerle Textile Ltd, (NLAT, July 2018), Davinder Ahluwalia v. Sumit Aviation (NCLT, Delhi, August 2017), Neeraj Bhatia v. Davinder Ahluwalia (February 2018), V. Kanchana v. P.B. Radhakrsihnan & Ors. (NCLAT, August 2018), Mrs. Anita Kumaran and Anr. v. KGS Developers (NCLT, 2019).

However, if Surety / Insurance Companies are considered as an operational creditor owing to surety covering performance risk, then insurance companies will not benefit from IBC the way banks do. This is a serious area of concern for insurance companies. And hence would require amendment of existing regulations. Alternatively, if RBI & IRDA were to clarify the position of Surety as a Financial Creditor then it would assuage the concerns of insurance companies from a risk & default perspective.

4. Pricing

Surety bond prices are typically market driven. The pricing of Surety Bonds depends on the underwriters' assessment of various important factors representing the profile of the Principal. Underwriters assess the risks associated with a certain project based on various parameters which include the risk profile of the Principal, the bond amount required, the duration of the particular project and other relevant information about the project. Underwriters assess risk of individual accounts based on financial statements and other documents. The Surety makes an informed decision after the underwriters' review of the contract.

The price of the Surety Bond depends on the following factors:

- Financial Performance: This includes the status of the financials of the Principal- balance sheets, cash flows and income statements. This enables the underwriters to evaluate a better understanding of the financial position of the Principal and the ability to sustain the bond obligations in the event of a claim.
- Credit Score and Credit Ratings: Better the credit score, the lower is the premium. If your credit score is strong, the premium can be as low as 1% of the bond amount. The sureties and their underwriters believe that there is a strong relationship between the credit history and the likelihood of adhering to bonding terms and conditions. An applicant who has not satisfied financial obligations in the past may be more likely to violate a bonding requirement, and thus presents a higher risk of loss for the Insurer/Surety.
- Past Performance: This includes review of the performance of the company in the last 5 years, claim history of previous bonds, past history of whether bank guarantees have been issued and revoked. The experience in the industry also matters to a large extent. More experienced professionals are less likely to get stuck and abandon projects halfway.
- Type of Bond: The type of bond is essential because it determines the risk that the surety is taking. It is believed that generally, bonds associated with construction projects are considered to be expensive as compared to others.
- Current requirements: This refers to the value of the project under consideration, current status of the project, current business plan, financial requirements, bond coverage amount required.
- Contract failure: This refers to the probability of failure for that particular project which can be evaluated on the basis of past records.

Probability of failure of that particular projects depends on past records. Traditionally, in order to evaluate this important aspect of surety pricing, actuarial techniques have been used. Two methods- Experience Rating and Exposure Rating are commonly used in this area.

Experience rating is the amount of loss that an insured party experiences compared to the amount of loss that similar insured parties have faced. Insurance companies closely monitor the claims and losses that come from the policies that they underwrite. This evaluation includes determining whether certain classes of policyholders are more prone to claims, and are thus riskier for the company to insure. Experience rating helps an insurance company determine the likelihood that a particular policyholder will file a claim. In this sense, the past loss experience of a policyholder is used to determine future changes to the premium charged for the policy. Experience rating is a demanding methodology which requires reasonably extensive data, thus restricting its applicability to larger volumes of business and longer time intervals. It also requires reasonably good quality data. Experience rating has been used by insurers when reviewing the rate adequacy of their book and also by reinsurers when pricing reinsurance.

Exposure rating is a procedure used to calculate risk exposure in a reinsurance treaty. In this method, risk associated with the loss experience of a portfolio, is examined in order to determine the potential losses of a client. In this methodology, pricing is done on the basis of the risk exposure and not on past trends. Exposure rating is more complicated phenomenon. The lack of credible exposure rating parameters is generally a greater problem than the judgement required for experience rating. Exposure rating systems typically require so many soft factors that the results are unsuitable for the purpose of portfolio analysis.

In the case of Surety Bond Pricing in India, insurance companies would use exposure rating. If surety is underwritten with a zero loss expectancy, using the method of experience rating, would not be apt. It would thus make sense at least in the initial phase of implementation, to look at the risk associated with the project under consideration and evaluate the pricing based on exposure rating. Since, experience based rating is based on the quality of data, it is extremely important to have a universal credit database created by IRDA and RBI which puts together banks experience with respect to bank guarantees and defaults. Insurance companies should be able to access this data. The presence of such a database will enable insurance companies to move from exposure based rating to experience based rating. While exposure based rating will be an individualistic approach, experience based rating will be able to give a holistic picture. Experience based pricing will then enable insurance companies to pick their client base in a better way and will allow them to be more competitive with clients who have an excellent track record.

In addition to reviewing the above parameters, analytics from internal data and industry organizations has begun to supplement the process of underwriting while determining Surety Pricing. Analytical techniques are used to determine various important variables like the financial risks associated with the projects, appetite required to bear the risk, cost of losses incurred (if any) etc. Incorporating analytics has led to the making the decision process more data driven.

The cost of a surety bond is called the premium and is set as a percentage of the bond amount. The "bond amount" is sometimes referred to as the "penalty," "coverage," or "bond limit". The percentage can vary widely, ranging anywhere from 0.5% to over 10% of the bond amount. The rate multiplied by the bond amount equals the cost of the bond for each year. Higher risk bonds usually carry higher premium costs. Surety companies assess the level of risk by the bond type and the applicant's financial history. A bond type with higher risk plus an applicant's poor credit may result in a premium that could be as high as 20% of the bond amount.

In US, the cost of the surety bond varies in the range of 1% to 15% of the bond amount. The pricing differs from country to country, as the risk associated in every country is different. In India, the cost of funds is around 0.6%. This cost plus the premium gives us the total fixed cost to insurers. Insurance companies in India are of the view that the pricing of surety bonds in India should be around 1% to 3%.

The pricing of Surety Bonds also depends on how reinsurance is managed. Reinsurance is an insurance that an insurance company purchases from another insurance company to insulate itself from the risk of a major claims event. With reinsurance, the company passes on some part of its own insurance liabilities to the other insurance company. U.S. regulations require reinsurers to be financially solvent so that they can meet their obligations to ceding insurers. U.S. reinsurers are regulated on a state-by-state basis. Regulations are designed to ensure solvency, proper market conduct, fair contract terms, rates, and to provide consumer protection. Reinsurance premiums falls between the range of 20% to 30%.

Challenges in creating an Indian Surety Bond Market

While Surety Bonds are a globally accepted product, creating a new market for the same in India has its own challenges, primarily arising from the risks related to market making of a new financial product. The biggest challenge which discourages players is the lack of awareness about the product. While NHAI has shown understanding and intent to issue Surety Bonds, many of the State Governments are yet to adopt Surety Bonds.

Apprehension of Insurance Companies to enter the surety bond market

Though Surety Bonds are looked at as a promising alternative to bank guarantees, insurance companies are apprehensive of the nature and implementation of the product with respect to the Indian market.

The areas of concern are as follows:

- **Indemnification:** The existing guidelines are unclear regarding the indemnification clause in a Surety contract. Indemnification serves as a reminder for the principal to fulfil their obligations to the project owner and also offers protection to the surety provider. However, the absence of provisions related to the principal’s responsibility to indemnify and hold the surety provider harmless from any liabilities, as well as the principal’s cooperation with the surety provider during the investigation of a claim, are causing concerns for insurance companies.
- **Loss mitigation tools:** The loss mitigation tools underlying in the Surety contract are not clearly defined, causing insurance companies to worry about their risk-bearing capacity. The absence of sufficient information in this regard is making it difficult for them to assess and mitigate risks. Additionally, in the event that the principal fails to fulfil their obligations as per the contract, there is limited regulatory framework available to address the situation. This leaves insurance companies exposed to more risk and raises significant concerns about their ability to recover losses. In addition to this, there is an absence of a vibrant Re-insurance market. As a result, the insurance companies are concerned that they would not be able to diversify/distribute the risk. Insurance companies rely on re-insurance market for risk management.
- **Database creation:** To effectively price surety bonds, it is crucial to undertake actuarial pricing, which is based on analysing past data. However, this requires an extensive database of product issuances, which is currently lacking. The absence of sufficient data is hindering the development of a pricing model and is also contributing to a reluctance to offer the product in the initial stages, making it challenging to create a market for it. This issue is further compounded by the financial and policy-related challenges typically associated with launching a new financial product.

Insurance companies are worried that they may not have access to the historical data on bank guarantee issuance and defaults, which is currently held by the banking sector. However, even within the banking sector, there is no consolidated central database for this information. This lack of access to historical data is making it difficult for insurance companies to properly assess risk and effectively price their products.

- **Absence of legal recourse:** Insurance companies are concerned about their position with regard to IBC. Insurance companies are not considered as financial creditors, and as a result, they do not have the same rights as financial creditors under the Insolvency and Bankruptcy Code (IBC). Due to this, they are concerned about their ability to enforce their rights against project assets in case of a default.

Given the urgency of an Indian Surety Bonds Market owing to massive infrastructure building that India is undertaking, we present a set of recommendations which would address issues of various stakeholders in trying to build the same.

Recommendations for efficient implementation of Surety Bonds in India

1. Awareness Campaign

The authorities need to understand that Surety Bond is akin to a Bank Guarantee and they need to be persuaded to accept Surety Bonds. In practice while NHAI has come out with a policy on the matter, state governments in the road sector are yet to adopt a similar approach. **Workshops need to be held to bring all the authorities on the same page on acceptance of Surety Bonds.** The Insurers also need to allay the concerns of the Authorities in respect of claim settlements.

2. Nature of Surety Bonds

It is important to understand the fundamental difference between Surety Bonds and other insurance products. **Policy makers, players & regulators need to appreciate the unique nature of Surety Bonds**. Surety Bonds are different from a typical insurance product. Insurance is a contract between the Insured and the Insurer where the Insurer agrees to provide financial protection to the Insured in exchange for a premium. Upon a claim, the Insurer does not get any recovery from the Insured. But **in Surety Bonds, Insurer has the right of recovery against the project assets of the Insured**. This aspect has to be factored in structuring, pricing, capital guidelines for Insurance companies.

3. Indemnity Agreement

It is extremely important to incorporate an **Indemnity Agreement** while implementing Surety Bonds in India. The requirement for Indemnity can met in two ways. First by classifying the Surety Bond Issuers as Financial Creditor thus bringing the insurance companies under the ambit of IBC. This can a good way to take away the need of providing indemnity by the infrastructure players, which would also enable wider use of Surety Bonds across MSMEs and mid-sized companies. However, this would require material changes to IBC at the legislative level which may take time to happen.

An alternative method of meeting the requirement of indemnity is by having standard Indemnity Agreements as mandatory as part of Surety Bonds. Under these Indemnity Agreements, the Principal would unconditionally indemnify the losses of the insurance companies. It may naturally be expected that insurance companies would be comfortable with indemnities from corporates rated in the AAA and AA family but not below this rating. To enable a wider issuance across the credit spectrum, particularly MSME sector, the Government may think of providing a partial counter indemnity in line with Credit Guarantee Scheme for MSME sector.

4. Credit Ratings of Surety Bonds

The risk assessment of Surety Bonds is based on risk perceived basis counterparty rating and track record / history (invocation of bank guarantees, performance defaults, discontinued or deferred projects). Insurance companies are used to using Actuarial Pricing Models to assess and price underwriting risk. **Actuarial Pricing Models won't work** here yet due to lack of data. Further there is no centralised, synchronized database providing history of execution or projects or invocation track record of BGs across banking sector. So, we recommend that regulators **permit insurance companies to use external credit rating to assess the underwriting risk of Surety Bonds**. The insurers can rely upon the external credit rating of insured companies from SEBI registered rating agencies like CRISIL, ICRA, India Ratings etc to calculate the probability of default under the counter indemnity and accordingly price the surety bonds.

5. Right of Subrogation and IBC

Another way of ensuring the effective implementation of Surety Bonds can be through the **Right of Subrogation / Substitution**. The Right of Subrogation requires that 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. It is important to include this as mandatory under Surety Bond issuance. Many of the developed Surety Bond markets globally have this as a practise.

In India, a few agreements provide substitution rights under the PPP Concession Agreements, however, **substitution hardly finds a place in EPC Contracts**. The Authorities need to be persuaded to permit Subrogation rights to the Surety, in order to ensure that the contracting work does continue in a seamless manner and the insurers also have adequate capacity to step into the shoes of the Contractor. This also would require an effective legislative framework.

Further, we expect the Surety to predominantly cover performance risk. So, there is a risk of insurance companies being subordinated to financial creditors such as banks as per IBC. In this scenario there is a risk of Subrogation Rights not being effective. So, we recommend that in due course, legal amendments be made to include Surety Bond also within the ambit of financial creditor as per IBC.

6. Solvency Ratios

According to the IRDA guidelines, it is important for insurance companies to have their **solvency margins** above a certain threshold. Unlike traditional insurance offerings, under Surety Bonds insurance companies have access to project assets & cash flows in the event of a claim. So, the Solvency Regulations should take into account the credit rating of the Principal, considering that the reimbursement from the Principal is assured. Normally Required Solvency Margin, Available Solvency Margin and Solvency Ratio from a capital perspective is arrived at considering Actuarial evaluation and probability of defaults. However, in absence of adequate data-points, Solvency ratio can be calculated on net basis i.e., the Actuarial calculation of invocation minus the credit rating based probability of default weighted indemnity payment by the Insured.

Conclusion

Overall, the development of Surety Bond market is extremely important for meeting the infrastructure development aspirations of India. But for Surety Bonds to take off, the concerns highlighted in this report need to be effectively addressed. It may not be possible to implement all the six recommendations made in this report. **Three recommendations i.e., awareness campaign, indemnity agreement and permitting insurance companies to rely on external credit rating are implementable immediately with limited challenges**. The rest of the recommendations will require a broader engagement of multiple stakeholders. However, a roadmap for implementing these recommendations may be drawn up to ensure Surety Bond market develops to its fullest extent in India.

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