Surety bonds: A roadmap to break out of limbo

The IRDAI guidelines for surety insurance business in India came into effect on 1 April 2022, however, insurers have not been able to kickstart the process. Asia Insurance Review spoke with **Intl Risk Consultants Insurance Brokers' Mr Suresh Khairwar** to understand more.

By Anoop Khanna

The Insurance Regulatory and Development Authority of India (IRDAI) has permitted Indian insurers to offer surety bonds and guarantee products domestically. This ruling came into effect on 1 April 2022 and is in line with the government's reforms push for the construction sector by allowing the acceptance of bonds and guarantees as a replacement for bank guarantees or performance or retention bonds.

According to a market estimate, around INR7tn ($86bn) is expected to be invested in infrastructure in the coming years. For the cash-strapped infrastructure sector, the availability of guarantees could catalyse much better performance.

Until the end of 2022, however, virtually no insurance company in India has formally announced that it is able to offer guarantees.

Asia Insurance Review spoke with Intl Risk Consultants Insurance Brokers principal officer Suresh Khairwar about what could be holding insurers back.

Apprehensive insurance industry

Mr Khairwar said, "It appears that insurance companies are either highly apprehensive or benchmarking this insurance cover with bank guarantees. These apprehensions can be categorised into either short-term or long-term issues."

Short term apprehensions could involve poor prior experience and knowledge about these products, availability of legal recourse and collaterals, lack of effective recovery mechanisms, differential treatment as compared to banks and the lack of reinsurance capacity.

Long-term issues could include lack of reinsurers' confidence in the Indian market and fear of negative regulatory interventions.

Benchmarking

Speaking about the present system of bank guarantees Mr Khairwar said, "Bank guarantees may not be the best comparison point for designing surety bonds because even for banks, the guarantees may not have been the starting point. Banks typically start with creating charge on assets and come up with a collateral-backed 'line of credit' before carving out the bank guarantees."

He said, "For banks, a legal ecosystem of enforceability and rights of recovery through regulatory intervention mechanism is already in place for funded facilities which gets extended to non-funded facilities as well. Creating collateralised guarantee facilities may be detrimental to the objectives set out by the government which is to facilitate freeing up the working capital locked in collaterals."

He said even if the insurer can influence the regulators to provide access to collaterals and the same recovery mechanisms as banks have, "It will result in dilution of banks' risk appetite, prompting change in risk weightage of collaterals and push borrowers to provide more collateral or better-quality collateral to enjoy similar limits which they enjoyed before dilution."

Top-down or bottom-up

Mr Khairwar said, "The whole process may push the entire problem back to square one with many products available but not much liquidity infused or freed up. For choosing between two main ways to

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approach and address the systemic introduction of surety bonds in India, we need to weigh the top-down or bottom-up approach."

In view of their apprehensions, currently it seems the insurance industry could be looking at these products from a 'bottom up' perspective, which means looking at competing product offered by banks and trying to fit in an insurance product around it.

Mr Khairwar said that so far successfully developing and deploying these product lines working with the largest Indian reinsurer and the largest global monoline insurer has always taken the 'top down' approach.

This approach includes identifying the risk, quantifying through available statistics, measuring risk probability with well-defined risk underwriting methodology, rating the company/industry/sectors for their individual risk profiles, designing the internal exposure norms (company/group/sector), to achieve proper spread of risk and pricing it in accordance with the risk appetite, risk weightage and exposure norms to create adequate reserves.

He said, "It is also possible to set up a reasonable starting point or create a pole position and reaching the end goal. There could be a few organic ways to acquire the underwriting skills during the initial phase for all round development of surety bond, guarantee and other financial products. The core issue of freeing up the working capital can be addressed comprehensively through these steps."

Trade credit insurance

Speaking about products that exist already in the Indian market that can be adapted, Mr Khairwar said that trade credit insurance (TCI) is one option.

He said, " Globally, monoline insurance companies offering TCI also offer surety bonds and guarantees based on similar underwriting principles. TCI companies do not have any charge on assets but provide similar result via access to availability of additional working capital by cutting down the working capital cycle."

Mr Khairwar said, "TCI companies rely solely on a bespoke, ever-evolving robust internal system of 'risk underwriting' based on past statistical data points of industry, sector, company and geographies."

He said, "Based on the statistical data points and sectoral research, TCI companies also create a commercial underwriting structure for comprehensive deployment of risk management principles to different industries, products or services."

TCI companies combine underwriting structure together with exposure management norms to spread the risk and also firmly deploy timely proactive loss minimisation and management and recovery processes to either come out of losses early or end up recovering the majority of their outstanding.

Roadmap for the future

Mr Khairwar said to achieve the government's objectives of comprehensive development and promotion of surety bonds, the industry could adopt a roadmap that can include the following the formation of a monoline TCI, surety bond and financial guarantee company.

Three of these global monoline companies command the majority of the market globally to an extent that in many countries they also support government owned export credit agencies.

In India, the Export Credit Guarantee Corporation of India (ECGC of India) is a monoline company which only writes TCI, surety bond and guarantees, successfully.

With the combination of these short-term and long-term initiatives, a robust ecosystem can be created for sustainable development of these lines which can help boost Indian economic growth.

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