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Insurers keen to launch surety bonds, but infrastructure companies may have to wait longer for booster dose

IRDAI has issued guidelines for surety bonds, which come into effect on April 1. Contractors will be allowed to use these bonds as a substitute for bank guarantees for government contracts

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The government has allowed contractors to use surety bonds as a substitute for bank guarantees for government procurements, which could be a shot in the arm for the cash-strapped infrastructure sector (Representative Image)

The infrastructure sector has been eagerly waiting for insurance companies to offer surety bond products beginning April 1, when the insurance regulator's guidelines come into effect. However, infrastructure firms may have to wait some more for these bonds to see the light of day.

The government has allowed contractors to use surety bonds as a substitute for bank guarantees for government procurements, which could be a shot in the arm for the cash-strapped infrastructure sector. Regulator, the Insurance Regulatory and Development Authority of India (IRDAI) has issued guidelines for these bonds.

Insurers, while keen to launch these products, are looking for more clarity on pricing and recourse options in case of a default by contractors. The insurers are also exploring reinsurance options and working to build teams that can help in evaluation of projects.

"We are closely looking at the surety bond business and examining all aspects such as international best practices, reinsurance arrangements, regulations, pricing, etc. Once we have clarity on all such aspects, we will be keen to offer surety bonds to our customers," Sanjay Datta, Chief – Underwriting and Claims, ICICI Lombard General Insurance, told Moneycontrol.

Moneycontrol spoke to insurers and insurance agents, many of whom said that they have sought the government's help to have in place a strong and effective recovery mechanism that aligns their rights with other creditors under the insolvency code.

"To undertake Rs 20 lakh crore of infrastructure construction as per the National Infrastructure Pipeline, if you don't have surety bonds we can miss the target because the bank guarantee is a major bottleneck. For smaller construction companies, banks ask anywhere close to 30-50 percent of cash money margin, which is then stuck in the guarantees," said Vinayak Chatterjee, Chairman of the Confederation of Indian Industry's (CII) National Task Force on Infrastructure Projects.

Unchartered Territory

A surety bond is a contract signed by three parties: the principal (contractor), the surety provider (insurance company) and the obligee (the entity requiring the bond, such as a government entity). It provides a mechanism to transfer risk and works as an assurance that the contractor will perform the task as per the contract.

Contractors who buy these unsecured bonds will pay a premium to an insurer in exchange for an underwriting guarantee in case there is a default in a project. In the case of a default, the surety company pays the project owner the promised amount.

This will be a new fee based business line for insurers.

TA Ramalingam, Chief Technical Officer, Bajaj Allianz General Insurance, said that his company is keen to launch surety bonds soon and is engaging with reinsurers who have dabbled in these products in Europe and the United States for a better understanding of exposure, risk, pricing, rating and other aspects, and also to tie up for reinsurance.

Uncertain launch timeline

So, when will the industry be ready to launch these products?

"The timeline is a bit uncertain. Reinsurers have raised a couple of issues relating to the recourse that is available. As far as the Insolvency and Bankruptcy Code (IBC) goes, banks have priority in case of a default. So, they (reinsurers) want to have clarity on what is the recourse available to recover the money because one of the main tenets of insurance is subrogation," Ramalingam said.

Vinay Sohani, MD & CEO at Gallagher Insurance Brokers, said that indemnity documents will play a pivotal role in boosting this business and the government should allow surety underwriters to become a financial creditor under IBC.

"Data sharing between bankers, surety underwriters, and rating companies will also help insurance companies while assessing risk," he said.

Another sticky point is the IRDAI mandate that allows them to enter the surety bond business only if they have 1.25 times the solvency margin they are required to maintain. The regulator requires them to maintain solvency of 1.5 times at all times.

“Insurers are quite keen. However, with the solvency margin at 1.875 percent to launch or write this product, most insurers would struggle to start,” said Saroj Kanta Satapathy, Chief Operating Officer of JB Boda Insurance Brokers.

Some infrastructure sector executives said there is not much commercial incentive for insurance companies to launch the products soon. “This business will be a small portion of their total business, so the motivation to launch products soon does not seem to be high,” a senior executive said.

Who gains?

While presenting the Union Budget 2022, Finance Minister Nirmala Sitharaman said that surety bonds can be used as a substitute for bank guarantees in the case of government procurement and also for gold imports.

A bank guarantee blocks a huge amount and is a more expensive option than a surety bond. The infrastructure industry has struggled with muted cash flows and welcomed this move, especially in the hope that this will empower small and medium contractors to bid for a project and compete against bigger contractors with deep pockets.

Insurance industry players said that the surety bonds may first be launched as construction bonds, covering the bid, performance and maintenance aspects.

“Not many are talking about customs and legal bonds, which are also allowed by IRDAI. Very large contractors will be the first preferred target for large insurers like ICICI, SBI and New India,” Satapathy said.