Surety Bonds

For Prelims: Surety Bonds,Performance Bond,Advance Payment Bond, Bid Bonds

For Mains: Surety bonds and its role in boosting infrastructure development

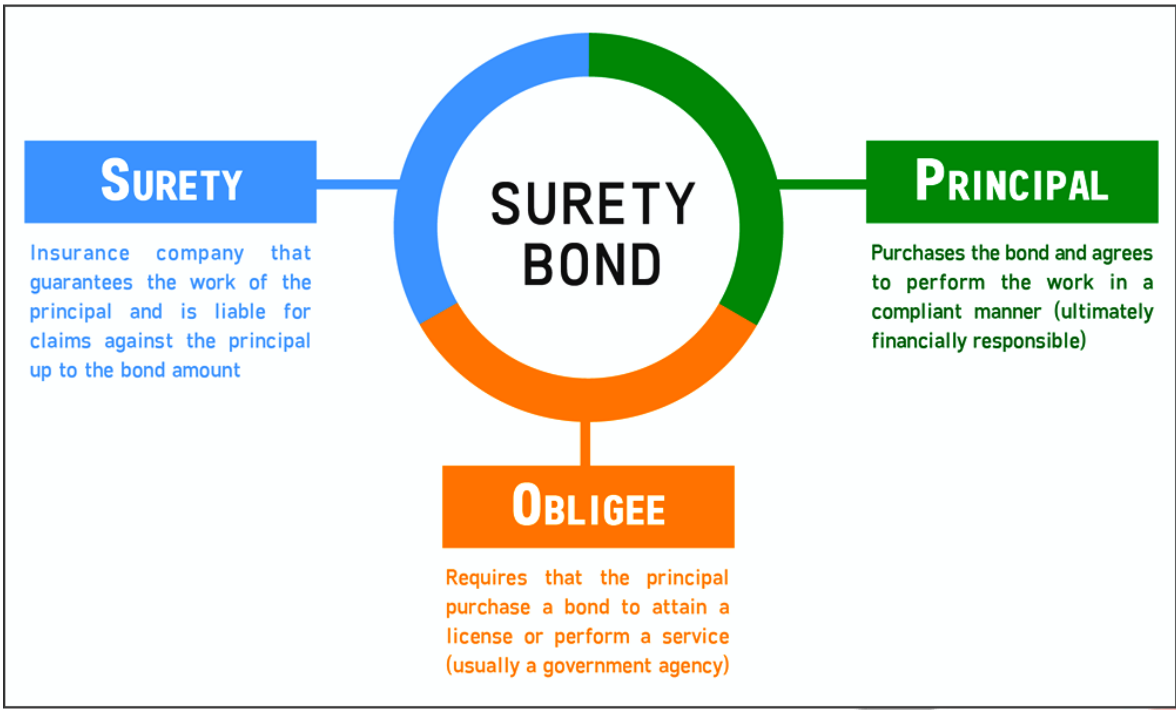
Why in News?

Recently the Ministry for Road Transport & Highways (MORTH) has asked insurance regulator **Insurance Regulatory and Development authority (IRDAI)** to develop a model product on Surety Bonds in consultation with general insurers.

- **Several challenging issues which made Surety Bond a complete non-starter** with the insurers have also been discussed and it was proposed to IRDAI that it should design a model product.
- The issue of Changes to the Indian Contract Act as well as the **Insolvency and Bankruptcy Code (IBC)** was also highlighted so that Surety Bonds are on the same footing as bank guarantees when it comes to recourse available to them in the case of default - are also being considered.

What is Surety Bond?

- **About:**
    - A surety bond can be defined in its simplest form as a **written agreement to guarantee compliance, payment, or performance of an act.**
    - Surety is a unique type of insurance because it involves a **three-party agreement.** The three parties in a surety agreement are:
        - **Principal** – the party that purchases the bond and undertakes an obligation to perform an act as promised.
        - **Surety –** the insurance company or surety company that guarantees the obligation will be performed. If the principal fails to perform the act as promised, the surety is contractually liable for losses sustained.
        - **Obligee** - the party who requires, and often receives the benefit of— the surety bond. For most surety bonds, the obligee is a local, state or federal government organization.
    - Surety bond is **provided by the insurance company** on behalf of the contractor to the entity which is awarding the project.
- **Aim:**
    - Surety bonds are mainly aimed at infrastructure development, mainly to reduce indirect cost for suppliers and work-contractors thereby diversifying their options and acting as a substitute for bank guarantee.
- **Benefits:**
    - Surety bonds **protect the beneficiary** against acts or events that impair the underlying obligations of the principal.
    - They **guarantee the performance** of a variety of obligations, from construction or service contracts to licensing and commercial undertakings.



What are the issues with the Surety Bonds?

- Surety bonds, a new concept, are **risky and insurance companies in India are yet to achieve expertise** in risk assessment in such business.
- Also, there's no clarity **on pricing, the recourse available against defaulting contractors and reinsurance options.**
    - These are critical and may impede the creation of surety-related expertise and capacities and eventually deter insurers from writing this class of businesses.

How can it boost the Infra Project?

- The move to frame rules for surety contracts will **help address the large liquidity and funding requirements** of the infrastructure sector.
- It will **create a level-playing field for large, mid and small contractors**.
- The Surety insurance business will assist in developing an alternative to bank guarantees for construction projects.
    - This shall **enable the efficient use of working capital and reduce the requirement of collateral** to be provided by construction companies.
- Insurers shall work together with financial institutions to share risk information.
    - Hence, this shall assist in releasing liquidity in infrastructure space without compromising on risk aspects.

What are the IRDAI Guidelines on Surety Bonds?

- IRDAI (Surety Insurance Contracts) Guidelines, 2022 came into force in April 2022.
- The regulator has said the premium charged for all surety insurance policies underwritten in a financial year, including all installments due in subsequent years for those policies, **should not exceed 10% of the total gross written premium** of that year, subject to a maximum of Rs 500 crore.
- As per **Insurance Regulatory and Development Authority of India (IRDAI)**, **Insurers can issue contract bonds**, which provide assurance to the public entity, developers, subcontractors and suppliers that the contractor will fulfil its contractual obligation when undertaking the project.
    - **Contract bonds may include:** Bid Bonds, Performance Bonds, Advance Payment Bonds and Retention Money.
        - **Bid Bonds: It 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.
    - **Performance Bond:** It provides **assurance that the obligee will be protected if the principal or contractor fails** to perform the bonded contract. If the obligee declares the principal or contractor as being in default and terminates the contract, it can call on the Surety to meet the Surety's obligations under the bond.
    - **Advance Payment Bond:** It is a promise by the Surety provider to pay the outstanding balance of the advance payment in case the contractor fails to complete the contract as per specifications or fails to adhere to the scope of the contract.
    - **Retention Money:** It is a **part of the amount payable** to the contractor, which is retained and payable at the end after successful completion of the contrac.
- The limit of guarantee **should not exceed 30%** of the contract value.
- Surety Insurance contracts **should be issued only to specific projects and not clubbed for multiple projects.**

UPSC Civil Services,Previous Year Questions (PYQ)

Q. With reference to 'IFC Masala Bonds', sometimes seen in the news, which of the statements given below is/ are correct? (2016)

1. The International Finance Corporation, which offers these bonds, is an arm of the World Bank.
2. They are the rupee-denominated bonds and are a source of debt financing for the public and private sector.

Select the correct answer using the code given below:

(a) 1 only
(b) 2 only
(c) Both 1 and 2
(d) Neither 1 nor

Ans:(c)

Exp:

- The **World Bank Group,** which is a vital source of financial and technical assistance to developing countries, consists of five distinct yet complementary organizations, viz.,
    - International Bank for Reconstruction and Development (IBRD),
    - International Development Association (IDA),
    - **International Finance Corporation (IFC), Hence,statement 1 is correct.**
    - Multilateral Investment Guarantee Agency(MIGA),
- International Centre for Settlement of Investment Disputes (ICSID).
- Membership in IFC is open only to member countries of the World Bank. Its board was established in 1956.
- IFC is owned by 184 member countries, a group that collectively determines the policies. Through a Board of Governors and a Board of Directors, the member countries guide IFC's programs and activities.
- **Masala Bonds are rupee-denominated borrowings issued by Indian entities in overseas markets.** Masala means 'spices' and the term was used by International Finance Corporation (IFC) to popularise the culture and cuisine of India on foreign platforms.
- The objective of Masala Bonds is to **fund infrastructure projects in India,** fuel internal growth via borrowings and internationalize the Indian currency. **Hence,statement 2 is correct.**
- **Therefore, option (c) is the correct answer.**

Source: IE