Surety Bonds

Source: IE

Why in News?

Recently, some of the leading general insurers like New India Assurance, SBI General Insurance etc. have announced their plans to issue **Surety Bonds**, but nobody has been able to do so due to lack of supporting elements.

- The **Ministry of Finance** and the **Ministry of Road Transport and Highways** are putting pressure on the **Insurance Regulatory and Development Authority of India (IRDAI)** to push the insurance industry to launch surety Bond Products.

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.**
  - It 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 that is awarding the project.
  - It will help contractors to have financial closure of their projects **without depending upon only bank guarantees.**
- **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.

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 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.
- Surety Bonds need extensive **reinsurance support** and no primary insurers can issue any policy without proper reinsurance backup.
- The issuer of Surety Bonds in India should be in a position to legally enforce tripartite contracts that guarantee compliance, payment and/or performance.
    - **Indian Contract Act** and **Insolvency and Bankruptcy** code does not recognize rights of Insurers at par with financial creditors yet and thus insurance companies do not have recourse to recovery like banks in case of any default.

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 2

Ans:(c)

Mains:

Q. The product diversification of financial institutions and insurance companies, resulting in overlapping of products and services strengthens the case for the merger of the two regulatory agencies, namely SEBI and IRDA. Justify. **(2013)**