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SURETY VS GUARANTEE

Surety bonds have begun to outshine bank guarantees. But did they come in too late?

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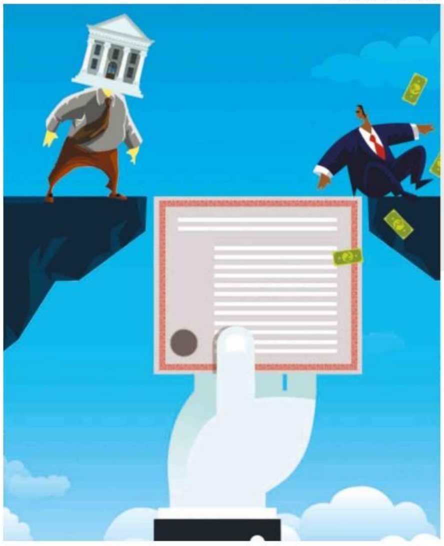

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BOND STREET

- **Surety bonds can be issued by companies** subject to 10% premium cap of the total gross written premium that year, subject to a maximum of ₹500 crore (monoline surety insurance companies excepted)
- **Upto 100%** of a project value can be offered as a bond
- **Types of surety bonds:** Advance payment bonds, bid bonds, contract bonds, customs bonds, performance bonds
- **Some of the companies accepting surety bonds:** AAI, DMRC, GAIL, ONGC, IOC, NHAI, RVNL
- **The upfront rates are higher for surety bonds** than on bank guarantees, but there is no demand for a collateral, which bank guarantees require
- **This allows** the buyers of the bonds (in this case, the contractor) to bid on more tenders and contracts, enhancing their business prospects.
- **At the same time,** surety bonds offer less financial cover to the agency or beneficiary, since the insurance company will pay back the money only after it is satisfied that the project has failed because of the contractor
- **A bank guarantee,** on the other hand, is almost available "on tap" and can be encashed at any time by the agency

A few years ago, there was a scare in India's banking sector because of a surge in non-performing assets (NPAs), with the combined figure for banks rising from 2.3 per cent in 2011 to 11.2 by 2018. The result was a grave concern about the health of the sector. And it bore quick lessons all around.

One of those lessons led to the creation of the bankruptcy mechanism and the Insolvency and Bankruptcy Board of India in October 2016. The other was the rollout of the surety bonds by the insurance regulator, the Insurance Regulatory and Development Authority of India (Irdai), in February 2022, which work as an insurance against project failure or under delivery.

Both the IBBI and surety bonds seek to ring fence banks from the horrors of loans gone bad. They also make a business case.

"The surety bonds market in India has the potential to generate billions of dollars in premiums over the coming years. With a project pipeline of almost $2.4 trillion, even a modest 10 per cent penetration would translate into substantial market size," says Akshay Bhardwaj, Senior Vice President and Practice Leader—Credit Specialities, Marsh McLennan, a global leader in risk advisory.

However, the issuers of surety bonds, predominantly the non-life insurance companies, expect sops from the Budget for 2025-26, which Finance Minister Nirmala Sitharaman is slated to present in Parliament on February 1 next year.

Unlike a conventional bank guarantee, issuers of surety bonds do not figure as financial creditors in a bankruptcy. But they want to be counted in the waterfall mechanism, which is a system that decides the preference order and percentages in which these creditors would receive their payables from the defaulting company.

Rapid transformation

The markets in India took their time to embrace surety bonds, though they were already a familiar instrument in the more developed markets overseas. After the Irdai's approval, the first surety bond was issued by Bajaj Allianz in December 2022. However, by March 31, 2024, fewer than 100 surety bonds had been issued.

Then things got galvanised. In a rapid transformation, insurance companies have been issuing an average of 25 such bonds every week. At this rate, the market for the paper could hit ₹1 trillion by FY30.

But there are naysayers, too, who say surety bonds came to India a tad too late.

How surety bonds work

When a contractor bids to build a project for an agency, say a government or a private party, there is the risk of failure. A bank guarantee offered by the contractor keeps the agency asking for the project to be built safely. If the project does not come through because, say, the contractor goes bankrupt, the payment defrayed by the agency is safe. The vanilla version of this mechanism is a financial bank guarantee. On behalf of the contractor, the bank offers to stand in with the money. The sophisticated version of it is a performance guarantee, where the agency can seek reparations from the bank for non-performance of the obligations.

A surety bond does all of that but as an insurance. They are usually issued by insurance companies instead of banks. If a contractor builds a shoddy bridge or abandons it midway, the surety company steps in to assume the financial responsibility.

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At the same time, surety bonds offer less financial cover to the agency or beneficiary, since the insurance company will pay back the money only after it is satisfied that the project has failed because of the contractor. A bank guarantee, on the other hand, is almost available "on tap" and can be encashed at any time by the agency.

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Changing the game

"Surety Bonds are emerging as a game-changing alternative to bank guarantees. They offer significant advantages, particularly in fostering financial flexibility for businesses. Unlike bank guarantees, surety bonds do not require as much collateral or impact working capital, allowing businesses to deploy their resources more effectively," says Tapan Singhel, MD & CEO, Bajaj Allianz General Insurance.

The market for surety bonds has expanded because banks are now reluctant to offer bank guarantees. At the height of the NPA crisis, banks were saddled with huge exposure on their guarantees as contractors for a host of projects, particularly infrastructure ventures, turned turtle.

Surety bonds shift the risk to insurance companies. An industry estimate notes that a bank guarantee costs about 1.5 per cent of the total sum asked for, and a surety bond can go anywhere up to 6 per cent.

Currently, the bonds being issued are on demand, as unconditional irrevocable bonds. There is a commitment of capital from the underwriters that makes them costly. "So, the underwriters are slightly more cautious. Yet they realise the market is potentially huge. But that potential can only be realised with adequate reinsurance capacity," Bhardwaj says.

The demand for other products with project-specific terms and conditions, such as advance payment bonds, bid bonds, contract bonds, customs and court bonds, and performance bonds, are slow to pick up. The big issuers are SBI General, Bajaj Allianz, New India, and HDFC Ergo.

Backing the issues will be the global reinsurance players. Bharadwaj explains that the big reinsurance players have the capacity to absorb the losses but will not wish to get bogged down in a long recovery process through the courts. "The reason why the insurers and reinsurers remain hesitant to loosen their purse strings is because there is a lingering concern about enforceability of indemnity. The ask from the industry is that since surety underwriting is a financial product, it should be given the same status as a financial creditor. In its absence the concern for large reinsurers is not the volume of the potential loss but that a recovery is only possible through long term litigation.," he says.

According to Sanjay Agarwal, head of BFSI Ratings at CareEdge Ratings, this is a genuine demand. He also says that the market for these bonds was opened up a bit late, almost by a decade. Banks have cleaned up the mess in their guarantee business and will soon be keen to participate in the market vigorously. "A surety bond has a limited scope compared to bank guarantees, as those are unconditional, which means the attraction for them is always going to be higher," he says.

Bhardwaj is more hopeful. He expects things will move faster if the challenges are addressed. "These will not only enhance the role of sureties in the market but also position them as vital contributors to India's ambition for world-class infrastructure development," he says.