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# Swiss Re Risk & Finance Seminar 1999

## Surety Insurance



Rodolfo Bretscher  
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  - **Comparison, Underwriting Aspects**
- **Exposure / What constitutes a Risk?**
  - **One Bond, one contractor, one group of companies, construction industry as a trade sector**

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  - **Key Elements, Example**
- **Underwriting**
  - **Capital, Capacity, Character, Collateral, Conditions, Confidence, Cedant**
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# Suretyship

- Definition
- Triangular Relationship
- Obligations of Parties involved
- Key Elements
- Insurance vs Suretyship
- Types of Bonds
- Types of Bond Wordings



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## Suretyship Definition

**Suretyship may be defined as an obligation which one party (Surety / Guarantor) undertakes to another party (Beneficiary / Obligee / Project Owner) for the debts, obligations and/or conduct of a third party (Principal / Contractor / Guaranteed).**



# Suretyship



Basis Contract: Performance

Basis Contract: Payment



Contractor Principal

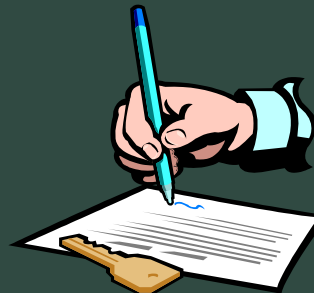
Project Owner Beneficiary

Premium  
Collaterals

Right of  
Subrogation

**BOND**

Claims



Surety

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## Obligations of the Contractor / Principal

- Performance in accordance with the terms and conditions of the **Basic Contract**
- Payment of the premium for the **Bond**
- Indemnify the **Surety** for any payments made under the bond or other costs incurred as a surety of the relevant project
- Provide the **Surety** with all relevant information



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## Obligations of the Surety / Guarantor

- To abstain from making any payments under the bond if the **Contractor / Principal** has a valid defence
- Professional claims handling with prompt payments if **Project Owner / Beneficiary** has sustained a loss





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## Obligations of the Project Owner / Beneficiary

- Performance in accordance with the terms and conditions of the **Basic Contract**
- Inform the **Surety** of all major changes agreed upon in respect of the underlying agreement, progress of work as well as arising problems
- Discharge the **Surety** from its liabilities after completion of the contract



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## Key Elements in Bonding

- **Accessory Instrument**

*The need for an underlying obligation (⇒ Basic Contract)*

- **Joint & Several Liability**

*Both the Surety and Guaranteed are liable*

- **Limited Liability**

*Surety's liability is limited to the bond amount*

- **Right of Indemnification**

*Surety is entitled by law to be refunded for any payments made under the bond by the defaulting contractor for any payments*



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## Key Elements in Bonding

- **Non-Cancelable**

*Contrary to other insurance products a bond can not be cancelled until the underlying obligations have been fulfilled*

- **Subrogation**

*As soon as the Surety steps in due to failure of the Contractor all obligations and right of the Contractor are automatically inherited by the Surety*



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# Insurance vs Suretyship

- Two Party contract between Insurer & Insured
- Premium is calculated to cover costs, losses and profits
- Law of large numbers
- Normally no recovery after settlement of losses
- Triangular Relationship of three parties
- Premium is mere service charge
- Law of large number not applicable  $\Rightarrow$  0% claims ratio underwriting
- Unchanged obligations of bonded party incl. Right of subrogation of the surety

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## Types of Bonds

- **Contract Bonds**

*Advance Payment, Bid, Performance, Supply, Maintenance, Ret. Money, L&M*

- **License & Permit Bonds**

*Warehouse, Tax, License*

- **Customs Bonds**

*Deferred Duty Payment, Immigration, Re-exportation*

- **Excise Bonds**

*Alcohol, Tobacco*



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## Types of Bonds

- **Judicial Bonds**

*Plaintiff, Attachment, Replevin, Injunction, Administration*

- **Fidelity Bonds**

*Agent, Employee, Forgery*

- **Financial Guarantee Bonds**

*Loans, Mortgage, Payment*




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## Types of Bond Wording


### «Conditional Bonds»

*Accessory to the basic contract with claims payments only being made after having obtained full evidence as to whether the principal has defaulted and as to the size of the actual sustained damage incurred by the beneficiary*



### «Unconditional Bonds»

*Abstract Guarantees which are not accessory to the basic contract and under which payment becomes due upon first demand of the beneficiary independent of whether the principal has defaulted or not*



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# Surety Bonds vs Abstract Guarantees



- ⇒ Suretyship
- ⇒ Abstract Guarantees
- ⇒ Comparison
- ⇒ Underwriting Aspects



# Suretyship



Basis Contract: Performance

Basis Contract: Payment



Contractor Principal

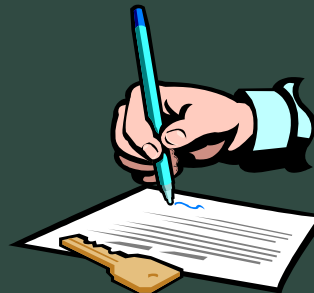
Project Owner Beneficiary

Premium  
Collaterals

Right of  
Subrogation

**BOND**

Claims



Surety

# Abstract Guarantees



Contractor Principal

Basis Contract: Performance

Basis Contract: Payment



Project Owner Beneficiary

Contract of two Parties

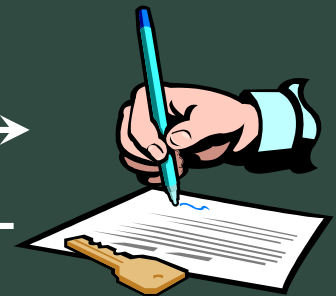
Contract of two Parties



Guaranteed Contractor Principal

Premium / Securities

**GUARANTEE**



Guarantor Bank Insurance Co



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# Suretyship vs Guarantees

## Conditional vs On Demand Bonds

- **Bond accessory to underlying contract (I.e. basic contract = integral part of bond)**
- **Bond valid until expiry of basic contract**
- **Payment only due after default of principal has been identified**
- **Claims handling which requires know-how and resources done by Surety**
- **Legal right of subrogation**
- **Two individual contracts between two parties each**
- **Limited period with a clear & valid expiry date**
- **Payment due upon first demand without the right to interfere**
- **Fair claims handling very difficult**
- **No automatic right of subrogation in case of payment**

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# Unconditional Bonds Underwriting Aspects

- **Bond Wording**

*Abstract and/or on demand  $\Rightarrow$  almost no valid defence not to pay in case of a claim, even if unfair call is obvious*

- **Risk involved**

*Both parties involved represent a risk ( $\Rightarrow$  contractor = non performance & beneficiary = unfair call)*

- **Basic Contract**

*If abstract, guarantee no longer integral part of the basic contract and therefore important terms & conditions should be stipulated in the guarantee wording itself*

- **Securities**

*Counter-guarantee wordings should also be on demand / Banks ask for 100% collateral unless granted within an approved credit facility*



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# Exposure

## What Constitutes a Risk?

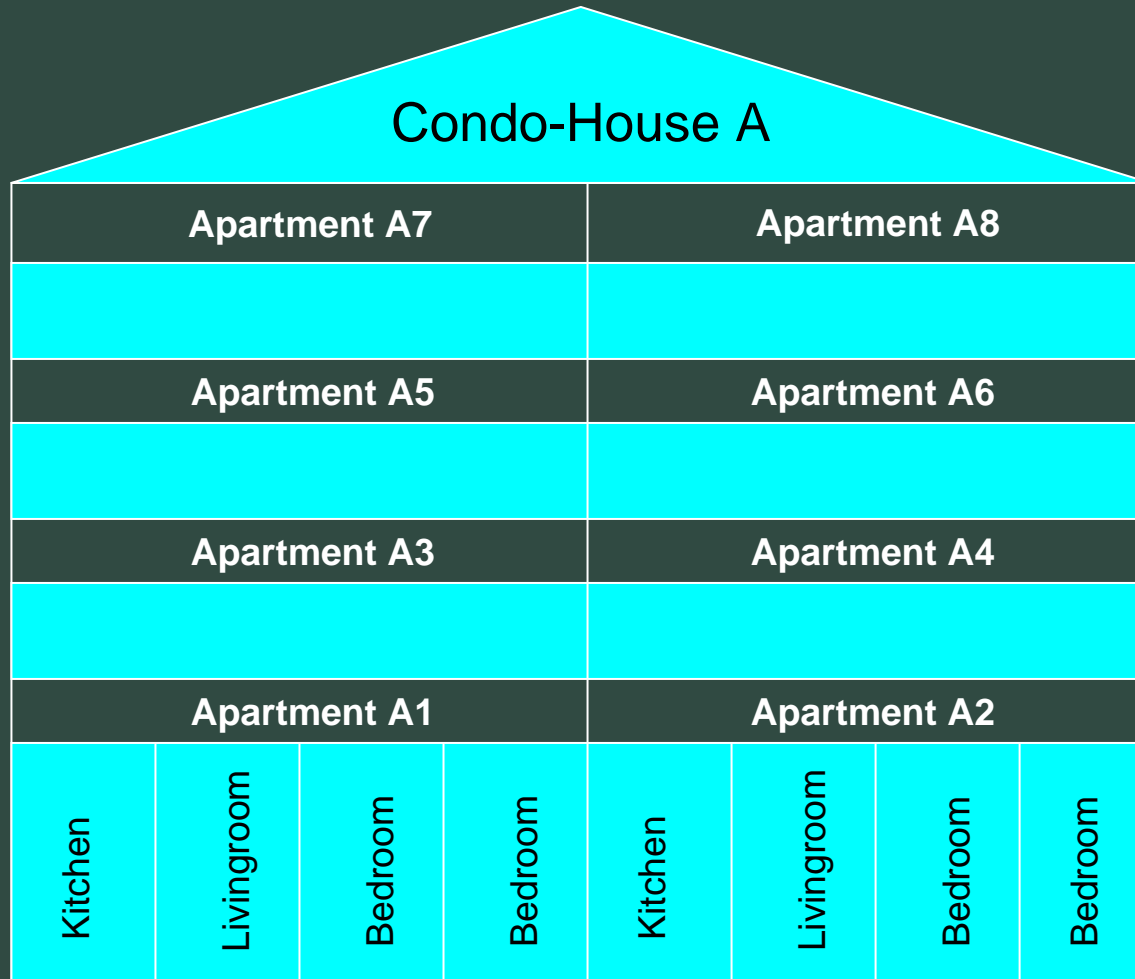


- Apartments in a Condominium House (⇒ Property Insurance)
- Several Houses in a Residential Area (⇒ Natural Hazards)

**compared to**

- Contractors belonging to one Holding Company (⇒ One Risk?!)
- Construction Industry (⇒ Recession)

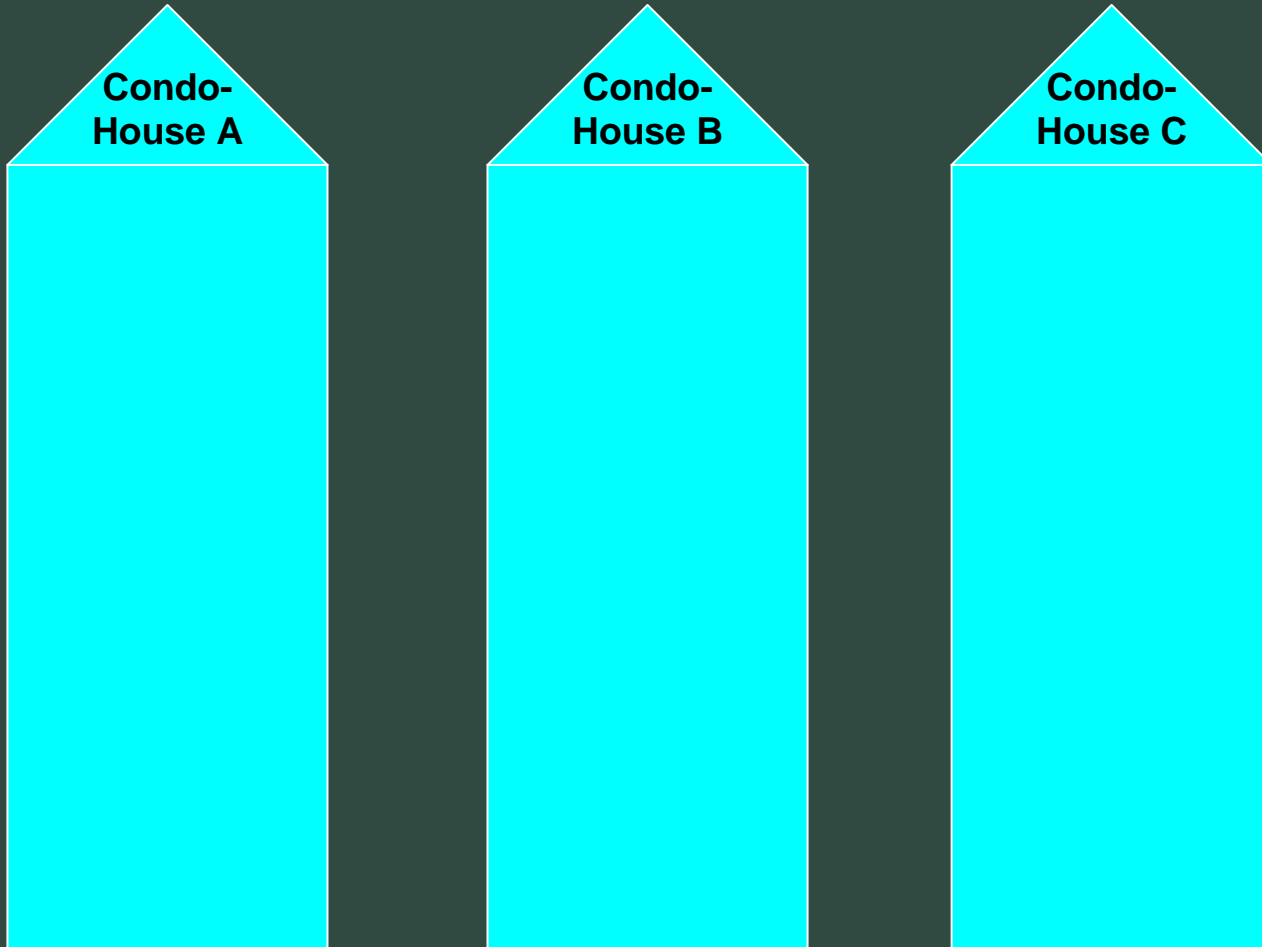
# What constitutes a risk?



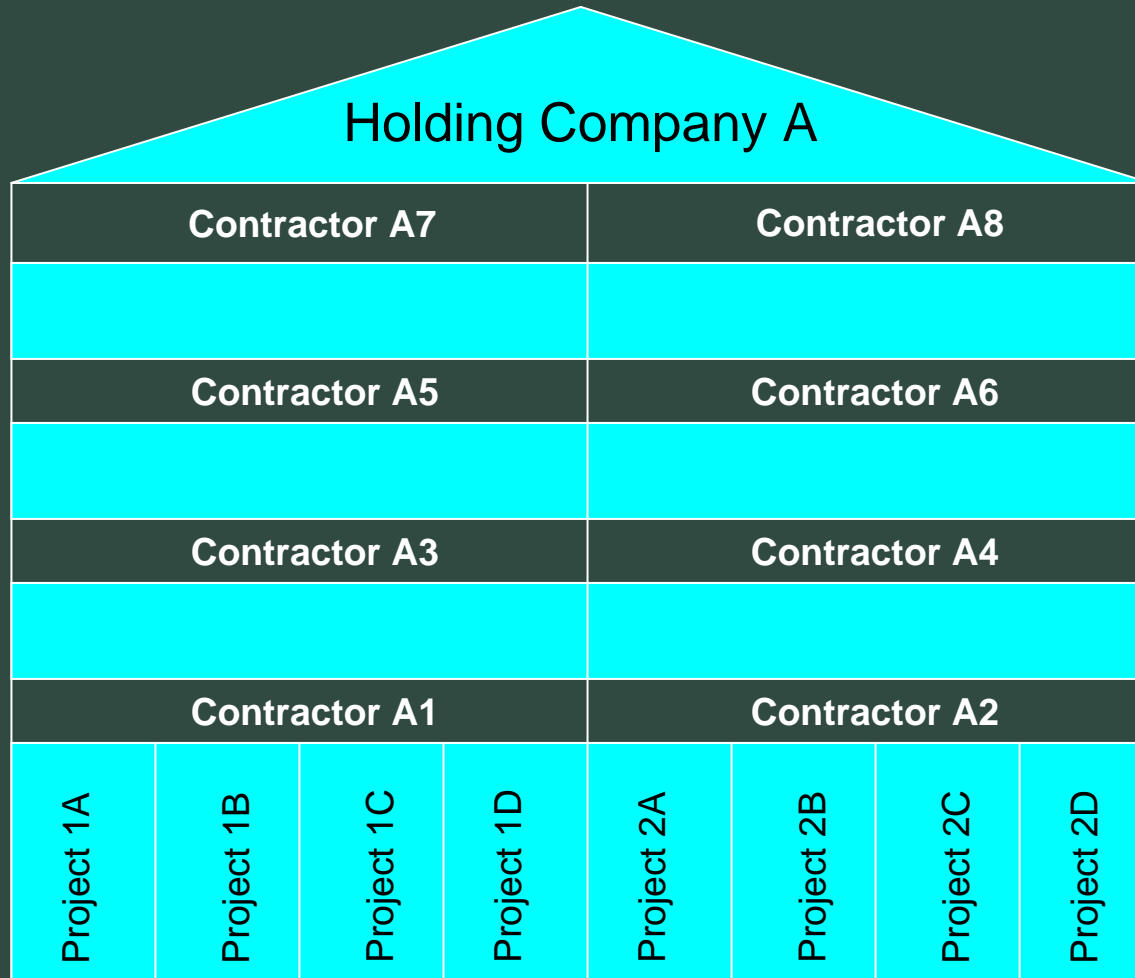
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# What constitutes a risk?

Residential Area



# What constitutes a risk?

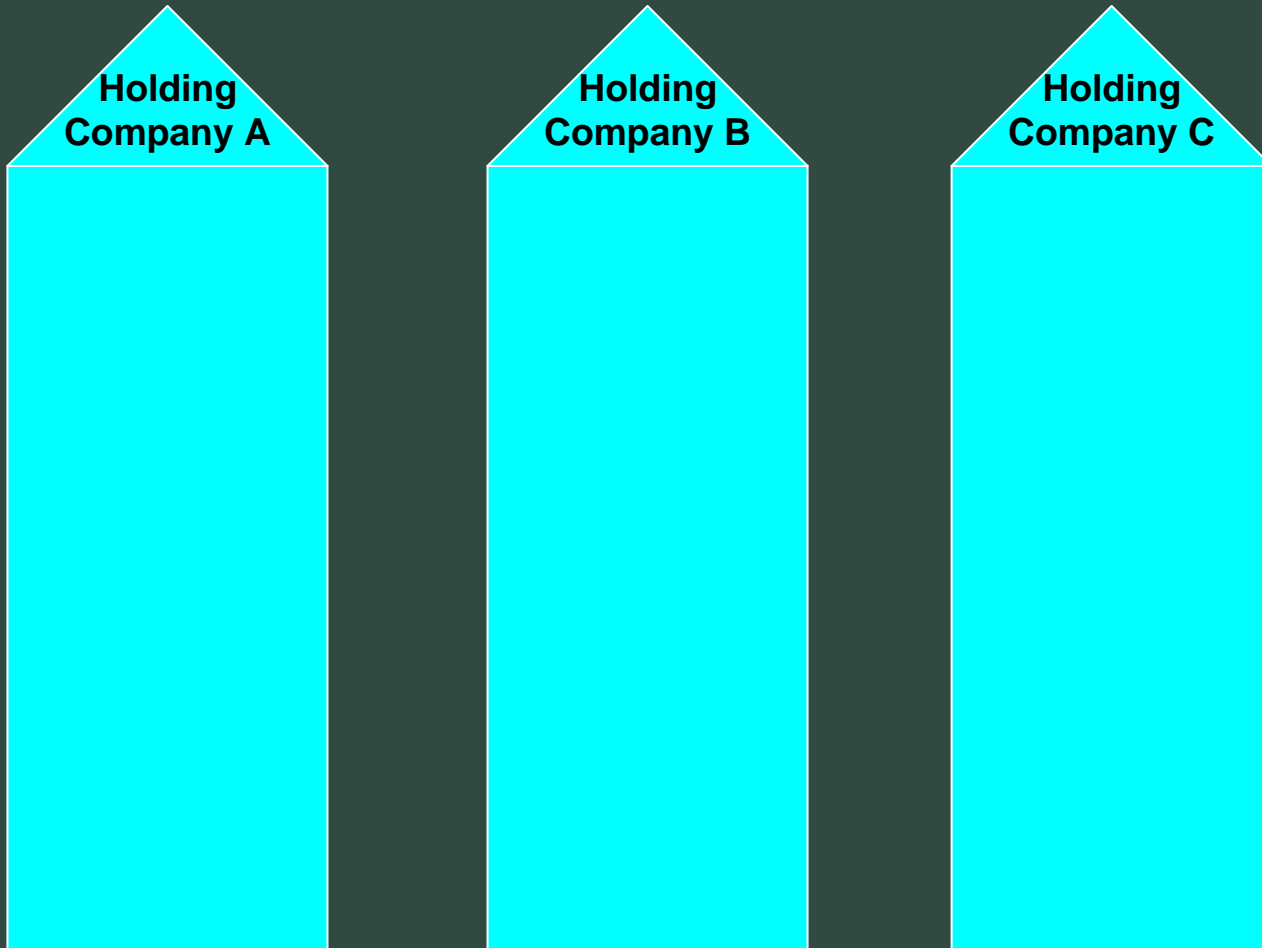




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# What constitutes a risk?

Construction Industry



# Pricing



## ✓ Key Elements

- ➔ *Capital Costs*
- ➔ *Risk Element*
- ➔ *Administration Costs*
- ➔ *Profit*

## ✓ Example for Premium Calculation

# Premium Calculation

## Key Elements

### ✓ Capital Costs

- ➔ *Applicable Capital (e.g. BIS requirements)*
- ➔ *Interest Rate Level*

### ✓ Risk Loading Factor

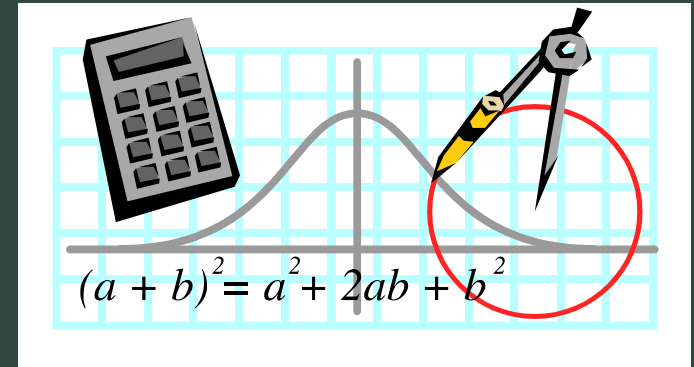
- ➔ *History / Experience*
- ➔ *Portfolio Structure*
- ➔ *Risk Appetite*
- ➔ *Collateral*

### ✓ Administration Costs

- ➔ *Acquisition Costs*
- ➔ *Internal Costs*

### ✓ Profit Elements

- ➔ *Equalization Reserves*
- ➔ *Cat Events*
- ➔ *Provision for future Investments*



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## Premium Calculation Example

<b>Capital Costs</b>	<b>0.45% - 1%</b>
<b>Risk Loading Factor</b>	<b>0.1% - 5%</b>
<b>Administration Costs</b>	<b>0.2% - 1%</b>
<b>Profit Element</b>	<b>0.1% - 0.2%</b>
<b>Total</b>	<b>0.85% - 7.2%</b>



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# Underwriting

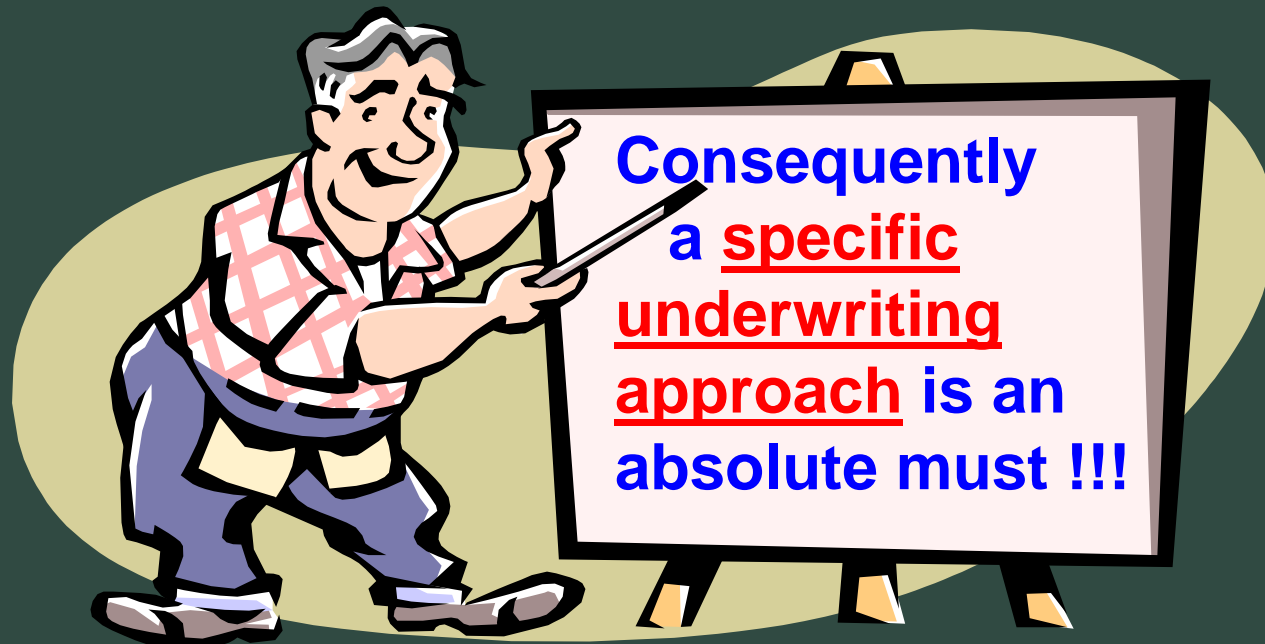
- Capital
- Capacity
- Character
- Collateral
- Conditions
- Confidence
- Cedant



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# Underwriting of Surety & Credit Risks

! Suretyship & Credit Insurance are not classical insurance covers but rather financial products !



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# Capital

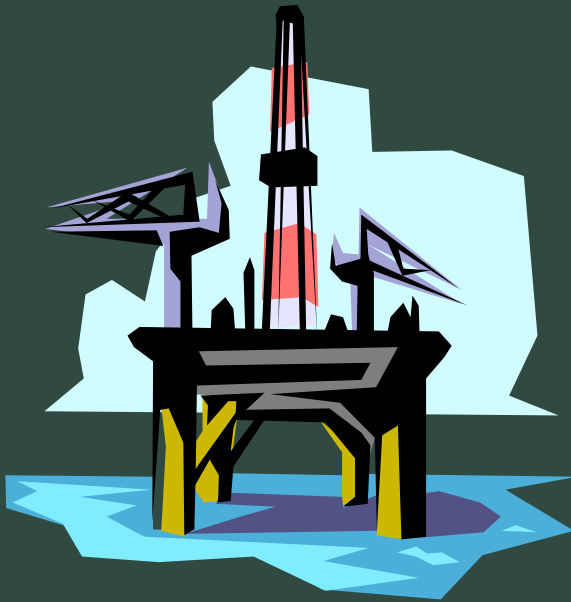


- Balance Sheet
- Profit & Loss Account
- Tax Returns
- Bank Facilities Available
- Income & Health of Owner and Directors
- Authorized vs. Paid In
- Share Capital

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# Capacity

- Work in Progress
- Work on Hand (Order Book)
- Machinery / Equipment
- Human Resources
- Skilled Engineers
- Past Experience / Track Record





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# Character



- Year of Incorporation
- Reputation of Company
- Owners & Management
- Who owns the Company
- Form of Incorporation
- Philosophy / Strategy of Top Management
- Links & Relationships

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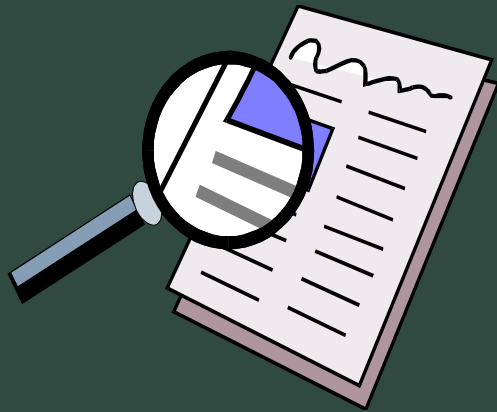
# Collateral



- Indemnity Agreement
- Counter Guarantees
- Personal Guarantees
- Letter of Intent
- Cash / Assets
- Completion Guarantee from 3rd Part Contractor
- Bank Guarantee
- Back to Back Guarantee

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# Conditions



- Economy
- Trade Sectors
- Basic Contract
- Acts of God, Political Risks, Fixed Time & Price, Price Escalation, Arbitration Clause
- Bond Wording
- Indemnity Agreement
- Counter Guarantees
- Escrow & Pledge Agreement

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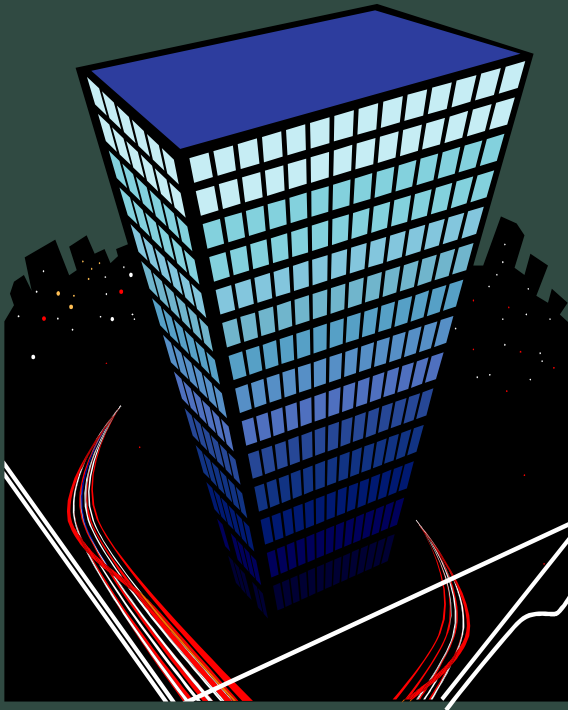
## Confidence



- Underwriting Experience
- No, in case of slightest doubts
- Careful with cases looking too good to be true
- Careful if only limited or verbal information is available
- Why are we approached
- Who wants to give away what risk

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# Cedant



- Specialized Company
- Experience
- Accommodation or Professional Underwriting
- Background of Underwriters
- Corporate Strategy
- Reputation

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# Claims



- Reason for Claim
- Handling of Claim
- Recovery of Claim



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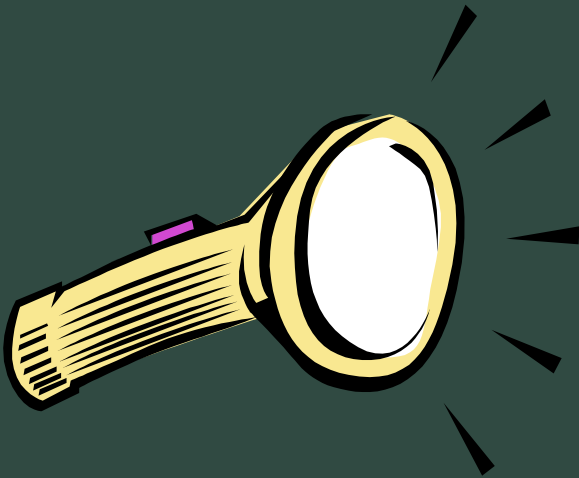
## Reason for Claim

### → Unfair Call of Beneficiary

- on demand bonds / abstract guarantees

### → Default by Principal

- Non-performance of principal in accordance with terms & conditions of the basic contract (i.e. breach of contract)
- Default due to insolvency of the principal and/or the group of companies it belongs to



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# Handling of Claims

## → Unfair Call

- If possible (I.e. no abstract guarantee) avoid payment but file court injunction



## → Default

- Amount of actual damage sustained by the beneficiary?
- Payment respectively Completion of Contract?



# Recovery of Claim



## → Counter-Indemnity

- Compensation by principal (⇒ insolvency)

## → 3rd Party Guarantee

- Completion guarantee by other principal
- Counter-guarantee by directors, shareholders and/or outside parties

## → Collateral

- Cash, Securities
- Pledged Assets