Conceptos básicos de la **FIANZA**

Basic concepts of ***SURETY BONDS***

PASA APF

Asociación Panamericana de Fianzas
Panamerican Surety Association

Oficina Operativa
Av. Santa Fe 830, Piso 7
C1059ABP Buenos Aires
Argentina

Teléfono: 5411 5032 8375
e-mail: info@apfpasa.ch
www.apfpasa.ch

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English

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Introduction

Statistics show that in most of the developing countries the contracting of insurance is not a widespread culture, which is even more evident when we analyze the surety penetration figures in these economies.

The Latin American surety market has grown significantly over the last decades. However, in many countries, the purpose, characteristics and details of this product are little known by the contracting and contracted companies and the population in general.

Even in countries where the surety market is more consolidated, brokers, policyholders and the insured frequently have doubts about the conditions, operation and covers of the products offered by insurance companies that write surety bonds.

Being aware of this situation, the Panamerican Surety Association (PASA) decided to prepare this booklet that briefly describes the main characteristics of this product in simple language and provides general concepts, respecting the specifics of surety bonds in each country.

The main goal of surety bonds is to guarantee the contractual obligations that help boost development in a myriad of different countries. And with this work and other initiatives, PASA endeavors to make our product increasingly known in these markets.

Gustavo Henrich
Surety Committee President

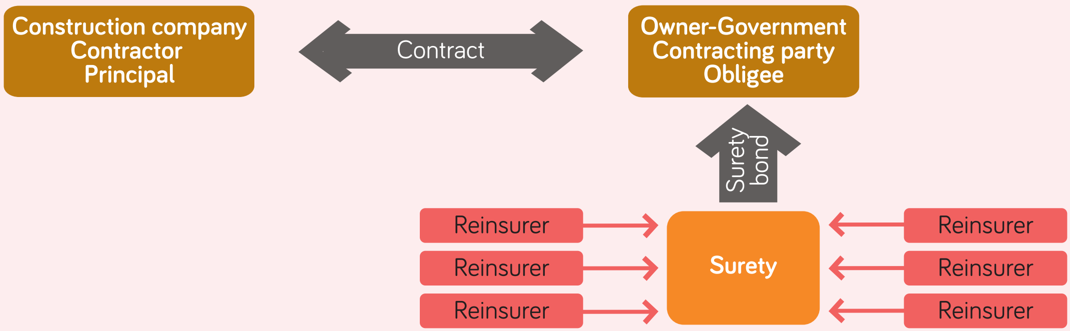
SURETY BONDS

Definition, types and underwriting criteria

Definition

According to the dictionary, a surety bond is *an arrangement between parties whereby someone agrees to do something which somebody else was bound to do*, if the latter fails to comply with said obligation. It is also the collateral pledged as security for the performance of the obligations assumed. The *surety contract* is the written agreement whereby the parties bind themselves with regard to a specified matter or thing, and the fulfillment of which can be enforced on them. Said document sets forth the terms and conditions of the agreement.

A surety bond is a document accessory to a main contract, the contract which is being guaranteed by the *surety*, with respect to a *principal*, the construction company. This contract is entered into in exchange for a consideration, known as *premium*. Sureties share with their *surety reinsurers* the contingent risks they have assumed. The surety reinsurers back the sureties, the latter being bound to the Government or contracting party for the obligation of the construction company or principal, as this party is referred to in the sector.



General considerations

It is important to bear in mind that a surety contract is accessory to a main contract. Consequently, it may impose less but not more liability on the surety than the liability assumed by the principal. The *term* of the surety contract may be *equal or shorter* than the term of the main contract and the surety may become bound not only to indemnify the surety bond obligee (the contracting party) but also to complete the work. These are some of the features that attach value to surety bonds. In turn, if sureties have to either complete the works or indemnify the obligee, they are *entitled to recovery* from the principal. If the secured amount is lower than the principal's obligation, the indemnification may be proportional to the surety coverage underwritten, unless otherwise agreed prior to the underwriting of the surety bond.

In case of doubt in relation to claims, the *conciliation procedure* originally agreed by the parties must be followed. If in their contract the principal and the obligee have provided for arbitration, they must agree on the amount to be indemnified. The conciliation procedure will ascertain the validity and admissibility of the claim, will prevent the abuse of discretion by the obligee and will ensure the right of the surety to recover from the original obligor (the principal), that is, the contractor.

Other guarantees

There are other guarantees besides surety bonds, such as bank guarantees. *Credit* is defined as an amount of money owed by someone to an entity and which the creditor has the right to recover. In line with this, the *letter of credit* is a document issued by a bank on behalf of a third party to *guarantee* a certain payment to another party under specified conditions. A guarantee is the signature at the end of credit documents to secure their payment on the default of the principal. A *mortgage* is a vehicle that may also be part of a guarantee; it is a security interest that attaches to real property to answer for the default on an obligation. But there are significant drawbacks to mortgages: they are not divisible and they are not liquid (the item of real property is still to be sold).

Letters of credit were created to guarantee financial or commercial obligations, because they secure specific payment obligations (rather than performance obligations), under certain conditions that restrict or release the right to collect payment. These credit instruments are independent from the main contract. They are typically banking instruments. They are contingent liabilities that can be incurred, but, as has already been said, they do not depend on the main contract. As they are execution instruments payable on demand, they are particularly sensitive from the point of view of the principal. Letters of credit or bank guarantees have their pros and cons. Arguments in favor of letters of credit include the fact that they are liquid, payable on demand, backed by a banking institution and grant the right of recourse. One of the drawbacks of letters of credits is that they are difficult to get for very large amounts. Besides, the letter of credit issuer is constrained by banking regulations: it must be issued against the bank's own capital, but without being backed by any reinsurance, so risk cannot be shared, which increases exposure.

Furthermore, letters of credit impose costly conditions on the constructor and involve depositing money; they are high in cost and require excellent previous track record since it is never the bank's intent to assume risks. Letters of credit are, basically, instruments of payment. On the other hand, they take opportunities away from small and medium enterprises. SMEs have been the driving force behind the development of global economy, generating activity in all the spaces of the economy that are left behind by big companies. Besides, the letter of credit poses the problem of arbitrary claims because, as it is an instrument payable on demand, the obligee may call upon it without being legally entitled to do so. If payment in relation to the letter of credit has not been received, any right to such payment will no longer hold upon the expiration of said letter of credit.

Surety Bond Markets

Surety bonds in the Government area

The advantage of surety bonds in the Government area is that they are required by law. Statutory provisions establish which risks must be covered, the terms of surety bonds, the percentage of coverage required, the supervisor's duties in the works (when a supervisor has been appointed) and the administrative proceedings for calling on surety bonds.

Very often, important benefits are derived from surety bonds in the Government area: there is a third party to the contract, the works' supervisor, who monitors the other two parties' fulfillment of their obligations, that is, the principal's contractual obligations and the obligations that may have been contracted by the obligee, such as any right of way, payment on time, authorizations, recognition of increased costs in the works. This provides a great degree of certainty.

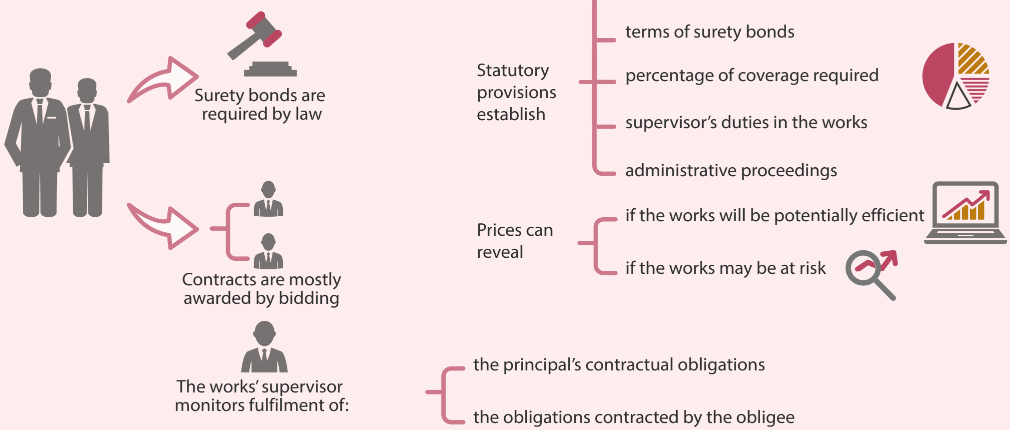
Most of the times, contracting in the government area is the result of competitive bidding, so if several bidders have taken part in a competitive bidding, there are many experts analyzing the works. Prices can reveal if the works will be potentially efficient or if they may be at risk because the principal has bid at a very low price, and, consequently, margins are jeopardized.

Surety bonds in the private area

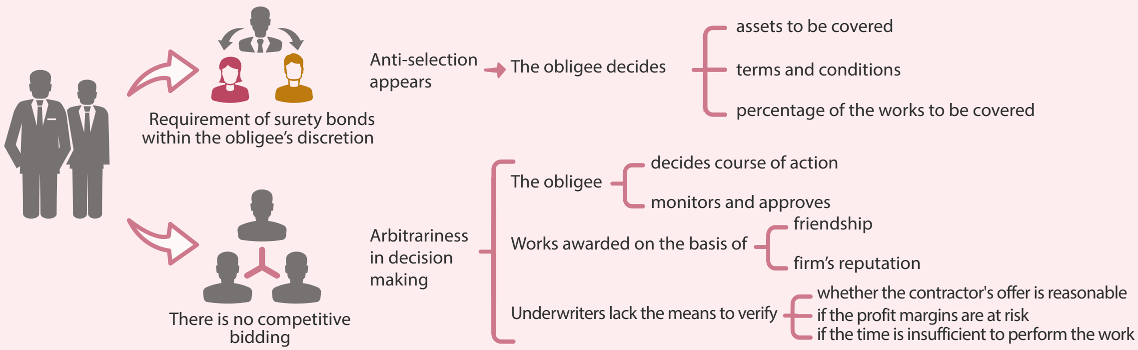
From the point of view of the market, anything that is not governmental is private. This area is a bit more subject to arbitrariness since it is within the discretion of the obligee (the works' owner) to require surety bonds. Here is where *anti-selection* appears; obligees will take out a surety bond only for what they consider highly vulnerable. Then, the "magic" of surety bonds is lost, because as nothing is predetermined, any decision may be taken as regards which assets are to be covered (only performance, down payment, etc.), terms and conditions to be required for the bond, and percentage of the works to be covered.

As regards the process, the decisions are made by the owner of the works and so, any courses of action may be allowed by the contract, even illegal ones. Generally, there is room for potential arbitrariness, since the obligee is in charge of supervision and decides what is right and what is wrong, often lacking the necessary knowledge. There is no competitive bidding in the private area. The works are usually awarded on the basis of friendship or the firm's reputation, but without deep knowledge of the alternatives offered by the market. Consequently, the underwriters lack the means to verify whether the offer made by the contractor is correct and reasonable or if, on the contrary, profit margins are at risk or the time is insufficient to perform the work.

SURETY BONDS IN THE GOVERNMENT AREA



SURETY BONDS IN THE PRIVATE AREA



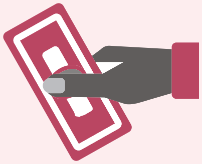
Types of surety bonds according to risk

Bid bonds

They guarantee that the principal will honor the terms of the bid for a specified period of time; in this way, the obligee has enough time to analyze the bids received, qualify them and select the best. During this period, the contractor that submitted the bid is obliged to maintain it. If the contractor decided not to honor the bid, the obligee would be entitled to call on the bond. The amount guaranteed ranges from 1% to 5% of the price of the works, and the indemnification would allow the obligee to recover the time lost. Likewise, if the best bidder, the one who offered the lowest price, does not maintain the price, the indemnification will help the obligee to make up for the increased costs the second best bid will carry. Bid bonds are submitted together with the bid. The effective period is 90 to 120 days, after which bid bonds will no longer be binding on the surety.

Advance payment bonds

They guarantee the cash advanced to the contractor. The effective period of these bonds is the same as that of the contract and the amount guaranteed has to be 100% of advance payment. They must be submitted upon receipt of the advance. The coverage will be terminated when the bonds have expired, or when the advance has been used up, after which the obligation to return it no longer exists; or in case the contract is terminated by mutual agreement of the parties; or in case the principal returns the amount to the obligee, or at least the unused portion of the advanced cash.

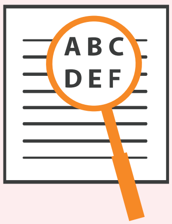


Performance bonds

They guarantee the full performance of the contract as regards terms and conditions, volume, quality, specifications and contract period. The effective period must be the same as that of the main contract. The amount guaranteed usually ranges from 10% to 25%, but in some markets, such as the U.S.A., performance bonds are required to guarantee 100% of the works price. They must be submitted on execution of the contract. If the works completion goes beyond one year, an additional premium must be paid in proportion to the time exceeding that one-year period. Performance bonds coverage is terminated on delivery of works or on expiration of the contract.

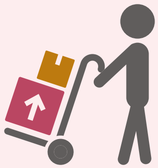
Maintenance bonds

They guarantee the conformance of the works to the requirements of the contract specifications. The effective period is 1 to 3 years and the amount guaranteed is 10% to 25% of the contract price. They must be submitted on delivery of the works. The coverage is terminated on expiration of the policy.



Payment bonds

They must be submitted by the contractor to the obligee to guarantee the strict payment of the contractor to its suppliers. If a supplier has delivered materials to the contractor and the latter fails to pay for them, the completion of the works could be jeopardized. In this case, the payment bond will indemnify the supplier thus preventing the materials provided to the contractor from being removed from the works. Payment bonds are issued for short periods ranging from 90 to 180 days. They must be submitted on delivery of the works. The amount guaranteed ranges from 5% to 20% of the contract price. The coverage is terminated on expiration of the policy.



Customs bonds

Customs bonds have significantly boosted commercial activity and they allow for great opportunities. Their purpose is to guarantee the payment of customs duties which may be unspecified. They are also applied to cases when the period to compute duties may jeopardize the quality of the goods. Then, the payment of the tax is guaranteed to enable the importer to clear the goods and, once the tax has been determined, the surety guarantees its payment. They work very well for temporary importation of machinery or raw materials in *maquilas* (assembly plants).They are also used for goods in transit. If the goods remain in the country, the duties must be paid. They are also used in case of discrepancy. When raw materials are imported, two or three tariff items may usually be involved in the determination of the customs duties to be paid, with the subsequent loss of time in trying to reach an agreement. Then the goods are cleared through payment of the lowest duties and, if it is later determined that higher duties should have been paid, the customs bonds guarantee the difference. Customs bonds also guarantee foreign companies' obligations. It sometimes happens that some companies settle in a foreign country, become liable to the Government and, in the end, leave the country without honoring their obligations. These bonds guarantee, on behalf of said foreign companies, the payment of those obligations, which may be fiscal or labor-related, or may arise from registration fees with trade authorities. The effective period is 90 to 365 days, and the amount guaranteed is always 100% of the secured duties. Customs bonds must be submitted to the Treasury or to the tax authority. Coverage is terminated on expiration of the policy.

Financial bonds

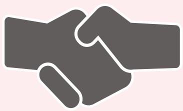
They guarantee the payment of monetary obligations. They are used for contracts for services (loss of profits), trade promotions or raffles (prizes delivery), goods on consignment (custody of goods belonging to others), deferred obligations (excluding bank or commercial credit). The effective period is the same as that of the main contract. The amount guaranteed is between 1% and 100% of the obligation. The conditions for submission depend on each case. The coverage is terminated upon expiration of the policy or payment of the obligation.

Judicial bonds

They provide for the smoothness of judicial proceedings. As a general rule, judicial proceedings take some time, and lots of things may happen until a decision is made by the court. These bonds guarantee the obligations that are the subject matter of judicial or even arbitration proceedings. In civil law proceedings (business-related matters), judicial bonds may guarantee the fulfillment of the obligations which give rise to the claim. If precautionary measures have been filed against the defendant, judicial bonds guarantee damages that may arise from the adoption of said measures, as a first step in case a lawsuit is instituted. The court may also require judicial bonds to guarantee the right of the defendant to a counterclaim should the defendant win the lawsuit; in this case, the defendant has recourse against the plaintiff for legal costs or damages. Criminal judicial bonds guarantee that the defendant will be prosecuted and in case of failure to appear for trial or to comply with the penalty imposed by the court, the Government will have the right to indemnification. These bonds are effective for the duration of the judicial proceedings, whether civil or criminal, and guarantee 100% of the amount to be paid pursuant to the court decision. The conditions of submission depend on the judicial decision. Judicial bonds coverage will expire only when the related judicial proceedings are terminated

Fidelity bonds

They are used in cases such as employees or third parties being in charge of the custody of company's assets as a result of a contract or commercial liability, or to protect property placed in custody of or on consignment with a third party (security companies). The effective period of these bonds is the same as that of the contract. The amount guaranteed ranges from 10% to 100% of the assets involved. Submission requirements for fidelity bonds vary according to the case. Since they are constantly in demand, fidelity bonds are issued for one year and are renewed on a yearly basis upon maturity of each effective period.



Underwriting criteria

the surety contract should include the conditions and regulations appropriate to the works. More than often, contracts are inappropriate because it seems easier to adapt a previously used contract than draft a new one especially intended for the works which the surety bond being underwritten is meant to cover.

As far as the *contract* is concerned, it is recommended to consider the following: are the design, the volumes and the quality clearly defined or are they vaguely stated? Is the term of the contract consistent with the volume of the works? If the price is fixed, are margins adequate to cope with price changes? If the price is variable, what are the adjustment criteria so that the obligee may make up to the principal for those price changes? Is the payment schedule timed with work progress, or must the principal finance part of the works at some of the stages? What is the final purpose of the contract? Is the obligee interested in completing the works? Are the works urgent? Are the works part of a more important project that will follow which may generate big exposures in future? Which are the penalties in case of delay? Are they proportionate to the size of the works and the amount of the contract, or are they rather opportunity costs transferred to the sureties under the form of risks? In any case, the amount of penalties should not exceed 15%.The interpretation of penalties is extremely important. This is generally expressly stated in the contracts. If in case of very complex works the obligee refuses to accept delivery of the works because of a minor problem, such as a missing key to a room door, are the works considered to be completed? The contract must establish that the amounts of the penalties ought to be proportionate to the breach, and that they will not turn into indemnification amounts which, in the end, will result in a reduction in the cost of the works to the obligee by unduly transferring a claim to the surety. If there are amounts retained at work completion, when will they be released? Are they part of the indemnification? Will those retained amounts add to the surety indemnification?

With respect to the principals, it is convenient to analyze the following: do they have previous experience in similar works or projects? In relation to the size of the works, do principals have adequate administration capacity and are they willing to have it? Quite frequently, contractors are very capable, but they run so many works at the same time that they lack the capacity to handle all of them properly and some may fail. Besides, do principals have financial capacity to cope with default? Do they have resources of their own or access to them? Do they have access to credit from their suppliers or are they new in the business and do not have credit and their working capital is compromised? Do they have control over key factors that allow them to perform the works, such as right of way, if it is their responsibility to get them? Can they have access to critical raw materials which are required for the performance of a particular contract? Are they currently handling other contracts that may jeopardize the whole company? Even if the works that are being guaranteed do not entail difficulties in performance, can they be jeopardized by other works? Are they aware of the importance of legal matters or do they tend to sign any contract without the necessary legal advice? Is the works margin attractive? Are principals interested in completing the works, or is the margin very tight and might eventually cause the works to be abandoned, thus triggering further risks? Are principals willing to commit the counterguarantees? If the principals are asked to set up a mortgage as security interest, would they be willing to do so? If they do not trust themselves, why should the surety company trust them?

Even though *obligees* do not appear to be very important, it is necessary to consider the following: are obligees really interested in the completion of the works or is there a political interest behind? Have obligees appointed a supervisor for the works, and this supervisor is both a third party and an expert? Is the obligees' attitude proactive? If there are any claims, will the obligees be willing to solve them? Or will they show an aggressive attitude towards the contract or the principal? This is very important because in the Government area as well as in the private area, some obligees pose risks which, although they might not be visible, could cause exposure to increase significantly. Do obligees have enough budget to complete the works? Very often the works are started with the sole resources of the advance payment but no further resources are available to complete them. Do obligees have a good administrative coordination so that payments may keep up with work progress? Because delay in payments may jeopardize the principals' cash flow or their working capital, and put the whole works at risk. Are their financial positions stable in the long run or should changes be anticipated, whether in their assets or in their intentions in relation to this contract? Have they obtained the permits and licenses necessary to complete the works? This is of the utmost importance, given the fact that, in most cases, the plan is to start work immediately after the advance payment is received, but if local authorizations for construction have not been obtained by then, the progress schedule will be jeopardized from the very beginning, and the works may even not have started six months afterwards, which would lead to an impending claim; work should never start without the corresponding authorization, and it is essential that this fact is expressly stated in the bond. Many underwriters have failed in this matter. Additionally, it should be useful to have information about how obligees have dealt with previous claims. Which criteria have been set? In case of delays, how do obligees handle penalties and opportunity costs?

Counterguarantees

There are many kinds of counterguarantees to protect sureties in case of claims. *Liquid guarantees* which are usually required by banks are very safe. They are cash deposits, checks, term certificates of deposit. They are difficult to access because they are part of the constructor's working capital, but sureties should try to include them in some proportion in their contracts. *Fiduciary guarantees* are those offered by other business firms to answer for the principal before the sureties. However, there are some disadvantages to fiduciary guarantees: one is that financial analysis will only provide current information; the other is that it is not possible to know how the principal's performance will develop in the course of time in case of medium and long term works. The principal's vulnerability in time may impair the guarantee. As regards *pledge guarantees*, depreciation is something to be aware of when machinery is pledged. Machinery depreciates in the course of time. When shares of stock or similar assets are offered as a pledge, it is impossible to know what their market value will be or how much they will be worth in future. *Mortgages*, on the other hand, appreciate with the passing of time, but they may also have been used to secure other transactions with banks or other institutions. The upside of mortgages is that they last in time since they attach to items of real estate, which are long-lived assets.

Conclusions

Surety bonds are the most preferable instruments to guarantee contingent obligations assumed. They can cover obligations that are difficult for banks to have access to because sureties can distribute risk through surety reinsurers or other sureties. They allow for a significant increase in competition, because, through surety bonds, new players may join in and take part in bids, thus allowing the owners of the works to obtain the best possible conditions.

They are particularly valuable to guarantee liabilities for unspecified amounts. This is perhaps one of the most significant differences with other financial instruments: surety bonds are issued to guarantee unspecified amounts and it is necessary to specify them to enable payment. In the case of the letter of credit, the obligee goes to the bank and receives the amount of the letter of credit with no further explanation. This is significant arbitrariness.

As regards the management of the principal's accumulation of risks, banks do not analyze in big depth the process of accumulation; they take guarantees for such high amounts that they are not concerned with analyzing which degree of accumulation could impair the call upon the guarantees. Sureties are more objective because they have a deep knowledge of the principals and their past record.

Unlike the letter of credit, surety bonds are called upon while they are in force; they are effective until the end of the conciliation procedure and this confers them great certainty to guarantee the obligations to the obligee. Negotiations, as long as the bond has been claimed on time, do not cancel the policy, but hold it in standby to be called upon when the pertinent amount is established.

The great upside of surety bonds is that they enable works to be finished on behalf of the principal. As the ultimate goal of government or private contracts is the completion of the works, surety bonds represent an extremely useful vehicle to achieve this end without making the obligee go through a new bidding process. Moreover, they contribute to the development of SMEs, because access to surety bonds is easier than access to other more conventional financial instruments issued by banks.

Surety bonds allow the contracting company to receive bids from other experts, and in other markets, which guarantees the completion of the work. Surety bonds result in an increase in the number of bidders, which, in turn, provides certainty that the price agreed for the contract is the best possible price to be obtained. Finally, surety bonds provide an objective guarantee of the principal's obligations.

Fronting

Definition

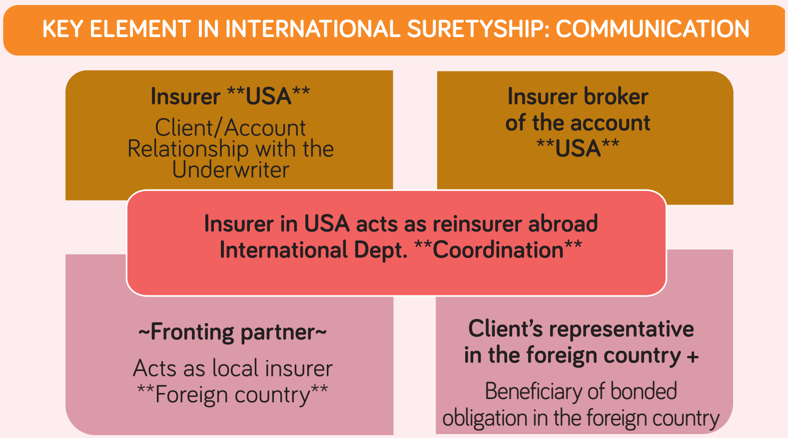
The fronting operation has been growing in the surety market and is relatively frequently used. Due to its characteristics, it has certain special features.

Two definitions of fronting operations may be given: one of them, as is known in the general insurance market, and the other as is normally used in the surety market. In the first case, it may be defined as the "type of coverage where an insurance company which underwrites a policy transfers the whole risk, or the best part of it, to another insurer or reinsurer."

And in the second case, the one related to the surety market, *fronting* may be defined as the "issuance of a policy for a principal who has been awarded a contract or has to comply with an obligation in another country, and therefore needs a guarantee in that market."

Participants

Fronting operations have an additional player because the client of a surety company needs a policy in a foreign country, but the surety company cannot directly issue it and asks a colleague company which operates in that market to do so. The company which needs to render this service to its client and is going to request the policy to a colleague company in another country is called the "instructing company" while the other is called the "issuing or fronting company."



Underwriting in other markets implies a higher risk

No doubt that for a surety company crossing the border to cover one of its principals implies an increased risk; therefore it has to be even more careful than in direct business underwriting.

Likewise, it is necessary to be familiar with that market and take into account the type of policies used there, mainly whether they are first-demand bonds or not. At least, the instructing company should know the basic and relevant aspects of the legislation, market regulation and legal certainty.

The instructing company should also consider: whether it has worked with the fronting company before (as an instructing or fronting company), its management, its position in the market, the reinsurers (also for both cases).That is, to be in knowledge of several aspects that will help clarifying doubts and get advice on key issues, such as legal and cultural aspects, type of surety bond required, claims management, among others.

This last point involves one of the most delicate situations, because when the beneficiary is a very important client for the fronting company (e.g. the Ministry of Public Works, which is a key player in a large number of surety markets) and a claim has been filed against the policy, the fronting company will feel pressed to pay the indemnity whether the policy has been duly called or not, or whether or not legal resources exist to reject or delay payment, which the company would generally do in its direct business. Otherwise, it could risk being included in a "black list," have some problems with the Superintendence, or some other similar or more serious consequences. Therefore, it is also convenient to be familiar with the Claims Department structure of the fronting company and, if possible, to know the responsible person there.

It is important to make quite clear that this is an additional service the surety company provides to its clients (which will obviously generate value added) and not to companies that do not belong to its portfolio. Although it may seem obvious, it should be mentioned that the only contracts that will be covered are the ones related to the normal activity of the client. It is not quite advisable to cover those contracts which represent the principal's first experience in a foreign country. However, there may be some situations in which some softening circumstances can be taken into account (a consortium with a local colleague, some type of strategic contract for the government of that country, etc.).There is always a first time, and if the surety company does not support the development and expansion of its client, this will be done by another competitor.

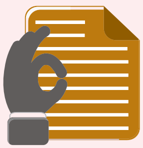
The experience of the client in such country is more than relevant. Above all, its business contacts (suppliers and others), lobbying, negotiation capacity (there can be language, cultural, measurement system barriers, etc.).

Underwriting and pricing

As to counterguarantees, the client should know from the beginning that this is an increased risk operation, and for this reason the guarantees should be higher, including higher liquidity than the one required for direct insurance.

Since the contract will be governed by legislation other than the usual, the instructing company has to examine it in far more detail than it usually does when underwriting in its own market.

Apart from the above issues on counter-guarantees, it is important for the fronting company to have another kind of guarantee, such as the Facultative Reinsurance Slip for Fronting Operations developed by PASA and ICISA, which the members of both associations have been recommended to use.



It is also recommended to use an additional document, such as a policy issued by the instructing company, the beneficiary of which would be the fronting company. This document is intended to cover the policy and the contract. The cooperation agreements between both companies are also valid, but it is advisable to sign them in advance. Furthermore, the issuing company should be thoroughly evaluated by the instructing company as if it were a principal or even in more detail. Most of the time the urgency lies in the anxiety and the need of the client and the surety company's commercial department to get the fronting contract as soon as possible, and important issues are left aside, such as the place and date of delivery of the policy, or its payment—sometimes the payment to each company is made separately, and others, at a single place.

These two issues have to be specified, because if the policy is sent to the instructing company, courier expenses should be included in the cost. If the payment is made at a single place, the details of the transfer of funds should be clearly stated: date, net amount, and other issues that may be of a regulatory nature, such as the procedures in force in some countries for the transfer of currency abroad.

Likewise, the client must also be clearly informed about the premium rate agreed by both insurers (which shall be higher because of the increased risks) and the taxes involved. Moreover, if a broker is involved, the commission should also be taken into account (though on many occasions it could be lower than those of the direct policies, because the fronting company shall have increased costs to close the operation). The Cover Note—if it is necessary and/or advisable—is not to be left aside.

Reinsurance

Another basic point is reinsurance coverage, because in many contracts these operations are not covered. On the other hand, it also happens that the coverage of these operations is 100% or a very high percentage (depending on the legislation, because in some markets fronting operations are not authorized), then the control authority will request a Cover Note because that policy will not be covered under the instructing company's automatic reinsurance treaty.

Then, the Superintendence regulations must be taken into account to analyze how to act, given that in a large number of markets the regulators request that the instructing company be registered as reinsurer. This is not so easy for many insurance companies that operate in one place only, mainly if they are mono-liners, due to the capital and international qualifications required.

An alternative solution would be for one of the instructing company's reinsurers (preferably the lead reinsurer company) to agree to issue a facultative Cover Note for this operation and then retrocede it (for a commission) to the instructing company (that is, its cedent company), which will include it in its automatic reinsurance.

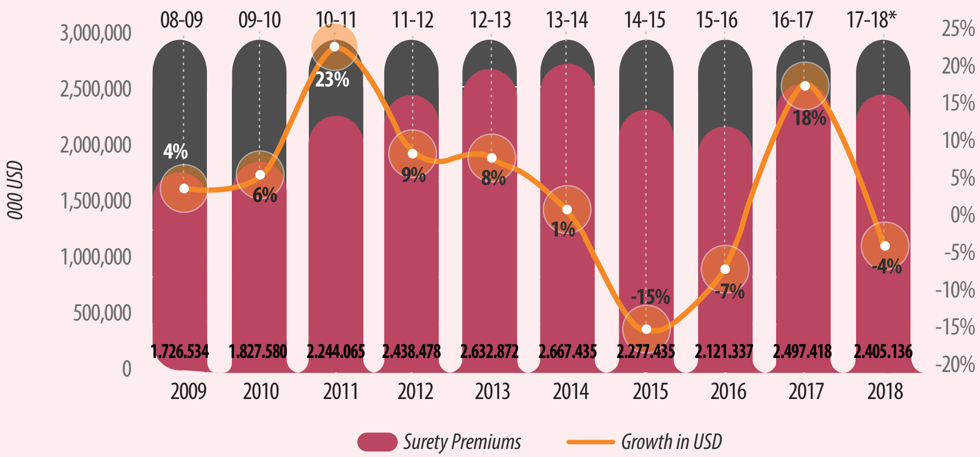
Finally, it is important to agree on the terms and conditions of the Cover Note, whose text and call terms should be the same as those of the policy, and may include specifications, such as the Premium Payment guarantee; the Note is to be sent before the policy is delivered.

Conclusions

Fronting operations may look simple but have a great variety of slight differences that make them more complex. Reality shows that today these operations are more frequent (to a great extent thanks to globalization) and are a very important tool to generate value added, apart from premium income for the clients.

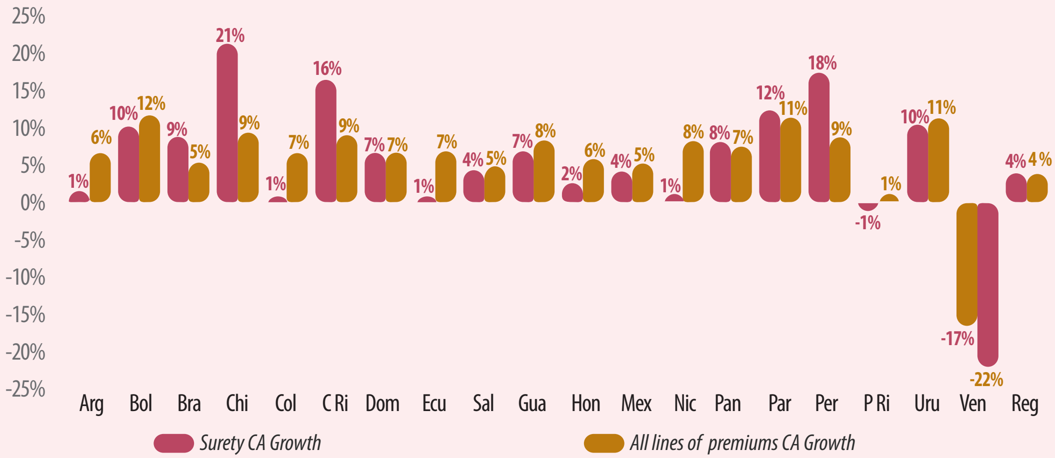
Latin American market statistics for surety bonds

Latin America – Surety bonds: Premiums & Growth



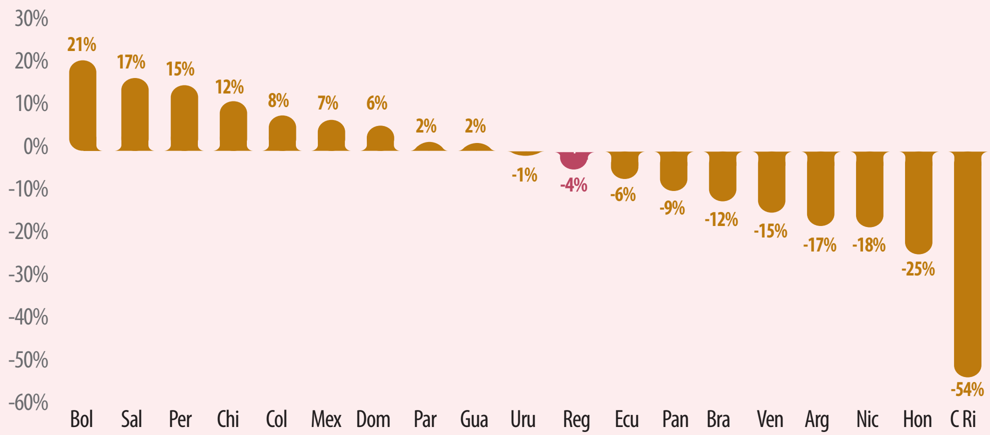
** Figures at December 2018, except for Bolivia (November 2018, 12 months), Dominican Republic (September 2018, 12 months), Puerto Rico (December 2017), Venezuela (figures estimated at December 2018).*

Latin America – Surety bonds: Premiums Compounded Average 2009-2018* Growth by country



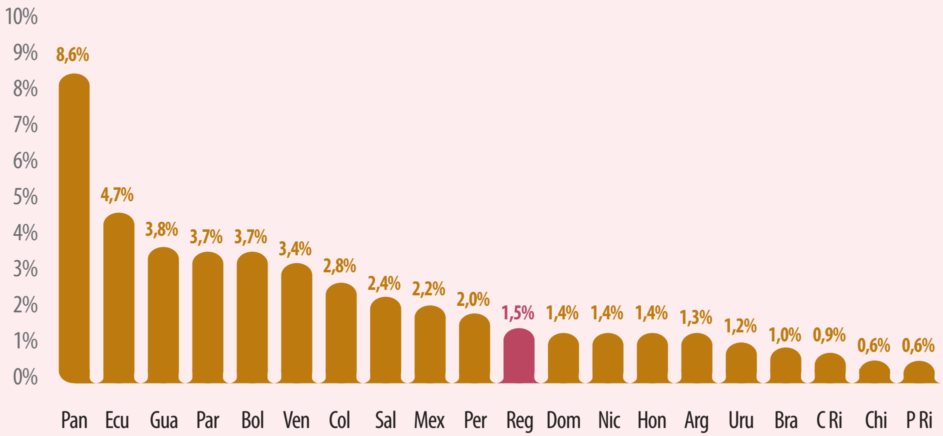
* *Figures at December 2018, except for Bolivia (November 2018, 12 months), Dominican Republic (September 2018, 12 months), Puerto Rico (December 2017), Venezuela (figures estimated at December 2018).*

Latin America – Surety bonds: Premium Growth by country 2017-2018*



* *Figures at December 2018, except for Bolivia (November 2018, 12 months), Dominican Republic (September 2018, 12 months), Puerto Rico (December 2017), Venezuela (figures estimated at December 2018).*

Latin America - Surety: Premiums as % of All Lines of Business by country 2018*



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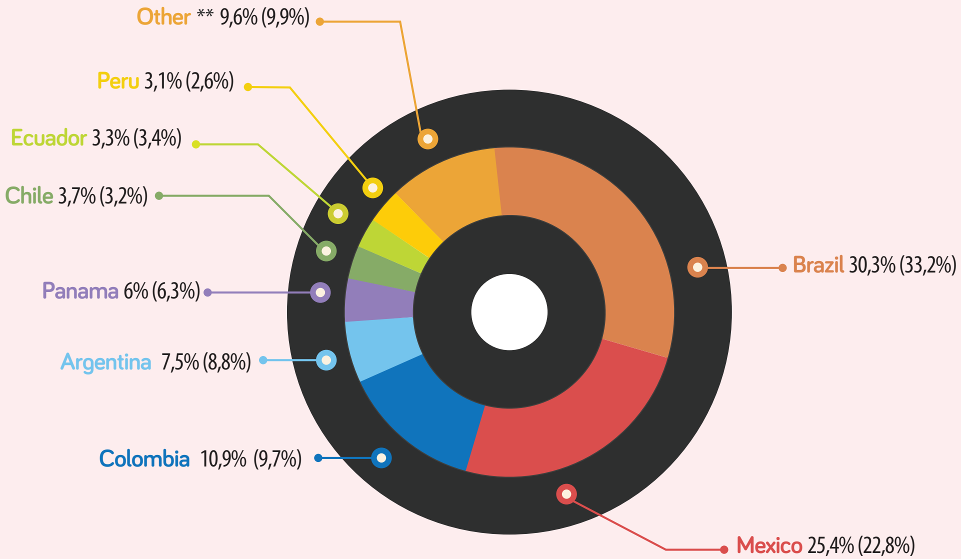
Latin America - Surety: Premiums Market Share by country 2018* (2017)



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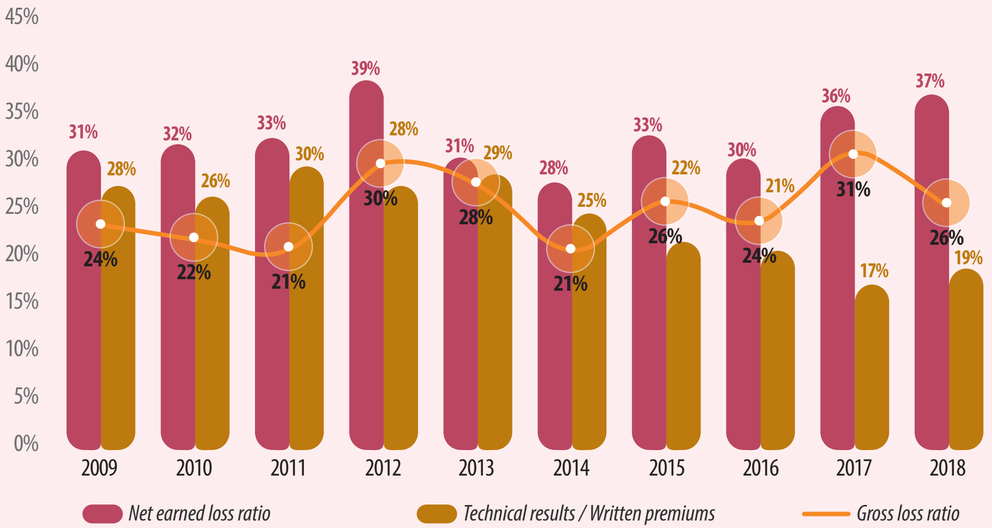
*** Includes: Bolivia, Costa Rica, Dominican Rep., El Salvador, Guatemala, Honduras, Nicaragua, Paraguay, Puerto Rico, Uruguay & Venezuela.*

Latin America - Surety: Loss Ratio & Technical Result (% Written Premiums)



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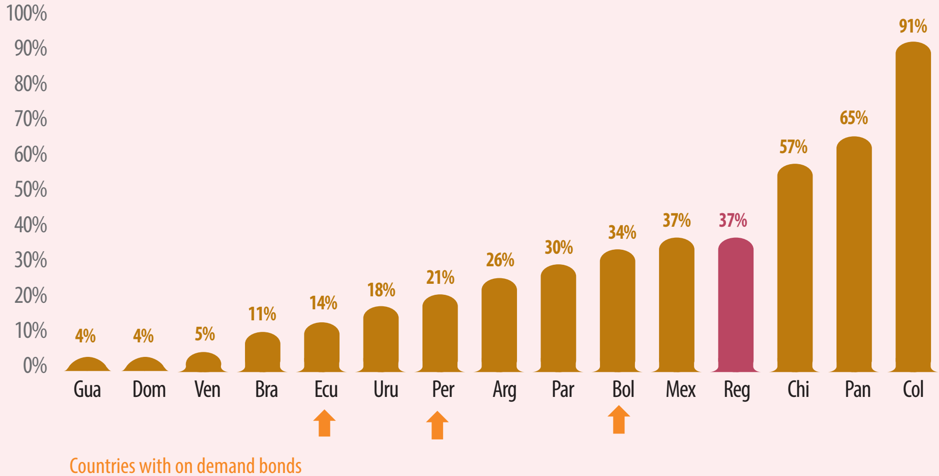
Latin America - Surety: Net Earned Loss Ratio Premium by Country 2018*



** Figures at December 2018, except for Bolivia (November 2018, 12 months), Dominican Republic (September 2018, 12 months), Puerto Rico (December 2017), Venezuela (figures estimated at December 2018).*

Glossary of surety terms

Advance payment
Money, securities and materials given in advance to the contractor to be used in the performance of the contract.

Advance payment amortization
Process through which the advance payment bond amount decreases proportionally against the presentation of documents duly endorsed by the beneficiary, showing that the advanced funds have been allocated to the project.

Advance payment bond
Bond guaranteeing the proper use of money and/or materials delivered in advance by the beneficiary to the principal to comply with the obligations set forth in the main contract, or its reimbursement in case of noncompliance.

Advance payment management/Joint management
Agreement between a trustee and an insurance or surety company, acknowledged by a bank, through which funds and securities are deposited in custody, so that both entities may jointly manage such funds and securities; certain requirements and signatures are needed for withdrawal.

(Risk) Aggravation
A situation where certain circumstances change the nature of the covered risk and aggravate the risks declared at the time of contracting. The principal is obliged to inform about any circumstances involving risk aggravation.

Award
Public or private act by which, once the tender formalities have been complied with, the contracting party assigns a natural or artificial person a supply, service or construction contract.

Bid bond
Bond guaranteeing that the winner of a public or private tender will enter into the contract at the offered terms. It guarantees that the bidder will sign the contract, provide the required bonds and comply with any other requirements.

Bond
Contract by which one party, called the surety, undertakes to perform the

obligations of another party, called the principal or obligor, to its creditor or obligee in the event of nonperformance.

Bond release

A surety is typically discharged from its obligations under the bond in the following cases: (a) the guaranteed obligations are fully performed, as stipulated in the underlying contract and/or in the applicable legislation; (b) upon the beneficiary's declaration of release; (c) upon payment of claims for the full bond amount; (d) when the underlying contract is terminated and/or the guaranteed obligations become null and void.

Bonding line

The maximum amount of bonds a surety is prepared to issue on a principal's behalf. The bonding line is based mainly on: the surety's experience with the principal, the available counter-guarantees, the principal's track record and financial position.

Concession bond

Bond guaranteeing the payment of royalties and the compliance with investment plans and other obligations arising from a concession of goods, services or works.

Conditional bond

A type of surety bond which, in the event of a claim, may be executed if the legal, contractual and policy requirements have been complied with.

Endorsement

Written agreement attached to the policy formalizing any amendments to its original wording (scope of cover, premium rate, cover enhancements or restrictions, clarifications, etc.).

Exclusion

An express statement by which the insurer details the facts and circumstances limiting its liability in the event of a claim.

Financial statements

Accounting documents which reflect the economic and financial situation of an entity at a given date, and are evaluated in the risk assessment.

Force majeure

Occurrence or event that prevents any party from performing their contractual obligations and has the following characteristics: it is unforeseeable and extraordinary; it is beyond the parties' control; it cannot be attributed to the parties' fault or negligence; it could not have been avoided through the exercise of due care. In a force majeure event, neither the principal nor the surety are liable for the nonperformance of their obligations covered by the surety bond.

Fraud

(1) Intentional act to deceive third parties with intent to harm them.

(2) Act by the principal who, usually through a distortion of the facts, is intended to hamper the collection and indemnification rights of its creditors (beneficiary, surety).

(3) Situation that arises when the beneficiary of a surety bond has intentionally caused a loss or exaggerated the impact of a loss to collect the agreed indemnification.

Fronting

Operation whereby, at the request of a foreign company, a local company issues a surety bond for the account and at the risk of such company. The “fronting company” is the one issuing the bond in the country where the guaranteed contract is executed. The “backing company” is the surety from the contractor’s country requesting the bond issuance.

Intermediary/Agent/Broker

A natural or artificial person authorized by the competent authority (of its country) to sell insurance products, assuming responsibility for advising the client on the purchase of different covers, informing about market alternatives, scope limitations, exclusions and cost of insurance. The intermediary is responsible for finalizing the policy issuance and advising the client in the event of claims.

Maintenance bond

A maintenance bond protects the owner/beneficiary of a completed project—for a specified time period—against defects and faults in materials/workmanship/design that could arise after handover and (provisional) acceptance. The bond makes sure the principal will correct the defects or that the owner/beneficiary will be compensated for such defects.

Mortgage/Pledge

Security, usually on real estate, to guarantee the performance of an obligation; if such obligation is defaulted, the creditor may sell the property to collect its debt. In suretyship, the mortgage can be a type of counter-guarantee for a transaction.

On-demand bond

A type of surety bond by which the surety undertakes to pay the beneficiary a sum of money on first written demand, without the obligation to prove the contractor's noncompliance.

Performance bond

Bond guaranteeing the performance of a contract, issued by an authorized surety, to be submitted by the tender winner to the beneficiary, following contract execution. It guarantees the punctual delivery of goods and services in the amounts and with the characteristics stipulated in the contract. The bond amount may usually range from 5% to 100% of the contract price. The bond is enforceable when the principal fails to perform any contractual obligation due to causes attributable to him and is normally claimed for a proportional amount of the unfulfilled obligations plus fines/penalties, if they are covered.

Principal

Natural or artificial person whose obligation in favor of a third party, called beneficiary, is covered by a surety bond.

Rental bond

Bond guaranteeing the contractor's obligations under a property rental agreement.

Risk analysis

A risk management component consisting of: identification of negative elements; assessment of their probability and magnitude; evaluation of their impact; application of quantitative and qualitative techniques to reduce: (a) risk uncertainty, (b) losses, and (c) associated costs.

Three C's (Character, Capacity, Capital)

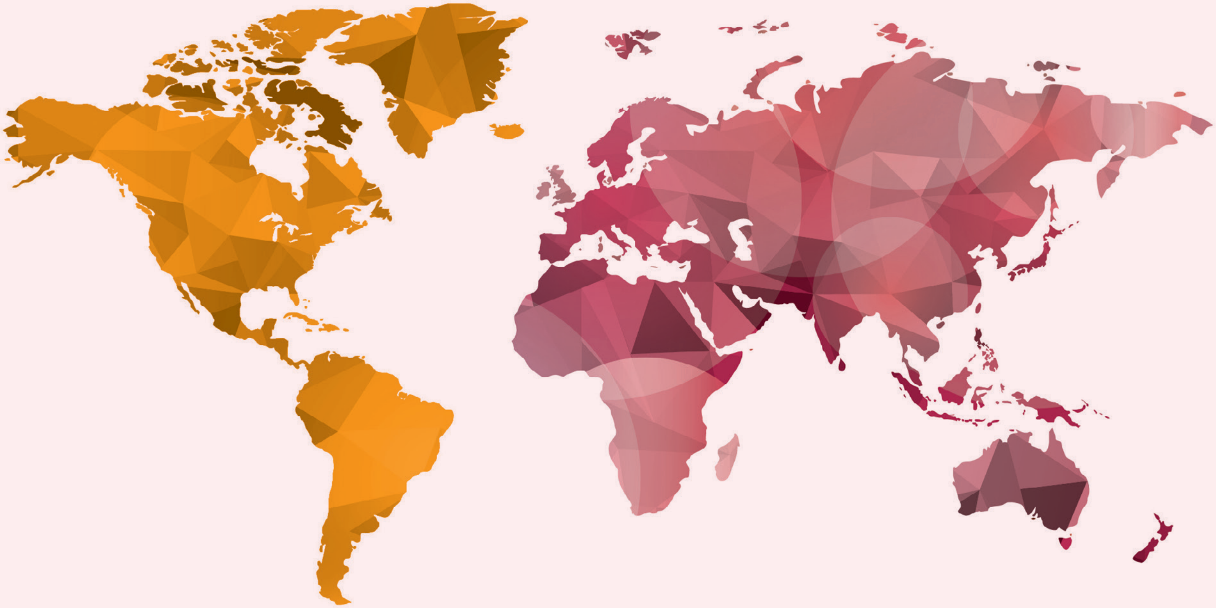
They are the three pillars of bond underwriting. Character: integrity, track record and reliability of either the principal or its shareholders/owners. Capacity: principal's experience in similar projects and technical expertise. Capital: principal's economic and financial strength and resources to complete all the ongoing projects.

Trust

Agreement whereby a natural or artificial person (the trustor) transfers to another person (the trustee) the ownership of one or more assets so that when a term expires or a condition is fulfilled, the trustee may assign the proceeds as established by the trustor for its own benefit or that of a third party (beneficiary).

PASA worldwide

The Panamerican Surety Association is a not-for-profit organization which was founded in 1972 by a group of sureties from the American continent.



Today, with members from more than 30 countries in three continents, PASA represents the world market of suretyship, surety insurance, guarantees, credit insurance and their reinsurance.

Operating Office
Santa Fe 830, 7th floor
C1059ABP Buenos Aires
Argentina

Phone: 5411 5032 8375
E-mail: info@apfpasa.ch
www.apfpasa.ch

PASA APF

Asociación Panamericana de Fianzas
Panamerican Surety Association