GOOD PRACTICE GUIDE FOR SURETY BOND REINSURANCE IN THE BRAZILIAN INSURANCE AND REINSURANCE MARKET

▪ GENERAL INTRODUCTION ▪

The National Federation of Reinsurance Companies - FENABER, in its ongoing effort to contribute to the development of the Brazilian insurance and reinsurance market, provides a Good Practice Guide for Surety Bond Insurance to highlight relevant aspects of insurance and reinsurance, especially in the surety business.

It's important to note that these suggestions are not obligatory. They are offered to enhance the understanding of each insured, policyholder, insurer, reinsurer, or broker within the scope of their activities. FENABER is committed to fostering free competition while promoting appropriate ethical and operational standards in the insurance and reinsurance market.

▪ INTRODUCTORY COMMENTS ON SURETY BOND INSURANCE ▪

Surety bond insurance, introduced in the Brazilian market in 1967 through the enactment of Decree-Law No. 200/1967, gained prominence in public sector contracting after the Binding and Concession Laws were enforced in 1993 and 1995. Its primary aim is to safeguard the insured against the risk of default by the policyholder on obligations they have undertaken.

In recent years, the surety bond market has experienced significant growth, mainly due to infrastructure projects and the demand for judicial guarantees.

It is a peculiar segment characterized by a contracting structure and tri-party interest (insurer, policyholder, and insured), high risk of accumulation (due to portfolios being very exposed to high-severity risks and the nature of the risk covered), and low frequency of claims.

The growth in demand and supply of surety insurance and its history of low loss ratios, including those associated with new entrants (insurers and reinsurers), may lead to practices in the medium and long term that generate market distortions. It's essential to be aware of this risk, especially in challenging economic scenarios, which are inevitable in economic dynamics and in which loss and litigation tend to increase.

Therefore, the purpose of this Good Practice Guide is to guide reinsurers and other relevant stakeholders for surety bond insurance in the Brazilian market, aiming to minimize distortions and reduce information asymmetries that could have negative impacts, such as:

- losses much higher than expectations;
- Legal uncertainty associated with the allocation of risks and losses under reinsurance contracts;
- negative impact on the insurance and reinsurance image;
- reduction in demand and supply of surety bonds due to inefficiencies, misunderstandings, and reputational risks; and
- reduction in the supply of reinsurance to insurance companies operating in surety bond insurance.

▪ GOOD PRACTICES IN THE SURETY INSURANCE MODALITY ▪

– JUDICIAL GUARANTEES AND CONCESSION GUARANTEES –

Adjusting the sum insured

The inflation adjustment of the sum insured and guarantees and the price level adjustment indices involved, especially in reinsurance contracts on risk attaching basis, may result in insufficient reinsurance coverage taken out by the cedent to manage its risks.

In this context, annual endorsements should be issued to adjust the sum insured and enable the collection of the respective insurance and reinsurance premiums to accommodate inflation adjustments.

On this topic, the Surety Insurance Manual (version 2023), prepared by DIR1/CGRES/CORES/SUSEP[1], clarifies that the adjustment of the surety amount, when applicable, shall take place based on the index and periodicity defined in the main subject or its specific legislation, respecting the linkage of the insurance contract to the subject of the main contract. Due to this linkage, the insurance contract shall respect the main subject's specific characteristics, provisions, and legislation, in addition to the legislation and insurance rules and concepts.

SUSEP states that when the main subject or its specific legislation provides for the obligation to adjust the amount of the guarantee, the insurer may carry it out without the express declaration of the insured or the policyholder, with Article 12, sole paragraph of SUSEP Circular Letter No. 662/2022. This possibility for the insurer to adjust the guarantee directly and automatically would be possible since the

[1] Available at: https://www.gov.br/susep/pt-br/central-de-conteudos/noticias/2023/dezembro/susep-lanca-manual-tecnico-de-seguro-garantia

insured's statement and the policyholder's acceptance of this adjustment had occurred previously, upon their prediction and upon becoming aware of the main subject or its specific legislation, and ultimately aims to bring greater agility and simplicity to the dynamics of insurance in response to the demands previously set by the insured. In any case, there shall be an express contractual provision to this effect.

In this context, the cedent shall estimate and reserve capacity in the reinsurance contract under which the original policy was issued.

Furthermore, the insurance proposal, the policy, and the counter-guarantee contract shall inform the policyholder of the need to issue future endorsements and all aspects of that procedure (including proposals to be submitted by the policyholder).

Allocation of endorsements and new policies under reinsurance contracts

the relationship between insurers and reinsurers; in the relationship between insurers and reinsurers, it is essential to establish the **criteria to define in which reinsurance contract endorsements and new policies will be allocated**.

The clarity of this allocation is essential, even considering specific situations related to companies experiencing economic and financial difficulties, such as court-supervised reorganization granted, not yet granted, or rejected.

In all cases, clear rules shall define the concept, how endorsements and renewals should preferably be allocated in the reinsurance contract, and the procedures to be adopted by the cedents.

In general, once the policy's term has terminated (even if the renewal is issued by endorsement), the renewal tends to be allocated to the reinsurance contract in force, considering that it will take place through a new underwriting process.

When this is the case, and in situations where the policy renewal does not fit the current underwriting policy, it is recommended that the panel of reinsurers discuss the possibility of including it in the original policy issuance contract.

In any case, the topic shall be the subject of clear rules and, where applicable, exceptions in reinsurance contracts.

Regarding this aspect, also according to the Surety Insurance Manual (version 2023), prepared by DIR1/CGRES/CORES/SUSEP[2], the term of the surety insurance shall be equal to the duration of the guaranteed obligation to ensure full guarantee of the risk, unless the main subject or its specific legislation requires and allows the structuring of the term with a different rule, as per article 7 of SUSEP Circular Letter No. 662/2022.

Suppose the policy, as per the main subject or under the respective legislation, is valid for less than the duration of the guaranteed obligation. In that case, the insurer shall ensure coverage maintenance as long as there is a risk to be covered and as long as it is in the insured's interest, according to Article 8 of SUSEP Circular Letter No. 662/2022.

Therefore, reinsurers should pay attention to the term of validity of the surety insurance, especially when determining the term of validity of the reinsurance contract.

Installment payments of premiums

Regarding the **collection and the possibility of paying the annual premium in installments**, the period granted to policyholders for the financial settlement of the premiums paid in installments shall be appropriately managed from an insurance and reinsurance point of view. Receiving the premium in cash is the most recommended alternative due to the risk of default and financial loss if interest is not applied to the installment payment.

Adjustment indexes for judicial guarantee insurance policies

Except for the possibility of establishing specific and exceptional rules, **adjustment indexes in the judicial guarantee insurance policy that do not comply with the index applicable to the respective lawsuit should be avoided**. Even if the policy with such conditions is accepted or a provisional remedy (not definitive) is obtained by the Policyholder, which changes the lawsuit index to manage the capacity of the reinsurance contract, the most conservative indexes (which may prevail in final decisions) shall be used.

It is also crucial for the insurance company to monitor the lawsuit associated with the guarantee and the policyholder's financial condition under legal guarantees, considering the deadline for paying the indemnity and the possible need to renew or replace the policy.

[2] Available at: https://www.gov.br/susep/pt-br/central-de-conteudos/noticias/2023/dezembro/susep-lanca-manual-tecnico-de-seguro-garantia

Expired and non-written-off policies

Reinsurers and cedents must take special precautions regarding the operational management of expired policies and precautions regarding the operational management of **expired policies that have not been written off**, including effective terminations and non-renewals.

Administrative installments in tax foreclosure

In the case of **administrative installments in tax foreclosure** guaranteed by a judicial guarantee insurance policy, the risk remains as long as the policyholder does not submit a new guarantee for the administrative installments. Even if the reinsurer has restrictions regarding the issuance of policies in the "administrative installment" modality, if adherence to the installment plan occurs during a process guaranteed by a judicial tax foreclosure policy and the policyholder is unable to submit another guarantee in the administrative installment plan, the reinsurer must be aware that the risk will remain covered by the judicial policy.

Accounting, underwriting, and claims audits

In compliance with global best practices, the reinsurer shall have free access to the insurer's accounting records, and the possibility of **accounting, underwriting, and claims audits** shall be contractually provided for.

Accounting, underwriting, and claims audits shall be carried out periodically, especially in the case of surety insurance, due to (i) the complexity of its administration (due to the possibility of several policies covering the same risk, a large number of endorsements, quota share contracts with different ranges and different retentions, etc.) and (ii) the low frequency of claims generates a tendency towards less monitoring, by the reinsurer, of the development of the portfolio.

Duties of the lead reinsurer

It is recommended that a clear and express definition of the **lead reinsurer's duties under reinsurance contracts** be established and the entire panel be consulted in appropriate situations. Establishing the general rule and the exceptions is essential in this context.

For example, decisions on limits exceeding the contractual limit, exclusions, and coverage of the contract, breach of conditions established in agreed-upon clauses, and other points that substantially amend the agreement and involve risk analysis usually depend on the resolution of the entire panel of reinsurers.

Cooperation and claims control

It is recommended that reinsurance contracts establish clear rules on cooperation and claims control, that is, whether and how decisions on claims will be shared between the insurer, lead reinsurer, and other reinsurers on the panel. Careful assessment of the suitability and need for clarity of this rule is critical in the case of surety insurance due to the usual low net retention of the ceding companies.

Counter-guarantee contract

Surety insurance transactions are preceded by signing a **counter-guarantee contract** between the insurer and the policyholder, which establishes, in the vast majority of cases, the obligation of the policyholder to submit an additional guarantee in favor of the insurance company. This guarantee can be used to reimburse amounts owed by the policyholder to the insurer. It cannot interfere with the insured's right under the surety insurance contract to which it is related (article 32 of SUSEP Circular Letter No. 662/2022), as clarified in the Surety Insurance Manual (version 2023), prepared by DIR1/CGRES/CORES/SUSEP[3].

Counter-guarantee contracts must be carefully drafted, including, if applicable, the provision of covenants and collaterals, following the credit analysis and underwriting policy of each insurer and the arrangements related to each reinsurance and each reinsurer. In other words, depending on the case, the participation and information of reinsurers in the discussion about the content of counter-guarantee contracts is critical, and the need for this must be agreed between insurers and reinsurers. Thus, discussions about the existence and extent of reinsurance coverage and the suitability of cedents' underwriting decisions are avoided in this aspect.

In the case of co-insurance, it is essential to ensure that the counter-guarantee contract is appropriate to the transaction, security, and procedures to be adopted by each co-insurance company, including, if applicable, regarding the possible representation of co-insurers by the lead co-insurer within the scope of the performance of the counter-guarantee contract.

Place in funds clause and respective covenants

The **possibility of including a place in the funds clause and respective covenants** shall be evaluated, establishing the policyholder's obligation to deposit the amount in case of deterioration of their financial situation and failure to submit a guarantee to replace the insurance if the insurer is not interested in renewing it. A possibly appropriate measure when managing risk is signing the counter-guarantee contract by third parties, such as the policyholder's shareholder or members of consortiums with greater economic and counter-guarantee capacity.

Monthly report and expected claims

Considering the peculiarities of the surety insurance and its typically low loss ratio, it is recommended, for better control and compliance with legislation, that the cedent send a **monthly report on claims (Claims Report – including cases that do not yet have reserves) and expected claims** to the reinsurer. That report must also

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include loss expectations (i.e., events likely to generate losses reported by the insured and not converted into a claim notice) informed by the insured, containing, among other information, for example, the name of the policyholder, name of the insured, sum insured, underwriting year, allocation to the contract (informing the allocation by contract range, if applicable) and remarks.

Systems for efficient access and provision of information

Systems generating efficient access and provision of information shall be developed, and those that already exist, such as the National Claims Registry - RNS, shall be, always with all contractual and legal precautions, valued and adequately populated by the entire market, as is the case within the scope of the Central Bank with the credit market. The objective is for insurers and reinsurers to have information about the policyholder, mainly because when a failure to pay the premium occurs, the surety insurance policy remains in force, guaranteeing the insured's rights and risk coverage under Article 16, §1 of SUSEP Circular Letter No. 662/2022.

Furthermore, the use of specific information systems, whose complexity and cost are appropriate for each reinsurance and retrocession, can be provided for in the guideline for reinsurance contracts.

Amendments to surety bond insurance legislation and regulations

Amendments to laws and regulations applicable to surety bonds are frequent and impact interpretation, enforcement, renewal, and endorsements. Therefore, a clause may be included in reinsurance contracts, providing that amendments to legislation may result in a review of the conditions of the reinsurance contract. For example, it can be established that the reinsurer will have a deadline to express its opinion on the amendment. The reinsurer will have tacitly accepted the amendment once that period has passed without a response. Furthermore, specific rules and aspects may be subject to a particular treatment.

Insurance contract amendments

According to the Surety Bond Insurance Manual (version 2023), prepared by DIR1/CGRES/CORES/SUSEP[4], **the surety bond insurance contract can be amended** to follow changes to the main subject or to meet any specific demand of the parties. However, any amendment may only be made upon request from the insured or with their express consent.

When the possibility and criteria for a specific amendment are previously stipulated in the main subject or its particular legislation, it is considered that the insurer was fully aware of the possibility of that amendment occurring and, consequently, has

[4] Available at: https://www.gov.br/susep/pt-br/central-de-conteudos/noticias/2023/dezembro/susep-lanca-manual-tecnico-de-seguro-garantia

already underwritten the respective risk. Thus, in this case, when changes occur in the main subject, provided for in this subject, in the respective specific legislation, or in the document that served as the basis for the acceptance of the risk by the insurer, which implies the modification of the policy, the latter shall follow such amendments. In this case, the insurer cannot deny making such amendments.

On the other hand, when changes not previously stipulated occur in the documents mentioned above, the policy may follow such changes if accepted by the insurer; that is, at that moment, the insurer will carry out the risk analysis, and analysis and may decide whether or not whether if accepted by the insurer. That is, at that moment, the insurer will carry out the risk analysis and may decide whether or not to accept the changes.

Article 11 of SUSEP Circular Letter No. 662/2022 provides for this.

Therefore, reinsurers shall be informed about any amendments to the insurance contract resulting from changes to the main subject, aiming to adapt the reinsurance contract as well, if applicable.

List of premiums

Regarding the **list of premiums**, article 134 of SUSEP Circular Letter No. 648/2021 establishes that cedents or their reinsurance brokers shall submit at least related information to reinsurers, such as accounting for the reinsurance contract. Special attention must be paid to the need to report the value of the premium ceded and written with Article 134, item I, paragraphs “f,” “g,” and “h” of SUSEP Circular Letter No. 648/2021.

Reporting this information directly affects reinsurers' recognition of actual premiums and reversal of estimated premiums.

Coinsurance clause

In the reinsurance contract (especially in automatic contracts), the need to include a **coinsurance clause** obliging the cedent to inform the reinsurer about any pre-existing coinsurance shall be evaluated. This is so that the reinsurer can limit or not its exposure, considering the risk of accumulation and the fact that policyholders operate with several insurers. Transmitting that information and contractual rules before the start of the operation is essential. The consequences of any failure to provide information may also, if applicable, include the loss of reinsurance coverage or the charging of an additional reinsurance premium, all of which must be clearly and expressly established.

It is worth noting that coinsurance is used differently in Brazil than in the rest of the world. Here, Brazilian insurers often adopt coinsurance as an alternative to reinsurance, requiring special care from reinsurers.

Reinsurance contract

When it comes to general precautions **when drafting a reinsurance contract**, it is essential that said instrument is entered into with clear rules, including, but not limited to, the adjustment and settlement of claims, underwriting rates and conditions, and premium payment terms, among other information. It is also essential that mandatory clauses under the legislation are carefully drafted. The risk of non-compliance with legislation and conflicts of interpretation is thereby mitigated.

Adjustment and settlement of claims

Clear contractually established rules are essential for **adjusting and settling claims**. This is important considering the possibility of enacting new laws on the subject, which, without adequate contractual treatment, could become applicable even to claims related to insurance and reinsurance contracts entered before the rule came into force. In other words, the existence of a contractual treatment of claims adjustment and settlement processes attracts the constitutional protection of the perfect legal act for previously established relationships.

Arbitration clause

Another necessary clause is the **arbitration clause**. The existence of an arbitration clause in the insurance contract does not imply the application of arbitration in the reinsurance contract or the necessary participation of the reinsurer in insurance arbitration, despite the evident correlation between insurance and reinsurance. Therefore, as it is the parties' preference, the arbitration clause shall be adopted in each contract, including insurance and reinsurance. All legal requirements shall be complied with, including, preferably, the signature on a separate instrument in the case of the insurance contract.

Embargo and sanction clause

Special care must be taken with the **embargo and sanction clause**.

First, it is necessary to distinguish between unilateral sanctions (imposed by one country) and multilateral sanctions (imposed by a group or organization of several countries of which Brazil is a part –whose decisions tend to affect the Brazilian legal system directly).

In Brazil, unilateral sanctions are not applicable except if provided in a contractual clause. Therefore, there is no sense in having a non-exhaustive list of jurisdictions whose unilateral sanctions must be respected. This would imply, for example, the possibility of applying sanctions imposed by nations as diverse as the USA, the

European Union, Iran, and Russia. In other words, from the perspective of Brazilian law, for example, there is no difference between US and Russian sanctions. Therefore, the jurisdictions whose unilateral sanctions are essential in the contract shall be expressly and exhaustively listed in the contract.

In turn, multilateral sanctions are applicable, not due to an essentially international standard, but due to treaties and internal regulations in Brazil, the content of which has reference to applied international sanctions. This is the case of Law No. 13,810/2019.

On the other hand, Law No. 13,810/2019 provides for compliance with sanctions imposed by United Nations Security Council Resolutions and the national designation of people investigated or accused of terrorism, its financing, or related acts, which aims to accelerate the process of freezing assets and identifying natural and legal persons associated with terrorism and the distribution of weapons of mass destruction, about the law previously in force (Law No. 13,170/2015).

With the enactment of the Law above, regulatory and supervisory bodies, including SUSEP, will be responsible for editing the rules necessary to comply with the provisions of said Law and supervising and monitoring compliance with asset unavailability measures by natural persons or legal entities referred to in article 9 of Law No. 9,613/1998, and for applying the applicable administrative penalties.

It is worth noting that the expected suspension legally associated with multilateral sanctions is difficult to operationalize since, as the name indicates, it will last as long as the sanction lasts and cease to exist when it ceases to exist. In short, managing suspensions resulting from multilateral sanctions can be complex and subject to operational errors.

Therefore, nothing prevents reinsurers from using embargo and sanction clauses that exclude, and not just suspend, payment in the case of sanctions by certain jurisdictions and the UN.

Credit analysis and underwriting policy

Whenever applicable, the cedent's **credit analysis and underwriting policy** must be an annex to the reinsurance contract.

– PERFORMANCE BOND FOR THE PUBLIC SECTOR – LAW No. 14,133/2021 –

Law No. 14,133/2021, the new Law on Competitive Bidding and Administrative Contracts, was enacted on April 1, 2021. Articles 89 to 108 of Law No. 8,666/1993 were immediately revoked and, on December 30,

2023, Law No. 8,666/1993, Law No. 10,520/2002, and articles 1 to 47-A of Law No. 12,462/2011 will be revoked.

Given the new regulatory framework, some measures and adaptations are necessary.

Underwriting

Regarding **underwriting**, the reinsurer shall qualify the risk analysis through an assessment compatible with the project's complexity, especially for large-scale engineering works and services.

Reformulation of surety insurance set of clauses and reinsurance contract

It is also pertinent to reformulate the **surety insurance set of clauses and the reinsurance contract**, especially for large-scale engineering works and services. Pay special attention to the following: a) definition of the claim, its trigger, and the claims adjustment and settlement procedure; b) establishment of a robust step-in clause (assumption by the insurer of the policyholder's obligations); c) definition of reinsurer liability limits.

Recommendations and determinations made by the reinsurer to cedents

Before characterizing the loss, the reinsurer shall permanently evaluate and respond directly to the actions of ceding companies and indirectly to the actions of policyholders and insureds through **recommendations and determinations**. In the case of ceding companies, risks arising from engineering projects must be mitigated, which, if not resolved, could result in the insurer having to carry out the work (directly or through its subcontractors).

Continuity of the principal contract x payment of losses and penalties in cash

Law No. 14,133/2021 and SUSEP Circular Letter No. 662/2022 establish that once the loss has been characterized, the insurer will fulfill the obligation described in the policy up to the maximum guarantee limit. As agreed between the parties, compensation may occur by **guaranteeing continuity of the main contract or payment in cash of losses and penalties** arising from the policyholder's default. Therefore, the insurance contract, if applicable, must clearly and expressly establish the limitation of the insurer's liability to the completion of the work or service without broad or universal succession of the defaulting policyholder. The risk of problems with applying labor, tax, environmental, and civil standards, among others, is mitigated.

Reimbursement for default by the policyholder

Along the same lines, counter-guarantee contracts must show whether there will be **reimbursement for any amount spent due to the policyholder's default**, including expenses incurred in hiring service providers to resume and complete the works. In addition to the above, the counter-guarantee contract may clearly and expressly provide for the insurer's right to monitor the performance of the contract, recommend good practices, and determine mitigating measures.

Arbitration clause

Another important clause, also in the case of counter-guarantee, resumption, and other contracts, which is the parties' preference, is the **arbitration clause** for conflict resolution. As mentioned above, all legal requirements shall be complied with, including the signature on a separate instrument, especially in insurance.

Receipt of available funds from the policyholder to carry out the work covered by the concession

Regarding the bidding instruments and the resumption contract, it is worth highlighting the importance of including in these instruments whether all the **policyholder's available funds to carry out the work covered by the concession and all outstanding installments of the contract balance must be transferred to the insurer or whoever it indicates for the conclusion of the contract. The impact of receiving these amounts on reinsurance** shall also be clearly and expressly provided for in the reinsurance contract.

Contracts between insurers and subcontractors

Also in the context of the resumption of work, the **contracts signed between the insurance company and the subcontractors** may provide that the responsibility for debts of a labor, tax or social security nature, and damage to third parties, including for the completion of the work and services, shall lie with the subcontractors. A rule may also be established under which the insurer and reinsurer are not responsible for the solidity and safety of the work, with Article 618 of the Brazilian Civil Code, which will be the subcontractor's responsibility. The subcontractor may be required to have insurance to cover the risks above.

Legal relationship between the reinsurer and Public Administration

Another suggested measure is that the insurer and, if applicable, the reinsurer negotiate with the Public Administration a new autonomous legal relationship, distinct from the original, with the signing of a recovery contract delimiting each party's obligations.

Simplifying claims adjustment

Insurers tend to **simplify claims adjustment**, making the process less complicated and reducing the number of documents requested to open the claim. Despite the benefits of simplification, reinsurers shall ensure that the procedure is adequately defined and monitor whether it is working when applicable and appropriate. This is to ensure coherence between the insurance and reinsurance claim adjustment and settlement processes and to avoid conflicts of interpretation regarding the insurer's decisions in this context.

▪ CONCLUSION

With this Good Practice Guide, FENABER hopes to have contributed to the sustainable development of the surety bond insurance and reinsurance market, whose growth and transformations that have become

evident in recent years bring countless opportunities, but also challenges, to be overcome by everyone interested in this important instrument that makes general economic activity viable.