

# Panel Discussion – Judicial Bonds in Brazil - Characteristics and Underwriting A reinsurers’ perspective



**XIV** SEMINARIO TÉCNICO DE FIANZAS Y CRÉDITO  
DE LA ASOCIACIÓN PANAMERICANA DE FIANZAS

**SANTO  
DOMINGO** 

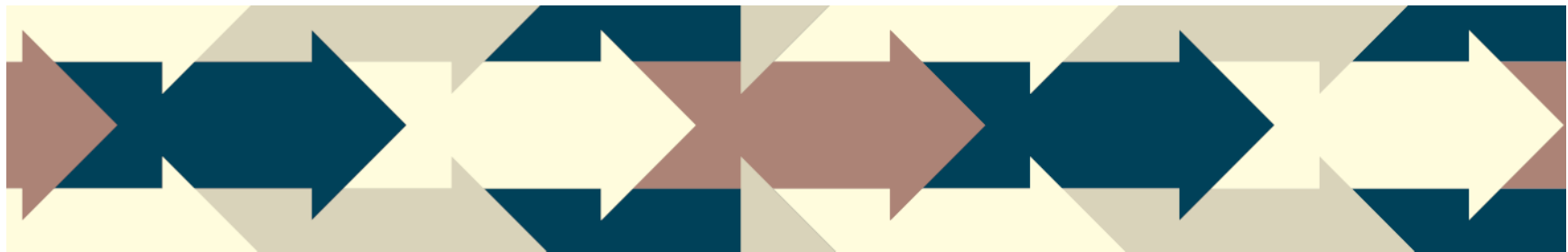
REPÚBLICA DOMINICANA - 3 AL 6 DE OCTUBRE DE 2017

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# Agenda



- High level definition of a Judicial Bond
- How did Judicial Bonds emerge in the Brazilian Surety Market?
- Diversification in the risk landscape/composition of risk portfolios
- Difficulties and Challenges
- Underwriting Criteria
- Bond extensions / renewals – Allocation of U/W years in the reinsurance treaties
- Pricing Method
- Monetary adjustments and capacity reserve
- Bonds on tax disputes – Is payment really due in 48 hours?
- Conclusions



# High level definition of a Judicial Bond

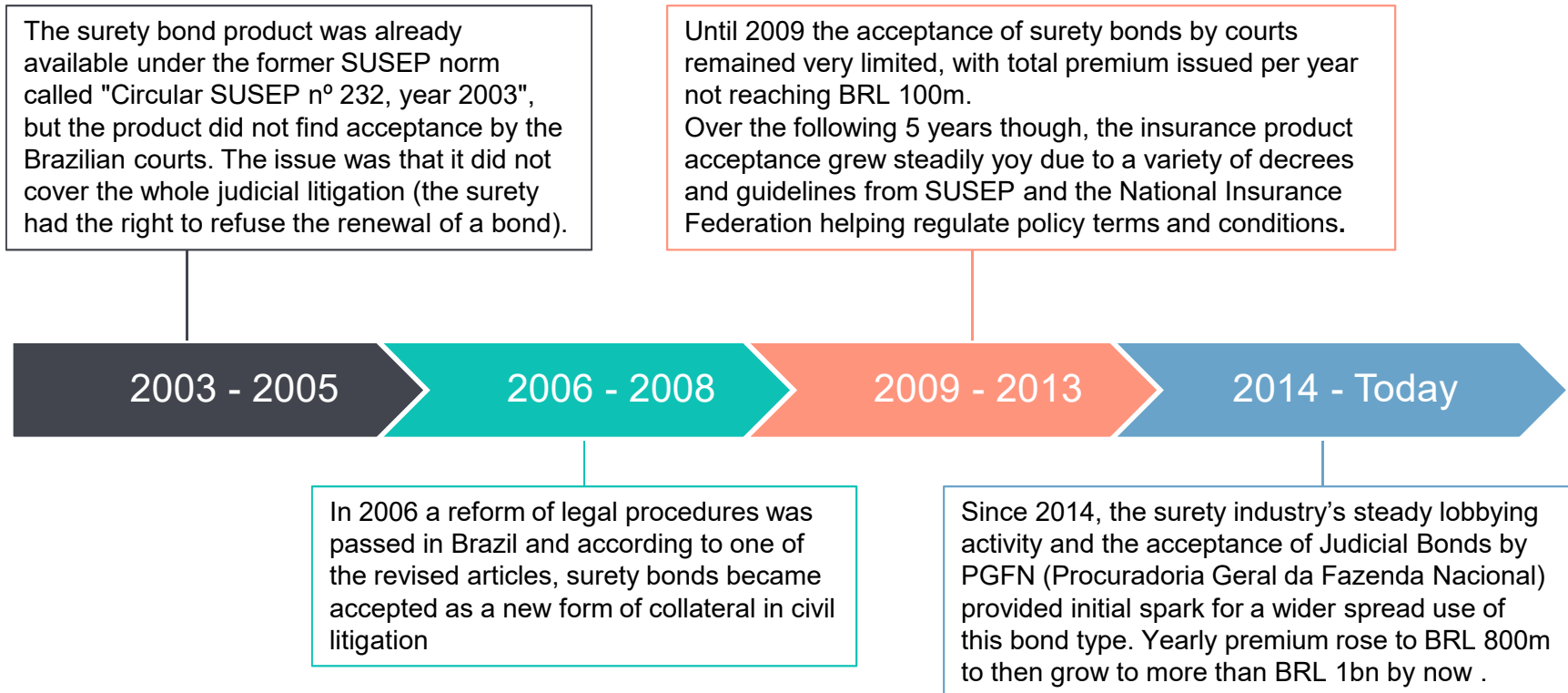


- A Judicial bond is a bond required by the courts, in order to secure a party's costs of appeal, attachment, and injunction. A bond is filed with the court as a guarantee.
- Judicial bond includes specialized bonds such as fiduciary bond, removal bond and appeal bond.
- Surety deposited by a party to a lawsuit to indemnify the opposing judicial or governmental body party from any loss arising from delay caused by the legal proceedings. In general, all bonds required in judicial proceedings are called judicial bonds.

# How did Judicial Bonds emerge in the Brazilian Surety Market?



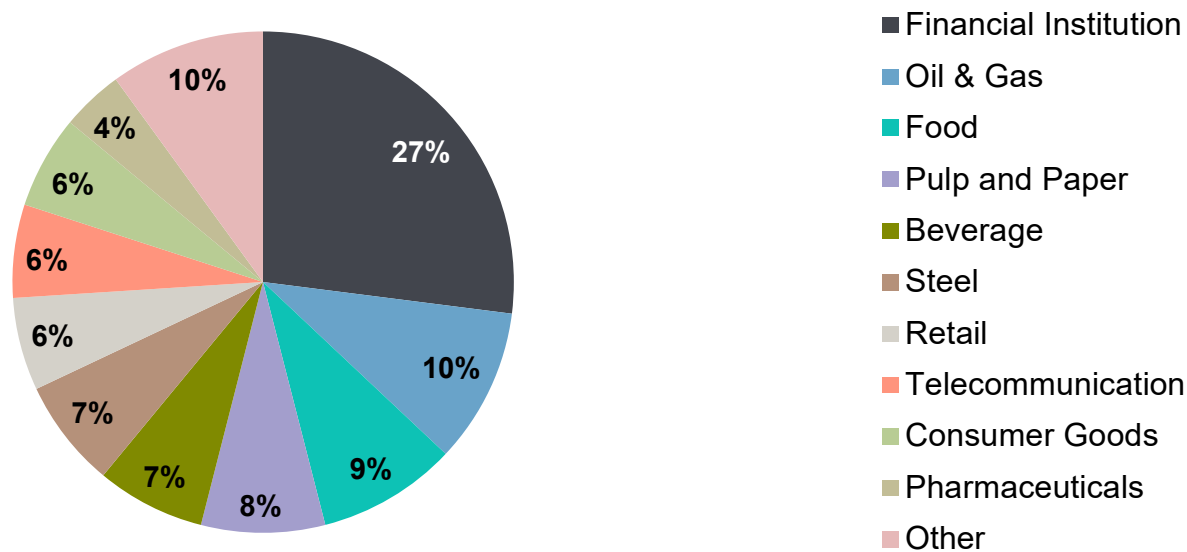
- In Brazil judges require the defendant party in a judicial dispute to provide collateral to guarantee their ability to pay potential indemnifications. Historically, cash, government bonds, other assets (at their own discretion) and bank guarantees or LCs were accepted



# Diversification in the risk landscape/composition of risk portfolios



- Industries which traditionally have not formed part of a surety risk landscape can now be tapped, diversifying the risks away from construction and engineering into other, unrelated industries (positive diversification effect, new risks/names to the surety business)
- Example of a judicial bond portfolio by industries (in total 25 different industry sectors):



# Difficulties & Challenges



## Characteristics

- Fin. Guarantee characteristics: abstract, unconditional, on demand, absence of right of objection and defense
- Indefinite tenor (the weighted average tenor is ~4 years, however, in theory the tenor is open ended, as the underlying bond has to be prolonged, forced renewed / evergreen, as long as no definite court decision is being taken evergreen)



## Underlying Dispute

- Matter in dispute is often hard to assess as to its outcome (often complex cases)
- Impacted by “human factor” – limited predictability



## Pricing & Limits

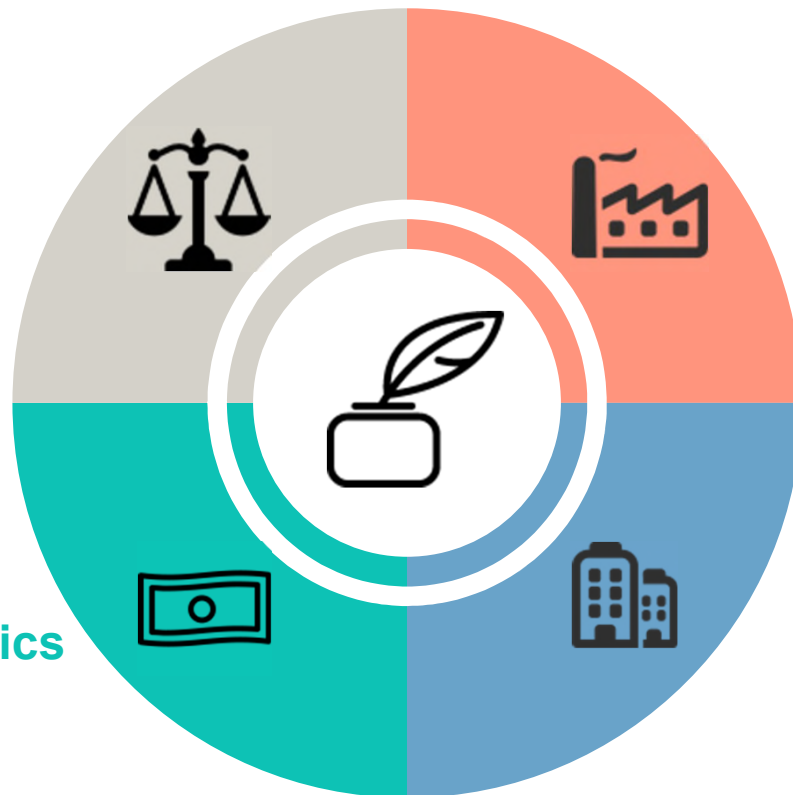
- If insured amounts are high, policyholders often get discounted rates (and insured amounts are often very high in Brazil, the largest one I saw was in the range of BRL 4bn); this is exactly to the contrary of any capital cost model
- Very large & bulky exposures

# Underwriting Criteria (I)



Underlying Dispute

Industries



Bond Characteristics

Obligor

# Underwriting Criteria (II)



## Industries

- Create balanced portfolio over several industry sectors (preferably stable ones such as pharma, food & beverage, apparel retailing)

## Obligor

- Detailed fin. analysis: Size, Liquidity, Capital Structure, Cash Flow (from operations), Operating result/net income; Analysis of financial debt; Interest coverage; Serasa reports; also CDS Spreads, market data, information from Rating Agencies, etc.
- Definition of minimum criteria: BRL 150m of equity; BRL 250m of sales
- An internal rating system should exist to qualify the risks
- Soft factors: Experience, Business Model, Ownership structure, years of client relationship, etc.
- This product is only suited for top tier companies and a continuous monitoring of the counterparts is necessary

# Underwriting Criteria (III)



## Bond Characteristics

- Diversification over several bond amounts and over different courts (not only turbo bonds, but also a significant number of small bonds; average bond amount of BRL 3m as a goal; BRL 50m or BRL 100m bonds should be special)
- Decision taking on large single bonds should always take place in interdisciplinary committees
- Security instruments, strengthened counterguarantee texts with place in funds clauses or even collateral/real counterguarantees
- Premium rates (all U/W criterias mentioned must influence the pricing) – prices need to be risk adequate and not just market driven or a comparison with bank guarantee pricing



# Underwriting Criteria (IV)



## Underlying Dispute

- Merits of the matter in dispute; strength of the obligor's case; legal precedents (for cases > BRL 15m)
- Analysis of expected duration and outcome
- Must be done by specialized lawyers, means surety companies must have specialists for the underwriting of judicial bonds

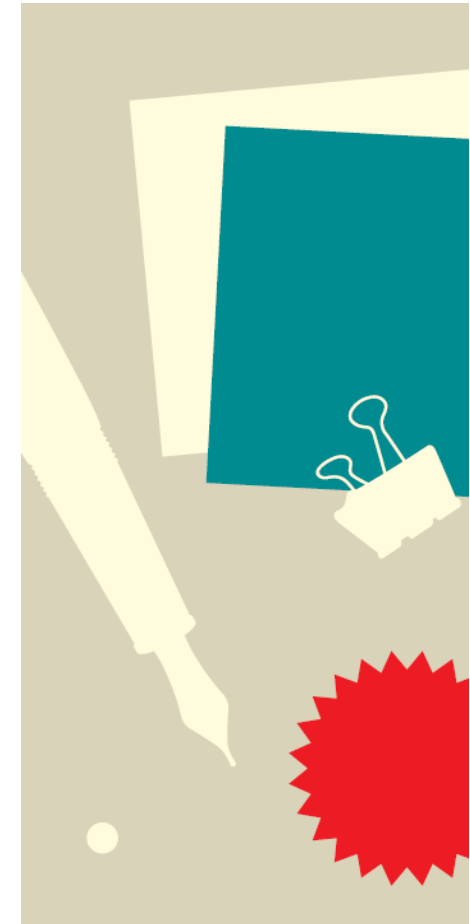
## Post Sales

- Monitoring of larger court actions through the websites of the courts, in order to anticipate the course of the process

# Bond extensions / renewals – Allocation of U/W years in the reinsurance treaties (I)



- Min. tenor is 2 years; in order to monitor the risk it is recommendable to issue for this tenor only (the market is full of 3y and 5y bonds)
- After expiry these bonds must be renewed, in case that the judicial process is not finished yet (renew, replace or pay) and often even competition exists between insurers for these renewals
- Majority of cedents renew the bond and allocate it to the new U/W year (as long as a risk is healthy and the panel of reinsurers relatively stable, this is acceptable); these extensions/renewals can be done by issuing a new bond or by endorsements
- The problem arises when a company deteriorates and runs into a Chapter 11 situation...



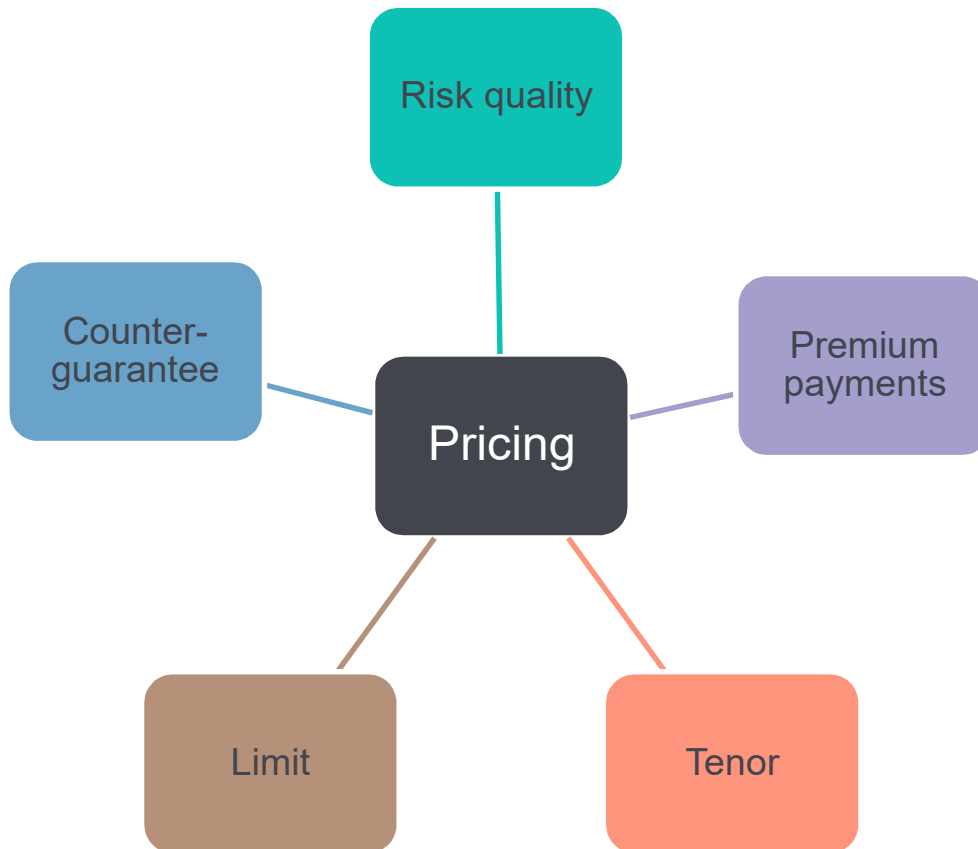
# Bond extensions / renewals – Allocation of U/W years in the reinsurance treaties (II)

(Risks in distress – market dilemma)



- SUSEP does not define any kind of procedure, this must be a be-spoken agreement between insurer and reinsurer
  - Distressed Risks (a risk in chapter 11 or where the bond renewal is complicated):
    - Some cedents, even in such a situation, allocate the bonds to the new U/W year (also because of the 5y tenor limitation which they have)
    - Other cedents defined that they would use the old U/W year, but asking back from the lead reinsurer of that time to accept this
- => A MARKET DILEMMA: The procedure can vary from cedent to cedent**
- One cedent created a clause in the reinsurance treaty to have a clear and bespoke solution in writing with its reinsurers (this is the most recommendable solution, find a mutual understanding)

# Pricing Method (I)



## Risk quality

- Prices must be dependent on risk quality; internal risk rating

## Premium payments

- Often upfront; if annual payments then this should be factored in accordingly

## Tenor

- >2 years (minimum) must result in an adjustment of annual premium rate upwards. Theoretically open-ended tenor must have price effect

## Limit

- Large bond amounts or contractors with already large exposures in the market should pay higher prices (risk concentration/capital costs)

## Counter-guarantee

- Quality of counter-guarantee / wording

# Pricing Method (II)



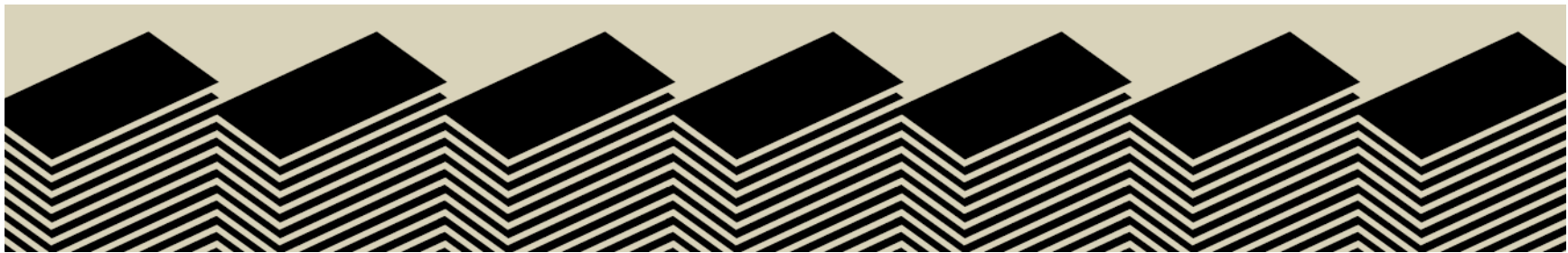
- **Likelihood of dispute outcomes**
  - is not part of the pricing; maybe, if the probability to win is very low, there might be a malus
- However, in reality, market dynamics play:
  - Competition with the banks / rule of supply and demand
  - Fact is that Petrobras today pays 2%, while Nestlé pays 0.15%
  - Price examples: Itau; 0.3% to 0.5%; Ambev: 0.13%; Bradesco: 0.17%

*Are these really acceptable und sustainable rates?*

# Monetary adjustment and capacity reserve



- Yearly adjustment of bond amounts are defined from court to court and can differ; yearly adjustments lead to additional premium
- Max. yearly adjustment rate is defined by the Selic Rate (Central Bank's overnight rate); around now this max. would be 8% p.y., but it can be lower
- All cedents in Brazil now do reserve treaty capacity for these bond amount adjustments or they ask for special limits under their treaties to accommodate future adjustments
- One cedent informed me that there is a court in São Paulo which in some ICMS (VAT) related cases adjusted in a higher % than the Selic rate, but these seem to be very rare cases



# Bonds on tax disputes – Is payment really due in 48 hours? (I)



- Prolongations of the payment terms in a judicial bond claim are possible. It is part of the negotiations with the judge. If a judge realizes that the goodwill to pay exists, he is open for negotiations
- Payment terms of up to 15 days or 30 days seem to be possible, because judges are also aware of the fact that these bonds are largely reinsured and the collection of monies from the reinsurers takes time
- Very often the bond is not executed. Either the principal pays or the judge negotiates a repayment plan with the principal (the judicial bond is then prolonged to cover these payment installments)
- Therefore, claims experience, is very low (see next slide)

# Bonds on tax disputes – Is payment really due in 48 hours? (II)



- Very little jurisprudence or concrete examples exist, since this product entered the market
- One example: Judicial bond (BRL 15m) related to a civil process, the execution had been as follows:
  - The judge first executed the principal and notified the insurer in parallel
  - From this moment on the insurer had direct contacts to the judge
  - They negotiated that – in case the principal does not pay – the insurer would pay under the bond within 30 days (sufficient time to do the cash call with the reinsurers)
  - Today the bond wordings already stipulate this payment term of 30 days and judges in general agree with this policy wording.



# Conclusions



## Product & Market Developments

*Positive*

- In my view, Judicial Bonds are a good example of a “new” product making its way to become an important premium contributor after intense lobbying by the insurance industry (a product only offered by banks is now offered by our industry)
- The market has reached a size of around USD 500m in premium and surety companies can still see a potential for future growth

## Claims Experience

*Cautious*

- While claims experience has been very good in the past, this is still a product with little history, at least in the surety industry
- Currently we encounter a challenging situation with a number of Brazilian risks which are in financial distress. It remains to be seen whether any of these names will produce an increased number of Judicial Bond claims going forward

## Underwriting

*Diligent*

- What is key, as is true for any surety bond product, is a diligent, professional underwriting of the relevant risks. Several of the risks associated with Judicial Bonds have been identified and a further and intensified dialogue between insurers and reinsurers on this product will be necessary