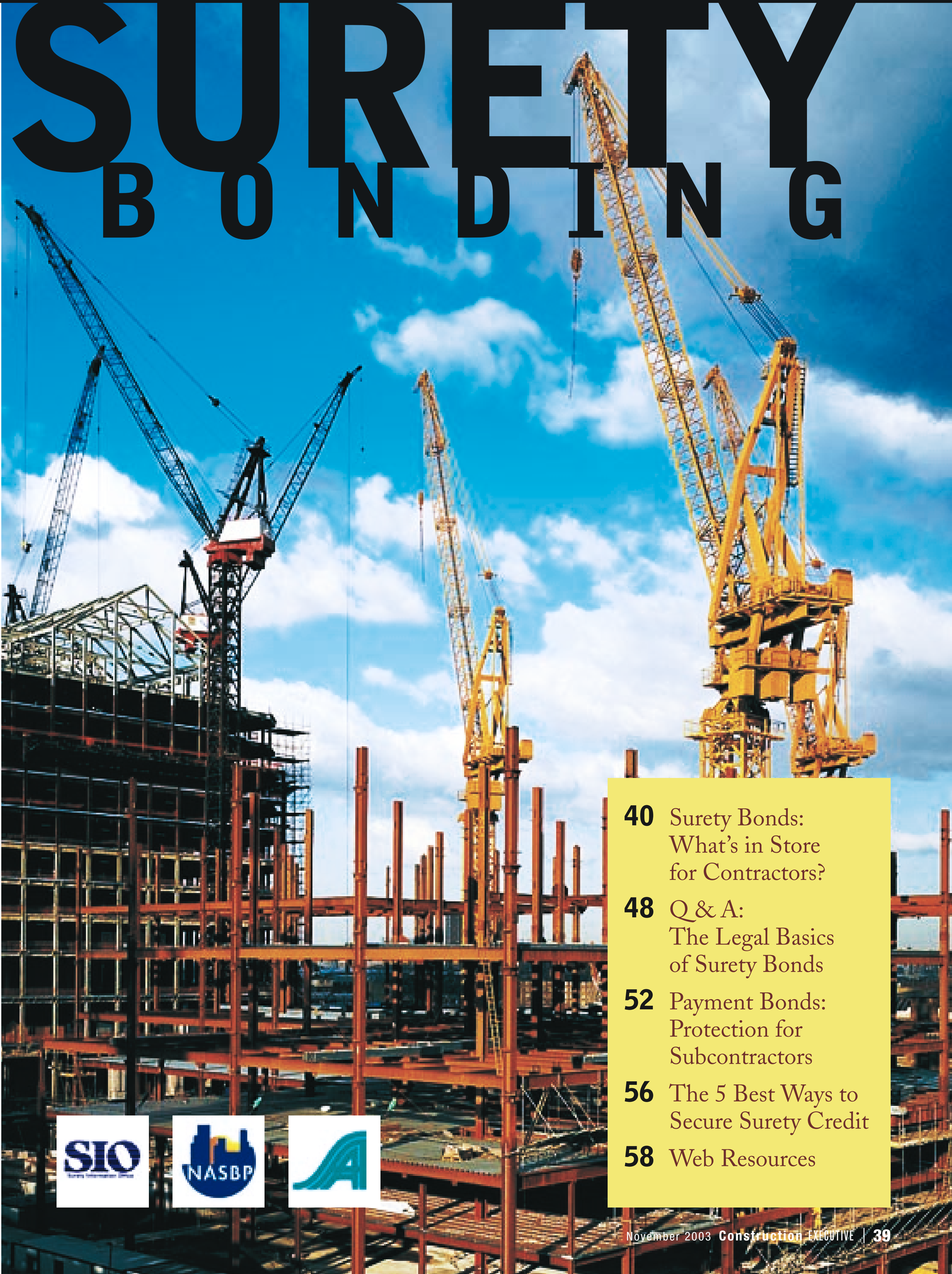
SURETY BONDING



SURETY BONDS: WHAT'S IN STORE FOR CONTRACTORS?

The downturn in the economy in recent years coupled with high-profile corporate insolvencies has changed the surety bond market. What happened and how does this affect contractors?

Surety Executives Offer Their Perspective

BY MARLA MCINTYRE

In the late 1990s, after more than a dozen years of profitability, the surety industry experienced record losses in a declining economy. Commercial surety was especially hard hit in 2001 from the effects of a series of high-profile corporate failures. Surety companies were left with a $1.8 billion price tag in claims for contract surety in 2000 and 2001, according to statistics compiled by the Surety Association of America (SAA), Washington, D.C.

Dennis Perler, president of Liberty Mutual's bond operations explains, "As construction firms grew in number and size, surety bonding capacity also grew proportionally, raising to new levels the aggregate exposures assumed by insurance companies. By 2000, an over-extension of surety capacity coupled with a slowing economy caused contract loss ratios to rise rapidly."

The contract surety product line also experienced a series of several large losses in excess of $100 million. The huge severity losses coupled with the smaller and mid-sized frequency losses drove many insurance companies to curtail bonding capacity for the larger construction companies, he says.

Surety companies extend their bonding capacity and spread risk through reinsurance. However, the reinsurers experienced property and casualty losses stemming from Sept. 11, 2001 and lower investment returns, which reduced their capital base. These circumstances forced them to either seek improved underwriting returns through higher premiums and increased deductibles, or to avoid unprofitable product lines that drained surplus. Although several reinsurers have exited the business, those remaining have refocused their strategies and continue to support well-managed surety companies that demonstrate an interest in partnering with reinsurers.

Mike Peters, president of Safeco Surety, concurs. "Reinsurers play a major role in providing capacity to the surety industry, and given the large losses, they are less inclined to concentrate large amounts of capacity on an individual case. The surety reinsurance market is showing signs of greatly increased selectivity in the sureties they provide capacity to, resulting in some further industry capacity shrinkage."

IS CAPACITY THERE?

With consolidation in both the reinsurance and surety markets, contractors may wonder if the capacity is available. The short answer is yes but only for contractors with a solid balance sheet, a profitable work program and experience history.

Contractors may experience changes in bonding capacity depending largely on their company and project size. Qualified mid-sized contractors are the least likely to see changes to their bonding programs, although there may be moderate price increases, depending on location, as well as a firming of underwriting terms and conditions.

"There is plenty of capacity for small and medium-level accounts. The issue is re-educating contractors as to the reasonableness of certain levels of capital," William E. Cheatham, president of Zurich North America Surety, says.

Small contractors may encounter challenges in meeting the more meticulous underwriting. Michael Murphy, president/managing member of Bush, Cotton + Scott LLC, says, "Due to sureties facing higher reinsurance retention levels, small contractors will face much tougher scrutiny, particularly on aggregate work programs, and the length of the project and relating warranty periods."

Mega projects (over $250 million) may have to use more innovative surety arrangements. According to Zurich's Cheatham, "Foremost, you likely will see more joint ventures and co-surety arrangements. Sureties and contractors are looking to spread the risk more today. There are fewer surety companies willing to cover large contractors and some that are limiting exposures to individual size projects."

John Welch, president and chief executive officer of CNA Surety, agrees that larger companies are taking the brunt. "Capacity has only affected the larger contractors as far as we can see. Mega projects have been affected, as well. The reinsurance companies now underwrite to potential exposures as opposed to experience underwriting an account. Most companies have targeted the small- to mid-sized contractor as an attractive customer."

What Can Contractors Do in Today's Tight Market?

- **Cut G&A.** More construction companies are chasing fewer construction dollars. Be realistic, cut overhead, and be selective in assessing jobs as to risk. Good financial results will be rewarded, contractors losing money will see capacity drop.
  —Rudy Drost, vice president, T.J. Adams Group an Assurex Global Partner

- **Cooperate** in providing requested financials and other information on a timely basis, enabling your agent/underwriter to be prepared in advance. This will avoid fulfilling last-minute questions on the day of the bid.
  —James Lee, Old Republic

- **Have good checks and balances** and a solid cost-accounting system. Don't hide anything from your surety. Problems can be fixed if you act quickly. Ignoring the problem will typically cost you more money, or worse, down the road.
  —Michael Greer, Penn National Insurance

- **Manage overhead** on a monthly basis as revenue dictates. Owners, pay your contractors on time. Contractors, pay your subs and suppliers on time. That money will yield higher dividends if you pay people promptly. Sureties are constantly looking for new clients that are solid and can pay. It doesn't matter if the contractor is third generation or three weeks old.
  —Matt Cashion, NASBP

- **Employ better risk management**, not just in terms of insurance, but also ensuring that the contract terms with the owner are equitable. Dedicate more time communicating with the surety. The current level of dialogue is one that should be maintained rather than being viewed as an anomaly during a tight market. GCs need to meet with their surety regularly and communicate past and future work programs so that the surety can anticipate their needs or help them deal with capacity issues on large projects.
  —Terrence W. Cavanaugh, Chubb Surety

- **Be selective.** Place more emphasis on project selection, the type and location of work, project controls, overhead containment, and risk transfer through appropriate contractual language, subcontractor selection and bonding policy.
  —Michael Murphy, Bush, Cotton + Scott LLC

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PREQUALIFICATION CRITERIA CHANGES

Surety companies want to bond contractors that can meet their obligations. Contractors can expect more detailed and dynamic underwriting as sureties seek to understand the contractors' business.

"Underwriting is essentially a prequalification process, which over time develops into a valuable partnership dependent on integrity, credibility and performance. We look for contractors whose history demonstrates the ability to obtain, process, and consistently meet profit projections, as well as to retain profits and accumulate equity," Brian Curry, director of business development of St. Paul Surety, says.

What Sureties Want from You

With the traditional underwriting standards of today's market, surety companies are emphasizing the three Cs—capital, capacity and character—to develop a thorough understanding of a contractor's business. Accordingly, a surety may request more information and examine it more closely than it did in the 1990s.

To be assured of a contractor's financial strength and commitment, sureties may now require:

- personal and corporate indemnity (while indemnity is nothing new, sureties will be more consistent and diligent about requiring it);
- independently audited financial statements within 90 to 120 days;
- a review or audit of financial statements (compiled reports may lack the necessary credibility and assurance);
- interim financial statements;
- aging of accounts receivable and payable;
- analysis of overhead costs;
- equipment schedules;
- profit and loss statements;
- outline of complete bank agreements (line of credit, turnaround to collect, etc.); and
- up-to-date work-on-hand reports.

In terms of a contractor's capacity, the surety will review:

- resumés of key employees and management;
- contingency plans;
- plans in place to deal with loss of key personnel; and
- short-term and long-term business plans, forecasts or strategies.

William A. Marino, chairman/CEO of Allied North America, adds: "A greater emphasis is being placed on the underwriting of the project's contract provisions, liquidated damages, warranty requirements, and the owner's prior performance history. Requirements regarding financial reporting and project underwriting have tightened significantly. Greater emphasis is also being placed on the quality of financial projections, continuity plans and inter-creditor agreements."

For larger contractors, prequalification will include a focus on financials, such as capital structure, assets, cash flow and operating results. Contractors should also be prepared to discuss their business operations with the surety. Business components include risk avoidance, insurance coverage, management depth, subcontractor and supplier selection criteria, and the contract review process.

What else are sureties looking for? "More financial commitment to support work programs and in many cases, personal indemnity," Safeco's Peters says.

Matt Cashion, secretary/treasurer of The Cashion Company, Inc., and president of the National Association of Surety Bond Producers (NASBP) promotes the importance of business planning. He advises contractors to "Provide a well-thought out and properly funded continuity strategy that focuses on management involvement planning and long-term vision."

CLAIMS—GOING UP?

CNA's Welch puts it bluntly: "Both frequency and severity of claims have increased overall. The industry loss ratio is still hovering in the 65 percent range. I would expect the trend to moderate by late 2004."

As with underwriting, early detection is the key in any claim situation, he says. "Many surety companies will work with the contractor to get him through the claim situation. However, if the contractor is non-responsive or does not see the surety as a partner in the process, the claim situation will most likely deteriorate."

James E. Lee, president and chief executive officer of Old Republic Surety Company and chair of The Surety Association of America (SAA) board of directors, claims that frequency and severity definitely slowed through the first quarter of 2003, but picked up again during the second quarter of this year. "If the current economic indicators of a growing economy are correct, then pent-up needs for plant, equipment and infrastructure should turn into spending which promotes work, jobs and profits. If it doesn't turn, then we will see the overhead nut begin to crack under the strain of low-income dollars."

S. Frank Culberson, CEO of Rimkus Consulting Group, had this observation on claims. "We have seen extraordinary events taking place in surety, contractor and owner attitudes during the past few years. We believe that there is greater sophistication on the part of all the participants, both in the 'front-end' of the bond process and on the 'back-end' when claims and default become an issue.

"Most sureties already have the reporting and monitoring procedures in place that will give an early indication that a project is having problems. The keys are making the reports mandatory, diligence in assuring the information is submitted in a timely manner, critical and professional review of the information, and quick follow-up on questionable items."

Overall, most surety company executives believe that by 2005 and 2006 losses

FOR THE LARGER CONTRACTORS, PREQUALIFICATION WILL INCLUDE A FOCUS ON FINANCIALS, SUCH AS CAPITAL STRUCTURE, ASSETS, CASH FLOW AND OPERATING RESULTS.

will have worked their way through the system—thanks largely to the more traditional underwriting standards now in place.

ARE BOND PREMIUMS INCREASING?

Whether contractors experience rate increases depends on the contractor's bonding capacity, surety relationship, size and geographic region. According to Cheatham, "Pricing is an individual company decision. The model dictates that we cover increased costs sustained from reinsurance and overhead. The average rate increase has been from 15 percent to 25 percent. The increase is predicated on variables, one being the credit risk rating of the individual account."

Allied's Marino justifies the increases. "Adverse industry experience has resulted in sureties reexamining the financial exposure in their portfolios of business. Wherever possible they have looked to increase pricing to match identified exposure."

Cashion insists that while prices have increased in the past 18 to 24 months, the product line, when viewed against other business lines and their pricing models, is still undervalued given the risks undertaken.

But at least one surety is "not seeing significant movement in prices," Lee says.

WHY SHOULD CONTRACTORS CARE?

Michael F. Greer, vice president Surety & Fidelity of Penn National Insurance, considers the surety/contractor relationship a value-added service deserving a fair return for the risk taken.

"A surety always needs to understand its clients, their focus, where the business is going, and how they intend to manage that business. When you have confidence and trust in a client, it makes it a lot easier to approve a bond or a series of bonds. You can't have confidence when you don't get information," he says.

NASBP's Cashion reminds contractors that the better surety bond producers are setting themselves apart by assisting their contractor clients through this "everything old is new again" underwriting cycle. "Contractors should work closely with their surety bond producer to stay abreast of industry changes and trends," he says. "If you are just starting to perform work that requires a bond, go to www.nasbp.org to locate a surety bond producer. Contact them, explain what you need, listen to their recommendations, and keep a clear, constant line of communication going."

Top 10 Writers of Surety Bonds in 2002

Company	Direct Premium Written	Direct Loss Ratio
1. Travelers Property Casualty Corporation	$522,288,148	46.9%
2. The St. Paul Companies	$450,448,789	114.9%
3. CNA Insurance Companies	$360,372,339	30.5%
4. Zurich Group	$260,158,209	108.6%
5. ACE USA Group	$202,140,844	-44.2%
6. Chubb Group of Insurance Companies	$172,651,420	-61.4%
7. Safeco Insurance Companies	$164,611,345	26.2%
8. Liberty Mutual Group	$150,209,449	44.1%
9. Kemper Insurance Companies	$122,815,820	289.7%
10. The Hartford Insurance Group	$122,075,060	48%

The direct loss ratio is calculated as the ratio of direct losses incurred to direct premiums earned.

©The Surety Association of America, "Top 100 Writers of Surety Bonds" June 4, 2003, www.surety.org.

WHAT'S NEXT?

While the surety industry has been undergoing changes, it remains a solid ally to contractors and the nation's construction needs. Will losses continue or are things leveling out?

Liberty's Perler predicts that post 2003 prospects will improve as proper underwriting and pricing practices reduce further losses. "Businesses should no longer expect surety bonds to be marketed as a commodity, but rather like other credit products. Businesses should seek to establish long-term partnering relationships with stable surety companies."

Penn National Insurance's Greer insists losses will continue for the next 12 to 18 months. "With the absence of work, contractors that have equipment and other bank debt will be most susceptible to failure," he says. "When contractors have a clean balance sheet, they can afford to not take work. When they have bank debt to support, this forces contractors to take work too cheaply just to generate cash flow."

Mark E. Reagan, chairman and CEO of Willis Construction Practice Group, summarizes the state of the surety industry this way, "As contractors look at the surety market, they need to keep in mind that each surety expects to make an acceptable margin, with steady growth and a real control on the downside. The decade of the 1990s saw the sureties impacted by an economic environment that flattened their results and their growth on both top and bottom lines."

He adds, "The cost of completing troubled projects is rising, while the underwriting discipline and lower appetite for risk are reducing premium income despite increased rates. This leverages against a quick return to better results and will delay surety credit through at least the end of 2004."

Construction companies are becoming more complex, with many growing in size and scope. The surety team, the producer and underwriter, can help contractors with many aspects of their business.

Together, the contractor and surety team can review contract documents for equitable risk/reward quotients, demand adequate drawings and specifications to allow pricing and scheduling commitments to be made with less risk, and review the contractor's internal systems for assessing and managing risk.

McIntyre is the executive director of the Surety Information Office (SIO), which distributes information about contract surety bonds. Located in Washington, D.C., SIO is supported by the National Association of Surety Bond Producers and The Surety Association of America. For more information, contact SIO by email at sio@sio.org, call (202) 686-7463, or visit www.sio.org.