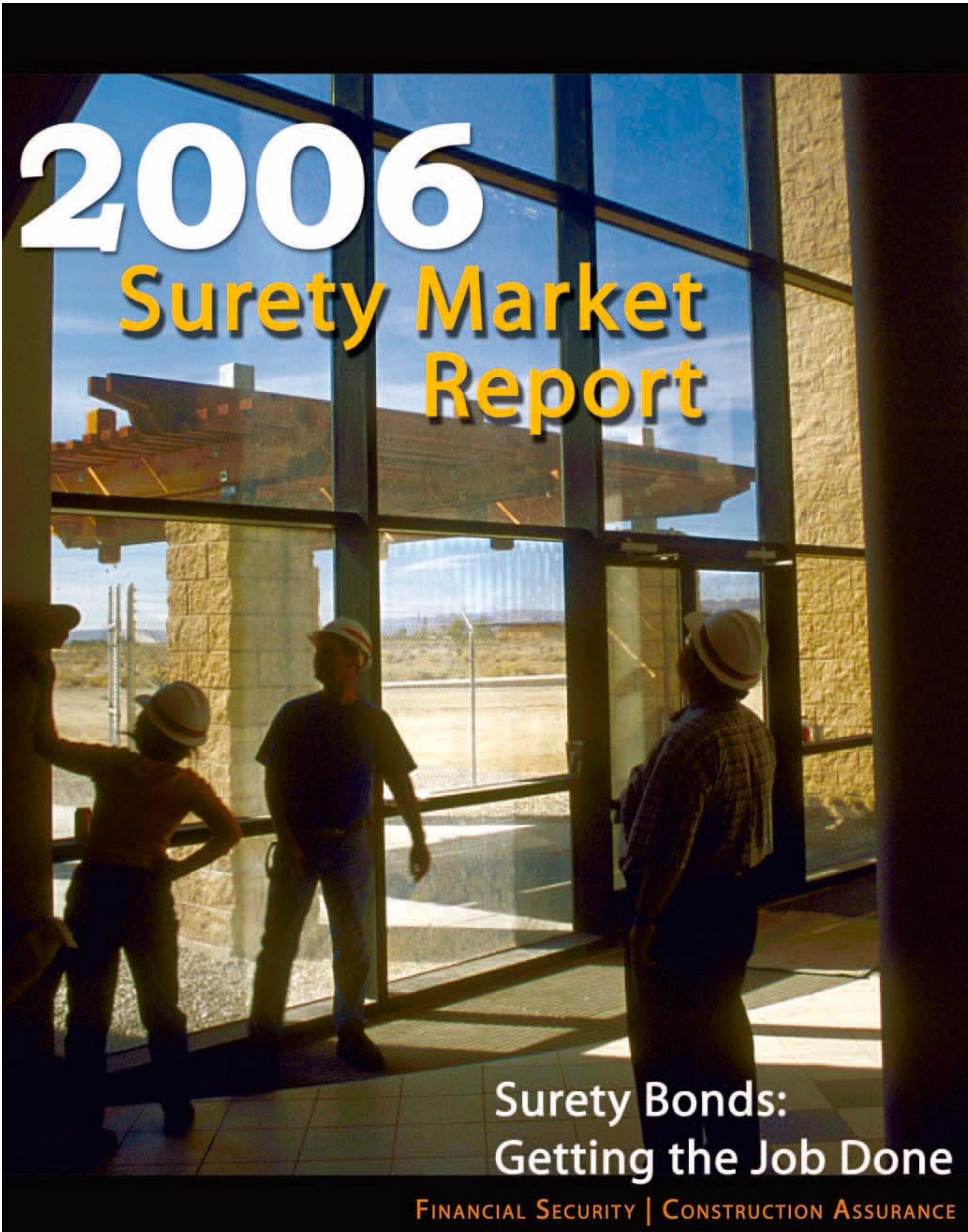
2006
Surety Market
Report
Surety Bonds:
Getting the Job Done
FINANCIAL SECURITY | CONSTRUCTION ASSURANCE

LIGHT AT THE END OF THE TUNNEL:
SURETY BONDS AVAILABLE FOR QUALIFIED CONTRACTORS

The construction economy is going strong. According to the U.S. Census Bureau, both non-residential private construction and public construction have shown gains for the first quarter of 2006 over the same period last year. And, with the passage of federal highway legislation and some states' renewed focus on long-neglected infrastructure, there appears to be no slowdown in sight. So, will the surety industry be able to meet this demand for surety bonds?

In a word, absolutely!

Most surety executives are optimistic that their industry will be able to meet the construction industry's appetite for contract surety bonds. While opinions vary as to the degree that capacity is available industry-wide, as well as within the small, middle and extremely large, or jumbo, markets, executives say the industry is showing signs that surety bonds are, or will become, more readily available in the near future.

The bigger concern for surety executives is whether contractors are actually qualified for the surety bonds.

SURETY AVAILABILITY

Most surety executives agree that surety bonds are available now for qualified contractors.

"Absolutely, capacity is available," asserted William Cheatham, president, Zurich North America Surety. "But the issue is whether the contractors qualify for it."

Sureties look at a number of factors to determine whether a contractor is qualified for surety bonds. High on this list are the contractor's financial statement and reputation with subcontractors, suppliers, lenders and project owners. Sureties also consider such qualities as a contractor's work history, strategy for future work, risk management or safety program, business succession plan and access to equipment needed for the particular job, among many others.

Steven Swartz, president, South Coast Surety, said, "There are a lot of markets coming in to help the small and emerging contractors, but we are still experiencing a lack of interest to support the larger small contractors and the smaller medium-sized contractors."

Geoffrey Heekin, managing director, Aon Construction Services Group, agreed there is no lack of capacity for small- and middle-market contractors. There may be some challenges, he said, in the jumbo market: "We must figure out a way to bring more capital to this business by rethinking how we assume risk and how we do risk mitigation," he said.

John Welch, president and chief executive officer, CNA Surety, said the surety industry is struggling a bit with capacity for jumbo projects. "We need to find a way to work together to meet the need out there," he said.

On the other hand, Terry Lukow, executive vice president and chief executive officer, St. Paul Travelers Bond, Construction Services, is confident sureties can meet the demand in the jumbo market, even if these $500 million-plus projects challenge capacity and underwriting skills of the industry. "For the right contractor with the right financial structure and management, the right business leadership and the right strategic plan, there is enough capacity and willingness to handle the demand in the jumbo market," he said.

LENDERS AND PRIVATE CONSTRUCTION

Some surety executives are noticing a marked increase in requests for surety bonds by lenders, as more and more require surety bonds as a condition of the loan, especially in the condominium and multifamily housing markets.

"The percentage of private work on which bonds are required varies greatly across the country," said Brian Driscoll, president, The Driscoll Agency. "Even national banks seem to impose different requirements depending on the location of a project. As an example, almost 100% of the private work our customers perform in Florida requires bonds. On the other hand, less than 30% of the private work performed by our clients in New England has bond requirements imposed by owners or lenders."

Lenders are realizing the true value of surety bonds, particularly those who have experienced a contractor default. "I wouldn't be surprised to see more going forward. Suretyship in the private segment is as valuable as in the public sector," Aon's Heekin said. "Surety is an excellent risk mitigation tool for the lender and owner."

"I think owners do see the real value of surety bonds, and that's why there's a strong demand for the product. For decades, the surety bond has lived up to its promise," Timothy Mikolajewski, senior vice president, Safeco Surety, concurs.

While the bonding requirement by lenders is seen as an endorsement of the surety product, some executives warn that surety bonds are not intended to pass financial guarantees of the contractor to the surety. "We're pleased that lending institutions are requiring bonds, but from time to time there's confusion about what the product is designed to do," Zurich's Cheatham advised. "A surety bond guarantees the performance and payment obligations of the contractor building the construction project. It is not designed to guarantee the financing of the project."

Top 10 Writers of Surety Bonds 2005 (Preliminary)*

		Direct Premium Written (millions $)
1.	St. Paul Travelers Group	$885
2.	CNA Insurance Group	$382
3.	Zurich Insurance Group	$368
4.	Safeco Insurance Group	$309.5
5.	Chubb & Son Inc.	$234
6.	Liberty Mutual Insurance Group	$210
7.	Hartford Fire & Casualty Group	$181
8.	Arch Capital Group	$109
9.	HCC Surety Group	$103
10.	International Fidelity Insurance Co.	$86.6
Total All Surety (Top 10)		$2,870
Total All Surety		$4,509

*INCLUDES CONTRACT AND COMMERCIAL SURETY

Source: The Surety Association of America (SAA), "Top 100 Writers of Surety Bonds—United States," 2005 (Preliminary). Detailed statistical reports are available for purchase at www.surety.org. SAA now offers a subscriber service to non-members that includes bi-monthly newsletter; full electronic access to statistical reports and the right to use the reports in presentations; electronic access to the Binder of SAA Standard Fidelity Forms; a copy of the SAA Manual of Rules, Procedures and Classifications for Fidelity, Forgery and Surety Bonds; a web listing; and reduced rates for SAA's Loss Severity Study, other publications and special data requests. For more information, contact Barbara Finnegan Reiff at breiff@surety.org.

CLAIMS PROCESS

That the frequency and severity of claims appear to have lessened is another sign the surety industry climate is improving. Surety executives attribute this improvement to a strong construction economy, credit scoring in the underwriting process and the improved selection process.

"Adherence to this underwriting discipline should continue to help prevent the severity and frequency of losses the industry has experienced in the past five years," said Terrence Cavanaugh, chief operating officer, Chubb & Son Inc.

When claims do occur, a surety has an obligation to the owner and the contractor. "It's imperative that we are responsive to the owners, at the same time being diligent in our investigation on behalf of our clients," Cavanaugh noted.

St. Paul Travelers' Lukow added, "When a contractor says, 'I am in default,' that is the easiest thing for a surety to define. The difficulty is when the contractor says, 'I am not in default,' and we are obligated to do a thorough and unbiased investigation."

The investigation can be complicated. Typically, a default situation involves a contractor and architect who have been working together for two or three years or longer. It is not in the surety's best interest to drag the investigation out. After all, time is money.

William A. Marino, chairman and chief executive officer, Allied North America, said that determining the problem and magnitude to fix a default takes time: "Figuring out why, when a claim happens, everyone ended up at that point is not feasible overnight." he said

CNA's Welch advised, "Owners have to be prudent to consider the surety companies they're using. It's difficult for them to understand, but they need to find sureties that have adequate claims departments."

Steve Cory, president, National Association of Surety Bond Producers (NASBP), and president, Cory, Tucker & Larrowe Inc., added, "The industry has made great strides in improving the claims process and trying to educate those involved about exactly what it is and why it takes so long. The professional agent has relationships with all of the parties involved and should be kept in the loop because of his or her ability to communicate. A lot of times, because of his or her strong relationships with all of the parties, the agent has a position of trust and can help everybody work together to solve a problem."

"For the right contractor with the right financial structure and management, the right business leadership and the right strategic plan, there is enough capacity and willingness to handle the demand in the jumbo market."

—Terry Lukow, St. Paul Travelers Bond, Construction Services

A VIABLE INDUSTRY

The surety industry as a whole—including contract and commercial surety—returned to profitability in 2005, according to The Surety Association of America (SAA). While profitability is a sign that the surety industry is near the end of the record-long hard market, surety executives warn that expanding surety capacity to contractors too soon, too quickly, could extend the period of tough underwriting standards and limited surety availability. It could also mean continued high prices and lack of bidders for construction project owners.

"Surety is a 'cause and effect' industry," noted Dennis Perler, president, Liberty Mutual Surety. "Losses today can be attributed to relaxed underwriting decisions made in prior years. Hindsight shows us that we positioned ourselves for the significant losses that emerged in 2001 and lasted until 2004."

"We have to be careful that we don't walk too close to the edge and slide back into hard times. Certainly, we're on the tail end of the hard market," assured Henry W. Nozko, Jr., president, ACSTAR. "There is no way on earth that this will continue. Once the industry starts to turn and conditions become more favorable, it is almost certain the period of availability will last at least four or five years."

Vincent P. Forte, senior vice president and chief underwriting officer, Surety, American International Group (AIG), agreed, "We can't afford as an industry to fall back into an undisciplined regiment."

MEETING THE NEEDS

Underwriting discipline, adequate pricing and expense control have contributed to the stabilization of the surety industry and a climate of optimism by executives who, for the first time in years of record losses, are seeing light at the end of the tunnel. They are hopeful that sustained profitability across all markets, along with possible new capital entering the market, will lead to surety capacity becoming even more readily available.

Contractors and construction project owners may expect to see continued underwriting discipline, as sureties look to sustain momentum as the industry emerges from the record-long hard market.

Surety industry leaders will be keeping a close eye on several concerns that could affect this progress—including the upcoming hurricane season and potential consolidations within the surety and P&C insurance industries.

Surety executives are noticing encouraging signs that lenders and the private construction sector are recognizing the value and importance of surety bonds, but warn that surety bonds are not designed to guarantee a project's financing. Surety executives also were pleased with improvements made in the claims process in recent years.

Most surety executives were confident the industry would be able and willing to meet the growing demand for surety bonds by the construction industry, even in the small specialty and jumbo markets. ■

EXECUTIVE VIEWPOINTS

TERRENCE CAVANAUGH, CHIEF OPERATING OFFICER, CHUBB SURETY

The metrics that have been brought to the forefront for the industry—underwriting discipline, portfolio management, adequacy of pricing, and expense control—have allowed the industry to return to levels of profitability it has not seen in some time. There still remains a question of whether the proper return on investment is there to attract new capital in a market that has seen capacity diminish in certain sectors.

If underwriting discipline, portfolio management, pricing adequacy and expense control remain a focused measure for the industry, it can secure its stability. The industry swings in cycles, vacillating between fear and hunger: fear of the perils the construction and commercial markets present and hunger for market share as the industry returns to profitability.

Over the past three to four years, underwriting discipline has been the mantra. It is the professional surety producer who has been vital in driving this charge. Those who have provided the value added services to guide their contractors through the tough times have enhanced their relationships and added quality accounts to their portfolio. The transactional, commodity producer has been ineffective and left behind.

WILLIAM CHEATHAM, PRESIDENT ZURICH NORTH AMERICA SURETY

The current state of the surety industry is really driven by three to five markets that participate in the large contractor arena. The rest of the surety companies feed on small to mid-market contractors. You must maintain capacity for large accounts or the product's viability is at risk.

The sizes of projects are extremely large today, which challenge the capacity and underwriting skills of the industry, but there is plenty of capacity for all size contractors. The large market is most at risk, but it is more an issue of the financial capability of the contractors than of availability of capacity. Absolutely, capacity is available, but the issue is whether the contractors qualify for it.

Capacity is king today. Surety companies' capital commitment to the surety product drives availability of capacity. Return on equity (ROE) drives capital commitment of the industry. However, there is insufficient capital coming in to alleviate the pressures