2007 SURETY MARKET REPORT

RISING TO THE OCCASION

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2007 Surety Market Report Rising to the Occasion

By Marc Ramsey, Surety Information Office (SIO)

Surety is a cyclical business. Like a cruise line in rough seas, the industry withstands plunging waves of severe losses by catching intermittent waves of profitability. And that characteristic is one of the biggest values to the construction marketplace. It smoothes out the results for obligees to the extent that the surety industry pays for the volatility in the construction cycle.

In 2005, the surety industry rose from the depths of several years of record losses, floating atop a tide of profitability that surged through 2006 with a 16.2% loss ratio for all surety (contract and commercial), according to industry statistics provided by The Surety & Fidelity Association of America (SFAA).

"Last year's extraordinary performance was a perfect confluence of several positive events coming together," explains Dennis S. Perler, president, Liberty Mutual Surety. "Strong construction spending and larger profitable contractor backlogs joined with responsible underwriting driven by lessons learned from prior period losses to restore profitability and stable capacity to the industry."

Indeed, written surety premium grew a healthy 11% in 2006. Bonded contract values grew substantially due to material inflation on core construction materials. "While inflation contributed to increased revenues," Perler continues, "the strong construction economy and higher contractor bond utilizations helped produce in 2006 the perfect factors for the surety industry to be profitable. But surety is a long-term credit-driven product. To sustain bonding capacity necessary to support the construction industry, the surety industry needs to exercise continued responsible underwriting and management. As we talk about a very successful year, we need to remember that 2006's strong result has merely restored the product line to breakeven for this decade."

NEW OPPORTUNITIES

The surety industry faces new challenges. "The surety industry," says Rick Kinnaird, SFAA board chairman, and senior executive, surety, Westfield Group, "needs to understand changing insurance coverages and new trends such as public-private partnerships and broaden our focus beyond the traditional underwriting process of the past 50 years. There are a lot of new issues that we need to address and are addressing."

For example, some project owners—both public and private—are bundling projects together, including ones that are completely unrelated. This bundling discourages competition, inflates pricing and prevents contractors from growing through experience. "The trend to consolidate normal construction projects into megaprojects is troubling in that it reduces opportunities for local contractors," Perler notes. "Without these opportunities, local contractors may find it difficult to sustain their current backlog levels."

Meanwhile, public private partnerships are emerging as public owners look for capital to execute their plans. "Both sureties and owners are in the process of developing alternative procurement models that result in acceptable levels of risk assumption by all parties, including contractors, developers, operators and sources of private equity and project financing," says William A. Marino, chairman and CEO, Allied North America.

SMALL MARKET

Executives contend there are plenty of surety competitors in this market with the capacity to support contractors' bonding needs under $1 million. However, underwriting can be fairly stringent with collateral required in many situations. This may create somewhat of a barrier to entry for some contractors in this market. "It is important that we continue to work with new and emerging contractors," SFAA's Kinnaird emphasizes. "We need to address the needs of all levels of contractors."

The more sophisticated small contractors are, the more attractive they will be to the surety. This means using computer software systems, construction management systems, externally produced financials, having bank credit, demonstrating longevity of management and having continuity of programs.

MIDDLE MARKET

The mid-sized construction market (around $50 million) remains the most competitive arena in the surety market. This is the most dominant segment for both regional and national surety providers. Executives insist there is more than adequate surety availability and capacity.

While underwriting in this market has been relatively rational, there does appear to be some loosening of underwriting standards in some isolated markets.

Some surety executives also are seeing additional capacity from existing surety players in this market. "We're not necessarily seeing new surety companies," says Tom Kunkel, president and CEO, Travel-

Top 10 Writers of Surety Bonds 2006*

	Companies	Direct Premium Written (millions $)
1.	Travelers Bond	$941
2.	Zurich Insurance Group	$444
3.	CNA Insurance Group	$418
4.	Safeco Insurance Group	$360
5.	Chubb & Son Inc.	$276
6.	Liberty Mutual Insurance Group	$260
7.	Hartford Fire & Casualty Group	$206
8.	Arch Capital Group	$142
9.	HCC Surety Group	$131
10.	American International Group	$121

*INCLUDES CONTRACT AND COMMERCIAL SURETY

Source: The Surety & Fidelity Association of America (SFAA), "Top 100 Writers of Surety Bonds—United States & Territories & Canada," 2006 (Preliminary); www.surety.org.

ers Bond, "but those in the middle market are providing higher levels of capacity than they would have two and three years ago."

LARGE MARKET

Larger sureties are pleased with the performance of their larger contractor portfolios and appear to be willing to expand capacity commitments for the larger and better capitalized construction companies ($250 million+). "Rather than stretch underwriting standards in the middle market," explains Michael J. Cusack, senior vice president, managing director and operations board member, Aon Construction Services Group, "sureties are willing to expand capacity for larger clients with whom they have existing relationships."

There has been some consolidation in this market, so several construction firms need $5-billion and $10-billion work programs. "But with the right contractor and right co-surety partners, those kinds of work programs can be put together," insists Terry Lukow, executive vice president, Travelers Bond, Construction Services.

GROWTH CONSTRUCTION MARKET

"The construction boom," says Aon's Cusack, "is still alive and well for the majority of the United States. The Northwest, West, South, Southeast, and Mid-Atlantic all continue to enjoy a very robust construction economy."

BY MARC RAMSEY, SURETY INFORMATION OFFICE

"There is not a segment in the construction industry that we do not see growth in," Travelers' Lukow declares. "This is the first time in my 33-year career we've seen this."

There are signs that the vitality of this market will hold for another couple of years. "Architects and engineers, for instance, indicate that their coffers are full and that they continue to seek qualified professionals," observes Terry Cavanaugh, chief operating officer, Chubb Surety.

The surety product will serve an important role during this continued growth market, particularly with the reinvestment in the U.S. infrastructure, but also because of the increasing complexity of today's construction projects. "The value of the surety product will be needed more than ever," advises Sarah Finn, president, National Association of Surety Bond Producers (NASBP), and national surety vice president, IMA of Colorado.

A growing construction market does not come without some concerns. In addition to citing commodity volatility and contractual risk, surety executives are concerned about labor shortages. With the graduating class in all of the construction industry for 2007 at 75,000, "The construction industry will absorb those 75,000, and could use another 75,000," Travelers' Lukow notes.

UNDERWRITING

Maintaining underwriting discipline, surety industry executives agree, will enable qualified contractors to capture significant profitable work in this robust construction economy. "A loosening of underwriting discipline is a disservice not only to the construction community, but to the beneficiary of our product, the owner/obligee," Chubb Surety's Cavanaugh warns. "It is the owner/obligee who demands we prequalify the best available contractor or consortium seeking to bid their work. It is an obligation that is at the core of our industry principles and straying from those standards diminishes our product and services."

Meanwhile, sureties are being asked to support larger project contracts and overall work programs primarily caused by inflationary issues. "Unfortunately we do not typically see a corresponding increase in equity," explains Michael P. Foster, executive vice president, Merchants Bonding Company (Mutual). "Sometimes this is planned for tax or continuity reasons. Therefore we are being asked to support larger bonds and programs based on balance sheets that are not proportionately larger. It is essential to confirm that the contractor has the management capacity to handle the larger jobs. This includes understanding the organizational structure of the company and monitoring the account closely through the review of quality interim financial information."

If professional surety bond producers and underwriters are doing their jobs, they are asking contractors about the resources available to do existing work or new forthcoming work. "Do they have the people talent within their organizations to do the work?" asks Tim Mikolajewski, senior vice president, Safeco Surety. "Do they have the necessary equipment resources to do the work? Are they relying on a critical subcontractor or supplier to perform for them, and if so, is there a way of mitigating that risk? Is the contractor getting the appropriate margin for the risk involved in the project?"

Project owners and contractors also should be aware that a strong economy allows weak contractors to cash flow their operation longer because of the availability of work. "Contractors can keep transferring loss from job to job," explains William Cheatham, president, Zurich North America Surety. "The overall surety industry results are very profitable and stable. But there are some sureties experiencing adverse underwriting results. I don't want people to lose fear, because this industry has a history of being volatile."

sector being driven by construction lenders who want the protection of a surety bond in place to mitigate their exposure on construction loans. "Developers are going to extremes to satisfy the requirements of lenders and mortgagors," relates Henry W. Nozko Jr., president, ACSTAR Insurance Co.

Banks that have been burned by not having a bond in place now have a better understanding of the credit and prequalification protection that bonding provides them. "We are seeing more and more—especially in energy construction—investment bankers being more on the cautious side when it comes to security," Travelers' Lukow says.

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—Terry Cavanaugh, Chief Operating Officer, Chubb Surety

CONTRACTOR FAILURE

BizMiner reports a decline in contractor failure from 28.5% between 2002 and 2004 to 23.6% between 2004 and 2006. Surety executives attribute this decline to a number of factors. One is clearly the growth construction market. Contractors are being more selective on projects, as well as getting more profit margin on the work they take on. For those contractors who aren't performing as well, there appears to be enough work available in the market to generate enough cash flow to keep them going. "The problems will surface when the construction economy slows down and cash flows are reduced," suggests Safeco Surety's Mikolajewski. "I will give construction contractors credit for being more financially sophisticated today than they were 10 years ago. Most have invested in costs systems and other controls that give them early warning when a project gets off track from a budget standpoint. This gives the contractor the ability to make changes sooner and turn a project around."

A professional surety bond producer is a key strategic adviser who is a valuable resource for contractors to help them identify areas that need to be strengthened such as balance sheets, personnel, processes and systems. "The surety bond agent adds value, not just by providing a bond, but through the advice we provide," NASBP's Finn says. "We have the relationships with clients to identify certain challenges they're going to face and advise them how to overcome them."

PRIVATE SECTOR BONDING

Surety executives believe bonding in the private sector will continue to grow as owners recognize the value bonding provides. "We are in a market where contractors have record backlogs," Safeco Surety's Mikolajewski says. "So, if there is a failure to perform by a contractor, the owner may have only very limited, expensive options to complete the project. With a surety bond in place, that problem becomes the surety's problem—up to the penal sum of the bond. That is very significant protection for a private owner or lender."

Many executives are seeing the volume of bonding in the private

SURETY OUTLOOK

While 2007 results are expected to be consistent with 2006, surety executives do anticipate some erosion in the industry's loss ratios, primarily because it will be difficult to perform better than 2006. But 2007 and 2008, executives maintain, will be strong years for the surety market.

"The one thing that will happen in 2007," ACSTAR's Nozko says, "is more than 5,000 private and public project owners and lenders industry wide will avoid a loss by having a surety bond in place in 2007-08."

So far, 2007 is showing strong results, if only a quarter into the year. "Anything can happen," Chubb Surety's Cavanaugh says. "Providing that underwriting discipline is maintained, there is no reason to believe surety results should not share in the profitable results contractors should realize during this strong construction market. Historically though, defaults are more prevalent during booming markets as organizations find their resources too stretched."

Ultimately, the next two to three years should define whether the surety industry goes into a cycle again. "We're at a period of risk where there is potential overextension by both the contracting and surety industries," Zurich's Cheatham believes. "Both contractors and sureties tend to be undercapitalized."

Looking beyond 2007, surety executives are optimistic. "While there will be individual exceptions, I believe the surety industry as a whole will continue to enjoy strong profits in 2007 and likely, positive industry results will continue through 2008 and 2009," predicts Doug Hinkle, chief underwriting officer, CNA Surety. "A disciplined surety industry and a strong construction market are the primary components in determining ultimate surety industry results." ■

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