Surety Bonding in Today's Construction Market: Changing Times for Contractors, Bankers, and Sureties

by Marla McIntyre and Dev Strischek

Changing market conditions have led to changes and adaptations in the surety market. This article updates bankers and lenders on the current situation and trends within that constellation of financial organizations writing bonds for the construction industry.

For a fee, sureties transfer construction risk to themselves, and that is one less risk for bankers to worry about in lending to contractors. On the other hand, if the surety industry finds construction risk returns unattractive, it may have to consider several alternatives—raise premiums, reduce coverage, raise deductibles, tighten underwriting standards, or exit the bonding business. The net effect is to shift risk back to the lender. If sureties cannot make money writing payment and performance bonds, it is unlikely that bankers will do any better granting lines of credit to needy contractors or issuing letters of credit to supplant the bonding companies. Let's find out why.

Bonding 101[1]

Surety bonds assure project owners that contractors will perform the work and pay specified subcontractors, laborers, and material suppliers in accordance with the contract documents.

There are three basic types of contract surety bonds:

1. The *bid bond* assures that the bid has been submitted in good faith and the contractor will enter into the contract at the price bid and provide the required performance and payment bonds.
2. The *performance bond* protects the owner from financial loss if the contractor fails to perform and meet the terms and conditions of the contract.
3. The *payment bond* assures that the contractor will pay its subcontractors, laborers, and suppliers for the project.

Of course, the bonds are issued on the basis of careful analysis and evaluation of the contractor's ability and willingness to perform both operationally and financially. In other words, the surety is confident there is no risk and that the contractor will perform.

The use of surety bonds on private construction projects is at the owner's discretion. Alternatives to bonding include letters of credit and self-insurance, but these options do not provide 100% performance and payment protection, nor do they ensure a competent contractor. Consequently, many private owners require surety bonds from their

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contractors to protect their company and shareholders from the cost of contractor failure. To bond a project, the owner simply specifies the bonding requirements in the contract documents. Obtaining bonds and delivering them to the owner is the responsibility of the contractor, who typically consults a surety bond producer. Subcontractors may also be required to obtain surety bonds to help the prime contractor manage risk, especially if the subcontractor is responsible for a significant part of the job or provides a specialty that is difficult to replace.

Sureties want to be sure.[2]

Most surety companies are subsidiaries or divisions of insurance companies, and both surety bonds and traditional insurance policies are risk transfer mechanisms regulated by state insurance departments. However, insurance and bonding operate on different business models. Traditional insurance is designed to compensate the insured against unforeseen, adverse events, so the policy premium is actuarially determined by projecting expected losses and enough premiums earned to cover the losses and earn a satisfactory return. In contrast, the surety prequalifies the contractor by evaluating the contractor's financial strength and construction expertise. As noted earlier, the surety underwrites the contractor with no expectation of loss, so the premium is primarily a fee for the surety's comprehensive prequalification services

The prequalification process is an in-depth look at the contractor's business operations. Before issuing a bond, the surety company satisfies itself that, among other criteria, the contractor has:

- Good references and reputation.
- The ability to meet current and future obligations.
- Experience that matches the contract requirements.
- The necessary equipment to do the work or the ability to obtain it.
- The financial strength to carry and support its share of the project work.
- An excellent credit history.·
- An established bank relationship and line of credit.

In summary, the surety examines a contractor much the way the banker does. Before issuing a bond or extending credit, both the bonding company and the commercial lender must be satisfied that the contractor runs a well-managed, profitable enterprise, keeps promises, deals fairly, and meets obligations on time—as agreed and in full.

Performance and payment bonds typically are priced based on the value of the contract being bonded, not necessarily on the size of the bond. If the contract amount changes, the premium is adjusted for the change in the contract price.

Sizing Up the Construction Industry [3]

Betting on the construction industry is not as easy as it looks.

A Risk Transfer Mechanism with a Long History

The first known account of contract suretyship was etched on a Mesopotamian clay tablet around 2750 B.C. A farmer contracted with another farmer to tend his fields and split the proceeds equally. A local merchant served as the surety and guaranteed the second farmer's compliance. A millennium later, the first known written legal code, Hammurabi's code, addressed suretyship. A Babylonian contract of financial guarantee from 670 BC is the oldest surviving written surety contract, and of course, the Roman Empire promulgated surety law around 150 AD that survives in the principles of suretyship today. In a great leap forward aboard the surety time machine, our own Congress passed the Heard Act in 1894 that required surety bonds on all federally funded projects and then updated that law with the Miller Act of 1935 requiring performance and payment bonds on federal public works contracts exceeding $100,000. In addition, payment bonds may be required on federal construction contracts between $25,000 and $100,000. Subsequently, almost all the 50 states, the District of Columbia, Puerto Rico, and most local jurisdictions have enacted "Little Miller Acts" requiring surety bonds on their own public works. A 1999 amendment states that the amount of the payment bond must equal the total amount of the contract unless the contracting officer determines that a payment bond in that amount is impractical. The final regulations include a provision requiring contractors awarded federal contracts between $25,000 - $100,000 to obtain a payment bond equal to the contract price unless the contracting officer determines otherwise.

While generating almost $900 billion of revenues and accounting for 8% of the U.S. gross domestic product, its economic influence is spread among hundreds of thousands of relatively small, local firms. Its 667,000 firms employ around 1 million people—about 5% of the country's workforce. Some 200,000 general contractors and 38,000 heavy contractors and road builders are backed up by 432,000 specialty contractors. Thus, the average contractor employs fewer than 10 workers and spends an average $422,000 on its annual payroll. The small size of the typical contractor is evident in its asset size; about 58% of contractors have total assets in the $500,000 to $5 million range, but only one out of 10,000 has total assets over $50 million. RMA and Moody's collaborative *Industry Default Probabilities* tells us the smaller the contractor, the more likely it is to default, and the longer the term, the greater the chance of default, as illustrated in Table 1's array of asset size by one-year and five-year default probabilities expressed in basis points for five contractor lines.

Facts of Life [4]

As shown, the surety industry's well-being depends upon the risk-prone construction industry. Construction activity is much more volatile than the typical swings in the overall business cycle. Interest rates are critical to capital investment, and low interest rates can fuel construction even through economic recession, as was demonstrated by the housing boom during the most recent recession. Because residential construction is relatively fast to build, homebuilders pumping out new homes every 90 days or so tend to be affected more quickly than commercial contractors, whose projects are often years in the making.

Another contributor to volatility is the *accelerator principle*, which exacerbates the boom-bust impact of capital investment. As productivity improves, firms may expand their productive assets. But as a new factory is added to a firm's capital base, not all of its capacity can be employed immediately, so this new plant's underutilized capacity pulls down productivity, which dampens further investment and, in turn, reduces construction demand.

Ease of entry into construction means many firms compete for relatively few jobs, so competition has been historically price-dominated and is further aggravated by the competitive bidding that still accounts for the majority of the industry's contracts. Sharp bidding—on top of pricing driven by the contractor's best guess at his or her lowest cost—means narrow gross profit margins and high breakeven points. Other industries enjoy profitable operations because they are able to raise prices, cut costs, or employ a combination of both. The competitive bid contract restricts price increase, and the bid estimate puts a floor under costs. A contractor has literally almost no margin for error.

If volatile revenues and thin margins aren't enough to overcome, the typical contractor's asset mix is heavily illiquid—mainly work-in-progress inventory and fixed assets. What cash is on the books is needed to cover weekly payrolls, payroll taxes, and 30-day materials bills.

Thin, volatile profits make it hard for a contractor to accumulate equity, so debt is a crucial source of funding. Whether formal bank debt or informal trade financing, the contractor needs both to convert work-in-progress inventory into finished products while maintaining the firm's fixed-asset base. High leverage and low solvency go hand in hand with marginal profitability and illiquidity.

In today's market, the surety wants to see that the contractor has

Table 1

Asset Size ($MM)

	0-.5		.5-2.0		2.0-10.0		10.0-50.0		50.0-100.0	
Type of Contractor (NAICS)	**1yr**	**5yr**	**1yr**	**5yr**	**1yr**	**5yr**	**1yr**	**5yr**	**1yr**	**5yr**
Single family housing (236115)	1.5	8.6	2.2	11.8	2.2	12.6	1.3	8.9	1.0	6.9
Commercial building (236220)	1.2	6.9	1.1	6.7	0.9	5.6	0.7	4.4	0.6	3.4
Highway and street (237310)	1.1	6.7	1.1	6.6	0.6	4.4	0.5	3.1	0.5	2.9
Electrical (238210)	1.2	7.0	1.1	6.3	0.9	5.5	0.9	4.5	na	na
Plumbing (238220)	1.2	7.3	1.0	6.4	0.9	5.6	0.7	4.6	na	na

Source: *Annual Statement Studies*: Industry Default Probabilities and Cash Flow Measures, 2004-2005, RMA: Philadelphia, 2004.

a bank line of credit, but the surety will also pay close attention to how much the contractor actually relies on it. Liquidity and availability of capital at risk is more important than ever when obtaining surety credit. One of the advantages of requiring performance bonds is that a qualified contractor and project completion are assured without drawing on the contractor's line of credit. In effect, bonding capacity is a credit enhancement.

In our post-9/11 world, contractors are coping with higher insurance and bonding costs. While some of these costs can be shifted to clients, a combination of higher deductibles and narrower coverages means that contractors are carrying another claim against their collective modest capitalization in the form of self-insured residual risk no longer covered by insurance.

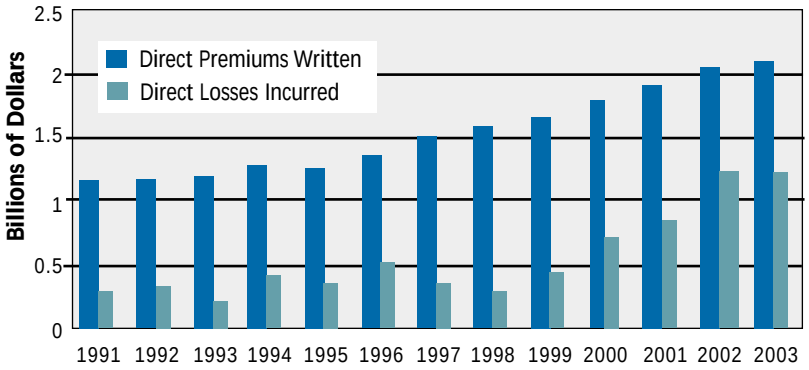
In particular, bonding has become more expensive for contractors as well as for owners who ultimately pay the cost of the bond. The turn of the century brought an abrupt end to the previous decade's expansion of bonding capacity. New sureties entered the market during the 1990s, and the excess supply drove down premiums and loosened underwriting. The combination of lower revenues and higher losses made 2000 the industry's first loss year since 1987 and its collective $1.5 billion loss the worst in 20 years. Six of the top 20 sureties lost money in 2000, and the industry's 105% combined ratio meant the surety industry lost five cents on every $1 of earned premium. Many surviving sureties have responded by raising premiums and avoiding bond writing under the $250,000 to $500,000 range. Smaller contractors may find it harder to get bonding for smaller jobs, and what bonding they do get costs them, and the owner, more.

Fortunately, survival continues to be a vital instinct for the contract surety industry. Throughout the 1990s, as the economy boomed and interest rates dropped, surety was a profitable industry. The strong economy kept contractors busy and failures low. However, the profitable bonding business attracted new entrants into surety, and excess capacity accumulated in the surety market. As competition for bonding intensified, bond premiums declined. Further, some companies relaxed underwriting standards to compete for more market share. As bonding shifted from a seller's market to a buyer's market, clients increasingly perceived surety bonds as a right rather than a privilege. As competitors exhausted pricing and underwriting options, other sureties tried product differentiation and proliferation by creating many new surety products with little actuarial experience or historical data with which to identify and underwrite these unknown risks.

Litany of losses. By the late 1990s, after more than a dozen years of profitability, the surety industry suffered record losses in 2000 and was especially hard hit in 2001 by a series of high-profile corporate failures. The reinsurers also experienced significant losses stemming from 9/11 as well as a number of corporate failures. The stickiness of low interest rates drove down the investment returns of reinsurance companies, which further eroded their loss-riddled capital bases. Several reinsurers left the surety market. Those that have chosen to remain have refocused their strategies and continue to support well-managed surety companies—at a price. The refocusing has meant renegotiated treaties with the sureties, increased prices, additional exclusions, and substantial-

Figure 1

Twin Peaks—Rising Premiums and Rising Losses, 1991-2003



According to preliminary data compiled by The Surety Association of America, $1.3 billion in contract surety claims were paid in 2003, a 66% loss ratio, compared to 30.4% in 1990. Surety companies have paid more than $7 billion in claims since 1992 and half of that was paid in just the last three years.

ly more risk retained by the primary surety company.

Changing of the guard. Seven of the top 10 writers of all U.S. surety (including contract and commercial) have merged or left the market since 1990. In 1990 the top 10 wrote 46.8% of total surety. By 2003, the names and numbers changed dramatically, with the top 10 companies now writing 65.5% of the total U.S. surety.

Looking at Figure 2's top 10 writers of surety in 2003 and in 1998 demonstrates how different the industry looks today than it did five years ago. Although the players may have changed, fortunately, enough surety capacity remains to support U.S. construction needs.

Current concentration. The top three writers in 1990 made up only 17.7% of the total surety written, but by 2003 the top three had captured 35.2% of the market. With the recent merger of Travelers and St. Paul, this one company may be writing more than a quarter of U.S. surety in the near future.

Construction Industry Outlook: Cautiously Optimistic

While construction slowed down a little in the recent economic downturn, low interest rates buoyed housing construction and largely mitigated the typical construction cycle contraction. The near future still holds promise of a mild recovery. According to the FMI 2003-2004 U.S. Market Construction Update, construction's share of the GDP remains fairly steady looking back to 1990 and ahead to 2007—between 7% and 8%. According to the U.S. Census Bureau, the value of construction put in place (residential, nonresidential, and nonbuilding) in 2004 was $1 trillion, a 9% increase over 2003. Take out single-family residential construction, and that figure is $448 billion. (See www.census.gov/const.www/)

The construction market has shown strong growth in the 2004, but the effects of rising gasoline and steel prices as well as prices of other construction-related commodities remain a key factor for prolonged growth. If economic conditions decline for contractors, the domino effect on claims may negatively affect the surety industry's bottom line. For the near term, construction is strong—according to the U.S. Census Bureau. The value put in place for construction stood at $1 trillion in September 2004, which is 9% over the same time in 2003. According to analysis of the census data by Ken Simonson, chief economist with Associated General Contractors, private residential construction climbed 15% and nonresidential and public construction were up 4% each.

FMI states that public safety, highways and streets, military facilities, and water supply facilities drove construction growth in 2004. The residential construction sector, which has comprised 51% over the total construction market in recent years, is expected to contract slightly. The national homebuilders and subdivision developers have begun to experience some inventory accumulation as the sales pace has slackened. In fact, the Fed's December 2004 Beige Book reported several Federal Reserve district banks observing a cooling pace in their districts' home sales and a slowdown in price appreciation. The Commerce Department reported new home construction had declined 13.1% between October 2004 and November 2004, the steepest decline in almost 11 years and that unsold new homes were at a 25-year high. Morgan Stanley's chief economist Richard Berner is also betting on a cooler

Figure 2

Top 10 Writers of Surety in the U.S.—2003

1. Travelers Property Casualty Corp.
2. The St. Paul Companies
3. CNA Insurance Companies
4. Zurich Group
5. Safeco Insurance Companies
6. Chubb Group of Insurance Cos.
7. Liberty Mutual Group
8. The Hartford Insurance Group
9. HICA Holding Group
10. American International Group

Top 10 Writers of Surety in the U.S.—1998

1. The St. Paul Companies
2. CNA Surety Corporation
3. Reliance Insurance Companies
4. Fidelity & Deposit Group
5. Travelers Property Casualty Corp.
6. American International Group
7. SAFECO Insurance Companies
8. Fireman's Fund Insurance Cos.
9. Amwest Insurance Group
10. Frontier Insurance Group, Inc.

Source: "Fifty Largest Writers of Surety-United States," The Surety Association of America (SAA), August 17, 2004. Additional detailed statistics are available for purchase at www. surety.org.

housing market in 2005 as rising interest rates make it more difficult for potential buyers to afford new homes. Further, U.S. home ownership has risen by 5 percentage points to 69% over the last 10 years, a level which suggests that there may not be many willing and able homeowners left.[5] Fortunately, a flattening housing market is likely to have little effect on the surety industry as a whole because bid, performance and payment bonds are rarely written on single-family residential or subdivision construction. Moreover, completion bonds make up only a small percentage of bonds written. Although FMI notes that the nonresidential sector did not perform well in 2003, it has predicted recovery in mid 2004; public building is expected to have experienced a mixed recovery in 2004 and beyond. Meanwhile, McGraw-Hill's Construction Contract Awards projections for 2005 show a 5% increase for non-residential construction from $162 billion to $176 billion.

Future Changes

Looking ahead, the surety industry is likely to continue to tighten its underwriting standards. Rates have stabilized but may be more contractor and project specific, unlike yesterday's "blanket pricing." Look for more "risk-based" pricing as higher risk exposures translate into higher rates.

Capacity. Capacity is available, but ironically, company size may be to the advantage of mid-sized contractors. Fewer sureties serve the jumbo contractors independently as the focus and competitive rates has shifted to the middle market. Compare this move down market to a similar move in banking from low-return corporate banking to potentially higher-yielding middle-market commercial lending.

While sufficient surety capacity is in place to support the U.S. construction industry, contractors may experience changes in the bonding process depending largely on underwriting factors previously discussed. Small contractors may encounter challenges in meeting the more meticulous underwriting, but several surety companies have programs for emerging contractors, and other companies specialize in the small contractor market. The U.S. Small Business Administration Surety Bond Guarantee Program may become a more popular option for those unable to obtain bonds by traditional means.

Mid-sized contractors probably will be the least affected. There may be moderate price increases depending on location, as well as firmer underwriting terms and conditions. The core contract surety market of contractors under $100 million remains competitive and attractive to sureties, so there is adequate capacity available.

Contractors on mega or jumbo contracts ($250 million and up) or with large aggregate programs, should expect to see more co-surety arrangements as surety companies look for ways to spread risk. Extremely large projects may need to be broken into smaller contracts, where feasible, in order to obtain competitive prices in bonding them, or the contractors may need to form joint ventures to share the risk. This segment of the market may be more prone to premium increases and more conservative underwriting conditions. Additionally, performance and payment bonds may be capped at specified dollar amounts or a percent of the contract. Nevertheless, contractors with a solid balance sheet, profitable work program, and experience should have no trouble obtaining the required suretyship.

Claims. The higher claims of 2000-2002 are working their way through the system much the same way that banking's problem loans of the recent recession are being digested. The loss ratios for 2005 and 2006 should show improvement. Sureties are seeing more frequency of claims than severity of losses at this point in the recovery phase of the business cycle, although increases in the severity and frequency of claims depend largely on regional conditions. The general consensus is that by the end of 2005, losses will have worked their way through the system and bond exposures will be on projects underwritten by today's more stringent standards, so loss ratios are expected to improve.

Underwriting. Contractors with sound business practices will continue to reap the benefits of surety bonds even as the industry continues through this readjustment period. Contractors are advised to develop and maintain a solid surety relationship.

With the return to 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. Some underwriters are looking at a fourth C—*continuity*. Accordingly, the surety may request more information and examine it more closely than had been done in the 1990s.

Equity capital is a challenge for any contactor, so access to debt capital is vital. Good relations with both banker and trade supplier are fundamental to success for the contractor. Paying obligations in full, on time, and as agreed is both good common sense and key to working capital financing as well as to the risk mitigation and transfer provided by the surety's performance and payment bond.

To evaluate capacity, as well as to gain some insight on continuity, the surety is likely to request resumes of key employees and management to determine management depth. Contingency plans will also be scrutinized. Sureties want to see that plans are in place to deal with loss of key personnel. Comprehensive business plans, forecasts, or strategies, both short term and long term, are also important to sureties. Lastly, the surety will want to see that the contractor has or can obtain the equipment necessary to perform the work.

In terms of character, the surety will want to be assured that the contractor maintains a satisfactory reputation. The surety expects the contractor to have established, positive, and ethical relationships with subcontractors and suppliers. Additionally, references from owners and lenders will take on more importance.

As further analysis of the Cs, the surety underwriter may look closely at the project's contract terms and the contractor's contract review process, liquidated damages, warranty requirements, and the owner's performance history. The underwriter may also review the contractor's subcontractor and supplier selection criteria.

Premiums. Surety bond premium increases may have leveled off—or not, depending on a number of factors. While many in the surety industry report a stabilizing in pricing, individual factors will play a larger role in premium setting, including the size and bonding capacity of the contractor, geographic area, type of construction, and the specific project. Surety bonds were a bargain in the 1990s, partly due to competition and excess capacity. As the market tightened, surety companies boosted their pricing structures to cover increased losses and the increased cost of reinsurance, personnel, and other costs of doing business. After a brief period of readjustment, surety bond premiums are now more realistic for the value provided.

Weigh the Risks

Sureties and bankers have much in common. Both industries underwrite risk to contractors, and both have enjoyed the good time profits of the cycle's expansion phase and suffered the losses during its contraction phase. The post-9/11 world adds another dimension to risk, and sureties have had to sharpen their analytical process, narrow their product focus, and raise their prices to accommodate economic evolution.

Bankers should pay attention to the surety industry if only because its ability and willingness to transfer risk has a complementary impact on financial institutions. The less construction risk the bonding company underwrites, the more risk the lender must consider, so both the surety and the banker need to evaluate and monitor their collective risk appetites for the construction industry. As construction cycles through another economic period, both should guide their risk management strategies according to Will Rogers' sage advice: "Even if you're on the right track, you'll still get run over if you just sit there." Stay on track, but move with the times. ❐

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Footnotes

1 "The Importance of Surety Bonds in Construction," pamphlet published by the Surety Information Office, 5225 Wisconsin Avenue NW, Suite 600, Washington, D.C., 20015-2014, 202-686-7463 or www.sio.org.

2 *Ibid.*

3 Dev Strischek, "Underwriting and Monitoring Consideration in Lending to Contractors Today, *The RMA Journal*, June 2004, pp. 31-32.

4 *Annual Statement Studies*: Industry Default Probabilities and Cash Flow Measures, 2004-2005, RMA: Philadelphia: 2004.

5 Justin LaHart, "Cracks in the Foundation?" *Wall Street Journal*, December 29, 2004, p. C1.