EXCELLING IN TODAY'S SURETY BOND MARKET

BY JASON HUNTSMAN

Times and the surety market have changed. But how do these changes affect contractors? The nation's top surety professionals talk about the state of the surety industry and offer advice to contractors on what to expect and how to thrive in today's market.

HOW DID WE GET HERE?

While the surety industry has gone through a number of changes in recent years, numerous signs indicate that stability is returning to the market. However, today's market does have many unique features, which savvy contractors need to understand fully in order to gain a competitive advantage.

The surety industry faced a number of large losses beginning in 2001, and while commercial surety was especially hard hit, contract surety also experienced substantial losses. Surety companies, like any other businesses, need to remain profitable; as such, the industry has had to reevaluate risks, contend with mergers and adjust pricing structures. Reinsurance companies, which take on a good deal of risk on behalf of sureties, also have had an effect on the industry as they renegotiate their reinsurance treaties.

William E. Cheatham, president of Zurich North America Surety, explains how the surety market changed in recent years.

"Two years ago the surety industry was divided along the lines of national or regional companies. Due to changes and mergers, that line has shifted to serving large, middle or small-sized contracting firms. A few companies are now vying for the large-sized accounts, while the rest of the industry is focused on the middle and small market."

Reinsurers' appetite and ability to help surety companies manage risk are important factors that can affect contractors that receive surety credit.

According to James E. Lee, president of Old Republic Surety Company and chair of the board of directors of The Surety Association of America, "There was some concern as to how much reinsurance capacity would be available to sureties. Thankfully, the void left by reinsurers that have merged or left the market has been partially filled, which in turn has enhanced capacity."

AVAILABILITY OF BONDS

So, is there enough capacity to go around? The answer is yes for qualified and capable firms.

According to Michael Cusack, senior vice president and regional surety director with Aon Construction Services Group, "Due to the contraction of the reinsurance market, capacity is still an issue for large contractors that need surety programs in excess of $250 million. The majority of contractors that have larger work programs will require the support of two or more sureties in the form of a co-surety facility."

While mega-contractors may contend with co-surety arrangements, middle and small-sized firms will most likely be unaffected by capacity issues.

Mike Peters, president of Safeco Surety, elaborates, "There does appear to be good competition and sufficient capacity available for contractors in both of these segments [middle and small-sized firms]. So, for the most part, successful, established contractors should not see capacity issues. Likewise, there will continue to be capacity available to the emerging and small contractor markets, but with more stringent underwriting standards as loss frequency in this market will continue to be a concern."

Geoffrey Haver, senior vice president and construction practice leader with Riggs, Counselman, Michaels & Downes, an Assurex Global Partner, adds, "There is plenty of capacity for small and mid-sized contractors. Minority contractors also have programs available from the Small Business Administration, local initiatives, and the Surety Association of America to strengthen business practices that work toward establishing a bonding program."

PREQUALIFICATION NEEDS

More than ever, sureties need accurate and timely information from contractors in order to manage individual bonding programs. This financial information is not sought for the sake of wanting more paperwork; it is vital for sureties to develop a solid, well-rounded understanding of a contractor's complete business operation.

According to Phil Tobey, vice president of surety with The Dale Group, "For small and emerging contractors seeking their first bond, a three-pronged approach is best. First, they should capitalize their business as best as they can. It's important to have as much money invested in the company as possible and have it documented by a CPA. Second, prepare and provide a resumé that contains detailed project experience. A contractor who has only done $200,000 projects should not expect to move right into half million-dollar projects without the prior experience. Third, don't be too aggressive. Look to build a relationship with a surety and don't expect unrealistic amounts of credit to be extended."

Dennis Perler, president of Liberty Mutual Surety, suggests that the emerging or small contractor who is seeking to move into public-bid projects do so with a balanced, steady approach. It is worthwhile to maintain some private work and not jump headfirst into the public arena, which has a unique set of demands and features that a private-construction firm may be unprepared to manage.

Aon's Cusack explains, "In response to the industry's poor results of the past five years, the implementation of higher underwriting standards was well underway prior to the start of 2004. These standards mandate that contractors commit to putting more capital at risk, retain profits, manage their business based on more restrictive work programs and provide the surety with a consistent flow of high-quality information."

So, what does the surety really want? Accurate, timely and clear information are themes echoed throughout the industry. Sureties need this information to develop a deeper understanding of a contractor's management team, finances, operations and risk-management strategies.

According to Henry Nozko, Jr., president of ACSTAR Surety, "Contractors really should submit financial statements quarterly rather than yearly. Accurate work-in-progress forms are also necessary. It is important that all information submitted to the surety be presented in a legible, easy-to-access manner. Because the volume of paperwork is being handled by fewer surety companies, high-quality, easy-to-understand presentations are essential."

Craig Hansen, senior vice president with Holmes Murphy & Associates, Inc. and president of the National Association of Surety Bond Producers, agrees. "The quality and frequency of underwriting information continues to remain a key to a contractor's success in maximizing the support of their surety underwriter. The surety's understanding of the contractor's business plan is critical to the surety relationship. Working with a professional surety bond producer will enhance a contractor's understanding of current market conditions, and will provide guidance in communicating a contractor's business plan to the surety underwriter," he adds.

The emerging and small contracting firm seeking to start a bonding program may be placed under more scrutiny than an established contractor. However, steps can be taken to make such a business more attractive to a surety.

THE SURETY RELATIONSHIP

Having a solid surety relationship is important during normal conditions, and invaluable during times of uncertainty and change. Open, honest and frequent communication among the contractor, surety bond producer and surety underwriter helps ensure this relationship remains healthy.

"The surety relationship should be treated similarly to other credit relationships. A solid working relationship with a surety company enhances many firms' ability to penetrate markets that fit their strategic plans. Understanding the strengths and limitations of your surety is also important because many surety companies target specific types and sizes of businesses; it is best that your risk profile is in line with the appetite of the surety," says John Welch, president and chief executive officer of CNA Surety.

Sureties, like other businesses that extend credit, have a vested interest in seeing their clients succeed. Because a surety is vouching for a contractor's performance

Writers of Surety

The latter part of the 1990s and the early part of this decade have been a time for change in the surety industry. A number of companies have consolidated or departed from writing the surety line. Looking at the top 10 writers of surety in 2003 compared to 1998 demonstrates how different the industry looks today than it did five years ago. Some of the players may have changed; however, enough surety capacity remains to support the U.S. construction needs.

Top 10 Writers of Surety in the United States—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

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Top 10 Writers of Surety in the United States—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.

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and backing that up with its financial resources, it is imperative that a surety has a clear picture of the principal's company. By regularly communicating with the surety team, contractors can help create a solid business partner for the long haul.

PREMIUMS

Realistically, surety remains an extremely low-priced risk management tool for the 100 percent payment and 100 percent performance protection afforded to an obligee. While many indicate that premiums have stabilized for middle- and small-sized contractors, sureties may continue to adjust pricing for more risk-intensive, large-scale accounts.

Terrence Cavanaugh, chief operating officer with Chubb Surety indicates, "With premiums, there is more of a focus on the risk of the individual project and contractor being taken into consideration. A project that will last four years would be priced differently than one that is scheduled to take one year to complete. Projects that last beyond two years generally have more risk associated with them and will be priced accordingly."

Zurich's Cheatham agrees, "Premiums have leveled off since the pricing restructuring of the past couple of years. However, accounts with high capacity or high-credit risk exposure may have to contend with higher rates. Not all surety companies have imposed realistic rates, but it is important that companies make the surety line attractive to reinsurers and their shareholders."

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CLAIMS

The word on the street about claims activity is mixed. Some see the more stringent underwriting conditions of the past few years as having a positive effect on claims, while others report that the frequency of claims remains a concern.

While surety bonds typically are underwritten under a zero-loss model, unfortunately claims do occur.

William Marino, chairman and chief executive officer with Allied North America, offers insights into today's claims activity, "The effects of today's back-to-basics underwriting standards won't be realized in the immediate future. While the economy is an important factor on the frequency and severity of claims, the standards employed in the mid to late 1990s are also still having an effect. The frequency and severity of today's claims are due in large part to the more relaxed underwriting standards of the past, not because of today's practices. There is a lag between more thorough underwriting standards and a reduction of claims," Marino says.

According to Safeco's Peters, "There does appear to be more frequency problems than severity problems. Probably the largest trend we've seen with contractors going into a claim is over-expansion either in their work program or in their territory. Usually this was 'promoted' by several years of successful operating results, but somewhat stagnant top-line growth. Obviously growth at the expense of control does not work."

While claims are an unfortunate situation, contractors can take steps in today's market to mitigate loss or even prevent a dispute resulting in an actual claim.

"Construction is a tough business—period. Disputes will happen even to the most solid contractor. However, contractors need to keep thorough documentation and be prepared to share it with their surety when problems arise on a project. Contractors must provide documentation and engage in frequent correspondence with their surety in order to defend their position. A contractor that ignores the surety's calls may be put under more scrutiny," The Dale Group's Tobey says.

An Assurex Global Partner, Riggs, Counselman, Michaels & Downes' Haver offers further advice for supporting contractors' positions and avoiding problematic situations: "Having written documentation is essential for a contractor's position to be preserved. All change orders should be in writing and signed-off by only those who have pre-approved authority. Contractors should enter into standard contract documents such as AIA's and must develop a thorough understanding of any manuscript contract. It's also important to know who you are working for and who's working for you. Bad reputations—both of owners and others potentially working on a project—should be seriously taken into consideration."

LOOKING AHEAD

Eventually the surety market will introduce new players, bringing with it additional capacity and the potential for a softening market. However, many predict this will occur slowly and also foresee today's market conditions and solid underwriting practices remaining in effect for several years to come.

The near future of the surety industry will be met with a cautious optimism. While the industry incurred nearly $1.3 billion in contract surety claims in 2003, according to the Surety Association of America, many foresee the possibility of moderate profitability within the next few years.

The short-term outlook for the surety industry has a great deal to do with the unpredictable nature of the overall economy. While the construction market has shown strong growth in 2004, the effects of rising prices for gasoline, steel, concrete and other construction-related commodities remain important factors for long-term 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, during the first seven months of 2004, non-residential construction spending amounted to $451.5 billion—5 percent above the $430.1 billion for the same period in 2003.

"Although there has been more of a focus on solid underwriting standards, economic uncertainties are an area for serious concern. Issues such as inflation, a lack of government funding for public works and scarcity of construction materials may coalesce to create a more hostile construction environment than was in place two to three years ago. This is something that may cause problems this year and next," Chubb's Cavanaugh says.

Michael F. Greer, vice president of surety and fidelity with Penn National Insurance, offers a candid view on the outlook for the industry. "The surety industry is currently in the reality stage. Losses in the past couple of years have been frequent and severe, and there are fewer sureties than there used to be.

"We hope sureties follow the same advice that they give to their clients. A consistent, underwriting-based surety company is the one that will be around in both good times and bad. The hot surety company that doesn't ask questions and competes on giving away capacity is just like that hot stock tip from the broker who calls you out of the blue: it might work for a little while, but in the long run, you can't retire with it," Greer advises.

By reevaluating risks, returning to solid underwriting traditions and employing realistic pricing structures, surety companies are poised to help contractors succeed for the near and long term. By relying on the advice from a professional surety bond producer and underwriter, contractors have the opportunity not only to survive in today's market, but also to thrive.

Surety is about more than just receiving a bond—it's about helping contractors succeed and excel—in any market.

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