SURETY BONDING: 2005 MARKET OVERVIEW

Executives Optimistic about Surety, Construction Industries

BY MARC RAMSEY

Today's surety industry may have tightened its belt a notch, but there is still room at the table for many contractors. Surety industry executives, who offer their perspectives on the state of the surety and construction industries, say there will be plenty of bonding availability in the middle market for those who qualify. And while availability may be tighter in the smaller and extremely large markets, sureties can meet the needs of the very best contractors.

SURETY AVAILABILITY

"I believe 2006 and 2007 will be positive years for the surety industry," says Doug Hinkle, chief underwriting officer, CNA Surety. "The effects of more conservative underwriting in the industry over the last couple of years in both contract and commercial surety has led to improving loss trends. In conjunction, we are seeing a much-improved construction market in both the public and private sectors and, of course, the recently signed federal highway bill will lead to greater and more consistent funding for public infrastructure work across the country."

Timothy Mikolajewski, vice president of contract surety, Safeco Surety, also cites the federal highway legislation in predicting a fairly robust construction economy over the next two to three years. "The passage of the federal highway legislation will provide much-needed matching funds to the state DOTs," he says. "Infrastructure project opportunities in general should provide plenty of opportunities and be the catalyst for a strong construction economy."

"Overall," he continues, "I'd say the surety industry is strong and will continue to get stronger over the next few years. Good underwriting discipline combined with appropriate pricing for the risk and a strong construction economy should fuel good results for the industry. These good results will allow the surety industry to provide the capacity to qualified contractors to take advantage of what should be good project opportunities."

However, William Cheatham, president of Zurich North America Surety, expects the economic environment for construction to remain stable rather than improve significantly. "The recent New Orleans catastrophe should remove some of the short-term risks," he says. "However, the construction and surety industries will have to manage labor and material shortages, while experiencing escalating costs."

Casey Warnecke, senior vice president of Marsh Global Surety Practice, also believes results in the industry have stabilized. "As long as the main players manage their business effectively, thereby avoiding catastrophic losses, there is reason to be optimistic for the next two years," he says. "Sureties today are using more sophisticated credit scoring and pricing models and are doing a better job managing their overall portfolios in order to justify the capital that is being extended to them by their company; so this bodes well for the future."

On the other hand, the surety industry can be a catalyst for construction industry success at all levels. "For a surety to add value," Zurich's Cheatham says, "it needs to provide more than simply a piece of paper. Contractors should draw on the experience of a surety for advice. Unfortunately, the large contractors seem to value the surety relationship more than the small- to mid-market contractors. That is especially unfortunate when you recognize those are the most vulnerable contractors."

Terry Lukow, executive vice president of St. Paul Travelers, is cautiously optimistic that the surety industry is in recovery. "I think it's still a very fragile environment," he says. "It is recovering, but we're not there yet."

"I think we're going to see more of the same," he adds. "If you look at the changes in the surety industry in recent years, companies are starting to make decisions based

areas that may take up to seven years. The Veterans Administration, for example, has hundreds of millions of dollars committed to building new hospitals, throughout the United States and Puerto Rico."

Michael J. Cusack, senior vice president, regional surety director and operations board member of Aon Construction Services Group, is more cautious about the construction industry climate. "Given the prevailing climate for increased interest rates and higher energy costs, albeit sound, I believe the fundamentals of this market dictate that construction expenditures will remain static during 2006. I do not envision any significant uptick in the market until the second half of 2007 at the earliest," he says.

Henry W. Nozko, Jr., president of ACSTAR Insurance Company, points out, "The normal expectation is that acquiring and increasing surety credit during 2006 and 2007 most likely will be easier. However, our expectation for 2005 was similar, and that has not really occurred. Therefore, the easing of credit during 2006 and 2007 should probably not be considered a given," he says.

How can a contractor make the most measurable positive impact on available capacity? William A. Marino, chairman and chief executive officer of Allied North America, says, "There are a number of ways a contractor can successfully increase the parameters of the support that it receives from the surety. Levels of worth and working capital can be strengthened through profitable operations or through the infusion of additional equity."

on allocation of capital. 'Are you successful in the surety industry as part of a larger property and casualty company?' The industry has failed to create the kind of economic returns that are demanded of it within the property and casualty industry."

Dennis J. Perler, president of Liberty Mutual Surety, says an improving general economic situation coupled with increasing tax receipts for state and local governments bodes well for construction spending. "When viewing these favorable economic trends, it should be noted that construction is still subject to sector and regional geographic variance," he says.

Terrence Cavanaugh, chief operating officer of Chubb Surety, explains, "The forecast really depends on what part of the country you're in. The state of the industry in Rochester, N.Y., is much different from Raleigh, N.C. But, overall, the numbers will show an increase in construction spending."

CNA Surety's Hinkle adds, "I see the balance of 2005 and 2006 as strong years for construction. Work availability seems to be much improved in most parts of the country."

Karen Barbour, president of The Barbour Group, also expects the economic environment for construction to improve in the coming year. "With Hurricane Katrina, especially, years of rebuilding are in tow," she says. "In D.C. alone, two new stadiums are on the construction slate, spurring redevelopment in surrounding

Two things are certain to have a definite impact on the surety industry, says Edward J. Heine, president of the National Association of Surety Bond Producers, and executive vice president of Payne Financial Group. "Pressure for profitable underwriting results will continue," he says. "Surety company results must reach anticipated returns on invested capital and equity. If they do not, corporate boards may no longer support a surety operation and may exit the business."

And, the underwriting procedures of surety companies will continue to be diligent, he adds. "New underwriting tools, such as credit scoring and comprehensive automation platforms designed to measure account quality, will be implemented by most underwriters. Bond credit will be made available for the strongest risks and will be limited for the specialized and under-capitalized clients," Heine says.

DEMAND FOR SURETY

John Stanchina, senior vice president and division manager of Rutherfoord Companies, sees condominium and multi-family residential construction driving a lot of demand for surety. "This represents a substantial percentage of growth in commercial construction around the country, and virtually all of these projects require surety bonds due to lender and buyer requirements. The question is, 'is this a short-term phenomenon or a long-term trend?' I don't think we know yet," he says.

"Demand for the surety product is again increasing," adds Liberty Mutual's Perler. "As building projects continue to grow in size, more private owners and financing entities recognize that the protections offered by a surety bond are necessary to protecting the significant capital that is invested in bringing a project through to completion. Coupled with a stable economy, expanding population and a deteriorating national infrastructure, both construction spending and the demand for bonds should increase over the next several years. Sufficient surety capacity will continue to be available for qualified, experienced and well-capitalized contractors."

Chubb Surety's Cavanaugh agrees, "We may see more demand for bonds by private owners and lenders as they recognize the benefits of financial protection."

Sureties have paid more than $7 billion in claims on contract bonds since 1992, according to The Surety Association of America (SAA). In 2004 alone, CNA Surety's Hinkle says, "The surety industry paid more than $2 billion in losses. Over time, the surety product has proven that it does provide value to owners, general contractors, subcontractors and suppliers. As the construction industry grows over the next few years, the demand for the surety product will also grow."

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MEGA PROJECTS

Co-surety arrangements may arise as surety companies look for ways to spread risk. "Larger projects have larger risks," Chubb's Cavanaugh explains.

Contractors may need to form joint ventures to share the risk. Extremely large projects may need to be broken into smaller contracts, where feasible, in order to attract competition and obtain bonding. This segment of the market may be more prone to premium increases and more conservative underwriting conditions.

NASBP's Heine explains, "There are fewer players responding to this class of business than there were a decade ago, but those that are do a fine job of servicing their customers. New products are being developed to provide capacity to the largest of jobs. Co-surety arrangements are common and reinsurers are playing in this area selectively. The surety industry understands the need to respond to the demands of this sector and is working hard with those that qualify to respond in a comprehensive way."

Zurich's Cheatham believes adequate capacity exists to manage mega projects.

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"The real concern for me," he says, "is expanded capacity and the limitation within the surety industry to bring expertise to this segment. Few surety companies have the real expertise to underwrite mega projects."

Michael Murphy, executive vice president of Bush, Cotton & Scott, a Hub International Co., says underwriting terms and conditions, particularly for contractors in the $10 million to $150 million range, have stabilized. "The middle market is clearly the most competitive and provides the most market options to the contractor."

"For smaller contractors," he adds, "underwriting has also stabilized, though fewer market options exist and rate increases have been more aggressive."

Indeed, contractors working on projects under $5 million may encounter challenges in meeting more meticulous underwriting. Several surety companies have programs for emerging contractors, while other companies specialize in the small contractor market. The U.S. Small Business Administration Surety Bond Guarantee Program also may be an option for those unable to obtain bonds by traditional means.

"Small or emerging contractors may find using escrow, funds control and collateral can be useful tools for obtaining bonding," Michael D. Williams, president of North American Construction Services Inc., says.

Murphy says the biggest challenge for 2006 and 2007 likely will be capacity for larger contractors. "With a limited number of markets with sufficient capacity to play in this arena, and those markets retaining much higher levels of liability and paying significantly higher reinsurance costs on these larger exposures, the result likely will be continued upward pressure on bond rates and requirements for additional levels of capital to support these larger work programs," he says.

INDEMNIFICATION

Liberty Mutual's Perler believes the underwriting trend will be to tighten personal indemnification requirements. "Sureties clearly prefer contractor owner-operators to have some form of 'skin in the game,'" he explains. "After all, the contractor stands to gain the most from his business so it is equally important that he be willing to back his job selection decisions with personal indemnity."

However, Michael Mitchell, CPA, CPCU, vice president surety of the Graham Company, believes corporate and personal indemnification requirements may be less demanding in the next few years. "Financial strength and consistency of profitability are more important factors than size," he advises.

Ultimately, time will tell. Regarding personal indemnity, Marsh's Warnecke says, requirements will be determined by the underwriting discipline of the sureties. "Assuming surety results are favorable, it is likely that there will be the typical loosening of underwriting standards, which the industry has seen throughout its history," he explains. "This is typical of any business relative to supply and demand. If more capital enters the business, or if sureties look for additional premium growth, the natural approach is to offer more attractive terms and conditions than the incumbent surety, thus affecting several different underwriting standards, not just personal indemnity. This is already happening to some extent today."

"With respect to a contractor's size impacting indemnity," he continues, "the stronger the balance sheet and earnings history of a contractor relative to the size of its work program and bond needs, the better the chances that there will be less demand for personal indemnity."

In addition to the strength of a contractor's balance sheet, there are other ways to increase bondability. Industry executives advise contractors to become familiar with common pitfalls, so they know how to avoid—and prevent—failure or default.

Zurich's Cheatham cited the top reasons contractors experience difficulties, such as low profit margins, poor estimating, onerous contract terms and conditions, job scope changes and inability to manage cost recovery from the owner.

"Another reason contractors experience difficulties is when the surety industry is too flexible in allowing contractors to leverage capacity against working capital and tangible net worth," Cheatham adds.

St. Paul Travelers' Lukow advises that contractor difficulties are rarely caused by a single event. "It is usually a series of events, and I am a firm believer that the top reason contractors experience difficulties is management decisions made at the senior level of their organizations," he explains. "If a surety is supporting a contractor's strategic business plan and not just transactions, it is in a much better position to see difficulties before they become a reality."

SURETY RELATIONSHIP

The bottom line is the contractor's relationship with a surety bond producer and underwriter is essential, regardless of the state of the surety and construction industry climates.

"The first thing contractors need to identify is what they expect from their surety broker," offers Marsh's Warnecke. "Are they looking for a transactional surety broker or an issuer of bonds, or are they looking for a business partner that can provide them with ongoing consultative advice, which will provide the surety support they need to meet their current and future business plans and ultimately enable them to increase the equity in their organizations?"

"Most contractors," he continues, "want a surety broker that possesses knowledge of their business, the construction industry and one that has a solid reputation in the surety industry, capable of adding value to their business just like any other trusted business advisor with whom they conduct business."

"A good relationship," explains Philip Tobey, vice president of surety for The Dale Group, "starts with the contractor providing complete submissions and answers to questions that will be asked. Documentation and verification are vital in the underwriting process. Be honest with the producer. Contractors should communicate in terms of what their business plans are, what their current difficulties or issues are, and what they anticipate in the future. Don't hesitate to be open with the producer. The producer can't solve an issue if he doesn't know what is going on."

Aon's Cusack advises contractors to transact a certain volume of business to develop confidence and trust in the surety producer/underwriter relationship. "Work through disagreements—while remaining focused on preserving the relationship—and develop mutually agreed upon strategies to service accounts," he recommends. "Although we are both in the business of writing bonds, we must first develop a sense of confidence and trust in each other whereby the outcome of any individual transaction, meeting or conversation will not undermine the welfare and well being of the overall relationship."

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Allied North America's Marino adds, "Balance sheet issues that are identified during underwriting meetings should be addressed promptly and action plans shared with the surety and broker. Your broker's proper communication of even incremental success in the execution of a plan to close an identified gap can have a positive impact on the surety relationship."

Barbour emphasizes that contractors need to know whether their producer has the energy to get the job done. "More often than not, contractors want to make sure that their producer is not going to be passive with their business needs. A producer with a lot of energy and wherewithal can create the synergy for ultimate success. Contractors also must be willing to work with their bonding agent and to take some constructive advice on how to improve the firm's operations," she says. "In return, we get the opportunity to grow with the contractor."

"Contractors need to look for a problem-solver, a strategic planner, not a quick-fix solution," The Dale Group's Tobey suggests. "Identify and address the issues, because if you don't do it today, you will face the same questions later on. Interview a few producers and focus on the ones that are willing to work through the issues, and not just produce the bonds."

Despite some challenges, the surety industry will continue to meet the needs of the nation's construction program. Industry executives are guardedly optimistic about future bond capacity and demand, although the market may remain tight for the very small and jumbo contractors. The very best contractors should have no trouble obtaining bonds, while others may have difficulty.

Contractors may need to tighten operations to make themselves attractive to sureties, but that should result in fewer contractor defaults. While the surety industry has been moving through a period of realignment, contractors and owners alike can rest assured that the industry is poised to support the needs of both groups—just as it has for nearly a century.

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