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WHAT'S UP WITH SURETY

Presented by

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Workshop C

Tuesday, October 30, 1:30-3:00 p.m. and 3:30-5:00 p.m.

Martin R. Brady Jr.
Director, Credit & Surety Department
Swiss Reinsurance America Corporation

Mr. Brady is one of the panelists for Workshop C, "What's Up with Surety," on Tuesday. He is a member of Senior Management and managing director of the Bond Department at Swiss Reinsurance America Corporation, located in Armonk, NY. He joined Swiss Re America in 1981 and became the bond director in June of 1993.

He began his insurance career in 1960 at Aetna Life and Casualty Company where he advanced to the position of manager of the New York Bond Department. In 1978 he joined Alexander & Alexander, Inc., as vice president and head of their New York Bond Department.

A graduate of Fordham University, Mr. Brady is active in a number of trade and industry associations. He is a member of the Board of Directors of the Surety Association of America and past president of the Surety Managers Association of New York.

Susan Hecker
Senior Vice President
Gallagher Construction Services

Ms. Hecker is one of the panelists for Workshop C, "What's Up with Surety," on Tuesday. In addition to her account executive and management roles at Gallagher Construction Services' San Francisco office, she is responsible for facilitating surety nationally for Gallagher Construction, including mergers and acquisitions.

Prior to joining Gallagher Construction Services, Ms. Hecker spent 20 years within Fireman's Fund Insurance Company's surety operation, most recently as the Surety Center Manager for the company's regional flagship surety operation in San Francisco.

She attained her CPCU designation in 1989. Within the construction industry, Ms. Hecker is a charter member of the Construction Financial Management Association, a member of the Beavers, and is active in the National Association of Surety Bond Producers and EUCA, in addition to serving on the Fiscal, Insurance, and Risk Management Committee of the Associated General Contractors. Ms. Hecker has spoken often to construction industry groups on the surety prequalification process, in addition to representing the surety industry on various panel discussions.

James Rudnik
Vice President Surety Counsel
Liberty Bond Services

Mr. Rudnik is one of the panelists for Workshop C, "What's Up with Surety," on Tuesday. As vice president, surety counsel, for Liberty Bond Services in Plymouth Meeting, Pennsylvania, he is primarily responsible for all surety claim-related matters. His surety career includes claim-related positions at two other surety companies, as well as surety claim manager at Allstate Reinsurance. He also was in private law practice where one part of his practice focused on construction and surety law.

Mr. Rudnik has made numerous presentations at CLE seminars, including the ABA Annual Meeting, the Minnesota Institute for Legal Education (MILE), and the Surety Claims Institute, and panel presentations at various regional conferences. He has also been a frequent speaker on surety claim topics for the National Association of Surety Bond Producers (NASBP) and the Surety Association of America (SAA) at national and regional seminars.

Mr. Rudnik serves on the Board of Directors of the Surety Claims Institute and is a member and past vice-chair of the Fidelity and Surety Law Committee and a member of the Forum Committee on the Construction Industry of the American Bar Association. He is also a member of the Claims Advisory Committee of the Surety Association of America.

Mr. Rudnik is a graduate of the University of Minnesota with majors in economics and political science. He received has JD degree from William Mitchell College of Law in St. Paul, Minnesota. He is licensed to practice in Minnesota and Illinois.

Casey R. Warnecke
Executive Vice President
Chief Underwriting Officer
CNA Surety Corporation

Mr. Warnecke is one of the panelists for Workshop C, "What's Up with Surety," on Tuesday. Located in Chicago, he became the senior vice president and chief underwriting officer of 24 of CNA Surety's offices, including Kansas City and cities east of the Mississippi River except Chicago. He began his career with CNA Surety in the home office in June 1987. He held various contract underwriting positions and in May 1995 became a territorial underwriting officer overseeing the production and underwriting of contract surety in about seven of CNA's more than 40 offices.

He has participated as a speaker at regional NASBP (National Association of Surety Bond Producer) meetings as well as at some subcontractor association meetings.

Mr. Warnecke graduated from Northern Illinois University with a B.S. in Finance in May 1987. He attended DePaul University's Graduate School of Management, where he earned an MBA with Distinction with an emphasis in accounting in February 1993.

WHAT'S UP WITH SURETY

Like its insurance market counterpart, the bond marketplace is undergoing some critical changes. After years of record profitability, the surety industry experienced some difficulties last year, and two of 1999's top 10 players essentially exited the business. Sureties are asking more questions, rates are no longer moving downward, and personal indemnities are coming back in vogue. Is the soft market over? What does the changing economic picture hold for sureties and their contractors? Additionally, some contractors and owners are frustrated with what they consider to be a lack of responsiveness from sureties with respect to contractor and subcontractor default. In this session, a distinguished panel of surety experts will discuss these and other key bonding issues facing contractors, owners, and surety professionals. Attendees will leave with a better understanding of the bond market's direction, underwriting and claims trends and how to prepare for them, and how to develop a mutually beneficial relationship with your surety.

In Their Words …

In preparation for this discussion, we asked each of our panelists to summarize what they believe are the most important challenges facing the surety industry during the next few years. Their responses are presented below.

Casey R. Warnecke
Executive Vice President
Chief Underwriting Officer
CNA Surety Corporation
Chicago, IL

We've seen some negative changes in the economy, and although the next few years' public works' spending should remain strong throughout most of the United States, the private sector is starting to suffer as there have been significant changes in many industries including technology, retail, manufacturing, energy, building materials, etc. In addition, the cost of credit is increasing for many contractors despite the Fed's ongoing rate reductions, jobless claims are up yet qualified labor is still difficult to attract, and many states have made, or are making, changes to their existing and future budgets that could impact construction spending in the future.

The surety industry in 2000 had its worst year in about the last decade, with a 45 percent loss ratio and probably break-even results. This compares to low to mid-20 loss ratios throughout the '90s. While the economic changes began to occur in 2000, the losses experienced were not economically driven. Of the industry's contract losses, most were the result of the overextension of bonding capacity by sureties to contract accounts—just bad decisions in many cases as sureties chased the almighty premium dollar. With a soft market in the '90s came a loosening of surety terms, and contractors found themselves able to bid larger jobs and take on larger programs, many times without the infrastructure to support their growth.

Reinsurers have had unacceptable results and are strengthening terms with many primary sureties. Two of '99's top 10 sureties have exited the business due to financial difficulties, and primary sureties are working harder to manage their portfolios of exposures in a declining economic environment.

The main challenges facing the industry today are:

- Managing their portfolios of risk in a changing economic environment.
- Responding effectively to ongoing criticism by the buyers of our surety product that the industry does not respond to claims properly.

How do we respond to these challenges? The first bullet point requires the industry to get back to underwriting basics, something that has gotten lost over the years. This is not an easy task as it requires many sureties to fundamentally change what they have been doing for many years. An economic downturn and poor surety results are nothing that the surety industry hasn't gone through before, and it will successfully come through this one, but not without some pain. Expect continued consolidation in the industry, and continued departure of several small and medium-sized surety companies. On smaller accounts, sureties are getting more premium dollar, requiring greater indemnity, and overall providing less capacity than before. Medium-size healthy contractors aren't really feeling any change at this time, and the large/jumbo contractor accounts at the minimum are seeing their current surety or sureties requesting additional surety players to come on board to share in the risk. Many independent surety agents are looking for quality surety partners who can provide support to their contractor clients.

As respects the second challenge, this is the greatest. Never before has surety been under attack like it is today from alternative products. How does the industry respond to this challenge? We need to find a way to provide a product that the buyers want. Many in the industry are looking for changes to bond forms which would provide an obligee (beneficiary of a bond) with the ability to draw down on a bond to a certain percentage in the event of contractual default, or changes which will ensure that a job doesn't get delayed by a surety's right to rely upon a principal's solvency. These changes are being discussed to a great extent, but are a long way from any type of finalization as many parties need to be involved in this type of process, including GCs, subs, attorneys to negotiate contractual verbiage, and of course sureties which may require some type of changes to the General Agreements of Indemnity. In addition, not all contractors will be considered credit worthy for such changes to the bond forms. Remember that the principal and obligee both have contractual rights which need to be taken into consideration when discussing such changes to a century-old product with established case law. Lastly, the vast majority of bonds purchased are done so due to legislation that requires owners to buy bonds to protect taxpayers' interests—how do we get the private sector to embrace the surety product when they haven't been satisfied with how it responds? How do we keep public buyers from finding ways to protect taxpayers' interests with alternatives to bonds?

Susan Hecker
Senior Vice President
Gallagher Construction Services
San Francisco, CA

Business in transition with lack of strong and visionary leadership is the most challenging issue I see facing our industry today. Regardless of our "business," we face very similar issues in our industry whether we are contractors, surety and insurance carriers, reinsurance companies, or brokerage firms specializing in construction.

Business owners and stockholders must run their companies with guiding principles, such as honesty, integrity, and trust. Lead by example. What you do is more important than what you say.

We need more talented people entering our collective business. For whatever reason, the construction and insurance industries aren't considered "sexy" enough for an economy driven by the "dot-comers" of the world. If we can make investments of both money and time in the students of the world, we can change that perception.

During the 1990's and the year 2000, during a spectacular overall business economy, while many companies made money and were very successful, we saw many others get overextended because they took on too much work, elevated people beyond their experience and ability, and failed to reinvest enough of their profits to sustain their future and move the firm to the next level. Margins did not rise with the amount of commensurate work available. If companies couldn't make it during that spectacular period of business growth and economic development, how can they expect to make it during a down market cycle? Learn from the mistakes of others. Be informed.

Many companies took on too many changes at once … without taking the time to digest them one at a time and make adjustments when required. Unfortunately, others stuck their heads in the sand instead of using technology or creative thinking to redefine their product to make it better and ensure its future. Other companies are loaded with "dead wood" just trying to get by until retirement. Tackle the tough decisions. Do it now.

Many of today's companies face generational issues, whether they are an insurance agency owned by individuals in their 50's with no exit strategy trying to figure out whether to sell out to a regional or national broker … or a second- or third-generation construction company founded after World War II now floundering because the second and third generation doesn't have the vision or the entrepreneurial spirit of its founder. Plan for your company's future. Develop a strategic and collaborative business perpetuation plan and implement it earlier than you believe necessary. Get buy-in. Provide career path opportunity. Be a mentor.

In conclusion, many of us lack balance between our personal and professional lives. Our days are action oriented and full leaving little time for the kind of coaching and strategic thinking that needs to take place in our industry. If we are to be successful in taking the steps to move our industry successfully into tomorrow, we must find the time today to do more than put out fires. Visionary leaders … it is time to step up.

- Provide the vision
- With input, write the business plan
- Monitor the results
- Challenge and champion your staff
- Set the bar high with your example
- Find the talent and create the opportunity
- Identify the obstacles and formulate plans to overcome them
- Be a cheerleader
- Anticipate the issues and have a fallback plan
- Get input and feedback
- Lead the celebration of your success

Martin R. Brady
Director, Credit & Surety Dept.
Member, Senior Management
Swiss Reinsurance America
Corporation
Armonk, NY

In 2000, the surety industry entered a new surety loss cycle with an increasing loss severity that continues to date. Historically, surety loss cycles average 3 to 4 years and occur about every 10 years, with the last being 1984 thru 1987. Indications are that the present cycle will not end until sometime in 2003. Inevitably, this will result in reduced surety capacity, tougher underwriting standards and higher product pricing. Exacerbating the problem has been a serious erosion in the historic profitability of the commercial surety area, which in the past tempered some the pain of contract surety problems.

As noted above, one of the foremost challenges facing the industry is the return to profitability for a product line that is underwritten to a zero loss assumption.

Other areas of concern are:

- Exposure aggregation issues on large contractor accounts and commercial surety users.
- Onerous contract/warranty terms that substantially expand contractor and surety exposure.
- Insurance and surety industry consolidations and mergers resulting in a reducing number of surety providers, possibly impairing ready access of surety credit availability.
- Increased reinsurance cost and availability with tougher treaty terms and conditions.
- Better balanced product pricing reflecting present loss experience and the increasing cost of capital.

James Rudnik
Vice President Surety Counsel
Liberty Bond Services
Plymouth Meeting, PA

Notes

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SURETY INDUSTRY ADDRESSES INCREASES IN SURETY LOSSES[1]

by Lynn M. Schubert
The Surety Association of America

On the whole, the surety industry is very well capitalized and financially sound. Periodically sureties incur greater or lesser losses based on a number of factors. To understand just how and why losses increase or decrease, you must understand that the concept behind surety bonds is to prevent losses, both for the obligees and the sureties themselves. As you will see by the statistics cited in this article, the success of sureties in this effort varies from year to year. However, the theory remains valid and one that anyone using surety bonds should understand.

Surety underwriters pride themselves on their underwriting abilities, that is, to write bonds only for contractors who pass their prequalification regarding the contractor's ability to perform the project. This prequalification process involves an extensive review of a contractor's business, both financially and substantively. Does the contractor have experienced people on board who can perform the work? Is the contractor financially capable of continuing work if pay requests are delayed on the project? Has the contractor ever performed this type of work before in this general geographic area?

While the surety evaluates many different issues to determine whether or not the contractor, in the surety's judgment, is likely to perform, a surety cannot predict with 100 percent accuracy. That is why sureties, as an industry, always have losses.

The Premise Behind Surety Bonds

As mentioned above, it is important when talking about losses in the surety industry to understand the premise behind surety bonds. Most insurance policies anticipate losses. An insurer expects losses from fortuitous events and charges a sufficient premium to pay for them and still make a reasonable profit. The insurer uses premiums to pay losses rather than to prevent defaults.

A surety, on the other hand, tries to avoid losses by prequalifying the contractor and, if cost effective, when problems do occur, financing it to complete the work. Over 100 years of experience has taught sureties that the benefit from money spent to avoid loss is greater than from money used to pay losses after they happen. The delay and disruption from a contractor's default often will cost more than completion of the work. It always is better and less expensive to do something right the first time than to have to pay to do it over. That is why any move away from traditional surety underwriting ultimately has such a dramatic effect on results.

Why Construction Booms Lead to Greater Losses

Often, the precurser to increased losses actually is a boom in the economy. A booming construction market frequently leads to greater bonding lines and more capacity. During a boom, contractors' financials look good, more and more work is available, and it is easy to carry unprofitable jobs with payments from new projects. Sureties often are as susceptible to the belief that a boom will continue indefinitely and provide bonding credit beyond what their normal underwriting standards might suggest is prudent.

Certainly this occurred in the mid- to late-1990s. Although not all sureties fell prey to this philosophy, even the failures of a few extremely large contractors can affect the results of the surety industry as a whole.

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When a boom is followed by a slow down, surety losses ultimately increase. Fundamental is the principle that the principal on the bond is primarily liable and the surety is secondarily liable. If contractors begin to have financial difficulty and lose the ability to complete all of their bonded projects, sureties begin to step in the shoes of these contractors, paying subcontractors and suppliers who have performed on the project, and arranging and paying for completion of the project. Often, if a contractor gets to this point, it also is unable to repay the surety for moneys spent on its account. That is when surety losses begin to mount.

1999 Loss Results on Contract Surety Bonds

The results of the surety industry for 1999 begin to reflect losses caused by a combination of aggressive underwriting and the rumors of an impending economic downturn, among other factors. Moving toward the present, it should come as no surprise to anyone that contractors have felt the pain of the recent shift in the U.S. economy. This pain is reflected in the estimated surety results for the year 2000.

This article will address only the results in the contract surety line, in other words, bonds to guarantee construction projects. There are a host of other types of surety bonds called commercial bonds, such as license and permit bonds, tax bonds, customs bonds, etc. There also are bonds that insure against loss from employee dishonesty, called fidelity bonds.

The Surety Association of America (SAA) has statistics on premium volume and losses on all of these types of bonds. If you are interested in these areas, please feel free to e-mail me for information or log onto www.surety.org. This article, however, discusses only the statistics on contract surety bonds.

Due in large part to the strong economy, 1998 saw a decrease in loss ratios for contract surety. In 1999, however, loss ratios returned to the more normal numbers seen in 1997, and started their creep upward. The days of normal surety loss ratios, however, appear to be gone for the near future. Estimates of loss ratios for the year 2000 see the results spiraling upward significantly.

So, what are the recent results and what are the predictions?

The average annual amount of direct losses incurred for the contract surety industry for the five-year period 1995–1999 was $411 million per year, resulting in a 29.2 percent loss ratio to earned premium. The losses incurred and loss ratios for the latest available three years are:

Year	Direct Losses	Loss Ratio
1997	$403 million	28.2%
1998	$280 million	18.4%
1999	$422 million	26.3%

These figures reflect the consolidated results of all companies that report surety data to SAA for the United States, which includes the 50 states, the District of Columbia, and Puerto Rico.

SAA data generally is available in late-third quarter for the prior calendar year. At this time we currently are processing data for the year 2000. However, our projection of incurred losses for the year 2000 based on a survey of companies is approximately $865 million with a projected loss ratio of 52.5 percent.

This increase in loss ratios already is affecting the surety industry. A few reinsurers (insurance companies which insure losses of other insurance companies) have determined that they no longer are interested in writing reinsurance for the surety line of business. The majority remaining have increased the pricing and limited the terms of reinsurance for many of their customers, the primary sureties.

These primary sureties also are beginning to make some changes. Existing accounts are receiving stricter scrutiny of their proposals for increased bonding capacity or expansions to new geographic areas or types of construction. New account proposals are receiving stricter scrutiny during all phases of the prequalification process. Some of the fundamental requirements for receiving surety bonds in the historical past, such as personal indemnity agreements signed by the principals of the construction company, are being reinstituted by many sureties who moved away from the fundamentals during the boom.

Surety credit still is readily available, and competition still is fierce for qualified contractors. The surety industry has more than enough capacity to provide surety bonds to protect taxpayers on public works projects as well as private owners and developers.

The Top 20 Surety Writers

The following is a chart of the top 20 surety writers in the year 2000 showing premiums and losses, followed by a similar list for the year 1999. These charts are for all surety products combined, not just contract surety, and are compiled from the SAA List of Top 100 Writers and the SAA List of Top 50 Writers.

Calendar Year 2000 Surety Results (Dollar Amounts in Thousands)	Direct Premium Written	Direct Premium Earned	Direct Losses Incurred	Direct Loss Ratio
Travelers Property Casualty Corporation (includes Reliance Insurance Companies)	388,872	386,120	105,063	27.2
The St. Paul Companies	387,649	377,219	202,777	53.8
CNA Surety Corporation	285,528	277,477	19,383	7.0
Zurich Group	206,922	226,276	82,468	36.4
American International Group	160,025	149,273	161,294	108.1
Liberty Mutual Group	141,603	134,875	69,925	51.8
ACE USA Group	125,781	125,870	87,876	69.8
Safeco Insurance Companies	124,739	117,067	51,972	44.4
Chubb Group of Insurance Companies	120,138	103,244	62,478	60.5
Fireman's Fund Insurance Companies	106,144	103,199	34,797	33.7
Amwest Insurance Group	105,390	108,737	70,037	64.4
Kemper Insurance Companies	99,266	85,024	55,837	65.7
The Hartford Insurance Group	87,974	80,414	30,076	37.4
Seneca Insurance Company, Inc.	63,854	62,396	38,312	61.4
Frontier Insurance Group	58,316	93,928	98,355	104.7
Great American Insurance Companies	53,880	46,563	10,946	23.5
NAS Surety Group	53,146	52,071	16,647	32.0
RLI Insurance Company	37,782	31,216	12,568	40.3
International Fidelity Insurance Company	34,895	34,611	16,687	48.2
Ohio Casualty Group	32,901	32,793	3,770	11.5

Workshop C

Calendar Year 1999 Surety Results (Dollar Amounts in Thousands)	Direct Premium Written	Direct Premium Earned	Direct Losses Incurred	Direct Loss Ratio
The St. Paul Companies	364,931	346,898	127,052	36.6
Zurich Group	294,547	212,278	47,843	22.5
CNA Surety Corporation	272,459	264,246	34,665	13.1
Reliance Insurance Companies	227,912	218,705	62,104	28.4
American International Group	157,470	146,027	63,047	43.2
Travelers Property Casualty Corporation	152,609	151,545	10,181	6.7
Liberty Mutual Group	139,669	119,991	49,178	41.0
Frontier Insurance Group	116,703	99,126	31,567	31.8
Chubb Group of Insurance Companies	112,556	99,232	28,691	28.9
Fireman's Fund Insurance Companies	109,756	103,099	15,621	15.2
Safeco Insurance Companies	109,305	108,781	24,040	22.1
Amwest Insurance Group	106,233	104,177	37,461	36.0
The Hartford Insurance Group	74,147	75,555	38,236	50.6
Kemper Insurance Companies	73,993	61,810	17,200	27.8
Seneca Insurance Company, Inc.	50,411	47,166	30,247	64.1
Great American Insurance Companies	46,686	49,037	8,060	16.4
Washington International Insurance Company	35,481	35,811	15,468	43.2
Ohio Casualty Group	32,911	31,499	2,090	6.6
Bankers Insurance Group	31,899	31,502	737	2.3
CGU Group	31,627	30,065	6,873	22.9

You will notice significant changes between these lists. Expect more in 2001. The chart for 2001 no longer will show either Amwest or Frontier. Amwest (excluding its bail bond company Far West) has been put into liquidation by the Nebraska Department of Insurance. Frontier no longer is writing new surety bonds. The Reliance surety operation was purchased in 2000 by Travelers and no longer appears individually on the list of Top 100 Surety Writers. The parent company, Reliance Insurance Companies, currently is in receivership.

On the other hand, insurance companies continue to enter the surety field. There always will be changes in the makeup of any list of top writers of any line of insurance. Companies, of course, make decisions based on the current profitability of a line, but also make decisions based on other overall company strategies.

Conclusion

The surety industry as a whole remains financially strong and viable, and committed to providing protection to construction owners and developers. The changes in underwriting that are beginning to occur should help the surety industry overall return to more normal loss ratios in the future. Most sureties are well-capitalized, well-run corporations on which you can rely to secure your projects.

If you have any questions about a surety bond provided to you by a contractor, check the Bond Authenticity Program—Obligees' Guide in the surety section of www.surety.org. Be sure that all bonds provided by your contractors are authentic, and that all sureties provided by your contractors are financially sound and will be available if a claim needs to be made on the bond.

The SAA has more detailed statistical data available for both the surety and fidelity lines for purchase. If you would like to review what is available, log onto www.surety.org, or e-mail Sean Foley at sfoley@surety.org.