TOUGH TIMES IN THE SURETY INDUSTRY

Presented by

Mark Munekawa
Surety Manager
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Workshop C

After a decade of stable pricing and consistent profitability, the surety industry has been hit with a spike in losses. Although some of the major losses have occurred outside the construction industry, the construction bond market is feeling the effects of a hard market in surety—more restrictive underwriting practices, increased rates, and tightening credit conditions. Large contractors and jumbo projects are faced with capacity limitations from many of the large national surety companies. Smaller subcontractors are faced with increasingly restrictive underwriting guidelines and fewer sureties specializing in the small contractor market. When bond underwriters have to allocate their capacity, clearly the contractors with whom they have the strongest and most favorable relationships will be those they want to retain. This session will discuss some of the key events that have brought the surety market to this point, outline the probable impact on both contractors and owners, and provide tactics that contractors and their insurance and bonding representatives can utilize to strengthen their relationship with their surety underwriters.

Tuesday, November 12, 2002

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Mr. Munekawa is presenting Workshop C, "Tough Times in the Surety Industry." He is the surety manager for Woodruff-Sawyer & Co., located in San Francisco, one of the largest independent insurance brokers in the nation. Woodruff-Sawyer is an active partner in Assurex Global, the third largest insurance brokerage in the world.

He is responsible for managing surety relationships for the firm's construction clients, including new client acquisitions, customer servicing, and underwriting analysis.

Prior to joining Woodruff-Sawyer & Co., Mr. Munekawa spent 22 years as a surety underwriter. Most recently he has held regional management positions with Great American Insurance, Ulico Casualty, and Hartford Insurance.

Mark received his undergraduate (B.A., economics) and graduate (M.B.A.) degrees from San Francisco State University. He is an active member in the Northern California Surety Association and the National Association of Surety Bond Producers.

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TOUGH TIMES IN THE SURETY INDUSTRY

Mark Munekawa
Woodruff-Sawyer & Co.

I. INTRODUCTION

A. Recent visibility of the surety business

B. Current issues relating to losses and economic slowdown

C. Introduction to the presentation

1. Review of suretyship
2. Discuss what events and trends caused the changes in the surety market
3. Outline the impact will these changes have on the construction community in general, and your company in particular
4. Strategize a plan should you put in place to strengthen your surety relationship

II. SURETY BONDS

A. Surety definitions

B. Surety underwriting process

C. Benefits of surety bonds

III. CHANGES IN THE SURETY MARKET

A. Cyclical characteristic of industry

B. Surety Results

1. In the ten-year period from 1990 to 1999, total surety premium increased from $1.8 billion to $3.3 billion—an average annual growth rate of 8 percent
2. Sureties aggressively worked to increase market share in a growing, profitable market.

C. Hard Market

1. Late in 1999, the current "hard market" phase of the cycle started.
2. The loss ratio grew as the economy began to slow.

D. Reinsurance Issues

1. Exacerbating this problem is the tightening of the reinsurance market.
2. Reinsurers (surety company's insurers) have started to increase the cost of reinsurance, negotiated restrictive agreements and reduced capacity.

E. Market Concentration

1. One outcome from the reduced profitability of the surety line of insurance business is a reduction in overall capacity as characterized by the departure of a number of surety companies
2. It is generally recognized that we are now in the hard market phase of the industry cycle.

IV. IMPACT ON THE CONSTRUCTION COMMUNITY

A. More restrictive credit policies

B. Prequalification Value of Surety Bonds

C. Changes in the underwriting practices

1. Credit Restrictions (financial analysis related)
2. Indemnity
3. Rates
4. Financial Information

D. Other effects on the construction community

1. Subcontractor Bonding.
2. Quality of bonding companies
3. Bond forms and contract wording
4. Availability of credit

V. MANAGING YOUR SURETY RELATIONSHIP

A. What capacity is available within the Surety industry?

B. Directing your Surety relationship

1. Establish a rapport with the surety.
2. Evaluate your banking relationship.
3. Communicate financial progress throughout the year.
4. Monitor liquidity and practice debt management.

VI. FINAL COMMENTS

A. During the hard market phase of the industry cycle, managing your surety relationship will pay dividends.

B. The surety industry is not going about their business in a fundamentally different manner.

C. Understand market forces

D. Recognize the "risk/reward" equation of the Surety

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TOUGH TIMES IN THE SURETY INDUSTRY

Challenges, Opportunities, and Strategies for Developing a Long-Term Surety Relationship

Surety Definitions

- **Surety Bond**—an instrument under which one party ("Surety") guarantees to another ("Obligee") that a third ("Principal") will perform in accordance with an underlying contract.
    - The rights and obligations of each party are documented in the underlying contract. Bonds often state that the contract is attached hereto and made a part thereof …
- **Bid Bond**—provides financial assurance that the bid has been submitted in good faith and that the contractor intends to enter into the contract at the price bid and provide the required performance and payment bonds.
    - A Bid Bond is in an amount that is a percentage of the amount bid (usually 10% or 20% of the total amount bid).
    - Bid Bonds do not obligate the Surety that writes the Bid Bond to provide the Performance and Payment Bonds.
- **Performance Bond**—protects the Obligee from financial loss should the contractor fail to perform the contract in accordance with the terms and conditions of the contract documents.
- **Payment Bond**—guarantees that the contractor will pay certain subcontractors, laborers, and material suppliers associated with the project.
    - Protects claimants who have statutory lien rights.
    - On projects where lien rights are not available, often the main source of protection for subcontractors and suppliers.

The Surety Underwriting Process

- **Prequalification**—An in-depth look at the contractor's entire business operations to determine its ability to meet current & future obligations. Once a Surety relationship is established, the prequalification process continues through regular financial updates and discussions/approvals of individual projects.
    - Capacity to perform—an examination of the contractor's track record to determine the capabilities of an organization to estimate, construct, manage and monitor both a specific individual project and a backlog of projects.
        - Review of completed projects. The Surety identifies the type of work , the degree of success and the financial performance of individual projects that make up the contractor's work experience.
        - Background and expertise of owners and key employees.

- Financial strength—mostly a focus on profitability, liquidity and equity from analysis of current and past financial statements, supplemented by a review of other credit information.
    - Profitability—gross profit margins, overhead ratios and individual job profitability tracking.
    - Liquidity—working capital, cash flow, underbillings vs. overbillings, credit history and bank line usage
    - Equity—net worth, debt ratio and the contractor's financial risk appetite.
- Organizational strength—a review of the structure, systems and people who generate the financial results.
    - Who are the individuals responsible for the key functional areas of estimating, operations, field management and accounting?
    - Does the organization's strengths match its business plan?
    - Depth of management—Experience, demonstrated expertise beyond the first level of ownership/management.
- All projects in progress
    - Review of current job schedules. Identifies the projects, owners, geographic territories and contract terms (fixed-price vs. cost-plus) that is characteristic of the contractor's work portfolio.
    - Trending of projects for profit. A comparison over time of individual job profitability to assess the contractor's ability to manage projects to meet profit estimates.

- **Indemnification**—Through a General Agreement of Indemnity, the contractor and all other signatories to the agreement indemnify the Surety for losses.
    - The indemnity agreement indemnifies the Surety for all losses and expenses incurred by the Surety by reason of executing any Bond or incurred by the Surety due to a default under the agreement.
    - Used to secure indemnity of company owners (and spouses), affiliated entities such as equipment companies, real estate partnerships and LLC's.

- **Work Program**—The limitations ($ and otherwise). Often annually-reviewed lines of authority establish surety limits by size of any single project and the total amount of costs-to-complete the contractor can carry at any one time. Requests outside of these limits are reviewed on a case-by-case basis.
    - General parameters. Does not limit consideration for exceptions, usually by size, but often scope of work or geographic location.
    - Beyond the written line (usually extended to the broker), there needs to be a discussion between all parties to discuss the surety's ability to support a contractor's business plans.

- **Surety Program Management**—Quarterly financial updates, review of project specifications, tax planning (surety credit vs. tax consequences), continuity planning and business planning.
    - Sureties look to monitor financial performance on an interim basis.
        - The contractor's ability to generate meaningful information used to actively manage its operation provides the surety with indication of the quality of the contractor's financial management system.
    - Balancing tax considerations with an outside creditor's need for capital requires an understanding of impact of capital withdrawals through dividends, distributions, bonuses, pension plan contributions, etc.

The Benefits of Surety Bonds

- **Prequalification**—From the Obligee's perspective, the contractor's ability to provide a Surety Bond is an indication of an outside party (Surety) assessing the contractor's entire organization and determining that the contractor is qualified for the project in question.
- **Unseen Services—**to avoid a default, the Surety may provide support to the Principal that is in the best interest of the Principal, Surety and Obligee.
    - Trained personnel—in addition to claims investigators, accounting, engineering and construction consultants.
    - Provide payment to subcontractors and suppliers
    - Provide financial assistance—in each case, the surety assists the contractor to meet its financial obligations, allowing the contractor to continue its performance on the project.
        - This triggers the Principal's indemnification to the Surety via the indemnity agreement.
- **Claims**
    - The Surety may act on behalf of the contractor only after the contractor is declared in default.
    - Investigation—the Surety will review the contract, all records and documentation and the position of both the Principal and Obligee.
    - Claims Options
        - Retain original contractor
            - Decision made to extend financial support
        - Re-bid project for completion
        - Arrange for completion contractor
        - Financial payment

Changes in the Surety Market

- **Trends—**The surety industry is cyclical in nature. Since the early '90s, the surety industry has been the beneficiary of a number of factors that have resulted in a "soft" market for most of the '90s. Late 1999 started the hardening trend that we have been experience since then

- **Surety Underwriting Cycle**
    - Generally lags the property-casualty insurance cycle
    - Most recent soft market stated in the early 1990s
    - Hard market started in 1999–2000

- **The Soft Market—**During most of the '90s, up until 1999, the industry was characterized by growing revenues and profits. This increased competition and reduced underwriting standards.
    - Strong, growing economy
    - Overall strength of the construction industry
        - Low failure rates and ample opportunities for most segments and geographic markets.
    - Growth and profitability in the Surety Industry
        - Average annual growth rate of 8%. Total industry Written Premium grew from $1.8 Billion in 1990 to $3.3 Billion in 1999.
        - Average industry loss ratio of 25.7% in the '90's. Surety departments continued to provide consistent profitability to the overall insurance organizations.
        - Access to capital
            - Some merger and acquisition activity. Major Sureties sought to expand their market share through acquisitions and mergers.
            - New entrants into the market, mostly regional and specialty players. In the soft market, markets for emerging contractors and subcontractors provided additional capacity for this segment of the market.
    - Expansion of Commercial Surety
        - This segment of the market grew from $536 million in 1990 to $802 million in 1999 with annual loss ratios averaging 17%. Most of this business was non-contract with large obligations guaranteed for national and multinational publicly-traded "large cap" companies.
        - Expectation that Commercial Surety would continue to provide consistency in profitability to offset some of the volatility of the Contract Surety line of business.

- Competition on rate and capacity.
    - Excess capacity in the industry combined with the growth initiatives by a number of Sureties resulted in the Surety line of business becoming a commodity business.
    - Rate competition was prevalent
    - Larger work programs, leveraging the contractor's financial wherewithal.
    - Reduction in indemnity requirements. Release of personal indemnity for the higher quality credit risks.
- Reduced underwriting standards**.** As Surety credit became more available, the value of "prequalification" provided by Surety Bonds was diminished.
    - Subcontractor default insurance and prequalification requirements by some public entities become more visible in the '90s.
    - In California, more public school districts are imposing prequalification requirements in addition to Surety Bonds.

- **The Hard Market—**Starting in late 1999, various factors resulted in a swing towards a difficult environment throughout the surety industry.
    - An overall slowdown in the economy—the effect of the overall slowdown in the market resulted in both slower revenue growth for the Surety industry and increase in losses.
    - Increase in loss ratios
        - 2001 industry total loss ratio was 82.5% and 45.9% in 2000 compared to an average of 26% in the 1990s. This moved a number of major Sureties and the industry as a whole into an unprofitable mode.
    - Commercial Surety losses impact Contract Surety. These losses affected most of the major Contract Surety underwriters, both reducing the overall industry's profitability and adversely affecting their reinsurers.
        - Dot-com bubble burst and well-publicized business failures in technology, communications and energy industries have had a cumulative impact on primary Sureties and their reinsurers.
        - Enron, …
    - Surety executives are under pressure to return their departments to their expected place as a stable profit contributor to the overall insurance organization.
    - Market Concentration. One result of the recent reduced profitability and the mergers and acquisitions of the '90s is a reduction in capacity characterized by the departure of key markets.
        - Three of the top 12 Sureties (representing $454 million in Written Premium) are no longer in the business, either through acquisition, merger or bankruptcy.
            - This is in contrast to the 1990s when the industry saw a number of new entrants into the market.

        - The 10 largest Sureties represented 47% of the total industry's Written Premium in 1990. In 2001, the 10 largest Sureties represented 65%.

        - The 5 largest Sureties represented 27% of industry revenue in 1990 compared to 45% in 2001.

    - Hardening of the Surety reinsurance industry

        - Exacerbating the difficult market conditions is the tightening of the Surety reinsurance market.

            - As with the primary companies, Surety reinsurers operate in a specialized industry.

            - The number of active reinsurers have been reduced.

            - The cost of reinsurance has increased substantially. Primary Sureties are passing part of this increase through to contractors, one reason for the increase in rates.

        - Reinsurance treaties have been renegotiated. Primary Sureties are required to take a larger share of each risk.

        - For larger cases, reinsurers are more actively imposing their underwriting criteria on the primary Sureties.

        - Reinsurance capacity restrictions have already caused some Sureties to restrict their risk on any individual contractor or project.

Impact on the Construction Community

- **Changes in Contract Surety**—With the changes in the Surety industry, underwriting is becoming more difficult and capacity restrictions are becoming more prevalent

    - Sureties look to quickly return the line of business to profitability. In addition, Sureties have implemented strategies to reduce potential negative impact to their balance sheets.

    - Although Contract Surety remains the larger and more visible line of business, it has been impacted by Commercial Surety losses and the impact on reinsurance.

    - Prequalification value of Surety Bonds increase in a hard market.

        - As market conditions harden, access to surety bonding becomes more difficult—those who have strong surety relationships can differentiate themselves from lesser credit-quality competitors.

        - In the '90s, many contractors were able to secure bonding capacity beyond their financial strength and construction experience—this is one factor that lead to the increase in industry losses.

- **Surety Credit Restrictions**—Sureties again are establishing bonding capacity more in line with the financial position of the contractor.

    - Aggregate limits (allowed costs-to-complete) will be more closely tied to the contractor's financial position, especially working capital.

    - Character assessment remains an important ingredient, but sureties are being forced to make decisions based more on quantitative measures.

- **Indemnity**—Beyond indemnification of the contractor, Sureties again are looking to strengthen indemnification from additional indemnitors.
  - Personal indemnity was being released in stronger cases during the soft market. In some cases, personal indemnity has again been required.
    - If a contractor is required to change Sureties in a hard market, personal indemnity may be added as a condition.
  - Related-party indemnity. Securing the indemnity of real estate partnerships, LLC's, equipment companies and other affiliates may be added to strengthen indemnification to the surety
  - To the contractor's benefit this may provide the Surety with tools to extend additional Surety credit.
- **Rates**—In theory, Surety premiums are a fee for the surety's underwriting. Sound underwriting should not result in a loss to the surety.
  - Rates have increased starting in 2001. This is has been for first industry-wide increase since the late '80s.
    - Rates are still relatively low—between 1% - 2% of contract value.
    - Rates have been increased across-the-board by some sureties, others have been selective in the increases based on credit quality.
- **Financial Reporting—**As Sureties focus more on quantitative measures, more weight is given to the quality of the financial information.
  - Timeliness of financial information has again become more stringent.
    - In the soft market, this is one area where underwriting conditions were relaxed.
    - A return to 90-120 days for year-end financial reporting.
  - Full disclosure in accordance with AICPA and construction industry guidelines is again an important component of the surety underwriting process.
  - Even prior to the recent "accounting scandals" Sureties have been focused on the quality of the CPA firm preparing the fiscal year end financial statements. More confidence in the financial information is given to CPA's who are known to the Surety industry.
  - Greater underwriting scrutiny of accounts receivable and underbillings.
    - As more importance is placed on working capital in determining a surety program, the analysis of old (over 90 days) receivables, receivables in dispute and underbillings can directly impact the amount of available surety credit to the contractor.
    - Reflects concern by underwriters over financial pressure on property owners, developers and lending institutions.

- Overhead and breakeven analysis.
    - Sureties are looking at fixed overhead (operational and financial) in a market that could result in lower revenues.
    - Does the contractor have adequate backlog to cover overhead?
- Gross Profit Trending
    - One reason for the requirement of job schedules (jobs-in-progress and completed jobs) is trending of profitability of individual projects.
        - Gives the Surety a quantitative measure of the contractor's estimating and field management capabilities.
- Financial Forecasting and Planning—As market continues to tighten, Sureties expect that the contractor utilizes financial forecast (revenues, backlog, cash flow).
    - Sureties look to determine breakeven, adequacy of backlog
    - As important is conveying to the Surety that the contractor has the business management and planning aspects of the organization.

- **Bond Form Language—**During this stage of the market, it becomes more important to review bond form language.
    - More so on private projects, bond forms look to transfer more risk to the contractor.
        - For the contractor's benefit, the Surety will be reluctant to approve bond language that extends liability.
    - Multiple Obligees added to the Performance Bond has become more prevalent as lenders seek additional protection on financed projects.
        - Adding Obligees, usually lenders, to the Bond extends benefits to parties that are not parties to the underlying contract.
        - Using Dual Obligee or Multiple Obligees rider is for the protection of the contractor. The rider accomplishes two goals:
            - Eliminates the possibility of the bond penalty being multiplied due to the increase in the number of Obligees.
            - States that obligations of the owner, the usual sole Obligee on the Bond, extend to the additional Obligees who have not entered into a contract with the contractor that outlines responsibilities to the contractor.

- **Surety Industry Capacity and Capabilities—**Industry capacity, in total and by individual companies, has been impacted during the recent trends.
    - The availability of credit for "mega" projects and "jumbo' contractors is limited, requiring co-surety arrangements with two or more Sureties.
    - Subcontractor Bonding can become problematic for prime contractors (Obligees on Bonds required of subcontractors).

- More restrictive underwriting has impacted the ability to secure Surety credit for smaller trade subcontractors.
  - Prime contractors need to be more cognizant of Sureties and bond forms used by smaller subcontractors.
- The "T-List" (Federal Treasury's list of acceptable Sureties for federal projects and their underwriting limitations) and A. M. Best's ratings are two means to underwrite the Surety's quality and capacity.

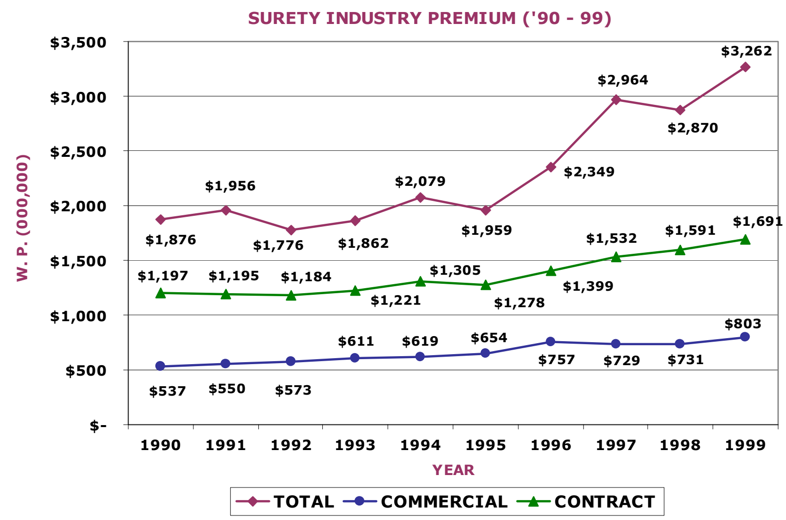
Managing Your Surety Relationship

- **The Objective**—the objective, opportunity and benefit of your Surety relationship shouldn't change with market conditions.
  - Your goal is to develop a Surety relationship with your broker and surety company that will support your business plan. With the assistance of your broker, translate your business plan into the amount and nature of surety support you need to meet your business goals.
    - Ideally, your Surety is an asset to your organization, not an obstacle.
- **Is capacity available to support your business plan?**
  - The issue is how the industry utilizes its available capacity. For the majority of contractors and projects, there is adequate capacity within the industry.
  - A broker's key role is to select the Surety whose underwriting philosophy is in line with the contractor's business strategies.
  - The Surety's decision is whether the risk of a particular contractor or project meets their risk profile.
- **Establish a rapport with your Surety —**In the absence of information in a hard market, Sureties will err on the side of conservatism.
  - Sureties are requiring more information on a frequent basis. Establish the parameters up front, prior to an imminent bond need.
    - Surety underwriting requirements can be incorporated in to a contractor's financial accounting system.
      - In absence of a constructive dialogue, requests for underwriting information may appear random.
- **Utilize your broker to monitor market conditions—**brokers who are active in the Surety industry are aware of industry trends.
  - In a hard market, some underwriting decisions may be made more in response to corporate strategies than the credit quality of the contractor.
  - Understanding the Surety's key issues allows the contractor to develop a strategy to meet underwriting guidelines within parameters of the contractor's business plan.

- **Monitor liquidity and practice debt management**
  - As underwriting decisions are becoming more quantitative, a clean balance sheet can allow the contractor to leverage its financial strength to a greater extent.
    - Shareholder receivables, intangible assets, excess interest-bearing debt can distract from what would be a good story.
  - Fiscal year end financial statements remain the most utilized means for conveying the financial success and wherewithal
    - Year-end planning for Surety purposes should occur in the same manner as year-end tax planning.
- **Analyze the risk profile of your projects.**
  - Bonding capacity on the aggregate level (costs-to-complete for all jobs in progress) may overstate the risk incurred by the Surety
  - A backlog composition that includes cost-plus contracts vs. all fixed-priced contracts can be viewed as lesser risk.
    - This requires that the Surety understands the contractor's business plans and the impact on financial risk.
    - Backlog and marketing plans need to be analyzed by the of contract, method of acquisitions, type of owner, etc.
  - Subcontractor prequalification, through the use of subcontractor bonds or other means, can be viewed as another mechanism that reduces the risk to the contractor, and therefore the Surety.
- **Communicate your financial progress throughout the year**
  - Interim financial information on either a quarterly or semiannual basis is being increasing required.
    - Sureties are looking for profitability trends and changes in liquidity from underbillings and receivables quality.
    - This requires that the information be conveyed so that seasonal or cyclical trends do not override the more important long-term trends that reflect the overall stability and profitability of an organization.
- **Evaluate your banking relationship**
  - Sureties are looking to see that the contractor has access to capital.
  - Even with a strong balance sheet, Sureties need to see that the contractor has the resources to sustain itself through a bad job, slow receivable or litigation.

Summary

- **The hard market conditions increase the need to manage your Surety relationship.**
    - For the successful and well-managed contractor, there may not be any change in the process.
        - Capacity issues for the "jumbo" contractors may mean a change in the structure of Surety credit.
        - The hard market can be advantageous to contractors with secure, well-established Surety support.
- **The Surety industry is not approaching its business in a fundamentally different manner.**
    - More stringent implementation of underwriting guidelines is returning the underwriting environment to the state of the market prior to the early '90's.
    - More attention is again given to financial indicators to assess credit quality.
    - The drive for market share has been tempered by the need to return this line of business to profitability.
- **Recognize the risk/reward equation of the Surety.**
    - Surety underwriting has similar characteristics to bank lending.
    - Sureties are creditors, not investors. They do not directly share in the upside of incurring additional risk.
        - Surety is a regulated insurance line of business. Premium rates are regulated and relatively fixed.
        - Given the cap on rewards, Sureties seek to quantify and manage the downside risk from extending Surety credit. In a hard market, the underwriting process becomes more stringent to reduce risk in a more adverse operating environment.
    - On a macro level, Sureties look to spread risk, reducing their exposure to their balance sheet. This has become more challenging in light of the hardening reinsurance market.
    - On an account level, Sureties are managing risk by reintroducing strict credit guidelines, securing proper levels of indemnification and relating individual project approvals to established experience levels.
- **Turn the challenge of the current market conditions into an opportunity to reassess your Surety relationship and develop a strategy to leverage your bondability.**
    - Understand the state of the industry and its effect on your business. Utilize your broker to stay current on market conditions.
    - Determine if your business plan is supported by your Surety relationship.
    - Formulate a strategy to keep your Surety informed and supportive of your operations.



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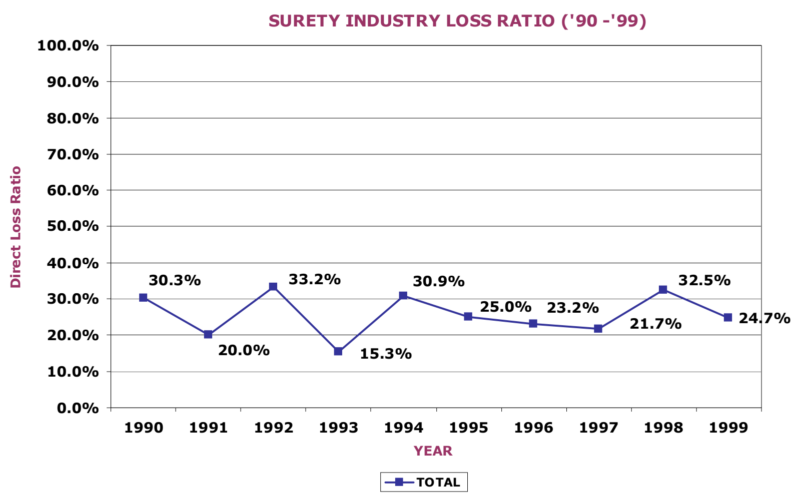

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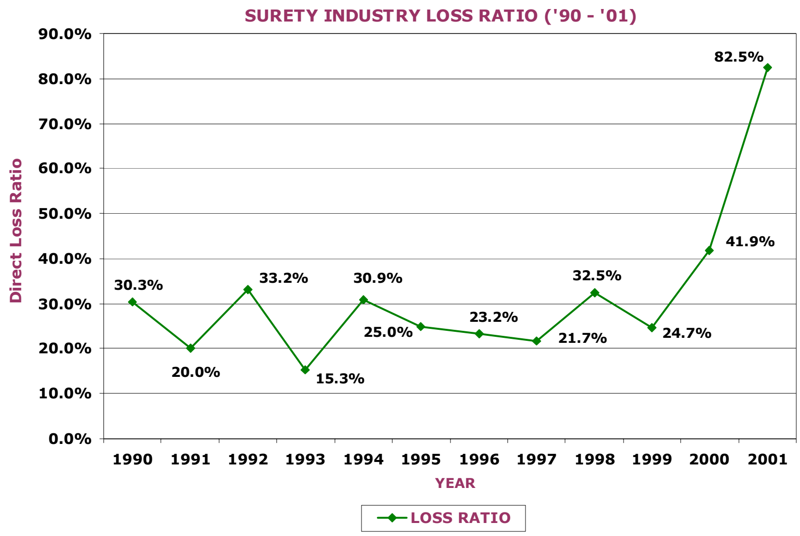

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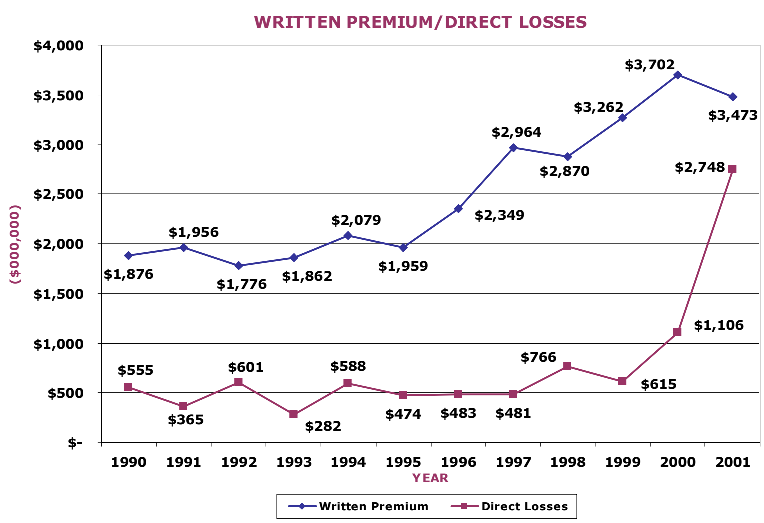

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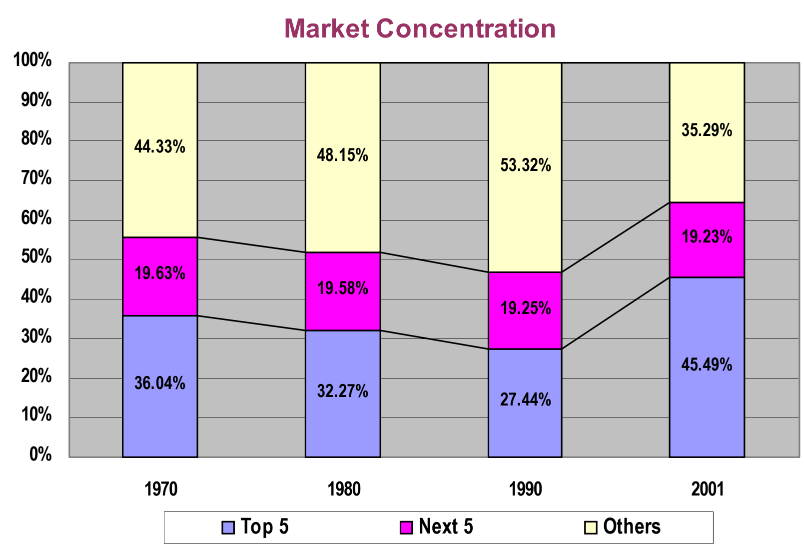
Ten Largest Writers - 2001

SURETY	W.P. (000,000)	DIRECT L. R.	% OF TOTAL
Travelers	$442.1	69.1%	12.8%
St. Paul	$375.6	56.8%	10.8%
CNA Surety	$304.9	87.4%	8.8%
Zurich	$268.6	43.3%	7.7%
AIG	$185.9	144.6%	5.3%
Safeco	$153.7	60.2%	4.4%
Liberty Mutual	$145.0	165.8%	4.2%
Chubb	$136.3	291.7%	3.9%
Fireman's Fund (now St. Paul)	$117.9	252.6%	3.4%
Hartford	$115.5	60.4%	3.3%
Ten Largest Writers	**$2,249.5**	**103.9%**	**64.7%**

Source: Surety Association of America



Source: Surety Association of America

Reinsurance Results

YEAR	REINSURANCE EARNED PREMIUM	REINSURANCE LOSS RATIO	PRIMARY COMPANY LOSS RATIO
1997	$228	52.5%	25.4%
1998	$296	53.0%	25.6%
1999	$237	94.9%	29.3%
2000	$335	214.0%	46.3%
2001	$428	274.3%	82.5%
TOTAL	**$1,524**	**157.0%**	**43.3%**

Source: Guy Carpenter & Company