FINANCIAL PERSPECTIVE

Financial conditions for contractors continued to improve in 2015, making the year another healthy and profitable one for the surety industry; however, some significant individual losses, coupled with significant changes among the insurers is making the outlook for 2016 more dynamic than in recent years. Even with public construction making a comeback from almost a decade of underinvestment, buyers of surety bonds will be in the driver's seat. That's good news for contractors looking to add capacity or improve conditions but it's worth noting that the construction industry has rarely benefitted from a soft surety market in the long run.

Based on premiums and losses recorded through September 30, 2015, the total loss ratio for all surety companies is forecast to be around 17.5 percent for the full year. That's the seventh year in the past ten that the industry's loss ratio was below 20 percent. The benchmark for profitability is 25 percent so sureties should have prospered again in 2015.

"In January my partners and I jump on a plane or hop in a car and visit every one of the insurers we represent. We go see the decision-makers, the policy-makers, even though they may have an office in Pittsburgh," notes Brian Jeffe, managing partner of surety bonds for agent Seubert Inc. "For the third year in a row the surety industry did well in 2015. [Surety] mirrors the construction industry. 2014 was better than 2015 and 2016 should be better than 2015. Losses are still well below 25 percent."

Much of the credit for the strong loss ratio performance goes to simple market improvements over the past five years. As volume has returned, contractors were able to land profitable work that enabled them to work through any weak projects with fewer defaults. Surety underwriters obviously deserve a share of the credit. Proactive during the wrenching downturn in 2009 and 2010, sureties avoided repeating many of the mistakes that plagued the industry during the 2002-2004 recovery. It also helped the insurance business in general that the years since the Great Recession have seen far fewer major disasters like those that occurred between 2001 and 2005.

The need to recover from losses like 9/11 and Hurricane Katrina pushed sales ahead of prudence. That was reflected in high premium growth, which spilled over into surety premiums and surety underwriting standards. By comparison, 2015 premiums were roughly $4.5 billion, down almost 20 percent from the heyday, and up about two percent from 2014. That means there is still plenty of excess capacity and room for growing premiums. Conditions in the general property and casualty insurance market are even softer, with even more appetite for premiums. That has made for a buyer's market.

"I've seen a couple of deals come through that surprised me in terms of rate and capacity, especially capacity," observes Jeff Ream, executive vice president for Willis of Pennsylvania. "The property and casualty market is relatively soft."

Still, few surety agents expect to see pressure for revenue impact underwriting. More to the point, the expected conditions for contractors should allow for growth even with the same underwriting standards.

"No one panicking to where they feel like they have to write everything," says Jeffe, pointing out that being in Pittsburgh is an attraction at the moment. "Sureties are coming to us, wanting to take advantage of a good construction market. They like Pittsburgh because sureties have seen very few big losses here over the years."

Although the industry is profitable overall and the outlook for publicly-bid work is positive, problems with several major insurers and consolidation among top insurers have caused turmoil among the sureties. There appears to be a yin and yang for every issue facing the industry but in general, surety bonding will be less predictable in 2016.

Among the factors impacting surety bonding is the continued fallout from a number of very large losses experienced in 2014 and 2015 from contracts awarded in 2010 and 2011. These losses caused the departure of XL Insurance from the surety market, taking with it $1 billion in capacity. Another of the industry's bigger players, Zurich North America, experienced large write downs in surety and losses in it Subguard subcontractor default insurance (SDI) product that have changed its approach to the marketplace. In fact, the competitive dynamics of the insurance companies are having a bigger impact on the surety market than the usual concerns about construction volume and contactor finances.

In the case of the SDI market, increased competition in recent years pushed the threshold lower for the size of contractors for which the SDI product made sense. SDI is purchased by the general contractor in lieu of having the project's subcontractors bonded individually. In the event of a subcontractor default, the general contractor files a claim with the SDI insurer, which then subrogates the claim to the subcontractor's insurance. The advantage of default insurance over a bond is that the contractor has access to the cash to complete the work without the delays of defending the bond claim.

SDI was originally aimed at companies doing $750 million or more, but SDI market competition created opportunities for pricing that worked for companies with annual volumes of $200 million to $300 million. SDI competition broadened the base of contractors who get feasibly get coverage and increased the opportunity for default. Moreover, the kinds of prequalification that general contractors applied to subs were different from the financial prequalification that an insurer would do. Contractors focus on performance and experience; sureties focus on balance sheet and financial benchmarks that would produce different red flags. As a result, claims rose.

As market leader, Zurich was hardest hit and has taken steps back to revise the product by changing the coverage, capping the limit on any loss. They are re-launching Subguard and going through a transition in the market.

Subcontractor default insurance is still attractive to general contractors, who can also profit by pocketing reserves for claim deductibles if they manage risk well. Jim Bly, managing director for Alliant Construction Services Group, says that Zurich's problems haven't diminished the demand for SDI.

"The good news is that there's a new SDI coming into the market through a [managing general underwriter] from California called Cove and Lloyd's is going to be the carrier," he explains. "They are coming into the market to fill the void or some of the void for business that Zurich couldn't renew or had problems with."

As the market leader, Zurich's problems were having a significant ripple effect throughout the SDI market. Initially Zurich's two other competitors, XL and Arch, were overwhelmed with requests for quotes from agents and effectively put a moratorium on new SDI business. That overreaction has settled down since then but Zurich's problems clearly created the opportunity for another carrier.

Because of the emphasis on prequalifying subcontractors, insuring against subcontractor default isn't going to decline. Bly says Alliant has a proprietary financial benchmarking service, called Contractor Credit Model (C2M) that uses the analytical tools that sureties use to qualify subs and risk rates them for the contractors, assigning capacity limits for single projects and total capacity.

“We’re getting a lot of interest in that. Sureties are the best at prequalifying subs in the market. That’s what they do; it’s all they do,” says Bly. “People are hungry for that. There are other services in the market that are emerging because all the underwriting with sub default has been pushed out to the general contractor or CM and they are not really equipped for it.”

In addition to XL’s exit from the surety market, there are several other competitive situations that are creating a frothier surety environment. The January 2016 merger of Chubb Corporation and ACE Ltd. created the fourth largest surety in the market, with $700 million in business written globally. Industry observers expect the merger to make Chubb more growth-oriented than in past, as evidenced by its increase in participation with one client to $5 billion, which was only the second instance of a single insurer at that volume.

“They’re going to get a mandate to grow and Chubb had a tendency to keep its powder really dry. That will be worth watching,” notes Bly.

The loss of XL’s capacity in the market will also likely be negligible because of inflows of new capital into the surety insurance sector. Unsatisfactory investment returns and poor performance in other markets is driving new money into surety in the hopes of boosting return on equity.

Global giant Allianz is entering the U.S. surety market through its Euler Hermes surety business, bringing $500 million in capacity per account. Tokyo Marine purchased HCC Surety Group to add to its U.S. surety business, which it serves with Philadelphia Insurance Group. The move makes the combined companies the equivalent of the sixth largest surety. Nationwide, which opened surety lines in 2014, is expecting to aggressively expand its business and offers $200 million in single-project capacity and $400 million aggregate capacity. Commercial surety companies have grown construction surety profitably and are expected to continue expanding capacity. Names like ARGO, Berkeley and One Beacon are each capable of adding $150 million in capacity.

Experienced surety professionals see the changes in competitive landscape as potential precursors to increased problems. Even without the new capital, utilization of surety capacity was inconsistent and less than potential. The addition of insurers that will immediately be among the ten largest sureties is likely to have some liberalizing of underwriting standards so that new capacity can be utilized. History has shown that such market dynamics can influence underwriting flexibility about pay on demand capacity, security and indemnification in the pursuit of market share.

“Stay tuned. Fasten your seat belt,” jokes Bly. “It’s still relatively soft but if anything, the needle is starting to move towards potentially hardening the market if the losses continue.”

At the Pittsburgh regional level, the biggest negative factor for surety bonding is the continued high level of competitive bidding. Prior to mid-2015 the bridge and highway market was mired in below average volumes for three or four years. School districts have been faced with slumping demographic support, political pressure against raising taxes and two separate moratoriums on the PlanCon process by two different governors. All of these factors have limited school construction volume. For more than a decade, both the city of Pittsburgh and Allegheny County have drastically underinvested in capital spending due to fiscal crises. Some of the frozen conditions began to thaw in 2015 and the taps should open wider in 2016 for public construction, but the pressure to get work hasn’t abated yet.

“It’s still very competitive. Contractors just don’t have backlog and backlog is life,” Jeffe points out. “They don’t have backlog like they did coming into 2008 and 2009, so bidding is still very tight to build backlog.”

There are significant increases in spending on highways and bridges planned for 2016 and beyond. Some $700 million more will be spent in PennDOT District 11 for example.

Brian Jeffe has seen plenty of early signs that 2016 will be a year of further improvement and says Seubert is counseling clients to avoid the trap of filling up on the first course of the meal.

“Seubert had the best January and February in its history. We’re writing 80 bid bonds a day,” he explains. “We’re preaching to be patient, be margin hunters. The opportunities will be there.”

Better discipline during the 2009-2010 downturn has helped keep surety losses relatively flat compared to previous business cycles.