Surety Market Commentary – 2014 Outlook

2013 is the Surety industry’s 7th consecutive year of recording an underwriting profit in excess of $1.2 billion. While the construction economy cooled and has remained below the spending levels of the mid 2000’s, surety industry profits have soared. The Surety and Fidelity Association of America (SFAA) reported an aggregate underwriting profit of $8.2 billion on revenue over that period of $26B (footnote SFAA) for the period 2008–2012. Assuming a conservative premium to surplus ratio of 1:1, that is a 31% return on equity. This runs counter intuitive to what one might have expected to see for an industry where 70% of their revenue comes from bonds that guarantee the performance of construction company contracts and payment of labor and material bills. Over this same period “Total Construction Put in Place”, as reported by the US Census Bureau has dropped from $1.2 trillion to just over $900 billion. The change in non-residential was more flat, as that has only dropped from $575 billion to $568 billion (footnote U.S. Bureau of Labor Statistics). Construction employment however paints the picture of what we have all felt about the construction economics over the past decade.

Seasonally Adjusted
Super Sector: Construction
Industry: Construction
NAICS Code: 23
Data Type: ALL EMPLOYEES, THOUSANDS

There are many theories about why the results have been so profitable, despite a very challenging construction market with much tighter margins. The consensus is that given the change in market was so distinct and steep, that contractors and owners did not get over extended. With the market slow to recover, expenses were managed down, receivables and retainages were collected and cash was accumulated. New backlog investments in equipment, people, mobilization, and cash flows were not required.

That may be changing. Some markets that had significantly slowed, such as Miami, are hot again. In the spring of 2013 the NY Times reported that of the 22,000 condos built in the Miami condo boom, only 600
were not sold. The rental housing vacancy rate in Miami is approaching 3% (footnote Marcus & Millichap Q4 2013 Market Research Report). Tower cranes are again common across the Miami skyline for new high-rise condo projects! The Boston Globe reported in November that over the past year Boston added 8,700 construction jobs, LA 8,900, and Houston 8,200. At a recent meeting in New York City, a surety underwriter asked the client about the private building market in NYC. The response was that it is booming and the challenge is getting people, subs and scheduling. Texas is a place where both the private and public/highway markets are strong. This acceleration of activity, where backlogs grow is when cash flow requirements increase. Re-investing in new work, funding JV’s, adding to payroll is more challenging than managing down expenses in a slow-down. The task is even more difficult when you know margins have remained stubbornly low for an extended period of time such that cash flow off that backlog is tighter. Funding new work off a backlog of tight margin work, will likely increase surety losses over the next few years.

A closer look at the surety numbers also sees change. While reporting very profitable results the last few years, the amount of profit has steadily declined since 2008. 2012 is the last full year of profit reported and it was down $812 million from a record year in 2008 – a decline of 40%. Losses and related adjustment and defense costs totaled $1.4 billion in 2012 – that’s a lot of loss dollars for a business predicated on a zero loss ratio target! The loss ratio for contract surety has steadily increased over the last five years from 6% in 2008 to 37% in 2012. (Footnote SFAA).

Another trend we have seen is the contractual liability pendulum swinging back to owners. This has evidenced itself in longer warranty periods, consequential damages, unconditional payment bonds, forfeiture proposal bonds, responsibility for changes in site conditions, hazardous material responsibility, increased/uncapped liquidated damages, and other contractual risk shifting. This more broad assumption of risk is coming at margins still half of what they were. A surety company executive recently commented that their clients are at or near their all-time backlog highs, but as soon as they test pushing up margins, they fail to win new work.

P3’s, DBF’s, PAB’s, TIFIA, SOQ, RFP, DBFOM, are the new alphabet soup of procurements! The procurement cycle of these major projects like I-4 Ultimate, CA High Speed Rail, the Purple Line, the Ohio River Bridges, TX DOT SH183, NY’s Goethals Bridge, and others make it important to be selective. The procurement costs are not fully covered by stipends and each project is a major commitment of surety and bank credit. The procurement cycle can last two years or more before any revenue starts to book. The formation of strong and strategic JV teams takes place very early in the process. If not very careful early on, contractors can find themselves spending valuable time and money on projects that sound exciting, but may be a team with a low win probability.

Underwriting risk is changing. All of the major surety companies bonding the larger firms have needed to add legal resources to improve their ability to assess contractual risk, particularly in reviewing complex RFP documents. Typical areas getting close scrutiny are extended warranties, damages, hazardous materials, and financing requirements. Underwriters have also needed to develop their understanding of International accounting standards (IFRS) after years of focusing solely on GAAP accounting. They have needed to be more skilled in analyzing significant balance sheet items of global companies, such as concession investments and currency risk. Project size and durations have dramatically increased over a relatively short period of time. We have seen several billion dollar plus projects and durations of 100 months and more. We expect the size and
duration trends to continue across the spectrum of contractors - each segment - small, middle, large and global are looking at bigger, longer projects which are testing approval procedures and are often mis-matched with reinsurance programs. This can delay approvals and commitments. Contractors need to be cautious about spending money on major pursuits when a bonding commitment may end up being elusive.

We have heard an interesting dichotomy emerging - GC’s who want to chase better margins by subbing less and self-performing more, versus heavy civil firms, who traditionally rely on self-performance, mitigating risk with tighter margins by subcontracting out and bonding back a higher percentage of their jobs. Can both sides of this strategy work?

The nine month Surety and Fidelity Association of America (SFAA) premium and loss results show a continuation of recent trends. The surety loss ratio remains low at 17.6% and the industry is profitable. The top line is flat with prior year reflecting a combination of modest growth in construction spending, especially in the public sector which accounts for about 80% of the contract surety bond premiums. It also reflects flat to declining surety rates. The industry remains concentrated with the top 10 controlling 65% of the overall surety market. The top 5 surety companies write 50% of the premium and have a loss ratio of 15%. The next 10 surety companies have a combined loss ratio of 24% - almost 10 points worse than the top 5. These 15 surety markets write about 75% of the premiums. If you look at market share in contract surety for contractors doing $100 million or more in annual revenues, the contract surety market is even more concentrated in about 7 markets that write virtually all of that business. Despite this concentration, the markets remain very competitive and the commercial surety market in particular has attracted new capacity over the last 24 months.

In addition to expertise in contract surety, Aon is the major broker for non-contract surety, or also known as commercial surety. This represents about 35% of the overall surety market. It is even a more profitable (12% loss ratio versus 37% for contract) and more competitive segment of surety these days. While contractors may think this market is not important to them, they need to be reminded it was the surety losses related to Enron, WorldCom, Global Crossing, Kmart and other commercial surety bonds that turned the contract surety market upside down in late 1990’s and early 2000’s.

Contract Surety Product Development - there has been much discussion, but little in the way of actual bonds written for new surety products aimed at the P3 marketplace. The basic concept is to add a liquid, "letter of credit-like" component to traditional performance bonds. The primary drivers of the liquid component are lenders who have debt service deadlines to meet. They are counting on a date specific payment from a completed project. It is usually either an availability payment from a public entity (i.e. a road is open for traffic and the State will begin availability payments) or revenue streams (e.g. toll revenues). Delays in meeting those deadlines creates an immediate need for liquidity, regardless of the contractual defenses that may come into play for delays that would therefore not trigger a performance bond claim payment. These lenders want liquidity and traditionally require letters of credit. Public owners involved with developing public assets like roads, bridges, transit systems, courthouses, hospitals, jails, etc. still have needs to protect labor and material providers with payment bonds and need performance bonds to be sure not only do the lenders get paid, but their public asset gets built according to the contract. This creates a great opportunity to blend traditional surety bonds with a liquidity component for P3 projects. So far the unwillingness of the rating agencies to assign a higher rating for this combination product than simply an LC, has stymied the products acceptance.
The subcontractor default market (SDI) - this market is for general contractors who insure for the risk of subcontract default. They buy risk transfer coverage over a deductible and a funded layer. It has been around now for over 15 years. It has stood the test of time. The contractors who buy this product generally speaking are in the general building market, primarily with private owners, subbing out 75% or more of their contracts. There are a limited number of SDI markets, but there have been two new entrants in the last few years. Their experience is similar to that of the SFAA results which means they have generally been favorable. That market is expected to have an element of competition and be stable in the next 12 to 18 months. Traditionally a GC needed at least $100 million of annual subcontract costs to provide the economies necessary to fund the program. However, the recent market entrants have been flexible with policy periods longer than a year which makes a lower amount of annual subcontracts feasible for SDI products.

The primary focus of these comments relate to the North American (NA) contract surety market. In NA we see mostly performance and payment bonds for 100% of the contract (typically 50% in Canada). However, the global surety market is more than $11 billion with NA making up a little over 50%. In other parts of the world low penalty, e.g. 10% of the contract are more common and they are "pay on demand" forms. Typically in the event of default, the surety pays the bond amount. In the NA market, the surety often acts to complete the project, as paying the bond penalty is too costly. A rule of thumb in surety claims is that a contractor in default will cost the surety about 30%–40% of the bonded backlog. We have seen a trend, particularly in SA where more NA type surety is being accepted. As the banking industry evolves from regulation and economic pressures, we expect to see a growth in NA styled surety bonds in the years ahead.

Aon has dedicated surety experts through-out the US and Canada. Additionally, Aon has offices around the world with on the ground knowledge of local surety requirements. Our teams have worked closely together to assist global firms obtain surety credit in North America and expand their business interests. We also help our clients as they look to new markets or for joint venture partners to pursue bigger projects. We help clients understand the nuances of emerging procurement methods such as design, build finance and public private partnerships. We work in the markets everyday to assist contractors in securing competitive surety programs in support of their business plans. We look forward to helping our clients grow their business and navigate the surety market changes that are evidencing themselves. We also look forward to partnering with the surety markets to deliver the best consultation to them on construction market risk.

Contact your Aon broker and let's plan to discuss the surety market and how best for your company to take advantage of the opportunities that lie ahead.
About Aon

Aon plc (NYSE: AON) is the leading global provider of risk management, insurance and reinsurance brokerage, and human resources solutions and outsourcing services. Through its more than 61,000 colleagues worldwide, Aon unites to empower results for clients in over 120 countries via innovative and effective risk and people solutions and through industry-leading global resources and technical expertise. Aon has been named repeatedly as the world’s best broker, best insurance intermediary, reinsurance intermediary, captives manager and best employee benefits consulting firm by multiple industry sources. Visit www.aon.com for more information on Aon and www.aon.com/manchesterunited to learn about Aon's global partnership and shirt sponsorship with Manchester United.

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