

Lake County Contractors Association

Professional Practice Report

January, 2003

CAUTION: BUMPY SURETY ROAD AHEAD

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Guess what? Surety rates are increasing, capacity is shrinking, and underwriters are asking more questions and requesting more information. What's going on?

You've probably been asking yourselves these questions since this past spring. Well, some say we're in the midst of the most difficult surety market for at least the past three decades.

How did this happen? - There are a variety of reasons, but they can be fairly well summarized by the following events; September 11th, high profile bankruptcies (think Enron), increased frequency and severity of surety losses irrespective of the Enron's of the world, and the exodus of primary sureties and their re-insurers.

Surety revenues typically account for a very small portion of an insurance company's overall sales. However, the key word here is that most sureties are part of an insurance company. Reinsurance capacity across most insurance and related lines has been significantly impacted within the past 18 months.

Enron's bankruptcy may cost the surety community in excess of \$1.1 billion in actual losses. With so much money at stake, my humble opinion is that a settlement will be reached prior to an actual verdict. Regardless of the amount paid, the impact will be enormous when compared to an overall industry with approximately \$3.5 billion in annual revenues. Other bankruptcies such as WorldCom, Kmart, UAL, etc., may also result in actual losses paid.

A continual surge in contractor losses is also adding to the current industry woes. Just a few months ago a verdict was reached regarding the Petrobas oil platforms in South America that goes

against two major sureties to the tune of \$207 million before interest and other expenses.

As a result of the combination of the above events, a few sureties have either severely withdrawn or entirely pulled out of the marketplace. This also holds true for reinsurance companies that provide the backdrop protection for front line companies. As recently as two to three years ago, some 25 or more reinsurers participated in the surety market. Today, that number has been reduced to single digits.

To reiterate, a number of factors have contributed to a tightening in the surety market as evidenced by higher pricing, lower capacity, and more stringent underwriting.

Where do we go from here? - With 12/31 fiscal year ends for many contractors just around the corner, the time for action is now. Specifically, attention must be paid to balance sheets, under billings, receivables and profitability.

Sureties are fine-tuning their financial analysis regarding questionable assets. These include shareholder/stockholder receivables, intangibles, and affiliated transactions among other items. Historically, these items may have been allowed to some degree in the soft market.

Today is a different story, as they will most likely be excluded in an underwriter's analysis of your working capital and/or net worth. Working capital and net worth are key determinants in calculating the level of surety support.

Under billing is also an area worthy of further consideration. Where possible, make sure your jobs are billed to their fullest. Sureties will often times question the validity of large under billings on jobs that are nearly complete.

More and more sureties are requesting an aging of receivables. Make every effort to collect receivables beyond 90 days and stay as current as possible. In some cases, sureties will exclude over 90's in their calculation of working capital and net worth.

Profitability. Do what ever can be done to show bottom line profits, especially if last year was unprofitable. Some sureties are pulling the plug on contractors that have posted two consecutive (or two out of three) years of losses.

Other areas worthy of mention include trimming debt levels, maintaining positive cash flow and staying within your historical scope and geography. For example, sureties will be hard pressed to support a road contractor suddenly interested in their first waste water treatment plant, or a GC entertaining their first bridge project.

Maximizing Your Surety Program

Here are some items to consider in an effort to maintain or increase your current surety programs.

- Meet with your broker/agent and surety underwriter. Take them on a job site visit and a tour of your office. Show them how you manage your company on a day-to-day basis. Essentially, show off your company and its successes. Surety, much like banking, is a relationship business.
- Seek input from your broker regarding current surety trends. Suggest meeting with your surety underwriter to review goals for the upcoming year and seek their input as to financial targets you should try to reach in order for them to support your business plan.
- Consider a backup surety position if you feel uncomfortable with your current market.
- Personal indemnity is a touchy subject. In fact, many sureties are reverting back to making this a must, reversing years of routinely waiving this requirement. While there is no 'one case fits all' scenario regarding personal indemnity, it is widely accepted that a surety will provide

increased support where they have this additional comfort.

- Make sure you have addressed continuity planning via a Buy/Sell Agreement or employment contract(s).
- Provide continual and timely financial and job schedule information to your surety.

Looking Ahead

Chances are your company experienced a price increase during 2002. Hopefully this is now behind us. However, the consensus is that the upcoming reinsurance renewals may again lead to a retrenching within the surety underwriting community.

As a result, pricing may go up, capacity may go down, and sureties may resign from certain accounts. There may even be instances where jumbo surety programs have to be supported by more than one surety company.

However, not all is doom and gloom. Barring an unforeseen catastrophic insurance loss and/or an extended period of economic uncertainty, some feel this hard market will only last up to 24 months. There are many, many unknowns between now and then, but as long as you stay true to your business and enjoy continued success, the surety community will stand behind your company.

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