Boom Or Bust

US Surety Market in a Post Covid World

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Objectives:

1. Analyze the key principles and components of surety, including its role in risk mitigation, contractual obligations, and financial security

2. Compare and contrast surety bonds and P&C insurance

3. Discuss the current state of the market including challenges and opportunities

4. Reinsurance and its role in the US Surety Market
History of Suretyship

- First reference is found in the Bible
- Surety came into mainstream in US upon adoption of Miller ACT in 1935
- Each of the 50 states has their own version of Miller ACT
- Miller ACT requires 100% performance and payment bonds on all state and federal financed projects.
- Bonds are conditional in nature.
  - “Pay on demand” and percentage bonds are the exception and not the norm
- Surety bonds are effectively an alternative to bank letters of credit
Surety in the Western Hemisphere

Other developed markets
• Japan
• Italy
• South Korea

Developing Markets:
• China - $750MM already
• India – First bonds written in 2023

Believe the global premium is between $15BB to $17BB and growing
What is a Surety Bond?

**Surety**
Insurance company that guarantees the work of the principal and is liable for claims against the principal up to the bond amount.

**Principal**
Purchases the bond and agrees to perform the work in a compliant manner (ultimately financially responsible).

**Obligee**
Requires that the principal purchase a bond to attain a license or perform a service (usually a government agency).
Surety Vs Insurance – What’s the Difference

- **Surety**
  - In theory, underwritten to **ZERO** loss ratio

- **Insurance**
  - Law of Large Numbers
# Surety vs. Insurance – What’s the difference

<table>
<thead>
<tr>
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<th>Surety Bond</th>
<th>Traditional Insurance</th>
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<tbody>
<tr>
<td>Regulation:</td>
<td>• By state insurance departments</td>
<td>• By state insurance departments</td>
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<tr>
<td></td>
<td>• <strong>Bonds are required by law and voluntarily by private owners</strong></td>
<td>• <strong>Buying insurance is a voluntary way of managing risk of loss for the insured</strong></td>
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<td>No. of Parties:</td>
<td>• Three-party</td>
<td>• Two-party</td>
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<td>Forms:</td>
<td>• Bond forms are standard or may be negotiated by owner or surety and contractor.</td>
<td>• Policy forms vary by insurance company.</td>
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<td>Coverage:</td>
<td>• <strong>Coverage is project-specific</strong></td>
<td>• <strong>Coverage usually term-specific and renewable</strong></td>
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<td>• Coverage: 100% of the contract price for performance; 100% for payment, up to penal sum of bond</td>
<td>• Coverage up to policy limit, less the deductible</td>
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<td>Underwriting Strategy:</td>
<td>• Prequalification intended to prevent loss</td>
<td>• Spreads fortuitous losses among a large group of similar risks</td>
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<td>Claims Mitigation:</td>
<td>• <strong>Surety has right to contract balance and indemnity from contractor</strong> (contractor remains primarily liable)</td>
<td>• <strong>No right to insured’s assets</strong>, however, companies can subrogate against a third party or another insurer</td>
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U.S. market differs from most of the rest of the world by requiring bonds at 100% of contract value.
The Three “C’s” of Surety

Unlike most insurance underwriters, surety specialist have a personal relationship with the client. Trust amongst all parties is paramount to a successful relationship.
Claims – Wording makes all the difference

• Significant differences in handling dependent upon bond form wording
  • Perform work to completion
  • Finance principal to completion
  • Buy back the bond – cut a check

• Indemnity is key – Always expect to get paid back in theory

• All three parties need to work together in the claim process
U.S. Surety vs. P&C Industry

- Surety represents ~1% of written premiums in the U.S. Property and Casualty Industry.
- Surety has outperformed the U.S. Property and Casualty industry in combined ratio 18 of the last 23 years.
- Surety combined ratios over 100% last seen from 2001 to 2005.

Source: US Statutory Data
The market share of the top 5 writers is moderately decreasing as new markets are established.
Continued long term industry profitability trend has led to new entrants as carriers seek expanded growth opportunities in the U.S.
U.S. Surety – Industry Overview

Ample Capacity in Competitive Underwriting Environment

Surety industry anticipated to have achieved strong growth in 2022 on the heels of increasing construction contract values driven by material price increases
- By mid-2022, inflationary concerns became prevalent as uptick in claims severity was observed
- Overall industry anticipated to have profitable results for 2022; industry mid-year direct loss ratio sub 20%
- Industry saw multiple new entrants in the past 12 months based on the continued resiliency of the business through COVID and in anticipation of increased infrastructure spending in 2023

Focus on economic risk factors increasing
- While inflationary pressures are being accounted for, monetary policy driving interest rate rise may continue to persist
  - Tightening credit environment may lead to increased default and refinancing risks
- Issues with the labor force, material prices, supply chain disruptions, and full contractor backlogs remain
  - Overall rising costs impacting claims severity

Contract Surety
- Despite economic uncertainty, competitive underwriting conditions persist with underwriting talent stretched
- Ongoing dialogue between contractors and sureties as to how they are mitigating material cost volatility
  - Implementation of cost escalation clauses into construction contracts

Commercial Surety
- Crypto and banking exposures being closely reviewed in wake of FTX collapse and recent bank failures
- More attention on regional homebuilders as housing demand slows
- Guarantees of bank letters of credit becoming more prevalent within US
Reinsurance in the Surety Space

• Xol vs Quota Share
  • Vast majority of placements are Xol’s on cedents net exposure

• Losses Discovered Nature on a per principal nature
  • Losses are not on individual bonds, but the aggregation of exposure
  • Exposure can run in the billions
  • Risk attaching “xol” is cheap quota share coverage and not an option

• Virtually all reinsurers purchase an xol treaty

• Increasing retentions and limits purchased – Inflation driven

• Reinsurance underwriters in the space are mainly former primary underwriters

• Thirty markets participate in the space

• Need to understand nuances of the product
  • There are no experts in surety only students
XOL Structure w/reinstatements

- **Net Retention = $2M**
- **1st XOL**
  - $3M x $2M with 3 paid reinstatements
- **2nd XOL**
  - $5M x $5M with 1 paid reinstatement;
- **3rd XOL**
  - $10M x $10M

Total aggregate coverage $32M
Co-participation of 5%-20% not uncommon