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

$700MM

$8.6BB

$900MM

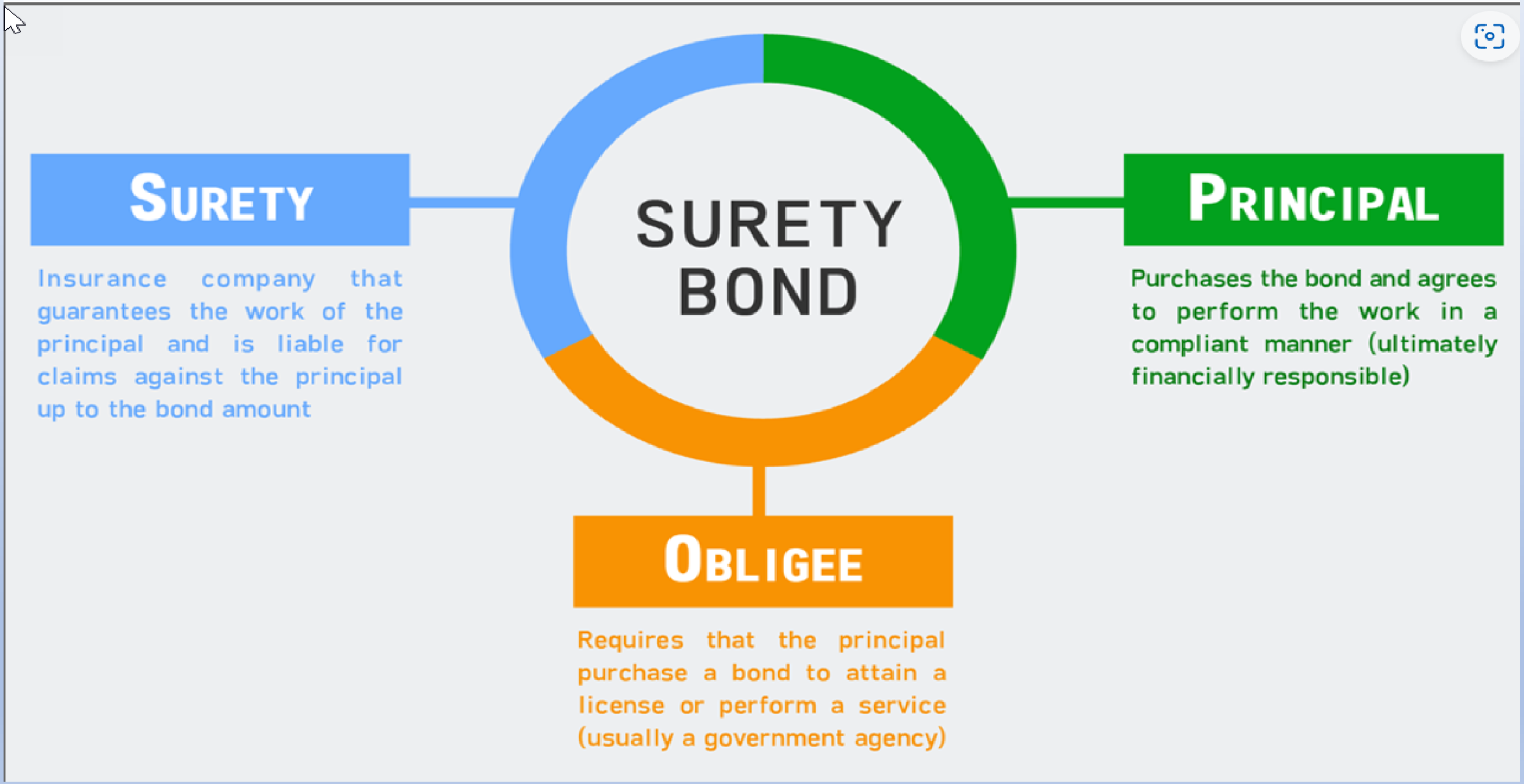
$1.9BB

Other developed markets
- Japan
- Italy
- South Korea

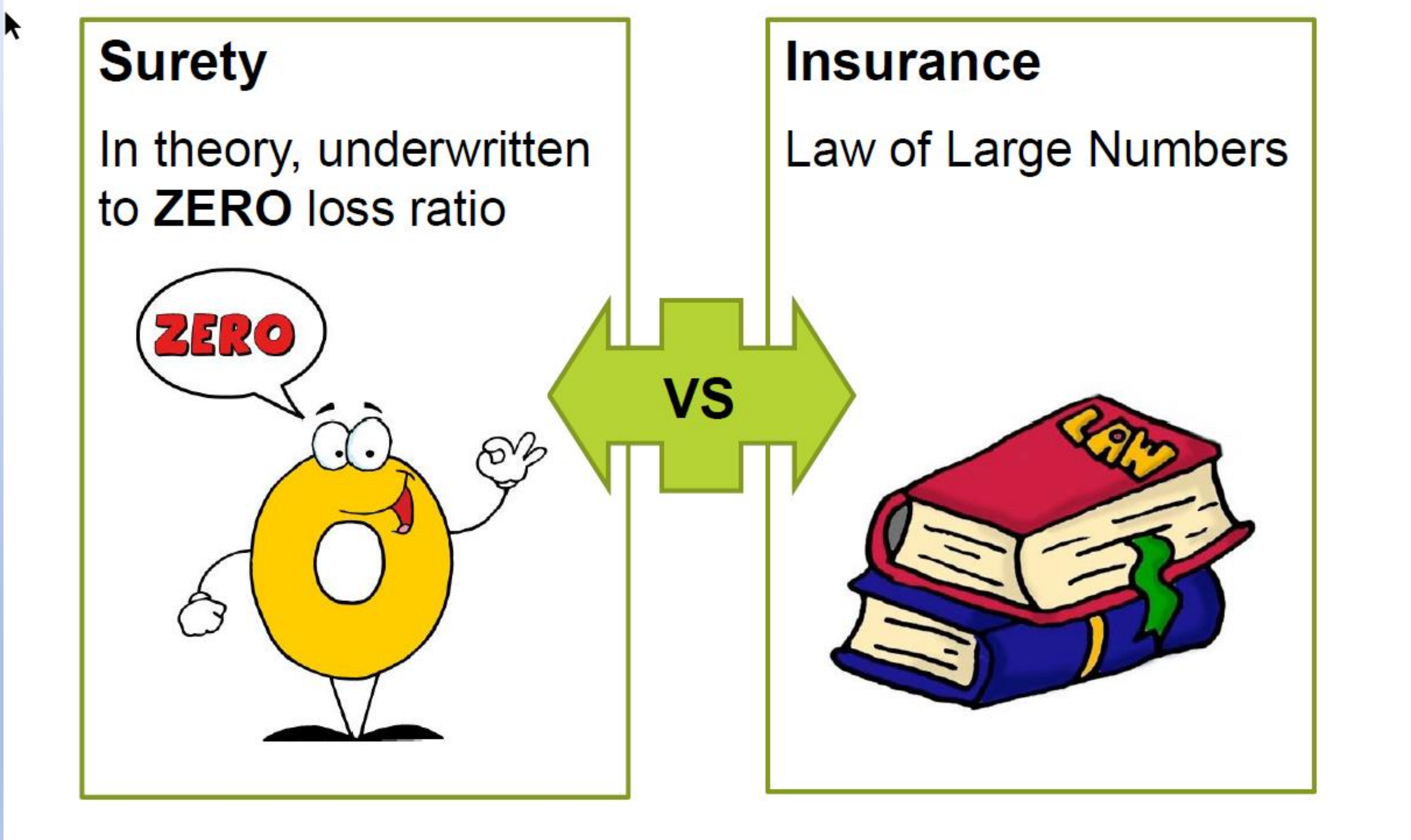
Developing Markets:
- China - $750MM already
- India – First bonds written in 2023

Believe the global premium is between $15BB to $17BB and growing

What is a Surety Bond?



Surety Vs Insurance – What's the Difference



Surety vs. Insurance – What's the difference

	Surety Bond	Traditional Insurance
Regulation:	• By state insurance departments • **Bonds are required by law and voluntarily by private owners**	• By state insurance departments • **Buying insurance is a voluntary way of managing risk of loss for the insured**
No. of Parties:	• **Three-party**	• Two-party
Forms:	• Bond forms are standard or may be negotiated by owner or surety and contractor.	• Policy forms vary by insurance company.
Coverage:	• **Coverage is project-specific** • Coverage: 100% of the contract price for performance; 100% for payment, up to penal sum of bond	• **Coverage usually term-specific and renewable** • Coverage up to **policy limit, less the deductible**
Underwriting Strategy:	• **Prequalification intended to prevent loss**	• Spreads fortuitous losses among a large group of similar risks
Claims Mitigation:	• **Surety has right to contract balance and indemnity from contractor** (contractor remains primarily liable)	• **No right to insured's assets**, however, companies can subrogate against a third party or another insurer

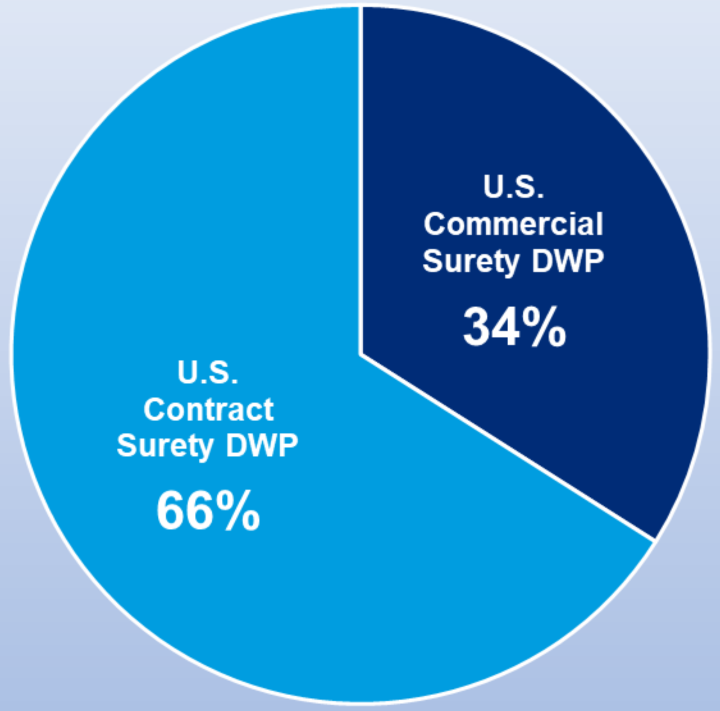
U.S. Surety Industry Overview

- Commercial
- Contract
- Transactional
- Bail

Distribution

- Business accessed through brokers
  - Specialty agents (National Association of Surety Bond Producers) control a significant portion of the business
  - Banks are prohibited from issuing Surety bonds in the U.S.

~$8.6B of Direct Written Premium Split



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

Character

- Without this nothing else matters
- History of paying subs/suppliers (any liens on property), reputation within community, personal credit score, prior bankruptcies
- How will he/she react in bad times (test of "true character")

Capacity

- Ability to perform a project
- Manpower/equipment, estimating ability, experience with type and size of job, geographical area, history with owner of project, good cost records, continuity planning

Capital

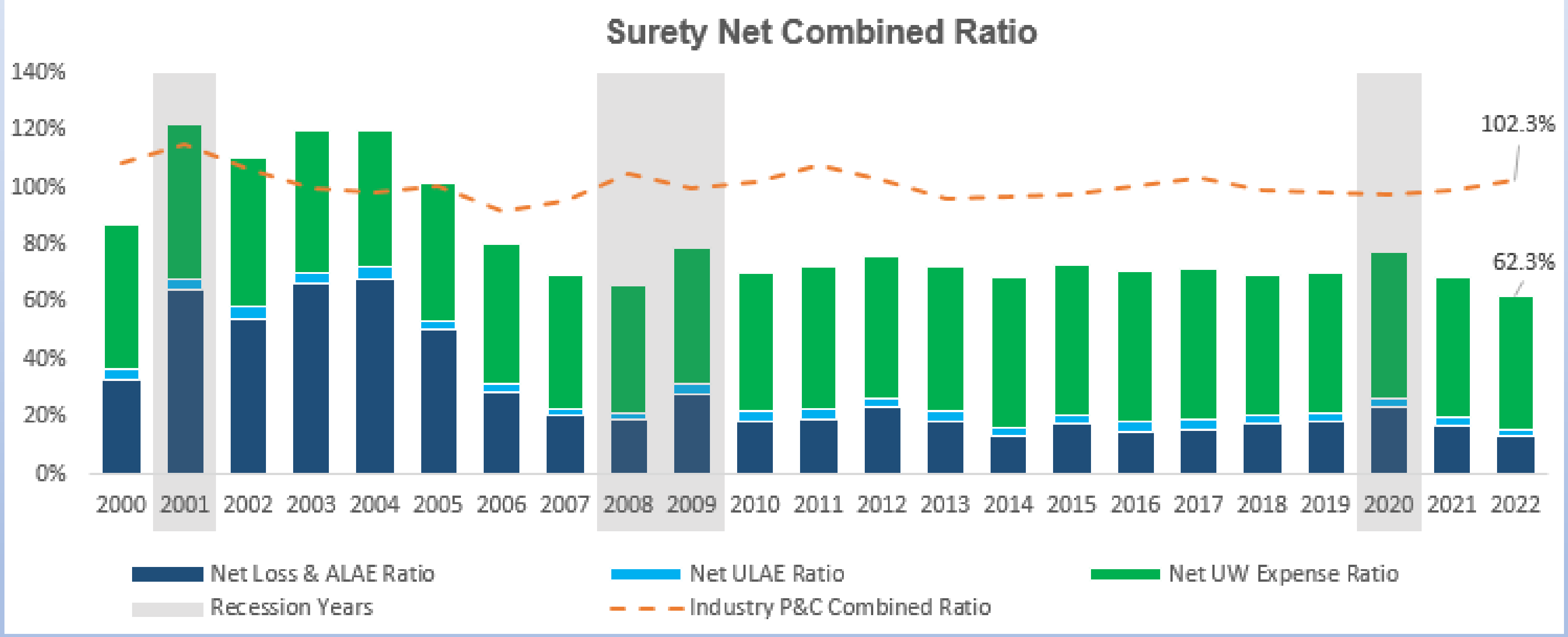
- Financial ability to assume the risks of business activity
- Equity, working capital, personal net worth, bank line of credit, interest bearing debt

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



Source: US Statutory Data

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

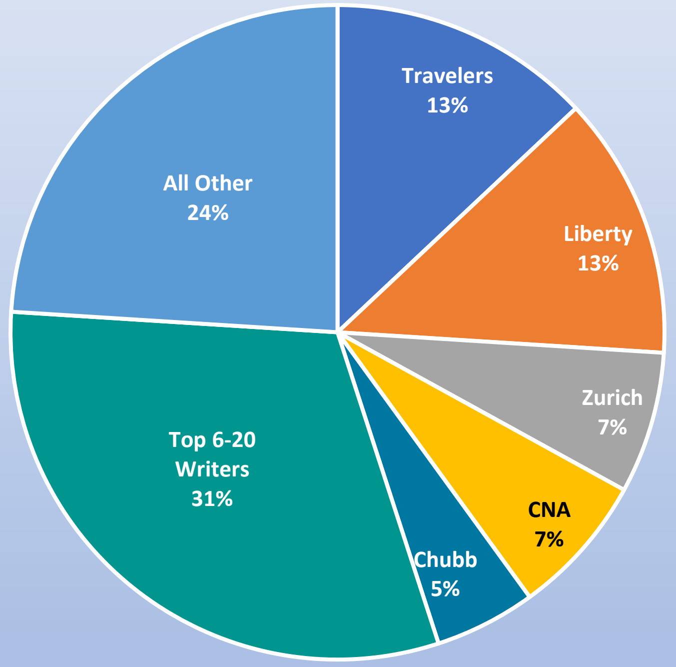
U.S. Surety Industry Overview

Market Size

No.	Company	YE 2022 DPW	Market Share
1	Travelers	1,133 M	13%
2	Liberty Mutual	1,098 M	13%
3	Zurich	580 M	7%
4	CNA	578 M	7%
5	Chubb	439 M	5%
Top 5 Writers		**3,827 M**	**45%**
Top 6-20 Writers		**2,675 M**	**31%**
Total Industry		**8,605 M**	**100%**

Source: GC Risk Benchmarks Research, US Statutory Data

Market Share of U.S. Surety Writers by Direct Premium



The market share of the top 5 writers is moderately decreasing as new markets are established.

U.S. Surety Industry Overview

Breakdown of Results

- The industry continues to run very profitability with a **combined ratio of ~71%** over the last five-year period
- Segmenting the industry reflects **loss and expense ratios efficiencies** for the top 5 writers
  - Some contributing factors:
    - Greater access to national and global construction and commercial accounts with strong credit profiles
    - Tiered commission levels for larger bonds offered by top 5 writers reduce their overall expense ratios

Name	Direct Premium Written				CY 2018 - 2022						CY 2022	
Company Name	2022 DPW ($M)	2021 DPW ($M)	Market Share	5 Yr. CAGR	Direct Loss & DCC Ratio	Net Loss & DCC Ratio	Direct Expense Ratio	Net Expense Ratio	Direct Combined Ratio	Net Combined Ratio	Direct Combined Ratio	Net Combined Ratio
Top 5 Writers	3,827	3,299	44%	5%	17%	17%	49%	49%	66%	66%	59%	59%
Top 6 - 20 Writers	2,675	2,289	31%	11%	23%	18%	53%	55%	77%	74%	77%	70%
Industry ex. Top 20	2,103	1,849	24%	6%	21%	19%	55%	56%	76%	75%	75%	67%
Industry	**8,605**	**7,438**	**100%**	**7%**	**20%**	**18%**	**52%**	**52%**	**71%**	**70%**	**68%**	**64%**

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

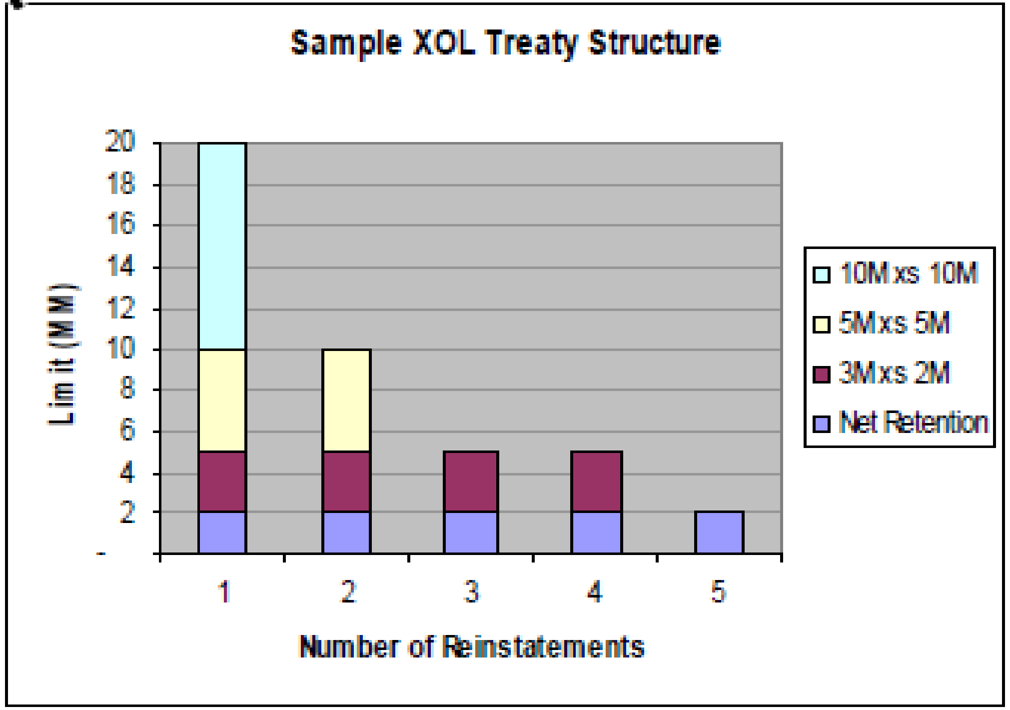
Commercial Surety

- 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 xs $2M with 3 paid reinstatements
- 2nd XOL

  $5M x $5M with 1 paid reinstatement;
- 3rd XOL

  $10M xs $10M

Total aggregate coverage $32M

Co-participation of 5%-20% not uncommon

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