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Building on Solid Ground

Recent mergers and acquisitions have consolidated much of the surety market among several multiline companies. And despite recent losses, surety remains a profitable and consistent business.

by Christian J. Gascou

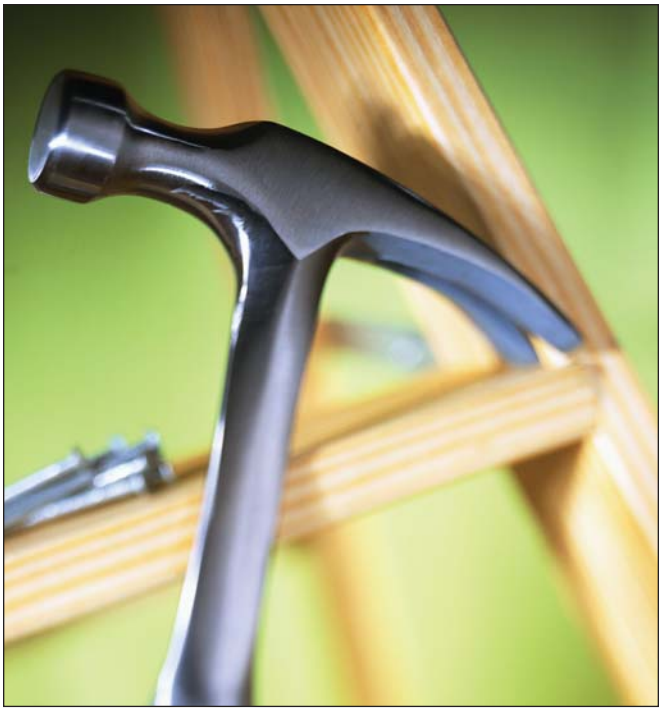
The niche market of surety bonds has been undergoing a dramatic change, with mergers and acquisitions reshaping the landscape. Just this past December, St. Paul Cos.—the top writer of surety bonds for 1999 and 2000—acquired the right to renew all surety bond business previously underwritten by Fireman's Fund, one of the top 20 surety writers in 2000.

Of the top five surety writers in 2000, the first four—St. Paul, CNA, Travelers and Zurich—have been involved in relatively recent mergers, and the fifth, American International Group, is decreasing its presence in the business, with its surety line representing only a sliver of its large property/casualty market. There have been many other consolidations in recent years—for example, Safeco with American States; Kemper with Universal Bonding and Lou Jones Associates; and Liberty with Peerless and Wausau. While some mergers and acquisitions may be the result of a strategic business move, several events in both the insurance and surety industries may be the root causes of consolidation.

From the late 1980s until recently, the surety industry enjoyed an extremely soft market. "We probably went from 50 sureties to 300," said Bill Cheatham, president of Zurich North America Surety. "Competition internally was driving the price down, with unlimited capacity due to the availability of capital, so any contractor could secure surety credit. Most sureties were growing for the last 10 years, dropping rates and expanding capacity."

"Reinsurance was inexpensive, and a lot of it could be bought for a very reasonable amount of money," said Robert Lamendola, executive vice president in charge of the Global Surety and Construction Group for St. Paul. The result was a surety industry that enjoyed unlimited capacity.

While the surety industry was experiencing a soft market, portions of the economy overheated, Lamendola said. "About two years ago, we recognized an increase in construction company failures while we were working within what most people thought was a relatively good economy. Many contractors were taking on too much work, and they weren't being able to complete the projects," he said. As a result, cross sections of contractors, from big names like Morrison Knudsen to smaller contractors, have failed, said Lamendola. When this happened, surety losses increased, and, in turn, reinsurers incurred significant losses.



"In 2000, there were something like $600 million of surety losses, mostly construction, and the primary companies shipped off about $400 million of that to reinsurers," said Lamendola. This was the genesis of what became a reinsurance crisis. Then the recession hit. "That has just compounded things, not only for construction, but actually more so for nonconstruction, because you saw this unprecedented number of public corporate failures," he said.

In addition, events related to the insurance business in general are, in part, driving the consolidation process. Catastrophes like the Sept. 11 terrorist attacks and Tropical Storm Allison, which slammed into the Gulf states last June, as well as exorbitant asbestos and tobacco claims and, of course, the bankruptcies of Enron and Kmart, have resulted in more losses than usual. The projected losses to surety companies from Enron alone are estimated in the $2 billion range. Virtually all of those losses were passed to reinsurers, who are calling 2001 the worst loss year ever. Couple this with the fact that reinsurance renewals started when Enron hit, and the surety industry, like other insurance lines, is reeling.

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Surety, Top Writers—2000

The top 10 U.S. surety carriers wrote more than 50% of the coverage in 2000.

Group	2000 Direct Premiums Written ($ Thousands)	Market Share (%)	% of Company Premiums
St Paul Cos	$379,742	11.5	6.9
CNA Ins Cos	282,840	8.5	2.8
Travelers/Citigroup Co	260,891	7.9	2.4
Zurich/Farmers Group	215,905	6.5	1.2
Amer Intern Group Inc	198,175	6.0	1.5
Ace INA Group	125,618	3.8	4.5
Safeco Ins Cos	123,814	3.7	2.6
Liberty Mutual Ins Cos	122,669	3.7	1.3
Chubb Group of Ins Cos	111,675	3.4	2.0
Amwest Ins Group	105,006	3.2	73.9
Total U.S. Companies	**$3,315,873**	**100.0**	**1.1**

Source: A.M. Best Co. State/Line Products

Remaining Afloat

While the surety world is shrinking, it is not sinking. Because most surety organizations are divisions of multi-line, or well-diversified, property/casualty companies, many executives are saying, "Hey, this seems like a volatile business; why should we be in suretyship if it's a sliver of our overall revenue?" said Lamendola. "I think what they fail to recognize is, on a long-term basis, suretyship is a fairly profitable and consistent business. In the last 32 years, the industry is running about a 92 or 93 combined [ratio], which is pretty good. I think they all got shocked a little bit in the last year or so," he said.

But the industry has and will continue to undergo major changes as a result of fewer players in the marketplace. How will this impact the future? Mike Peters, president of Safeco Surety, said he believes that the industry will see an increase in co-surety relationships in both the commercial and construction sectors. Co-surety relationships will become more frequent, especially for very large contracts.

But co-surety relationships may pose some new challenges. "Sureties competed very, very heavily in the '90s and may have made a lot of enemies of each other. Now and in the next few years, some of us are going to have to forget the past difficulties and work together on some large accounts," Lamendola said.

From an industry perspective, recent acquisitions and consolidations shrink the number of major players in the short term until someone else grows into a major surety, Zurich's Cheatham said. But, he added, "there is still sufficient capacity to support customers needing surety credit, or at least those product lines normal to the industry."

Consolidation is having, and will continue to have, an effect on reinsurance, at least in the near future. "Reinsurers are assessing their [return on equity] by product line. If a line is considered less attractive, meaning its ROE is inadequate, then they will invest their capital in another line," Cheatham said.

Reinsurers know that some of the mega-sureties—like St. Paul, Travelers and Zurich—still have the ability to pay the premium and still be in business, said Lamendola. But some companies are not as well situated. Some have not had their reinsurance treaties renewed. Others face the problem of paying for a reinsurance program that will allow them a reasonable net exposure. According to Safeco's Peters, companies are asking, "How many losses can we absorb under reinsurance?"

What impact will this have on regional companies and small or new sureties? Some regionals, some of the smaller companies and companies that have just started in the business didn't have a lot of exposure to big hits like Enron, so logic would say they may be able to survive in a smaller surety industry, said St. Paul's Lamendola. Some of the regional sureties may join forces—for example, a group of Western and Midwestern surety companies, Safeco's Peters said.

Disciplined Underwriting

Another fallout from recent tremors in the surety industry may be a shift in underwriting practices. "Companies will exact tighter underwriting discipline and prequalification processes," said Peters. "We may see a back-to-basics approach."

Throughout the 1990s, rates were down and sureties were fighting for more business and were getting into areas that were different from those they got into before, said Lamendola. Financial guarantees are a classic example. While the industry has always written financial guarantees, it started to look for bigger ones. "What I believe happened is that a lot of companies did not read the tea leaves and continued to write bonds for financial guarantees right up until Dec. 2, 2001, when Enron exploded and shocked the property and casualty insurance industry with extensive liability," he said. "About 15 months ago, we decided that the financial guarantee business just was not bringing in the kind of fees that we really needed to bring in for the exposure that we were taking on. So, I'm not saying that other companies didn't do this too, but we basically shut down that operation and decided we were not going to be in what we call the 'exotic surety business.' "

In the wake of Enron, many more companies may follow suit and focus instead on relatively steady sectors like construction. Consolidations also may pave the way for e-commerce to emerge as a major advantage for a few carriers. E-commerce already is being used to complete and issue bonds online, said Cheatham.

E-commerce also may level the playing field, allowing smaller or new sureties to compete with the giants. Other sureties, however, remain skeptical and point to the fact that the surety industry has been built primarily upon face-to-face relationships.

Whatever the future has in store for surety, it is clear that some of the players will be different. The recent mergers and acquisitions may have been an outflow of a confluence of many events, but they are driving a cycle of even more change in the future. BR