ANALYSIS

Trump's $1.5trn infrastructure pledge fuels surety bond market optimism

International insurers are eyeing the US surety bond market, tempted by low loss ratios and increased construction volume, but some fear underwriting standards could loosen and federal infrastructure investment may not materialise

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The US surety market is in rude health, posting strong premium growth, low loss ratios and high profitability levels, even though the US economy has performed modestly for most of the past decade.

With GDP growth accelerating and a much-awaited inflow of infrastructure investments looming, it is not surprising that international insurance groups are looking at the segment in their hunt for a reliable source of growth in a soft market.

Companies like Tokio Marine and Sompo International have recently made acquisitions in the US surety marketplace, while Allianz, Euler Hermes, Berkshire Hathaway and XL Catlin have variously started or resumed operations there, sources say. And market insiders say the expansion of the market, which provides protection against contractors' and service providers' inability to fulfill contractual obligations, is far from over.

Indeed, in a fragmented market, where dozens of companies have a market share of less than 3%, opportunities for acquisition or consolidation could be ripe for international insurance firms.

Skills shortages

Yet challenges also lie ahead for the sector. A shortage of skilled labour, both in the construction industry and among surety companies, coupled with the risks associated with a growing economy, could increase loss ratios and threaten the profitability of the sector, experts say.

$5.9bn
Value of the US surety market at end of 2016, in direct premiums written

Lynn Schubert, the president of the Surety and Fidelity Association of America (SFAA), also warns underwriting discipline could falter, given the abundance of capital in the market. "There is so much capacity and so much foreign capital coming into the surety bond market that people may write bonds for projects they might not have written otherwise, as they do not want to lose the account to the competition," she says.

So far, however, the sector's performance is holding up well. Ihab Loubieh, vice-president of surety at JLT Specialty USA, says in the past decade loss ratios have remained below 20% every single year, with only one exception, when they reached 21%.

Profitability trends have also been positive: in the same period, underwriting income for the industry breached $1bn in nine out of 10 years, according to rating agency AM Best.

Even the financial crisis, which caused a slump in construction spending after 2008, was unable to prevent surety insurers doing well.

"As we came out of the construction downturn the surety industry expected losses, but losses did not materialise to the extent feared," Loubieh says. "Improvements in underwriting analytics and technology have also helped sureties to better handle losses and increase underwriting sophistication."

The construction industry has done its part as well, as companies have adopted more efficient processes to survive the last recession and are now well positioned to benefit from a rebound in infrastructure investments.

"There has been a significant improvement in the performance of contractors," David Hewett, the US surety practice leader at Marsh, says. "They are much more sophisticated than they were 10 years ago."

Optimism about the US surety bond sector has also been fuelled by the expectation that growth of its main underlying market – the construction of infrastructure sponsored by government entities – will finally catch up with the rest of the economy. The deterioration of the country's bridges, roads and other infrastructure has been a recurrent theme in America in recent years. In February the US president, Donald Trump, announced a plan to inject $1.5trn into infrastructure spending.

The plan could provide a shot in the arm to the construction industry and, as a consequence, to providers of surety bonds, which have done well even though public spending in infrastructure has been sluggish. "Residential and commercial construction, which rely primarily on private investments, is thriving, but public spending, which is typically focused on infrastructure, has been relatively flat," Brian Beggs, executive vice-president of surety at Sompo International, says.

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Bonding is mandatory for contractors that work on projects commissioned or owned by the federal, state or local governments. The large majority of the market is therefore linked to public spending, although brokers have reported a spike in interest from private developers for bonding solutions.

"Private spending in construction has been strong in recent years and it has helped to drive the surety market," Loubieh says. "Private projects are not legally required to be bonded in the same way as public projects, but we have seen an uptick in demand for bonds associated with private spending."

It is estimated that contract bonds, which ensure the completion of projects, amount to around 60% of all premiums, with commercial bonds, which cover items such as the need for specific licences to meet requirements demanded by government agencies when hiring contractors, making up the remainder.

In the US, unlike other markets, bonds usually cover 100% of the value of a project, which means if a contractor goes bust, the insurer needs to make sure the works will be completed. It is a segment that is demanding in technical and financial capabilities, and companies that have looked at entering the sector have focused on acquiring established players so they can hit the ground running.

One example has been Sompo International, which in January agreed to acquire Lexon Surety Group, which by the third quarter of last year was the 13th-largest surety insurer in the US, according to the SFAA. "Lexon's scale is very attractive to us," Beggs says. "They are also highly regarded with many experienced underwriters, and a broad range of surety product capabilities."

Sompo has been in the American surety market since 2011, but repositioned itself a couple of years ago, narrowing its approach, Beggs says. Now the company has decided to pursue a more ambitious growth plan, and had already increased its presence with the purchase of Endurance in March last year.

13.4%
Travelers' share of the US surety market

Beggs believes consolidation and acquisitions are not over. "After the top five surety insurers in the US, there are a number of companies that hold between 1% and 3% of market share," he says. "In segments such as commercial surety, pricing, terms and conditions are extremely competitive and we do not see that changing in the near term.

"However, I do think that we will see a degree of churn, with new entrants, more consolidation and companies exiting the business. I expect significant changes in the surety market over the next five to 10 years," he adds.

In addition to Sompo International, another Japanese underwriter, Tokio Marine, placed a foothold in the American surety market with the purchase of HCC (the seventh-largest surety insurer in the SFAA ranking) and Philadelphia Insurance (the 12th).

Liberty Mutual, the second-biggest player, has increased its volume of premiums with the acquisition of Ironshore (41st).

The top 10 surety writers in the US in September 2017, in order, are Travelers (with a 13.4% share of the market), Liberty Mutual, Zurich, CNA, Chubb, Hartford, HCC, IFIC, Great American and NAS.

By the end of 2016, the industry totalled $5.9bn in direct premiums written, with a loss ratio of 18.7%, according to SFAA data.

Loubieh says the majority of new entrants in the surety market have focused primarily on middle-market contract business, a group in which he includes projects worth $150m and below. He sees opportunities for surety insurers not only from a flow of traditional government procurement, but also in new kinds of projects, such public-private partnerships (PPPs) and design building finance, as well as in the private sector, where bonding is on the rise.

PPPs, for instance, should provide an impetus for the market to innovate and offer bonds suited to the particularities of the model, which is still little used in the US, analysts say.

One of the fears in the industry, in fact, is that loss ratios could rise if contractors overextend themselves owing to an increase in the volume of work they take on. "We are all concerned that investments from the infrastructure package coupled with a lack of enough skilled workers even for the work that we have, will mean that contractors will overextend, resulting in project defaults and losses," Schubert says.

Top 10 surety writers in the US, Sept 2017*

1. Travelers
2. Liberty Mutual
3. Zurich
4. CNA
5. Chubb
6. Hartford
7. HCC
8. IFIC
9. Great American
10. NAS

*according to SFAA data

Susan Hecker, the director of national contract surety at broker Arthur J Gallagher, says that there have been cases, particularly with private projects, where construction costs have spiked up and developers are struggling to make payments to contractors.

There are also fears losses could emerge from so-called "stinker jobs" taken by companies at the height of the recession, so they could stay afloat, but which are now weighting on contractors. Losses have not materialised yet, however, Hecker says.

"There is still very adequate capacity, and very few underwriters are saying no," she adds.

A further concern is the scarcity of skilled labour in the construction industry.

But brokers say there are no signs that underwriting has become excessively lax due to the increase in competition. "There seems to be some relaxing in contract terms and policies, but is not leading to an increase in losses," Hewett says. "So it seems that the relaxing is appropriate."

Another concern for the industry is that all the noise about infrastructure spending made by the government may end up looking like a whimper. "The infrastructure plan has been a big disappointment for the construction industry and the surety industry," Hecker says.

"The president has budgeted a $1.5trn plan, but with only $200bn in federal money. He expects the rest to come from states and local agencies and private industries in the form of PPPs. But states and local agencies don't have the money. Also, there has been a number of examples where the PPP model has not worked well in the US." ■