TWELFTH ANNUAL
SOUTHERN SURETY AND FIDELITY CLAIMS CONFERENCE

HOW OBLIGEES VIEW THE BOND PRODUCT AND HOW CLAIMS REPRESENTATIVES CAN HELP CHANGE THAT PERCEPTION

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SUMMARY OF SIO'S MARKET RESEARCH ON PRIVATE OWNERS' PERCEPTIONS OF CONTRACT SURETY BONDS

In late 1999, SIO contracted with Hagler Bailly to conduct market research on private owners' perceptions of contract surety bonds. With the assistance of the SIO Policy Board, Hagler Bailly developed an "Interview Guide" to measure private owners' knowledge, experience, expectations, and perceptions of the surety bond product.

Hagler Bailly conducted 63 in-depth interviews, lasting 30 - 45 minutes each, with company representatives from hotel, restaurant, and entertainment (8); retail (9); utility (14); health care (7); manufacturing (6); and education (16). The persons interviewed included risk managers, construction managers, physical plant directors, and directors of facilities. Three bank construction lending officers also were interviewed. Companies to be interviewed were selected from a list of more than 2,000 companies provided by SIO. The contacts came from the *ENR* Top Owners list, Dun & Bradstreet, *Corporate Yellow Book*, and other sources. The market research was completed in early 2000.

FINDINGS

Awareness of Surety Bonds is High, Specific Knowledge is Sporadic

- Nearly all owners were aware of contract surety bonds and revealed a very basic knowledge. Only a few were able to discuss the different types of surety bonds. Many were unclear on the specifics of how bonds worked, what they cost, and how to make a claim.

- Nearly all owners recognized that the primary purpose of a surety bond is to protect the owner although a number of owners recognized that bonds also protect subcontractors and suppliers.

- Most owners were not aware of other services that surety bonds offer beyond project completion. A few were familiar with a maintenance bond.

- Most owners said the cost of a bond is 2-8% of the contract price.

Experience with Surety Bonds

- More than half of the owners have required a surety bond for one or more projects.

    - 9 always or usually bond
    - 15 sometimes bond
    - 17 rarely or occasionally bond
    - 21 never bond

- More than half said there is a high likelihood of requiring surety bonds on one or more future projects. They plan to use bonds selectively, especially:

- on large projects (over $250,000)
- on complex or “Cutting Edge” projects,
- when working with unknown contractor, or
- on projects with very long or very limited time frames.

! One in three said the underwriting process to pre-qualify contractors is useful.

- Some have developed their own prequalification process specifically tailored to their projects and saw no need to bond.
- Some only work with known contractors, eliminating the need (in their minds) for the surety=s pre-qualification.
- Some would like the contractor’s pre-qualification information made available to them.
- Several owners routinely waive the bond. Some simply ask the contractor if he can be bonded and at what level but don’t require the bond. One said,”If you use the prequalification ratings to find out if a contractor can get bonded, there’s no reason to require the bond.”

Some feel the process discriminates against smaller, but capable contractors.

Contractor Default/Claims

! Owners who use bonds regularly and who have not filed a claim view surety bonds as a good value.

- One felt that bonds required more paperwork and added 5% to the total bid but rated bonding as a generally positive experience.
- One owner who used bonds and experienced contractor defaults reported a positive experience 60% of the time.

! One in three owners who experienced contractor default had a surety bond in place.

- One in three owners had experienced a contractor default sometime in their career, although not necessarily in their current position.
- Some said the surety company handled the situation appropriately, helping to complete the project on time and within budget.
- Others cited “lack of responsiveness” by the surety, saying that the surety did not want to assume responsibility for the contractor’s actions. Some owners believe that the surety puts its own interests above those of the owner.
- Bank construction lending officers were generally dissatisfied with surety companies’ performance, although all 3 said they had recommended bonds as a condition of a loan.

! Most owners view surety companies claims handling as a negative attribute of surety bonds.

- Some said that surety companies don't want to "fix things" with the original contractor. They'd rather get a new contractor to finish the project.
- Others felt the claims process causes delays and down-time, rather than moving the project toward completion.
- Some owners felt that claims handling begins too late in the process to salvage the relationship with and trust in the defaulting contractor.
- Some that had no experience with a claim still viewed the process negatively through word-of-mouth.
- Owners believe that collecting on a claim from a surety company is a difficult and time-consuming process. Owners who never experienced a claim situation share this perception with owners that have.

! Owners who suffered significant losses said they were at least breaking even by not purchasing surety bonds for all of their projects. Their contractor default rate was low enough (1-2%) to justify the risk.

! Owners offered the following suggestions for improving the claims process:

- Provide schedule guarantees,
- Provide contacts within the surety company,
- Provide detailed information on the process and when the surety will intervene,
- Provide a timeline for handling claims,
- Give definitions of non-performance, and
- Spell out what is covered by the bond.

Perceptions & Attitudes

! Many owners viewed surety bonds as unnecessary because cost doesn't justify the risk.

! Decisions about bonds are made based on input from risk managers, construction reps, and financial managers. Each brings a different knowledge and perspective of surety bonds.

! Many felt they know enough about surety bonds to make the decision to bond or not, although in many cases the decision is handled by someone else in the company.

! Owners who bonded regularly but never had a claims situation viewed bonds more positively than those who had experienced a default/claims situation.

! Owners with negative attitudes about bonds seemed less open to learning more about surety bonds. Some however, admitted that they needed more information and were open to receiving it

! Many owners associate contract surety bonds with public sector projects.

- Advantages of surety bonds:

  - They allow owners to work with unknown contractors.
  - Surety bonds provide the most comprehensive protection available to them.

Other Risk Transfer Products

- Given the perceived incidence of contractor defaults and the low risk nature of the majority of their projects, owners generally viewed other risk transfer products as more efficient and cost effective than surety bonds.

  - Many thought Letters of Credit were faster and easier to collect and more flexible than surety bonds.
  - There was no consensus on cost of bonds vs Letters of Credit.
  - Owners also may use contract clauses, joint check payments, retainage, lien waivers, negotiation, E&O insurance, CMs, and cashier's checks to manage risk.

- Many owners stated that using contractors known to them was the best method for alleviating risk.

BARRIERS TO USING SURETY BONDS

- Many owners felt that the cost of surety bonds outweighs the expected value and potential benefits. They thought a bond cost from 2% to 8% of the contract amount. Most owners consider contractor default as a low risk (1% - 2%), because they tend to use the same contractor and the good relationships they've developed.

- Cost makes it feasible only for large projects or when using an unfamiliar contractor.

- A large percentage of owners expressed dissatisfaction with the claims process.

- Many answers given by the owners revealed a lack of knowledge and need for more information about surety bonds.

IMPROVING THE PRODUCT

- Simplified bond forms and faster and simpler claims process

- Owner involvement in the claims process

- Guaranteed rate

- Detailed financial information on contractors made available to owners

- More information on cost of bonds, cost-benefit analysis worksheet, how rates are determined

- Better explanation of claims handling process, number of claims, loss ratios

- Information on surety companies

- Definitions

- Causes of contractor failure

- Case studies

- Owners would use the following to obtain this information:

    - Web site (60%)
    - Phone call from agent or company representative - existing agent (majority) “cold call” (60%)
    - Seminars (less than 50%)
    - Advertisement in magazine (less than 50%)
    - Exhibit at trade show (3%)

Hagler Bailly Recommendations

- Continue education efforts.

- Simplify and clarify the cost and processes.

- Identify and clearly differentiate products and services for the private sector construction market. A product specifically for private owners will grab their attention and increase awareness.

- Offer different types of products to suit owner’s needs, such as a cost-effective bond for the small, low risk project.

- Overcome negative perceptions of cost and claims handling. Owners want to know which surety companies provide strong claims handling services and which ones do not.

SIO’S EFFORTS TO CHANGE PERCEPTIONS

- New products.

- Marketing strategy.

- Work with private owner groups.

- Work with design professionals.

- Work with surety industry.