GC SURETY SPECIALTY PRACTICE
U.S. and LatAm Surety State of the Market
FILE 2019088
Section 1

State of the Primary U.S. Surety Market
U.S. Surety Industry Overview
Mix of Business and Distribution

Contract Surety

- Driven by The Miller Act, which requires public works projects to have surety bonds in place that guarantee performance and payment obligations of the contract

Commercial Surety

- Traditional commercial surety products driven by statutory requirements
  - License & Permit Bond
  - Court – Fiduciary Bond
  - Federal & Public Official Bond
- Specialty commercial surety market includes obligations surrounding:
  - Coal
  - Oil & Gas
  - Waste Management
  - Environmental Hazard

Distribution

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

U.S. market differs from rest of world by requiring bonds at 100% of contract value
U.S. Surety Industry Overview
Historical Written Premium and Loss Ratios

- Premiums steadily growing since 2012
  - 2017 saw industry premiums reach over $6.0B
- Profitability of the line remains steady with loss ratios continuing generally below 20% since 2006

Data from Surety & Fidelity Association of America (SFAA)
U.S. Surety Industry Overview
Loss Ratios and Underwriting Cycle

Historical Calendar Year Direct Loss Ratios
(Excludes Loss Adjustment Expense)

- Periods of excess capacity drive softer underwriting conditions which are followed by periods of increased loss ratios
- Industry continues to perform well through current soft market

Data from Surety & Fidelity Association of America (SFAA)
Six states drive ~44% of DPW in 2018
- California and Texas represent nearly 25% of premium alone

With the exception of NY and IL, the largest six premium states have grown faster than the US average over last 5 years
- Other notable growth areas:
  - Colorado due to economic and housing growth
  - Wyoming has seen increase in Coal Reclamation bonding

The five year loss ratio has averaged 18% nationally; however, the southeast region of the US has incurred higher loss ratios

Source: GC Risk Benchmarks Research, US Statutory Data
U.S. Surety Industry Overview
Outlook for Contract Surety

- Industry continues to grow and remains profitable
  - Construction backlogs remain adequate for near term
  - Profit margins have been growing
- Areas of concern:
  - Construction labor force not yet fully recovered from pre-recessions levels
  - Increased material costs
  - Interest rate uncertainty

*Data from Federal Reserve Bank of St. Louis (https://fred.stlouisfed.org)
### U.S. Surety Industry Overview
Addressing Areas of Concern in Contract Surety

<table>
<thead>
<tr>
<th>Area of Concern</th>
<th>Issue / Solution</th>
</tr>
</thead>
</table>
| Labor shortage       | • Expand recruitment networks  
                      | • Improving retention practices  
                      | • Wage and salary reviews critical to compete  
                      | • Cross train employees to make them closer to organization  
                      | • Make worker safety a priority with employees  
                      | • Increase use of technology  
                      | • Utilize time tracking / scheduling applications to reduce labor costs  
                      | • Automate processes e.g. increased use of drones in lieu of surveyors to track site progress |
| Increasing Material Costs | • Purchase material and trade buyout contracts to lock in pricing post project award  
                      | • Lock in fixed pricing with vendors / suppliers pre-project  
                      | • Purchase and store strategies allow contractors to be paid for materials upfront rather than upon install |
| Interest Rate Rise   | • Lock in low rates  
                      | • Pay down interest-bearing debt  
                      | • Avoid use of operating lines of credit  
                      | • Understand that efficient financing strategies and cash produce successful contractors |
## U.S. Surety Industry Overview
### Opportunities and Threats for the US Surety Industry

<table>
<thead>
<tr>
<th>Strengths</th>
<th>Weaknesses</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Continued profitability of Surety line</td>
<td>• Underwriting terms and conditions softening</td>
</tr>
<tr>
<td>• Surety capacity is high</td>
<td>• Lack of experienced underwriters</td>
</tr>
<tr>
<td>• Contractor default rates remain low and profit margins improving</td>
<td></td>
</tr>
<tr>
<td>• Backlogs sufficient in near term</td>
<td></td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Opportunities</th>
<th>Threats</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Greater acceptance of public / private partnership project delivery</td>
<td>• Stalled infrastructure spending</td>
</tr>
<tr>
<td>• Increased focus on construction markets outside U.S.</td>
<td>• Continued labor shortages</td>
</tr>
<tr>
<td>• Mergers and acquisitions of smaller scale companies</td>
<td>• Volatile material price increases</td>
</tr>
<tr>
<td></td>
<td>• Rise in interest rates</td>
</tr>
<tr>
<td></td>
<td>• Competition from subcontractor default insurance</td>
</tr>
</tbody>
</table>
Results continue to be strong
- Historically smooth results other than outlier period; early 2000s loss ratio spike mainly attributable to Enron and soft underwriting cycle
- Loss ratios continue to trend favorably
- Ability to grow book easier than contract surety by offering capacity

Less barriers to entry than contract surety
- Less labor intensive/costly underwriting expenses
- Less field offices/representatives needed; financial statement underwriting can be centralized
- Opportunity for international capability in market for multinationals

U.S. Surety Industry Overview
Historical Results in Commercial Surety

Data from Surety & Fidelity Association of America

*Data from Surety & Fidelity Association of America

**Early 2000's**
- Reflects period of soft underwriting and industry driven loss activity (Enron)
- Numerous carriers substantially lessened their commercial surety presence

**2002-2009**
- Experienced market hardening
- Period of significant profitability

**Since 2010**
- Softer market environment
- Multiple new entrants
- Existing sureties broadening appetite
Hardening of the market does not appear likely in the near future unless capacity significantly reduces.
Surety represents ~1% of written premiums in U.S. P&C Industry

Surety has outperformed U.S. P&C industry in combined ratio 18 of last 23 years

Surety combined ratios over 100% seen during last cycle lasting from 2001 to 2005
  - Average combined ratio during this period: 116%

Average combined ratio in profitable years (i.e. < 100%): 75%
Surety industry premium has more than doubled in the last two decades from $2.9B in 1998 to $6.6B in 2018.

<table>
<thead>
<tr>
<th>No.</th>
<th>Company</th>
<th>YE 2018 DPW</th>
<th>Market Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Travelers Bond</td>
<td>888 M</td>
<td>14%</td>
</tr>
<tr>
<td>2</td>
<td>Liberty Mutual Group</td>
<td>816 M</td>
<td>12%</td>
</tr>
<tr>
<td>3</td>
<td>Zurich Insurance Group</td>
<td>586 M</td>
<td>9%</td>
</tr>
<tr>
<td>4</td>
<td>CNA</td>
<td>478 M</td>
<td>7%</td>
</tr>
<tr>
<td>5</td>
<td>Chubb Ltd</td>
<td>398 M</td>
<td>6%</td>
</tr>
<tr>
<td></td>
<td><strong>Top 5 Writers</strong></td>
<td><strong>3,165 M</strong></td>
<td><strong>48%</strong></td>
</tr>
<tr>
<td></td>
<td><strong>Top 6-20 Writers</strong></td>
<td><strong>1,828 M</strong></td>
<td><strong>28%</strong></td>
</tr>
<tr>
<td></td>
<td><strong>Total Industry</strong></td>
<td><strong>6,582 M</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>

Source: GC Risk Benchmarks Research, US Statutory Data

Market share is concentrated with the top 5 writers; however, top 6-20 writers have nearly 30% of market.

Strong industry performance trend partially due to disciplined underwriting of top five writers.
U.S. Surety Industry Overview
Breakdown of Results

• The industry continues to run very profitably with a combined ratio of ~70% over the last five year period

<table>
<thead>
<tr>
<th>Company Name</th>
<th>2018 DPW ($M)</th>
<th>Market Share</th>
<th>5 Yr DPW CAGR</th>
<th>Direct Loss &amp; DCC Ratio</th>
<th>Net Loss &amp; DCC Ratio</th>
<th>Direct Expense Ratio</th>
<th>Net Expense Ratio</th>
<th>Direct Combined Ratio</th>
<th>Net Combined Ratio</th>
<th>CY 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top 5 Writers</td>
<td>3,165</td>
<td>48%</td>
<td>3%</td>
<td>12%</td>
<td>13%</td>
<td>47%</td>
<td>51%</td>
<td>59%</td>
<td>63%</td>
<td>60%</td>
</tr>
<tr>
<td>Top 6 - 20 Writers</td>
<td>1,828</td>
<td>28%</td>
<td>7%</td>
<td>23%</td>
<td>18%</td>
<td>56%</td>
<td>61%</td>
<td>79%</td>
<td>79%</td>
<td>76%</td>
</tr>
<tr>
<td>Industry ex. Top 20</td>
<td>1,590</td>
<td>24%</td>
<td>6%</td>
<td>24%</td>
<td>20%</td>
<td>57%</td>
<td>59%</td>
<td>81%</td>
<td>79%</td>
<td>74%</td>
</tr>
<tr>
<td>Industry</td>
<td>6,582</td>
<td>100%</td>
<td>5%</td>
<td>18%</td>
<td>16%</td>
<td>52%</td>
<td>55%</td>
<td>69%</td>
<td>71%</td>
<td>68%</td>
</tr>
</tbody>
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Source: GC Risk Benchmarks Research, US Statutory Data

• 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 offerings by Top 5 Writers reduces their overall expense ratios

Continued long term industry profitability trend has led to new entrants as carriers seek expanded growth opportunities in the U.S.
### Standard Elements of a Successful Surety Company

<table>
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<tr>
<th>Financial</th>
<th>Underwriting</th>
<th>Profitability</th>
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</thead>
<tbody>
<tr>
<td>• Treasury listing (T-List)</td>
<td>• Hire leadership that has experienced both hard and soft cycles</td>
<td>• Manage expense ratio</td>
</tr>
<tr>
<td>• Required to write Federally funded projects</td>
<td></td>
<td>• Acquisition costs: 20% - 40%</td>
</tr>
<tr>
<td>• 10% of admitted assets</td>
<td></td>
<td>• Underwriting expense: 20% - 30%</td>
</tr>
<tr>
<td>• 6 to 18 month process</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• AM Best rating of A- or better</td>
<td>• Establish strong checks and balances for underwriting</td>
<td>• Recognize surety bond as a cat product</td>
</tr>
<tr>
<td>• Rate filings and licensing in all potential states</td>
<td>• Underwriting intensive, unless automated commercial surety</td>
<td>• Typical combined ratios near 80%</td>
</tr>
<tr>
<td>• Flexible rate plans are commonly used to adjust rate to risk</td>
<td>• Limited cross sell with insurance product lines</td>
<td>• Cat years can exceed 150% combined ratio</td>
</tr>
<tr>
<td>• Contract surety rates range from 0.5% to 3%</td>
<td>• Agency footprint generally involves surety specialized agents</td>
<td></td>
</tr>
<tr>
<td>• Commercial surety rates range from 0.25% to 5%</td>
<td>• Manage accommodation pressure from other profit centers</td>
<td>• Tie compensation to net profit over time</td>
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- Recognize surety bond as a cat product
- Typical combined ratios near 80%
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U.S. Surety Market Overview

New Entrants

*Freedom combined operations under Nationwide name in 2014

New entrants attracted to Surety industry due to strong historical profitability, new business growth and lack of correlation to P&C lines
Section 2
Surety Reinsurance Overview
U.S. Surety Industry Reinsurance Utilization
Industry transitioned from per bond quota share to per principal excess of loss in late 1990s

Surety Industry
Reinsurance Utilization (% of Surety DWP Ceded to Non Affiliates)

Reduction in ceded reinsurance premiums also due to significant increase in U.S. Surety reinsurance market capacity over time
Surety Reinsurance Overview
U.S. Surety Reinsurance Capacity Continues to Expand

The Guy Carpenter Surety Specialty Practice accesses 50+ surety reinsurers across the globe

Capacity Overview
• Lead capacity generally from U.S. domiciled reinsurers
• Following capacity from other US reinsurers, Bermudian and European markets
• Lloyds has shown growing interest in U.S. surety reinsurance over recent years
• Asian markets looking to better understand business in order to enter market

Matching Clients and Reinsurers based on:
• Business unit relationships
• Corporate trading partners
• Value added offerings by reinsurers
  — Facultative offering
  — Availability of fronting paper
  — T-listing capacity
Surety Reinsurance Market Update
Abundant Capacity Leading to Continued Soft Pricing Conditions

CAPACITY TRENDS

• Margin deterioration in standard P&C reinsurance lines has led to increased capacity allocation to surety reinsurance
  – Surety industry performance has made it an attractive option
  – Leads to improved terms and pricing for sureties

RATE TRENDS

• Significant rate reductions in past renewals
• Recent renewals indicate surety pricing continues to be soft
  – Loss free programs continue to see rate improvement
  – Loss impacted programs have seen rate reductions where going forward strategy justifies expectations for improved results
• No impact of recent property market losses on reinsurance pricing for surety lines
Surety Reinsurance Market Update
Flexible Coverage in Light of Increased Loss Activity

COVERAGE TRENDS

- **Reinsurers continue to be flexible** in adapting to surety strategic business plans
  - Expansion of bond warranties
  - Elimination / narrowing of exclusions
  - Longer extended discovery periods
  - Additional reinsurance limit purchases
- **Facultative capacity remains minimal**; however, some markets are showing case by case interest in providing this capacity as an added value
- Ability to provide **fronting paper continues to be lacking**
  - Co-surety support by select reinsurers remains available on a limited basis

CLAIMS TRENDS

- **Significant loss activity** observed outside of U.S.
  - Bondfield, Carillion and Astaldi claims in Canada have significantly impacted market
  - International bank syndicated surety losses have escalated
- Increased number of U.S. surety treaties impacted by loss activity
  - Tightening **construction labor** market and **interest rate uncertainty** continue to be concerning
Section 3

Latin America Overview
Latin America Overview

- Surety market is ~$2.4B in premium and is ~1.5% of LatAm P&C industry
  - Brazil, Mexico and Colombia are the largest markets by writings and make up two thirds of market
- Gross loss ratios over past ten years have moderated between 20% and 30%
  - Combined ratios have increased in recent years due to increases in expense ratios
- Significant variations by country in:
  - Economic outlook
  - Surety pricing conditions
Latin America Overview

• Overall developed market for Surety in the entire Latin America region, with the #2 largest global market in Brazil and several other pockets of strong business

• Mixed between On-Demand type of bonding and Actual Loss basis differing country by country

• Overall premium in USD 2 billion range, with the top 3 countries accounting for ~70%

• Loss activity under control, with peak losses ranging below USD 150m on worldwide cases such as Abengoa, and other examples coming from Brazil construction companies’ issues such as Odebrecht.

• Market demonstrated reliability on collecting collateral and counter guarantees, as well as resilience to overcome long stretch of years with political and economic turmoil

• Fairly open market with Global players highly active amongst local and regional companies
With a market ranging at about USD 800m in issued premium per year, Brazil is experiencing a long growth period following the advance of the Judicial bonds in 2014.

The new type of bonding opened a market for all companies with any type of legal and judicial disputes, especially tax appealing cases with high volumes that were previously collateralized with hard cash or liquid assets.

The demand is far greater than the market can offer on a per principal basis, thus creating challenges of the ever growing exposures on peak names and how to drive the development of the product with clients.

The surge in infrastructure expected to come with economic recovery will pose new challenges associated with change in bidding law, as well as capacities that are either taken or not available for the traditional infrastructure players deeply involved in corruption investigations of the past years.

Further to the challenges and special aspects pointed out, a market of steady double digit growth and doubling in size over the next cycle of 5 years is still quite possible.
• Boom in start ups, from both banking and non-banking groups as investors are keen on taking advantage of the lower capital requirements, higher leverage ratios (Bankers) and high returns of the market

• Net retentions driven by smaller initial capital and outdated solvency regulations still challenging reinsurance market in the country

• Primary drive to credit analysis following the Judicial bonds boom will need to give space for performance and engineering underwriting to coexist when traditional market recovers

• Project finance and private sector interactions will be “new features” for the underwriters from the comparison with the past surge in infrastructure mainly driven by state actors as financers and project owners
Latin America Overview
The Future of the Surety Market in LatAm

• Steady growth from main markets will keep pushing the region that has experience with the product
• Political and economic turmoil on some economies will continue to pose challenges for both growth and results
• Local companies are increasing product specialization, as well as strong credit and underwriting procedures
• New forces can come up depending on political inclinations such as Venezuela and Argentina.
• Losses have been under control in the worst economic period ever measured in some countries and negative across the region – expectation for continuation of same trend
  – Horizontal growth should further enhance premium balance to face peak losses when they occur
• Product development and distribution are main drivers as companies are looking to expand market base and market share
• Strong interconnection with regional banking and finance industry