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## **Contract Bonds: The Evolution of Surety Are these 7 Dangers Opportunities in Disguise?**

### **“If you are standing still you are moving backwards”**

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Contract surety bonds provide a security guarantee on the performance of the contractor, a key member of the 3-party relationship between obligee, surety company and principal. Until today, there are no truly comparable risk mitigation alternatives to Surety bonds.

However, the globalization of the construction industry is introducing real competition in the form of Letters of Credit (LOC) and other security guarantee instruments. Industry specialists suggest it is in part due to the current bond wording, product deficiencies and handling as well as the cash value that make alternatives look attractive. Industry organizations such as the Surety Association of Canada have made major strides to update bond formats (e.g. new “Process Enhanced Performance Bond”). Adoption by the Industry of electronic bonding will enhance these initiatives as well as present an opportunity for the industry to emphasize the added value of bonds – as well as make these alternatives look less attractive.

Where practices remain largely manual and labour intensive the result can be overruns, delays and inefficiencies leading to costs and losses estimated at hundreds of millions of dollars from claims, frauds and malpractices, quantitative and qualitative lack of compliance issues, processing inefficiencies and clerical errors. Owner dissatisfaction and litigation further aggravate the situation.

This white paper examines seven real exposures in contract bond underwriting, and describes the enormous opportunity available by creating bonding commitments entirely through an electronic transaction. Leveraging new technologies to automate the underwriting activities of contract bonds can help a surety or brokerage take a quantum leap in performance. When we stop to look closely at each component and actions that can be taken, the results are quite remarkable!

The stakes are high and the rewards are great. To a brokerage processing 10,000 bid bonds per year, the rewards are \$500,000.00 or more. For a surety billing \$10,000,000.00 in premiums a gain in the range of \$1,000,000.00 may be well within reach.<sup>1</sup> Underwriting system and bond processing implementations have demonstrated reductions of 50% of labour while at the same team delivering a 100% increase in productivity.

The message is, “Automate bond management where the ROI is greatest and systems changes are minimal.” Assess the new process for value based on before and after results and then look for the next opportunity. Many examples are shown below. The essence of making it all work is to take day-to-day practices that work well and are already in place and to automate them in an intuitive and user friendly manner to make them even more effective.

Broker/Surety Integration of Bond Management is an additional area of opportunity that is referenced in our conclusion, however deserves special attention in a following paper.

This article is the culmination of years of collaboration with surety business specialists on surety system design and development. We acknowledge the active support we have received from Surety professionals from executive level to the front line and appreciate their enthusiasm for the timeliness and value of this research project.

# 1. Contractor Failure

At the end of the day, the percentage of claims represents success or failure to a surety. The success of a surety is a combination of the science and the art of risk assessment and management. Revenues lost annually because of surety bonds' claims are tremendous. According to the Surety & Fidelity Association of America (*SFAA*), surety companies have paid more than \$11 billion due to contractor defaults since 1994<sup>2</sup>. The Surety Association of Canada (*SAC*) statistics reveal that the total surety losses in Canada in 2010 reached 31% with a direct written premium of \$513 million. This is up from 16.75% and 17.34% in 2008 and 2009 respectively.

**Contractor failure** is the leading cause for construction contract claims. This is in large part due to the complexity of initially assessing risk and the ongoing challenge of accurately managing that risk. Most often, it all relates to the 3Cs of surety: Capital (financial capability), Capacity (operational capability) and Character (i.e., integrity).

For example, a road builder undertook a highway development project owned by the transportation department of a provincial government in western Canada for the total value of \$5,800,000. The default occurred when the road builder experienced financial distress and could not complete the project. In this case the surety paid the anticipated completion costs less the balance of the contract price as well as multiple subcontractor and supplier claims under the labour and material payments bond. Total payments by the surety for this project were \$3,300,000.<sup>3</sup>

According to *BizMiner (a US leader in industry analysis)*, out of 1,424,124

contractors in business in 2007 only 969,937 were still in business in 2009 – a 31.9% failure rate. These firms leave behind unfinished private and public construction projects—and still worse, billions of dollars in losses to project owners and taxpayers.<sup>4</sup>

Contractor failure is usually the result of multiple causes. The *SFAA* reviewed 86 claims cases and identified the top five factors contributing to contractor failure to be unrealistic growth (37%), performance (36%), character (28%), accounting (29%) and management (29%).<sup>5</sup>

Each of these 'Failure' factors contains several sub factors and we could easily further divide those sub factors into additional lists. In fact the number of factors that impact risk of contractor failure can easily run into the hundreds. The underwriter's challenge is to assess the likelihood of all these factors given the data available (the 'science'), factor in the relationship with the contractor and provide a risk evaluation. This is the 'art' of underwriting.

As contractors grow it gets more difficult to get the information and to underwrite the information. The underwriter must manage an incredible volume of sensitive data and keep it current so he/she can help the owner, broker and contractor manage their risk and recognize upcoming threats or potential problems.

Mitigating activities face challenges of their own. Having the right information requires contractor compliance in reporting current status at an appropriate frequency and Surety resources need to be dedicated to staying on top of contractor risk status without negatively impacting the contractor-surety-broker relationship.

This is where technology and electronic bonding applications can make a significant difference.

It is important to differentiate between systems that merely automate bond issuance and those that offer true bond underwriting system support. The difference lies in the latter system's ability to track and flag the risks associated with contractor failure during the underwriting process and to intuitively help the underwriter in the complete end-to-end bond preparation, approval, issuance and maintenance activities.

One of the most powerful approaches to risk mitigation and management – one that has provided a quantum leap in productivity and effectiveness for surety – is **Exception Based Approval**. The concept is simple in that most bonds (approximately 80%) are vanilla bonds. The contractors are stable and their data is current and reliable so approval is rapid. The underwriting system provides further refinements – each project has its own unique characteristics. This is a powerful addition to the process in place at many brokerages and sureties. When a project falls outside of the vanilla range, the system recognises it as an exception and moves it up one level of approval authority.

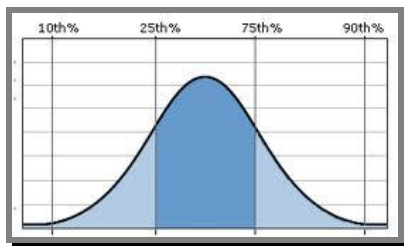


Figure 1

By automating to the maximum on vanilla type bonds and to some degree on more complicated bonds with e-bond applications, the underwriter is freed to focus on the

exception cases where the risk is the greatest.

Technology can also help with specialty tools like smart PDFs where the contractor or his/her professional representative (architect, lawyer etc.) can provide progress updates via smart PDF which are automatically uploaded on receipt. This is a powerful contractor risk tracking and recording mechanism that is available in an e-bonding underwriting system.

A carefully implemented e-bond application can deliver significant reductions in risk associated with contractor failure while simultaneously boosting underwriter productivity.

## 2. Incomplete Claims Processing Records

Incomplete claims processing records can cost millions<sup>6</sup>. A claim should theoretically never occur. However, when a claim is made the surety is expected to remedy the cause of failure or compensate for the losses based on the terms of the original agreement and subject to the compliance of all parties. But what if the supporting data is a combination of paper notes and various personalized spreadsheets, some collected in a conventional paper file and some in electronic format?

Add to this incomplete data and/or the fact that the underwriter has left the company and there is limited historical documentation. The audit trail is now incomplete because the paper trail is incomplete.

The surety may have to settle unfavourably. In any case, collection of pertinent information can be challenging if not, in some cases, nearly impossible. In speaking

with surety professionals this is a typical scenario for many.

It is virtually impossible to get an accurate tally of this cost. However if your file system is largely paper based and includes case notes and basic personalized spread sheet data it will lead to audit challenges and weaker positions on claims.

By design, comprehensive underwriting systems provide a single repository and audit trail for data required for claims documentation and are more effective approaches to data processing and information management than basic paper files, Excel, Word documents and off the shelf bond issuance systems.

### **3. Compliance, Audits and POA**

The Surety Industry, aside from being highly regulated is both internally and externally audited. Increasingly, surety companies, project owners (obligees), contractors (principals) as well as brokers and consultants are looking for and encouraging greater accountability through more effective bond underwriting and issuing practices. Data accuracy and quality become critical when a claim is filed. The paper trail must be followed and this is frequently a challenge during an audit.

When a contractor or subcontractor needs a bond, the first step is to contact a surety bond producer, also known as an agent or broker. The producer generally holds a power of attorney (POA) empowering the execution of surety bonds on behalf of a surety company for projects that fall within acceptable ranges established by the surety. One of the challenges in managing POA is capturing and managing the rights and agreements between surety insurers and

their representative bonding agents. The filing method that maintains the POA records must be accurate, current and easily accessible to all that need to review the producer's POA authority.

The Continental Insurance Company which was found liable to Herbert Construction Company (Herbert) in the amount of \$680,000 is a real case illustrating a surety's losses incurred from the misuse and lack of tracking and transparency of a manually processed POA.<sup>7</sup>

An electronic system provides a natural and intuitive means for meeting compliance requirements and providing an audit trail. Computers are becoming an extension of our everyday lives. It is only natural that the system has activity audits "built in". The audit trail becomes a by-product of a regular working day. This level of detail, checks and balances and reference can prove priceless during an audit.

Online POA management applications increase participant confidence by keeping up to date records of rights and agreements between surety insurers and their representative bonding brokers and agents. In addition, changes can be made in a timely fashion reducing the possibility of POA misuse. Accurate online POA records ensure the bond is enforceable and all aspects of the bond transaction are valid, including the identity and authority of the surety's attorney-in-fact.<sup>8</sup>

Electronic POA management further contributes to risk mitigation by enforcing specific guidelines for generation of a POA, naming the types of bond an agent is authorized to issue along with any monetary limitations. The system can automatically prevent an agent from proceeding and signing if their POA is revoked.

## 4. Fraud and Malpractice

From time to time obligees are finding the surety bonds they are accepting prove to be invalid. Contractors who buy these fraudulent bonds, and those who accept them at face value, are losing millions of dollars each year, according to bond-industry estimates.

No one knows precisely how severe the problem is, since most fraud of this type goes undetected. But federal investigators calculate that surety-bond fraud has exceeded \$800 million since the mid1980s.<sup>9</sup>

Contractors with a history of law-breaking have landed lucrative stimulus-funded construction contracts, with at least one contractor presenting fraudulent surety-bond documents as part of their winning bid.

The *Sacramento Bee* reported on how that city was swindled out of \$3.5 million by Advantage Demolition & Engineering owner Peter Michael Scott. A contract to install water meters was shut down by the city and both a federal and state investigation was launched into Advantage, which cashed city checks but allegedly did not pay workers.<sup>10</sup>

City officials were fooled by the bogus surety bonds Scott presented. The bonds appeared to be notarized and looked legitimate.

Contractors traditionally do not expect or allow for bond fraud – it could ruin their company and reputation, even if they were unaware of the malpractice committed by their bond agent.

Electronic bond issuance systems minimize the fraud issues related to paper bonds. They enforce mandatory business rules and limits

increasing bond security and reducing risk to nearly zero percent.

The Bid Depository in Quebec electronically processes 55,000 bonds/year, approximately 50,000 bid bonds and 5,000 contract bonds. Ninety percent of these bonds are electronic. In the 3 year history of the organization there has been a zero percent question on validity.<sup>11</sup>

## 5. Escalating Processing Costs

The cost of issuing paper based bonds is substantial. In addition to the underwriter's premium time and effort put into issuing the bond, there are other administrative and overhead costs involved. Market research shows that one administrative employee manually identifying, declaring and classifying one paper bond could cost approximately \$60.<sup>12</sup>

Bond delivery by courier is an accepted practice among brokers, sureties and contractors. According to *FedEx*, a priority mail piece (one ounce letter) approximately costs \$19 while a first overnight mail costs approximately \$30. This means that the average courier cost per one paper bond will be around \$15.<sup>13</sup>

What does this mean to the bottom line? For example, if the average contractor requires 4 bid bonds per month and wins 10 contracts per year a total of 58 bonds would be sent by courier each year. Total cost  $58 \times \$25.00 = \$720.00$ . Consider a broker or surety with 1,000 contractor clients. The annual courier bill is:

$$1,000 \times \$1,200.00 = \$1,200,000.00$$

Courier fees are typically absorbed by the broker and represent a significant annual operational cost. These costs do not include the 'green' costs of producing single

contract bids with as many as 8 or more copies. As one lawyer pointed out, “a single bid is not significant however when you multiply that bid by the millions that are submitted annually to municipalities, government and private business the carbon footprint is significant.

Delivery by courier or by mail is not fool proof. Obligees, brokers and sureties have shared many stories of routinely (weekly) receiving bond documents meant for another surety and, less frequently, missed deadlines due to an incorrect address or handling. In the case of a low bid award for example, a delay or loss of mail could cause the contractor to lose the job or a project worth millions of dollars.

With full end-to-end bond underwriting automation there is one place to enter the bond information, one source of information to review and approve one place to make corrections and one source of input on which to finalize the bond.

Bond issuance systems are showing their value through production numbers. A bond production volume increase of 40 – 100% typically involves no increase in staffing.

The benefits of streamlining and automating the bond build, review, approve, issue and maintain processes are impressive. As bidding time periods shrink, particularly on smaller contracts, processing of bid materials including bonds comes under more time pressure. The difference in delivery time and the certainty of delivery are important factors. Benefits include improvements in people productivity, faster delivery and increased accuracy along with all the bottom line cost savings associated with these improvements.

## 6. Errors and Omissions

To quote an obligee at a major Canadian corporation, “It’s frustrating when we have to toss out a bid from a reliable contractor because of a technical error. We have not had that experience with electronic bonds.”

How often does a clerical error take place? Industry averages peg the error rate in bonds at 10%+. One broker shared with us that data related to a bond may be entered as many as 30 different times in the course of preparing, issuing and following a bond. The potential for human error is very real here. The impact here is typically felt most directly by the issuing broker.

The underwriter administers and monitors complex underwriting rules and guidelines within surety to ensure that bond forms; application forms; forms for indemnity, subordination, collateral; and other agreements are completed and filled out appropriately.

What happens when an innocent mistake occurs? How much can a mistake cost? A small mistake can result in claims of negligence, misrepresentation, misstatement, professional malpractice, and breach of contract and can be expensive. Notarial losses are becoming more common everyday, from small suits – many in the \$3,000 to \$15,000 range – to major verdicts involving tens of thousands of dollars!

Errors and omissions can also result in a winning bid being disqualified and replaced by a second choice bid. In the US, many state departments of transportation (DOTs) estimate awards to second or third bidders cost millions of dollars in the course of a year—money that otherwise could be spent on projects.<sup>14</sup>

There is an additional cost to bid bond errors where the error causes the bond to be omitted from the bidding. The contractor/broker/surety relationship is damaged by this failure to provide a required service and will likely take some serious fence mending to remedy the relationship - a core element of the surety business.

Rigorous in-house procedures seem to be the byword in prevention of simple transcription of data entry errors in a manual bond processing environment. The use of bond templates has gone a long way towards prevention of errors however it does not address the quality of the data

More project owners or obligees are requesting or insisting contracts be bid electronically to reduce administrative costs and errors. At the September 19, 2011 general meeting of the Surety Association of Canada this message was reinforced.

For those with large-scale construction programs, the case for e-bonding is compelling. In 42 US states DOTs accept electronic bids and bonds.<sup>15</sup>

Reducing errors and omissions is a “sweet spot” for e-bonding applications.

## **7. The Talent War**

Sureties and Brokers are constantly on the lookout for qualified underwriters and brokers. Demand often exceeds supply in the case of top talent. In Insurance Networking News, December 1, 2011 changes in workforce are shown to be dramatic: “Half of today’s insurance industry workforce will retire during the next 10 years, forecasts National Alliance Research Academy research. The quickest

growing segment of the insurance workforce is employees older than age 60.”

Underwriters tell us they spend 60% or more of their time processing forms and following up on business process. Much of this work is repetitive and all of it is necessary, to meet the strict requirements of the surety industry. This work is, however mundane and time consuming.

One of the trademarks of surety underwriters is that they are always incredibly busy – one of the questions is ‘busy doing what?’ When a number of bonds are due and schedules are tight one underwriter confided they would like to spend more time on the risk aspects of bond underwriting. Where automation supports data access the surety underwriter is able to access more pertinent data faster for risk analysis and support data.

Sureties and brokerages can use their automated systems as an attractive benefit when competing for new talent.

The current generation of new brokers and underwriters are children of the electronic age, instant communications and processing. Cumbersome business practices are a step backward for them. It’s no wonder they get impatient with slower business processes.

The new generation underwriters are looking for companies that understand how to streamline business process and take advantage of effective new technologies that make their work more productive and enjoyable.

Top performers are attracted to companies that provide a great working environment, full support, high quality training, career opportunities and the most effective tools. They appreciate challenging work. The best

sureties and brokerages make a genuine effort to meet these requirements.

With an intuitive interface and robust electronic underwriting application, new underwriters can become productive in two weeks and standardized documentation requirements met simultaneously. The new generation has high expectations for rapid career advancement and a need to see they are making a contribution as soon as possible. Electronic bonding solutions meet their working world expectations.

## What's Next?

Across these 7 dangers/opportunities that contract bonds management presents, we are looking at potential costs savings (on a sample of 10,000 bonds) of \$250,000 in couriers and \$600,000 in internal processing. Overall reduction in the claims area, through risk analysis and processing efficiencies could in itself save millions of dollars. The former more directly impact brokers, the latter sureties.

The soft benefits may be even greater through increasing obligee confidence, building and keeping great relationships, reducing claims and lawsuits, knowledge management and the resulting advantages of a combination of these benefits.

As a bi-product of reviewing literature and having many generous conversations with industry stakeholders about bond issuance and maintenance and the underwriting systems currently in place one thing has become very clear. Embracing e-bonding is an evolution not a revolution. The responsibility of an underwriter to his/her obligee and principal cannot be jeopardized, projects must remain well protected. They must be comfortable with the e-bonding features and facilities and believe that the

application enhances their ability to assess and manage risk.

A proven way to proceed is to introduce process automation in phases, starting with the opportunities for greatest benefit for least effort.

Examples of automation opportunities that produce big gains include:

- Account Accreditation
- Bond issuance
- Integration of Broker/Surety Bond Management
- Bond post issuance amendments
- Project progress monitoring
- Electronic submission vs. courier
- Compliance and POA – audit trail
- Claims management
- Integration with accounting and other systems
- Analytics and Business Intelligence

In the Surety industry, there is acknowledgement that e-bonding offers unprecedented opportunities to reduce processing costs, enhance transparency and increase efficiency for all parties. Such electronic methodologies, however, must be open, interoperable and have adequate security and privacy safeguards to preserve the integrity of a competitive bonding environment. At a minimum, electronic bond processes should reduce confusion and allow access to all qualified bidders. Processes should not affect the legal rights and responsibilities of any party: owners, construction managers, contractors, sureties or bond producers.

These 7 surety situations are real and are costing the industry millions of dollars. E-bonding offers a solution, that is equally real and ready to save the industry millions of dollars.

*For more details on specific points of interest, please contact us at:*



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## Endnotes

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<sup>1</sup> Anecdotal. Numbers quoted are typically a combination of courier costs, reduced labor (50% recorded) claims management and others. Further information available on request.

<sup>2</sup> Surety Market Overview – Construction Executive magazine  
The Value of Surety in Today's Challenging Construction Economy  
[http://www.constructionexec.com/Issues/November\\_2008/Features2.aspx?pageNum=2](http://www.constructionexec.com/Issues/November_2008/Features2.aspx?pageNum=2)

<sup>3</sup> Surety Association of Canada Claims Files Examples  
Provincial Transportation – Road Builder  
<http://www.surety-canada.com/SITEFORUM;jsessionid=E77B6953B2FAB4CDD0393FC5A9487C59?t=/contentManager/selectCatalog&i=1286031022106&l=0&e=UTF-8&ParentID=1266424031948>

<sup>4</sup> Why Do Contractors Fail?  
Surety Bonds Provide Prevention & Protection <http://www.sio.org/html/whyfail.html>

<sup>5</sup> <http://www.sio.org/pdf/whycontractorsfailMCS.pdf>

<sup>6</sup> 10 Things You Should Know about Surety Bonding  
<http://www.sio.org/html/10things.html>

<sup>7</sup> <http://openjurist.org/931/f2d/989/herbert-construction-company-v-continental-insurance-company>  
<http://law.justia.com/cases/federal/appellate-courts/F2/931/989/423136/>

<sup>8</sup> Summit, Canada's magazine on public sector purchasing  
[http://www.summitconnects.com/Articles\\_Columns/PDF\\_Documents/w11\\_04\\_02.pdf](http://www.summitconnects.com/Articles_Columns/PDF_Documents/w11_04_02.pdf)

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<sup>9</sup> CBS/INTERACTIVE BUSINESS NETWORK RESOURCE LIBRARY

[http://findarticles.com/p/articles/mi\\_m1154/is\\_n7\\_v81/ai\\_14017932/](http://findarticles.com/p/articles/mi_m1154/is_n7_v81/ai_14017932/)

<sup>10</sup> Fake Surety Bonds Part of Stimulus-Funded Contractor Fraud Problem – February 19, 2010

<http://www.suretybonds.com/blog/fake-surety-bonds-part-of-stimulus-funded-contractor-fraud-problem/436>

<sup>11</sup> In discussions, Bid Depository has no record of questions re. validity of ebonds.

<sup>12</sup> Salary and wages of insurance underwriters [http://www.bls.gov/oco/ocos026.htm#oes\\_links](http://www.bls.gov/oco/ocos026.htm#oes_links)

<sup>13</sup> [http://images.fedex.com/ca\\_english/services/pdf/Express\\_Rates2011\\_EN.pdf](http://images.fedex.com/ca_english/services/pdf/Express_Rates2011_EN.pdf)

<sup>14</sup> Electronic bonding in the 21<sup>st</sup> Century – By Greg Davenport

[http://www.constructionexec.com/Issues/November\\_2008/Special\\_Section6.aspx](http://www.constructionexec.com/Issues/November_2008/Special_Section6.aspx)

<sup>15</sup> Electronic bonding in the 21<sup>st</sup> Century – By Greg Davenport

[http://www.constructionexec.com/Issues/November\\_2008/Special\\_Section6.aspx](http://www.constructionexec.com/Issues/November_2008/Special_Section6.aspx)