

Why Assigned Risk Plans Won't Work for Surety Bonds *(Commercial Surety Version)*

Issue

Business owners and others sometimes complain that they are being forced out of business, or denied the opportunity to engage in a business enterprise, because they cannot obtain a surety bond. Surety bonds guarantee that the business owner will follow the standards of conduct outlined in various laws, ordinances, rules or regulations. Some perceive this inability to obtain a surety bond as an “availability” problem that needs a legislative solution. They want laws passed creating compulsory mechanisms, such as assigned risk plans (ARP) or joint underwriting associations (JUA) that would provide surety bonds to all who applied regardless of their best public interest; they would increase the potential for abuse, increase the burden on the taxpayer and create havoc with the integrity and intent of the surety bonding process.

Background

The public interest often demands that certain types of business be regulated for the protection of citizens and public and private property. Ordinarily, the regulated business enterprise will be required to obtain a license or permit from the governmental body (municipal, county, state or federal) and agree to abide by certain standards of conduct. Surety bonds are recognized at all levels of government as an indispensable enforcement device to guarantee the business owner's promise to comply with the law. These bonds, called license and permit bonds, are so numerous and diverse that it is not practical to list them all. Some examples include: grain warehouse bonds, motor vehicle dealer bonds, health spa bonds, surface mining bonds and pest control applicator bonds.

Virtually all license and permit bonds are creatures of legislation aimed at preventing some well-documented abuse. For example, grain warehouse operators have been known to abuse the storage agreement by selling stored grain and absconding with the proceeds; motor vehicle dealers have sold cars that did not have a clear title; health spa operators have sold long-term contracts and later closed the facility and refused to give refunds; surface mining operators have extracted the coal or minerals and failed to perform the prescribed reclamation; and pest control operators have applied the wrong dosage or the wrong pesticide, creating public health hazards.

Surety Bonds Protect the Public Interest

The public interest must be protected. Surety bonding has proven to be a successful method of providing this necessary protection, and legislatures or other regulatory bodies often incorporate a surety bond requirement into statutes, ordinances and regulations.

When a surety bond company prequalifies applicants, the government and the public know that the surety bond company has judged the business owner capable of operating in a safe, honest, lawful way, consistent with public safety. If the prequalification judgment of the surety bond company is in error, and the business owner fails to perform in accordance with the law, the surety bond company has to pay for its mistake – not the government or the taxpayer.

The surety by prequalifying the applicant for a bond, not only increases the likelihood of proper performance, but also removes from the obligee (public or private) the burden and expense of having to make such determinations. This is much more attractive than having some political body devote the time, money and personnel needed to conduct exhaustive investigations and then be confronted with the possibility of additional taxpayer expense as a result of an applicant's failure to perform.

Surety Bonds—A Unique Form of Insurance

Any discussion of surety bonding must include the differences between a surety bond and a typical insurance policy.

Surety bonding is a form of insurance that transfers the risk of financial loss from “protected parties” to the surety company. What makes surety bonds different is that the underwriting inherently relies on credit principles. It is also important to recognize that the objective of surety bonding is not only to provide indemnity but also to prequalify the bond applicant thus reducing the possibility of loss to the general public.

A typical insurance policy involves two parties: the insured and the insurer. A bond involves three parties: (1) the principal (the applicant on whose behalf the bond has been issued and whose potential non-performance or default is the subject of the bond); (2) the obligee (the party to whom the debt or obligation of the principal runs and who is protected by the surety bond); and (3) the surety (the guarantor of the principal's performance).

A typical insurance policy is requested and purchased by the insured to provide coverage against specified losses. If these losses occur, the insured is compensated by the insurer. However, a surety bond is requested by the obligee to guarantee against the principal's failure to perform its obligation. Although the principal has the burden of obtaining the bond, it directly protects the obligee(s), not the principal. Unlike other types of insurance, bonds establish a creditor-debtor relationship between the surety and the principal while at the same providing a guarantee to the obligee.

The Prequalification Value of Surety Bonding

The surety underwriting process is intended to prequalify applicants so that bonds will be issued only to those applicants who the surety believes have the experience, skill, integrity and financial resources to abide by the proscribed standards of conduct.

Supporters of assigned risk proposals often fail to realize that the prequalification underwriting standards constitute a most valuable service to the obligee, the general public and to the principal. This prequalification function is clearly demonstrated by the example of grain warehousing bonds. By writing a grain warehouse bond, the surety is vouching for the

competence and financial ability of the grain warehouse operator to honor its obligations to storers of grain in its warehouse. The surety is, in effect, assuring the depositor of grain that the grain warehouse, at least in the judgment of the surety, is qualified to provide grain storage. Of course, the depositor is receiving financial security in the event the grain warehouse fails.

The value of such scrutiny can never be underestimated in light of the fact that losses caused by a grain warehouse failure may result in irreparable financial damage to depositors.

Why Surety Bond Assigned Risk Plans Are Not in the Public Interest

As a means of addressing a perceived availability problem for certain types of surety bonds, some states have considered legislation which could establish a JUA or assigned risk plan that would require sureties to write bonds for applicants. Upon close examination, however, it is clear that such plans are not in the best public interest; increase the burden on the taxpayer and wreak havoc on the integrity of the entire surety process.

Proponents of surety assigned risk plans point to similar programs established in many jurisdictions for certain property or liability coverages. They ask why these schemes cannot also work for surety. What these proponents fail to recognize is that not every applicant for a bond necessarily has the ability to perform certain actions or functions in a manner, which is in the public's best interest. They also are unaware that it is the function of the bonding process to weed out those who are unqualified to perform the obligation to be undertaken. It is this prequalification function of bonding that makes surety so unique. There are obvious reasons for not forcing banks to make loans or issue credit cards to all applicants. For those same reasons, laws forcing sureties to provide surety bond credit to all applicants are equally impractical and economically unworkable. A surety bond is not a right.

Compulsory underwriting associations or assigned risk plans for surety do not allow the prequalification function of bonding to operate properly. They subvert the underwriting process to accommodate unqualified applicants. Allowing applicants to pursue risks that are beyond their capabilities is a disservice to the principal as well as to those the bond is intended to protect.

While some may argue that an ARP or JUA for surety would protect the obligee via the guarantee by the surety, that position overlooks the fact that a principal's default or business failure constitutes risks to the public which are untransferable and largely uncompensable. The bond penalty does not always equal the total potential loss. In this regard, the present prequalification process serves as a loss avoidance mechanism for obligees and the public.

The creation of an ARP or JUA for surety would require that bonds be written for all applicants, regardless of financial or technical ability. Under this scheme, there is no loss avoidance mechanism and the integrity and value of bonding would soon diminish.

Most surety bonds protect the public from the incompetence, insolvency, dishonesty or non-performance of individuals in a particular situation. This protection would be substantially impaired if sureties are required to bond every applicant, regardless of ability or character. The public might then be subjected to dishonest or incompetent businesses simply because they could not be denied a bond by a surety. The free and open competitive surety marketplace preserves

the full integrity of the prequalification process and affords every opportunity to qualified applicants to seek and obtain bonds.

Compulsory underwriting for surety would undermine the surety concept, establish a policy that puts no value on commercial progress and subject society to widespread risk of loss due to increased commercial failures. The surety industry therefore urges that any form of assigned risk plan or joint underwriting association for surety be rejected.

Summary

Assigned risk plans and JUAs are not practical solutions to perceived bond availability problems. They do not offer the necessary prequalification protection to the taxpayers that the surety bond underwriting process does.

Just as a bank would not survive for long if it were forced to lend money or issue a credit card to someone who has a history of unpaid debts, legislation that forces surety companies to provide bonds to all applicants, regardless of their qualifications, is equally impractical, illogical and economically disastrous.