

## **Why Assigned Risk Plans Won't Work For Surety Bonds** *(Contract Bond Version)*

### **Issue**

Not all contractors have what's necessary to obtain surety bonds. Some people perceive this as a lack of availability of surety bonds, especially among small contractors. To address this concern, they want laws passed creating compulsory pooling mechanisms, called assigned risk plans or joint underwriting associations (JUAs), that would provide surety bonds to all contractors regardless of their qualifications.

### **Background**

Surety bonds guarantee that a contractor will perform the construction project according to the terms of the contract, on time and at the agreed upon price. These bonds are the foundation of our competitive bidding system. Federal, state and local laws require that public construction jobs must be awarded to the lowest responsible bidder, and in most cases that bidder must provide surety bonds.

The concept behind the bonding process is simple and direct: Applicants pass through a prequalification process that involves analyzing the contractor's job experience, management characteristics and financial health, and judging whether he or she has the right qualifications for a particular job requiring bonds. By having the surety bond company prequalify applications, the government and the public know that, in the judgment of the surety bond company, the contractor should be able to perform the project.

**If the surety bond company is in error in making its prequalification judgment and the contractor fails to perform, the surety bond company has to pay for its mistake – not the government, not the taxpayer.**

Some critics say that it is wrong to deny anyone a bond. These critics are right when they suggest surety bonds aren't given away freely. But they are wrong when they say all contractors must be able to get bonds. The fact is, not every contractor is qualified to perform every job that might be available. Bonds are provided only to those who are able to demonstrate to the surety company's satisfaction that they're qualified to do the work.

Surety assigned risk plans or JUAs would eliminate the important prequalification protection surety bond companies provide the public and the government. The loss of this protection ultimately could destroy the open competitive bidding system.

## **How a Bond Works**

To understand why surety bonds don't belong in assigned risk plans or JUAs, it's important to understand some basic surety concepts. The following example of a public construction project shows how a bond works.

A school district decides to build a new elementary school. The district formally invites contractors to submit sealed bids for the construction project. The low bidder is awarded the contract and provides performance and payment bonds.

These bonds (issued in the name of the contractor) protect the school district if the contractor is unable to finish building the school. Because the job was awarded to a bonded, prequalified contractor, the school district benefits by knowing that in the eyes of the surety bond company – an independent third party willing to put its own money at risk – the contractor is qualified to get the job done.

**If the contractor experiences trouble, the district still will get its school built on time and at the agreed upon price because the surety bond company will provide the necessary funds to see that the project is completed under the terms of the contract.**

What would happen if an unqualified contractor who automatically received bonds through a surety assigned risk plan or JUA were building the school? The contractor might be totally inexperienced and financially unable to overcome the kind of unexpected events that often occur in the construction business – an economic recession, a strike, material shortages, equipment problems, even bad weather.

Should the contractor fail, the claim still would be paid. But the contractor's problems already may have caused irreparable delays and significant inconvenience.

Because the surety assigned risk plan or JUA doesn't prequalify applicants, everybody can lose: the inexperienced contractor – because he or she faces bankruptcy; the school board – because its school isn't finished before opening day and students may be starting school in temporary facilities; and the surety bond company that is assigned to the risk through the plan or JUA – because it now has a loss on its hands that could have been prevented.

It's clear from this example that it would be bad public policy to bond unqualified contractors.

**It's good public policy to use contractors who are prequalified for the job and provide performance and payment bonds before they start a project. That's why surety bonds must continue to be written selectively.**

It's true that some contractors can't bid on construction projects that require bonds because surety bond companies reject their bond applications. It's the surety bond underwriter's job to carefully analyze applicants, separating those who demonstrate the necessary ability and financial strength to complete construction projects on time and at the agreed upon price from those who cannot.

An applicant probably will be rejected if his or her past experience and financial resources don't support what's needed for the job. After all, the school district is relying on the surety bond company's expert judgment that its new school will be finished properly and on time.

Choosing which contractors should receive bonds based on a thorough review of their knowledge, ability and financial capacity is sound business practice – a practice that's beneficial to the government and the public.

### **Why Assigned Risk Plans for Surety Bonds Won't Work**

Proponents of surety assigned risk plans and JUAs argue that if assigned risk plans can be mandated for automobile and other types of insurance, why not for surety bonds? The answer is simple:

**Not every applicant for a bond can perform the contract.**

If surety assigned risk plans and JUAs are mandated, then the concepts of prequalification and selectivity are eliminated. Bonds would be granted to everyone, even those who may be financially weak or technically inexperienced. By definition, these contractors virtually are certain to fail.

**Remember: Since all applicants automatically would receive bonds through assigned risk plans and JUAs, the overall chance of something going wrong is no longer reduced, but instead is greatly increased.**

### **Higher Losses & Rates Under Assigned Risk Plans and JUAs**

What would happen to rates if surety assigned risk plans or JUAs were mandated? With no prequalification or screening – in other words, if the bond underwriting process is eliminated – then there would be no means to prevent the poorly managed, financially unsound, inexperienced or otherwise unqualified contractors from obtaining bonds. Contracts would be breached and claims quickly would escalate. Ultimately the assigned risk plan or JUA would have to raise rates to an unaffordable level or face bankruptcy.

A good analogy is the interest charged by banks to their loan customers. If banks fail to screen out unqualified loan applicants and these borrowers cannot pay back their loans, charging them higher interest rates won't keep bank solvent.

### **Availability of Surety Bonds**

Are surety bonds available to every contractor? Not in all cases. Some contractors can't obtain bonds because they don't have the necessary credit history, job experience and financial capacity. Still others may not qualify for as much bonding as they want.

**It's the intent of the surety bond industry to judge all applicants for bonding on their qualifications and merit.**

Creating surety assigned risk plans and JUAs isn't necessary, because help already exists for contractors who are having trouble getting bonds. In fact, a number of new surety bond were formed specifically to market bonds to small contractors. Many surety bond companies have initiated pilot programs to bond more small contractors. The Surety Association of America has a model program and will work with any public entity to implement its program to assist small and emerging contractors qualify for and obtain bonds.

Government also is playing a role in making surety bonds available. The federal government and some of the states have created special programs that enable surety bond companies to write bonds for small contractors that do not qualify for bonds under the companies' normal underwriting standards.

Since the early 1970s, the Small Business Administration has operated its Surety Bond Guarantee Program, helping small contractors perform more than \$1 billion of contracts per year. This program provides surety bond companies with partial repayment against losses resulting from bonds they would not normally provide. The U.S. Department of Transportation also has devised various programs to assist disadvantaged contractors in obtaining bonds.

## **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 wouldn't survive for long if it were forced to lend money or issue a credit card to someone who has a history of unpaid debts, so, too, legislation that forces surety companies to provide bonds to all applicants regardless of their qualifications is equally impractical, illogical and economically disastrous.**