

**Testimony of William G. Peterson
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**Before the U.S. House of Representatives
Committee on Small Business**

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Madam Chairman, thank you for inviting us here today to testify on a matter that is critical to the surety industry, to the construction industry and to small and emerging businesses.

My name is Bill Peterson and I am Vice President/Public Affairs Officer for CNA Surety. CNA Surety is the nation's largest publicly traded surety and fidelity bonding company. Our corporate headquarters is in Chicago although my office is in Sioux Falls, South Dakota. We serve a full range of surety needs from the smallest commercial bond to multi-million dollar contract bonds. We have participated in the SBA Bond Guarantee Program since 1994. We are a significant writer of these bonds for SBA and were honored to be named by the SBA as its Surety Partner of the Year in both 2005 and 2006. On a more personal note, I served 8 years in the South Dakota House of Representatives, 4 years as Majority Leader, where we also dealt on occasion with the issue of small and emerging contractors so I have had the opportunity to see these issues from both sides of the table...that of a policy advocate and as a public policy decider. I am honored to have been asked to appear before you today as an advocate for the SBA's Bond Guarantee Program.

I am representing The Surety & Fidelity Association of America (SFAA) and the American Insurance Association (AIA), the trade associations that represent over 500 insurance companies licensed to write surety and fidelity bonds. SFAA and AIA members collectively provide the vast majority of performance and payment bonds on federal and state construction projects in the United States. The trades have discussed the issues regarding the SBA Bond Guarantee Program since its inception. My testimony here today reflects both the experience of the surety industry in general with the SBA Bond Guarantee Program, as well as the hands-on knowledge of it based on CNA Surety Corporation's participation in it since 1994.

The Surety Industry's Interest in the Funding and Activities of the Small Business Administration — The Surety Bond Guarantee Program.

Some History

Since the early 1970s, the SBA has operated the Program, which provides surety bond companies with partial repayment of losses from bonds that they would not ordinarily write for less qualified small and emerging contractors. The purpose of the Program is to obtain surety bonds for small and emerging contractors so that they can develop a track record of success. As these contractors grow and establish themselves, they then already have a relationship with a surety company. This surety company then can provide the bonds they need as government contractors, either with or without the SBA bond guarantee. The goal of the guarantee program is to graduate contractors into the standard surety market, making the guaranty funds available for new small and emerging contractors.

It is essential to understand why this is important. For most public construction projects, contractors are required to provide surety bonds to the government. These bonds guaranty that the contractor will perform the work and will pay the subcontractors, suppliers and workers on the project. Since the surety will be required to pay if the contractor cannot perform its contract and pay its bills, a surety carefully examines the contractor's capability, experience and financial situation when determining whether or not to put its own financial wherewithal behind the contractor. Establishing a track record and building capital is a challenge for small and emerging

contractors. Therefore, in order to assist these small businesses to obtain work on public projects, the federal government determined that it would act as a reinsurer to sureties willing to write bonds for these contractors.

As the Program has evolved, there are two plans under which sureties can participate in the Program:

The Prior Approval Program ("Plan A") was the original SBA bond guaranty program. In this program, the surety must obtain SBA approval for each bond prior to writing the SBA guaranteed bond. The surety is permitted to charge the rate for the bond that is on file and approved by the state insurance regulator in the state in which the bond is written. The SBA indemnification of the surety in the event of a claim on the bond in Plan A is 80%, and 90% for bonds written for socially and economically disadvantaged contractors and bonds written for contracts under \$100,000.

Because of the administrative burden of prior approval, over the years many of the larger, more traditional sureties declined to participate in the Program. Additionally, it appeared over the years that contractors were not graduating out of the Program, but continuing to obtain bonds only with the SBA guarantee. Although there were a significant number of sureties participating, the SBA wanted more of the traditional sureties to participate in the Program. Therefore, the SBA and the industry met to create a program that would be of interest to more sureties. That program is the Preferred Surety Bond Program ("Plan B"). Under this plan, sureties apply to participate, submitting information up front on their underwriting practices, financial strength, etc. Once a surety becomes a participant in Plan B, it is given an aggregate limit of bonds that it can write within the Program. As long as the surety complies with all of the requirements of Plan B, reimbursement of losses is provided without prior approval of the bond.

For Plan B, since it was enacted as a trial program, the SBA limited the rates that the surety could charge to those that the SFAA (then SAA) filed. At that time, the SAA was the rating organization for the surety industry. In exchange for the reduction in the administrative burden in Plan B, the surety industry agreed to accept only a 70% indemnification instead of the 80% and 90% provided in Plan A. Since that time, the original regulation has become unworkable. The SAA stopped filing end rates in 1993, but the SBA never has amended the regulation regarding what the surety should charge for a bond written in Plan B. Unfortunately, this means that current SBA regulations required sureties to charge the end rates that the SAA filed in 1987. Only recently has the SBA amended its regulations and eliminated that requirement to use outdated rates. We are pleased that since Plan B is no longer is a trial program, the SBA is moving to administer it accordingly.

The Value of the Program.

In the past ten years, over \$8 billion in bonds have been issued to small and emerging contractors through the Program. The Program has provided bonding assistance to small and emerging contractors who might not otherwise be able to obtain bonds. This has been especially true in times of economic downturn when bonding sometimes becomes more scarce and difficult to obtain.

The SBA currently is permitted to guarantee bonds of up to \$2 million, and the House legislation would increase the cap to \$ 3 million. A pending Senate bill, S. 1960, would do the same. This shows us that Congress recognizes the value of surety bonds on federal construction projects. It also shows the desire of Congress that the SBA Bond Program be effective in helping small and emerging contractors, especially now in the Gulf Coast reconstruction.

The Current State of the SBA Bond Guarantee Program.

Over the years, surety participation in the SBA Bond Guarantee Program has ebbed and flowed. On recent factor of change in participation in the Program, however, is the administration of the Program. In recent years participation in the Program has only decreased, and the reasons for this are listed below in the remedies suggested for the SBA reauthorization legislation. The fact is that the SBA Program currently is operating at about one-third of its capacity. While this made a great deal of sense in the years when surety was profitable and companies were writing bonds for small and emerging contractors without any need for the Program, it does not make sense now. The economy is such that there is a significant need for the Program. Some internal problems with the Program have discouraged many companies from participating, and caused many that do still participate to limit their participation. The Program no longer makes financial sense to many sureties.

In 2005, the SBA finalized changes to its regulations that would implement an increase in the guarantee fee to surety companies from 20% to 32% of the premium on bonds issued and guaranteed under the Program as of April 3, 2006. This fee increase, which amounts to a 60% hike, will likely make the program economically unattractive for most sureties and will affect the continued viability of the program. Sureties already write bonds with very little margin. This reduction in the premium the surety will receive is untenable.

The fee increase apparently resulted from an Office of Management and Budget (OMB) actuarial study of the SBA's losses under the Program, which led to the conclusion that the SBA had to increase the fees charged to sureties in order to cover its losses. Because of the potential impact on surety participation in the Program, the SBA reconsidered its fee increase and promulgated a regulation changing the percentage of the premium charged to sureties from 20% to 26%, instead of 32%, and also increased the fees charged to the small businesses obtaining a bond through the Program. The overall affect of this proposed revision is to increase the SBA's revenues to cover its losses from the Program, by dividing the burden of the increased costs between the sureties and the contractors.

While we appreciate the proposal to reduce the increase, any fee increase on sureties hurts the small and emerging contractors that the SBA is supposed to assist to the extent that it causes sureties to rethink their participation in the program. Without participating sureties, the SBA will not be there to help small and local businesses.

What is Needed in the SBA Reauthorization Legislation.

The SBA Surety Program remains vital to the growth of small and emerging contractors in America. One, well-run Surety Bond Guarantee Program assures consistency of participation requirements and administrative procedures. Without the SBA Bond Program, many federal

agencies may initiate their own program to assist small and emerging contractors. Some already have done so. States also have begun this process. Duplicative efforts among federal and state agencies waste time and resources that should instead be used to help small businesses.

One of the critical changes needed in the Program has been accomplished -- namely, that the Program staff, including both new and long time staff, is committed to making the Program work well. We also recognize and support the internal efforts of the SBA staff to automate and streamline the application process. This will modernize and improve the Program.

Efforts in Congress need to be aimed at assuring that small and emerging contractors are qualifying for bonds and graduating from the Program because of high levels of participation from bond producers and sureties in the Program. The SBA Reauthorization Act must be aimed at increasing the volume of bonds that the SBA Program writes and increasing the number of sureties participating in the Program. This can be accomplished by the following:

- ***Recognition that the SBA Program Serves an Important Public Policy Function and That It May Not be Self-Sufficient Each Year;*** Congress has never required the SBA Bond Guarantee Program to be self-sufficient. The Congressional declaration of policy for all the SBA programs in the Small Business Investment Act of 1958 was to stimulate and improve the economy by establishing assistance programs for small business which are to be "carried out in such a manner as to insure maximum participation of private financing sources." (15 USC Section 661). If the purpose of the Program is to help small and emerging contractors that may not otherwise qualify for bonds in the marketplace, it stands to reason that there will be losses, and the Program, as originally drafted, acknowledged that fact by recognizing that it could not be self-sufficient. The OMB's directions in the recent past to increase fees to cover SBA losses is a major shift in philosophy and direction for the SBA Program and is in conflict with the spirit of the law. The public policy of helping small and emerging contractors is a sound one and it needs to be supported in the funding structure and reauthorization of the SBA.

The House legislation would require the SBA to conduct a study of the funding structure of the surety bond program. We think that when the study is completed, it will show that the Program ebbs and flows with the surety industry and the economy in general. In some years, the Program might break even, while in others years it will not. In all years, however, the Program is vital program in assisting small and emerging contractors in obtaining bonding even in years when it cannot break even.

- ***Transparency in the SBA Fee Structure;*** The basis for the fees charged to sureties participating in the SBA Program should be open and apparent. In the last fee increase, the OMB apparently prepared an actuarial study that led to the fee increase. If this was the case, this study should have been made public so that actuaries in the surety industry can review and analyze the data and the conclusions drawn from it. Only then can a meaningful discussion of SBA fees take place. If, for example, more sureties participate and the bond premium volume rises significantly, the current 20% fee will generate more revenue and a fee increase may not be needed.

The House bill permits the SBA Administrator to use funds appropriated to the SBA to reduce

fees when funds are available for such purpose. That approach is similar to what has been done for some of the SBA's loan programs and makes sense to us.

- ***Prevention of the of Unraveling SBA Bond Guarantees;*** A strong deterrent to participation in the SBA Program has been the denial of reimbursement to the surety after a claim has been made on a bond issued through the Program. In the reauthorization legislation, we would suggest an amendment to the effect that once the SBA has approved a bond in the Prior Approval Plan, it cannot reject the bond after it has been issued, provided that the surety made a reasonable attempt to comply with the law.

The House legislation contains a provision that would prevent the unwinding of bond guarantees for sureties participating in Plan A, which requires SBA prior approval for any application for a bond guarantee. We urge that this provision also be extended to Plan B sureties. While the SBA does not approve each application for a bond guarantee application from a Plan B Preferred Surety, it does review and approve the surety's underwriting and claims practices upfront in permitting the surety to participate in Plan B. There is no reason that the SBA should unravel the bond guarantees of Plan B sureties that it has reviewed and approved. If the SBA has problems with the bond guarantees generated from a surety in Plan B, the SBA has the authority to terminate the right of such surety to participate in the Program.

- ***ADR to Resolve Disputes With Sureties.*** If the SBA is limited in its ability to unravel a bond guarantee, the number of disputes with the SBA will be reduced. The SBA should, however, have an internal agency, non-binding alternative dispute resolution (ADR) process to resolve claims issues. Currently, litigation is the only alternative.

We urge the House Small Business Committee to assist sureties in quickly and efficiently resolving disputes with the SBA. The only alternatives now are litigation or walking away from the Program. We think that a mediation program would have not only the benefit of resolving disputes, but also would give sureties considering participating in the Program the knowledge that there is some mechanism in place to resolve disputes, encouraging more participation.

- ***Increased Regional Staffing for SBA Bond Program;*** Several SAA members have noted the decrease in the number of SBA regional offices and the overall decrease in staffing in Washington DC and in the regions. We also find that the staff is inexperienced in the surety business such that we would suggest an appropriation for surety bond education and training.

We understand that the SBA is taking steps to improve its staffing. It has consolidated the regional offices for the Program and reorganized the operations so that they all now report to the main office in Washington DC. The SBA has openings in the two remaining regional offices and we have been told that the SBA is committed to filling these with persons with surety underwriting experience.

- ***Elimination of 1987 Rate Requirements;*** The requirements in the federal regulations imposing price controls on sureties in Plan B of the SBA Program became outdated. When the SBA recently revised the regulation and eliminated the requirement of 1987 rates, sureties in the Plan B were using 20-year old rates. It still is helpful to include in the legislation a prohibition on

price controls so that the regulations cannot again be changed to implement price controls.

Recently, the SBA revised its regulations and eliminated the requirement to use 1987 rates. We think that this shows that the SBA Program staff have listened to sureties as their partner in the Program and are willing to make changes to encourage greater surety participation in the Program. It would be even better if the House legislation contained a prohibition on the SBA getting involved in setting surety rates so that price controls cannot be reinstated in the future. The 1987 rates were a large obstacle to surety participation in the Program.

What are the Benchmarks for a Successful SBA Program?

We have suggested what the surety industry believes needs to be done in the SBA Reauthorization Act to revitalize the SBA Program so that it is attractive to sureties and agents and assists small and emerging contractors in getting their first bonds and graduating from the Program into the traditional surety market. We think that a common understanding between the surety industry, the SBA and Congress about what constitutes the success of the Program.

According to SBA data, it would appear that participation in the Program is declining. In 1997, the Program guaranteed 16,336 bonds; in 2005, it guaranteed 5,796 bonds; and in 2006 it is projected to guarantee 5,000 bonds. In 1992, the Program guaranteed 32,000 bonds. Currently, 10 sureties write through the Program. Four companies account for 89% of the bonds, and one company accounts for 45%.

There are many reasons for the decrease in bond guaranteed through the Program. One primary driver is the economy, which includes the profitability of the surety industry and the appetite for bonding small and emerging contractors. There also have been some changes in the surety marketplace that may have impacted the bonds guaranteed through the Program and that need to be considered in the operations of the Program going forward. The decrease in bonds in the Program may reflect small businesses growing in size and bonding capacity and “graduating” out of the Program. In addition, some sureties have developed alternates to the Program, such as requiring collateral or funds control and underwriting programs based in part on credit scores, in order to write small and emerging contractors. Other sureties have decided to focus on the small business niche such that more sureties may be writing this business outside the Program. One participant in the Program repositioned its book of business and is now writing larger contractors, and that may account for some of the decline in bonds guaranteed through the Program. The amount of bonds written through the SBA always has varied with the underwriting cycle in the industry. For many sureties, the Program has become an expensive, if not a commercially unreasonable, reinsurer, now that the Program charges 26% of the premium as fees from the sureties. These are all factors that contributed to the decrease of bonds written through the Program in recent years.

Because of these changes in the market, it may well be that the Program will never return to the number of bond guarantees in the late 1990s. That does not mean that the Program is not or could not be successful. It shows that the success of the Program cannot be measured merely by the number of bond guarantees. Rather, the success of the Program needs to be measured by the number of small and emerging contractors that were assisted, and more important, that graduated

from the Program to find bonding in the traditional bond market.

Summary and Conclusion.

The continued viability of the SBA Bond Guarantee Program is at stake at a time when the Program is needed the most. Unprecedented rebuilding needs to take place after the devastation of Hurricanes Katrina and Rita in the Gulf Coast region. Small, local and emerging contractors should have the opportunity to participate in this reconstruction. Bonding will be needed on construction projects in the Gulf Coast states for many years to come. The Program will be a vital part in ensuring that small, local and emerging contractors can obtain the bonds to participate in the reconstruction and go about the business of rebuilding their own companies as well.

To make the Program successful, the House Small Business Committee needs to focus on improvements that are needed. The SBA needs to work immediately to encourage more sureties to participate in the bond program so that it is ready for the upcoming spike in applicants for assistance.

The SBA needs to increase numbers of SBA bond personnel in field offices, provide greater surety education of SBA personnel, and develop a more streamlined application process.

CNA Surety and the surety industry in general are willing to provide any assistance in making these changes. We support the continuation and revitalization of the SBA Bond Program. We believe that the SBA and sureties must be business partners in making this Program work. SFAA, our trade association, is located in Washington DC and can be called upon

The current leaders of the Program appear committed to the Program, and have been working hard to revitalize it. However, they cannot do it alone. Congress must be a part of this solution.

Thank you.