ROSENBERG & PARKER WHITE PAPER

# CAPTIVES & SURETY

## How to use Your Captive for Your Surety Program

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For strong companies with strong captives, it is absolutely possible to use their captive in their surety programs. But before we discuss how it can be done, it is important to understand why it is not done more frequently and why many sureties are not lining up to work with a captive.

## SURETY IS NOT INSURANCE

Surety is very different from insurance for four main reasons.

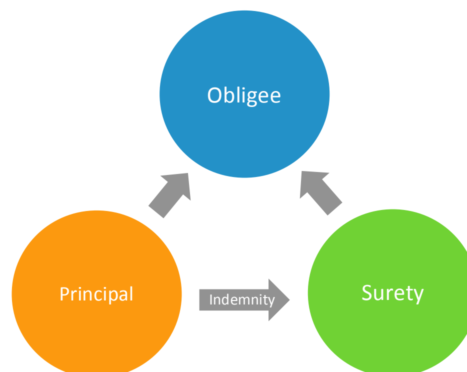
1. The number of parties involved.

While in insurance there are always two parties, the insurer and the insured, in surety there are always three parties.

Obligee - This is the party to whom the other two are obligated. This is the beneficiary of the bond and the party that would make a claim against the bond. In 95% or more of examples this is a governmental agency.

Principal - This is the party that has the primary obligation to the obligee, and the party that the surety is standing behind.

Surety - This is the party that guarantees to the obligee that the principal will fulfill its obligation. If the principal defaults then the surety must fulfill the obligation, find someone to fulfill the obligation, or pay the obligee so it can find someone to fulfill the obligation. While surety is very different than insurance for the reasons cited, a surety is generally a subsidiary of an insurance company.




2. No Losses.

Unlike insurance companies that expect losses, surety companies underwrite with the expectation of no losses, much like a bank does. This is actually a strong reason to consider using your captive for your surety program. If underwritten properly, the captive should not have claims.

3. Rate

Because sureties do not anticipate losses, rates are not determined actuarially like they are in insurance. Instead, rates are based on the financial strength of the principal as well as the type of risk.

Surety rates are currently at all time lows as a result of excess capacity that is contributing to the softest surety market in decades. As a result, the amount of potential savings in dollars by utilizing a captive is not as significant as it would be if rates were higher. In simple terms, 20% of a $10 per thousand rate is a lot more than 20% of a $3 per thousand rate.

4. Indemnity

100% of the time, the surety company requires the indemnity of the principal. This means that if the surety were to have to pay out on a claim, the surety would have the legal right to go back after the principal under the indemnity agreement and be made whole. It is preferable to the surety for the principal to make payment directly under the claim than a lengthy recovery process.

As a result, surety is not true risk transfer, at least not for the principal. Because the surety receives the indemnity of the principal, obtaining a guarantee of reimbursement from a captive under a reinsurance treaty does not necessarily provide the surety company with much additional protection as it would in an insurance policy where there is no indemnity. This is one of the primary reasons that many surety companies are not interested in fronting for a captive.

## GOING IT ALONE

So why can't a captive just write its own bonds without a fronting company? There are two main hurdles that prevent this from occurring.

Hurdle #1 – Licensing

The surety issuing a bond must be licensed in the state in which the bond is issued. Most captives are only licensed in one state, generally the state or territory in which it is domiciled.

Hurdle #2 – Treasure Listing

Many bonds are required by the federal government. In order for a surety to write bonds to the federal government, the surety must be on the Treasury List. This list is updated regularly and is published by a department of the US federal government in Washington. The T-list is available online at: (https://www.fiscal.treasury.gov/fsreports/ref/suretyBnd/c570_a-z.htm). The T-List shows every surety that has been approved and authorized to issue bonds to federal agencies, as well as the size of single bond that a surety company can issue on its own without reinsurance or collateral. Many non-federal obligees will only accepta surety that is on the T-List.

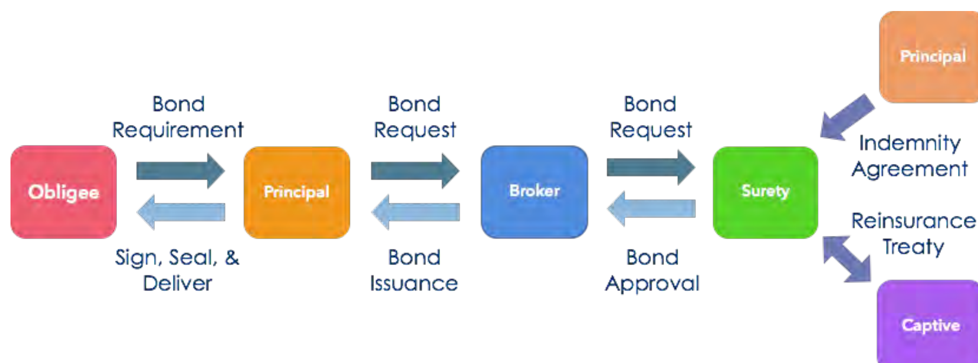
Obtaining a treasury listing is not easy. Not only does the government have very strict capital requirements, there are also experience requirements. Subsequently it is difficult for captives to become treasury listed.

## FINDING A FRONTING COMPANY

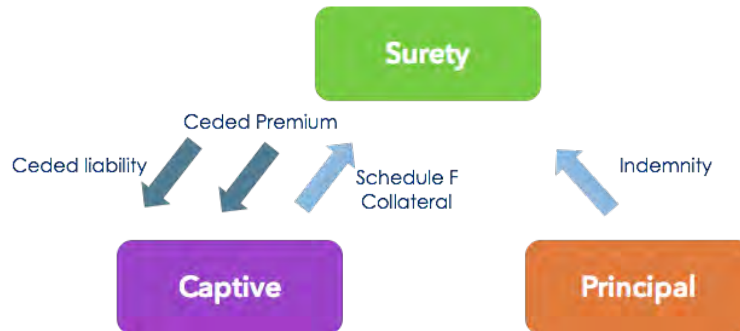
As a result of the aforementioned hurdles it is generally necessary for a captive to have a licensed, t-listed surety company as a front on most bond requirements. Not every surety company is willing to front because of the extremely competitive nature of the surety industry and the number of new entrants into the market place. Despite this, there are a number of strong, highly rated, T-Listed surety companies that will consider acting as a front.

## HOW DOES IT WORK?

The surety company obtains the indemnity of the parent company and/or the bonded principal. The surety enters into a reinsurance agreement with the captive. Bonds are issued by the surety company and provided to the obligee. This is referred to as a fronting arrangement. The surety company cedes a percentage of the risk, and a percentage of the premium back to the captive. The captive may also have to pay a ceding commission to the carrier. The amount of liability and premium ceded can vary depending on the particular agreement. The surety company also obtains the indemnity of the parent company of the bonded principal (the owner of the captive).



Schedule-F Collateral is a regulatory requirement when a US insurer reinsures risk with a non-admitted reinsurer. The amount will be determined based on a number of factors including premiums, IBNR, and others. This is provided in the form of a bank letter of credit by the captive to the surety. The amount is generally nominal.




## HOW IS A CLAIM PROCESSED?

In the unlikely event that a claim notice is received, the surety would first look to the principal to resolve the issue and resolve the claim. If this does not occur and a claim is actually paid by the surety, they surety will look for reimbursement by the captive as the reinsurer. Then the surety would go back against the parent company or other indemnitor under the indemnity agreement for the balance of the claim.

## THE BENEFITS

Because the parent company is ultimately responsible for any losses incurred by the surety anyway, there is no real downside in having the captive incur the liability for required bonds.

Utilizing your captive for surety can be a great way to gain maximum benefit from the capital invested in the captive, while at the same time reducing the cost of surety by as much as 35%.

## FAQs

- Does a captive have to be rated?

  No, a captive does not have to be rated, however, it should be financially sound. The surety company's reinsurance department will have to review the captive's financial statements and approve it as a reinsurer.

- Will writing surety through the captive affect it's A.M. Best rating (if it is rated)?

Writing surety through the captive should not affect the captives rating, but this should be confirmed with the rating agency.

- Will additional surplus be required?

  Typically there are no additional surplus or capital requirements required. However, you will need to confirm this with the captive's regulatory agency.

- Does the parent company have to indemnify?

  In most cases, the surety will require the indemnity of the parent company. There are exceptions to this, but they are few.

- Can a company use a captive as part of its overall program?

  Yes, a company can utilize a captive program in addition to an existing surety program. The fronting surety company will want to be sure that are not getting only the high-risk exposures. They will require that a mix of low-risk and high-risk bonds.

- Is Schedule F collateral mandatory?

  Yes, it is a statutory requirement.

For more information please contact Chad Rosenberg, Principal at Rosenberg & Parker, at chad.rosenberg@suretybond.com.

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## Chad Rosenberg, Principal

Chad Rosenberg is a Principal of Rosenberg & Parker where he oversees client and surety relations as well as marketing and technology. He has over 30 years of experience as a surety underwriter and broker. Chad began his career with Reliance Surety Company in 1987 and held underwriting positions in the home office in Philadelphia, and in offices in Seattle and Sacramento.

Chad presently handles the surety programs for publicly traded and privately held corporations in the energy, manufacturing, construction, technology, pharmaceutical, environmental, and waste hauling industries. He has brokered numerous complex surety bonds and surety programs domestically and around the globe.

A prolific speaker, Chad has given presentations on surety related topics to numerous construction trade associations and Risk & Insurance Management Society (RIMS) Chapters, as well as insurance companies, banks, law firms and accounting firms. His popular Surety, Wine & Cheese presentation has been enjoyed by dozens of organizations. He has authored numerous articles and publications, including the popular books *Commercial Surety for Dummies* and *International Surety for Dummies*.

Chad obtained a Bachelor of Arts degree in English Literature from the University of Virginia. He is a past District Governor of his Rotary District. In 2006 he created the Harry C. Rosenberg Youth Exchange Scholarship. Through the annual Aim for Exchange Charity Sporting Clays Tournament, over $100,000 has been raised to provide financial assistance to high school students participating in the Rotary Youth Exchange program. The father of five children, Chad and his wife Jennifer reside on their farm in Chester Springs, Pennsylvania. In his precious free time, Chad is a fly fisherman, a golfer, a skier, and a cheese entusiast. He also enjoys tending to his herd of Nigerian Dwarf goats.

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