



The Commonwealth of Massachusetts
Office of the Inspector General

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Ms. Julianne M. Bowler
Commissioner of Insurance
Massachusetts Division of Insurance
One South Station
Boston, Massachusetts 02110-2208

Subject: Performance Bonds and the New Construction Reform Law

Dear Commissioner Bowler:

Due to the July 2004 enactment of the new public construction reform law ("An Act Further Regulating Public Construction In the Commonwealth"), the Office of the Inspector General has been reviewing elements of public construction including bonding requirements for general contractors and subcontractors. The construction bidding laws require general and sub contractors to obtain performance¹ and or payment² bonds (also known as surety bonds) on certain contracts. Persistent issues and concerns related to construction and bond company defaults (at both a national and local level) prompted this Office to conduct an evaluation of how the Commonwealth deals with surety companies.

Based on the latest available Dun and Bradstreet *Business Failure Record* report, more than 80,000 construction contractors failed nationwide between 1990 and 1997, leaving more than \$21 billion in liabilities for unfinished projects. Recent examples of contractor defaults in the Commonwealth include the \$22 million Oak Street School renovation in Shrewsbury and the \$4.6 million Cox Street Fire Station renovation in Hudson. For public construction projects, surety bonds provide protection to taxpayers from contractor defaults. In both instances mentioned above, the surety company

¹ A performance bond is a bond obtained by the contractor, from a surety, that is payable to the awarding authority in the event that the contractor fails to perform on the contract.

² A payment bond is a bond obtained by the contractor, from a surety, that guarantees payment to material suppliers and/or subcontractors in the event that the general contractor fails to pay the materials suppliers and/or subcontractors.

stepped in to complete the projects. However, when the surety company defaults, the taxpayer is exposed. In our research, we found that surety companies are defaulting on their bonding commitments around the nation. Examples include defaults by First Assurance & Casualty Co. Ltd on a project in Denver, Colorado and Aetna Casualty and Surety Co. of Hartford on a project in Nassau County, New York. Fortunately, based on the list of approved surety bond companies compiled by the Division of Insurance, neither of these firms is licensed for surety business in the Commonwealth.

The National Association of Insurance Commissioners (NAIC) reported a total of 29 property/casualty insurance insolvencies for 2003. This is the highest level in the past 10 years. In the first three months of 2004, NAIC recorded 20 property/casualty insolvencies. This increased level of insolvencies is disconcerting. With respect to surety lines of business, it is also more troubling since our understanding is that the Commonwealth's guaranty or insolvency fund does not cover surety liabilities. Ratepayers and taxpayers (on municipal projects) in the Commonwealth are at risk whenever there is a surety related default.

This Office thanks you for the support you have provided in facilitating this review. The licensing packet including the forms used by DOI for monitoring the solvency of domestic companies were very helpful. We understand that as part of the licensing process, DOI conducts financial, legal and market reviews for each company. On an ongoing basis, DOI monitors the financial solvency of all insurance companies licensed to transact business in the Commonwealth. DOI maintains a list of all insurers licensed in the Commonwealth and this list is updated monthly. We also understand from your communication that since the insurance industry is subject to state-based regulations, DOI relies on the state of domicile for financial analyses of foreign companies, supported by accreditation by NAIC. We also acknowledge and commend DOI for the recognition received in 2003 from the National Association of Insurance Commissioners, which approved a full five year reaccreditation for your work in reviewing financial solvency of the Commonwealth's insurers.

Our review focused on the September 2004 DOI list of *Companies Licensed for Fidelity & Surety Designation* in the Commonwealth. For the 385 companies on this list, we performed the following:

- Determined by reference to data provided by DOI, those licensed surety companies, which have defaulted on their bond commitments for solvency reasons.
- Determined the A.M. Best Company ratings established for these licensees.

The results of our review are reflected below:

- 1) Ten companies on the September 2004 DOI list of *Companies Licensed for Fidelity & Surety Designation* have defaulted on their commitments for solvency reasons. This insolvency status is not flagged on the DOI license

listing. Based on DOI input, we understand that no domestic company licensed for surety has had its certificate of authority revoked in the past five years. However, as of September 2004 three domestic companies licensed by DOI for surety insurance are in receivership.

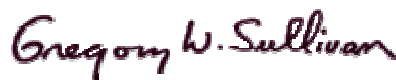
- 2) 78 licensees (20 percent) appear to have less than favorable ratings from the A.M. Best Company or were not rated at all.
 - a) 28 licensees (7 percent) were not rated by the A.M. Best Company due to a variety of reasons such as insufficient size and insufficient data;
 - b) 6 licensees (2 percent) had an E (under supervision) rating;
 - c) 3 licensees (1 percent) had a D rating;
 - d) 1 licensee had a C rating; and
 - e) 40 licensees (10 percent) had a B rating.

For your review and convenience, attached is a summary of licensees under each of the groupings reflected above.

We are concerned (based on the results above) that not only are insolvent insurance companies licensed to underwrite surety business in the Commonwealth, but also that a clear warning system alerting municipalities and contractors to an insurer's potential default risk does not exist. We are also concerned that 20 percent of the licensed sureties are not rated or have less than favorable ratings. Taxpayers and governmental entities should have the best protection available, however, it appears as though contractors may unwittingly be directed to licensed surety companies that are financially unstable or have other difficulties. This could expose the contractor, the municipality and the taxpayer to significant financial burdens. Contractors can lose bond premiums paid to a defaulting surety. Municipalities and taxpayers can have significant exposure when both the contractor and the surety default prior to project completion. We recommend that DOI establish more stringent criteria to weed out problematic insurers and look into developing a detailed warning system to alert contractors when surety companies are insolvent, have low ratings, or other problems. This system should flag known defaults and also provide an easily accessible and public rating reference of source similar to A. M. Best Company.

We are available to discuss this issue further. Thank you for your support and cooperation.

Sincerely,



Gregory W. Sullivan
Inspector General

Attachment One
Surety Licensees
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Licensees Not Rated By A.M. Best (28)

ACA Financial Guaranty Corp.
AMBAC Assurance Corp.
American Centennial Insurance Comp.
Atlanta International Insurance Comp.
Bankers Multiple Line Insurance Company
Berkshire Mutual Insurance Co.
Capital Markets Assurance Corp.
CDC IXIS Financial Guaranty North America, Inc.
Coface North America Insurance Co.
Connie Lee Insurance Company
Financial Guaranty Insurance Co.
Financial Security Assurance, Inc.
General Electric Mortgage Insurance Corp..
Gerling Global Reinsurance Corp. of America
Houston General Insurance Co.
Insurance Corp. of New York (The)
MBIA Insurance Corp.
MBIA Insurance Corp. of Illinois
MGIC Assurance Corp.
Nationwide Affinity Insurance Company of America
New England Insurance Company
Northwestern National Insurance Co. of Milwaukee Wisc.
Radian Asset Assurance Inc.
Rampart Insurance Company
South Carolina Insurance Co.
Transport Insurance Company
Western Diversified Casualty Insurance Company
XL Capital Insurance Company National Surety Corp.

Attachment One
Surety Licensees
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Licensees with E rating (6)

Central National Insurance Co. of Omaha
Frontier Insurance Co.
Highlands Insurance Company
Lumber Mutual Insurance Company
North American Lumber Insurance Co.
SEACO Insurance Co.

Licensees with D rating (3)

American Manufacturers Mutual Insurance Co.
American Motorists Insurance Co.
Lumbermens Mutual Casualty Co.

Licensee with C rating (1)

Republic Western Insurance Co.

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Surety Licensees
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Licensees with B rating (40)

American and Foreign Insurance Co.
American Country Insurance Comapany
Arbella Indemnity Insurance Co, Inc.
Arbella Protection Insurance Co, Inc.
Atlantic Mutual Insurance Co.
AXA Re America Insurance Co.
Bankers Insurance Company
Centennial Insurance Company
Centre Insurance Co.
Century Indemnity Co.
Connecticut Indemnity Co.
Converium Insurance (N. America) Inc.
Covenant Insurance Co.
Eastern Casualty Insurance Company
Globe Indemnity Co.
Lumbermen's Underwriting Alliance
Mountain Valley Indemnity Co.
Occidental Fire and Casualty Co. of N. Carolina
Paramount Insurance Co.
Pennsylvania Manufacturers' Association Insurance Co.
Phoenix Assurance Co. of New York
Professional Liability Insurance Co. of America
Providence Washington Insurance Co.
Public Service Mutual Insurance Company
Ranger Insurance Co.
Royal Indemnity Co.
Royal Insurance Co. of America
Safeguard Insurance Co.
Savers Property Casualty and Insurance Co.
Security Insurance Co. of Hartford
Shelby Casualty Insurance Co.
Star Insurance Co.
TIG Indemnity Co.
TIG Insurance Co.
TIG Premier Insurance Co.
York Insurance Co.
Ulico Casualty Co.
Vesta Fire Insurance Corp.
Vesta Insurance Corp.
Warner Insurance Co.