CONSTRUCTION PRACTICE

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SURETY: PREPARE FOR THE WORST. . . EXPECT SOMETHING CLOSE

- The Surety marketplace is calm now but Surety buyers should prepare for the worst – a long-anticipated loss cycle is likely around the bend.
- The run of record profitability from 2005 through the third quarter of 2009 still does not fill the hole created by losses incurred in the preceding four years.
- Underwriter focus on contract terms and conditions remains intense.

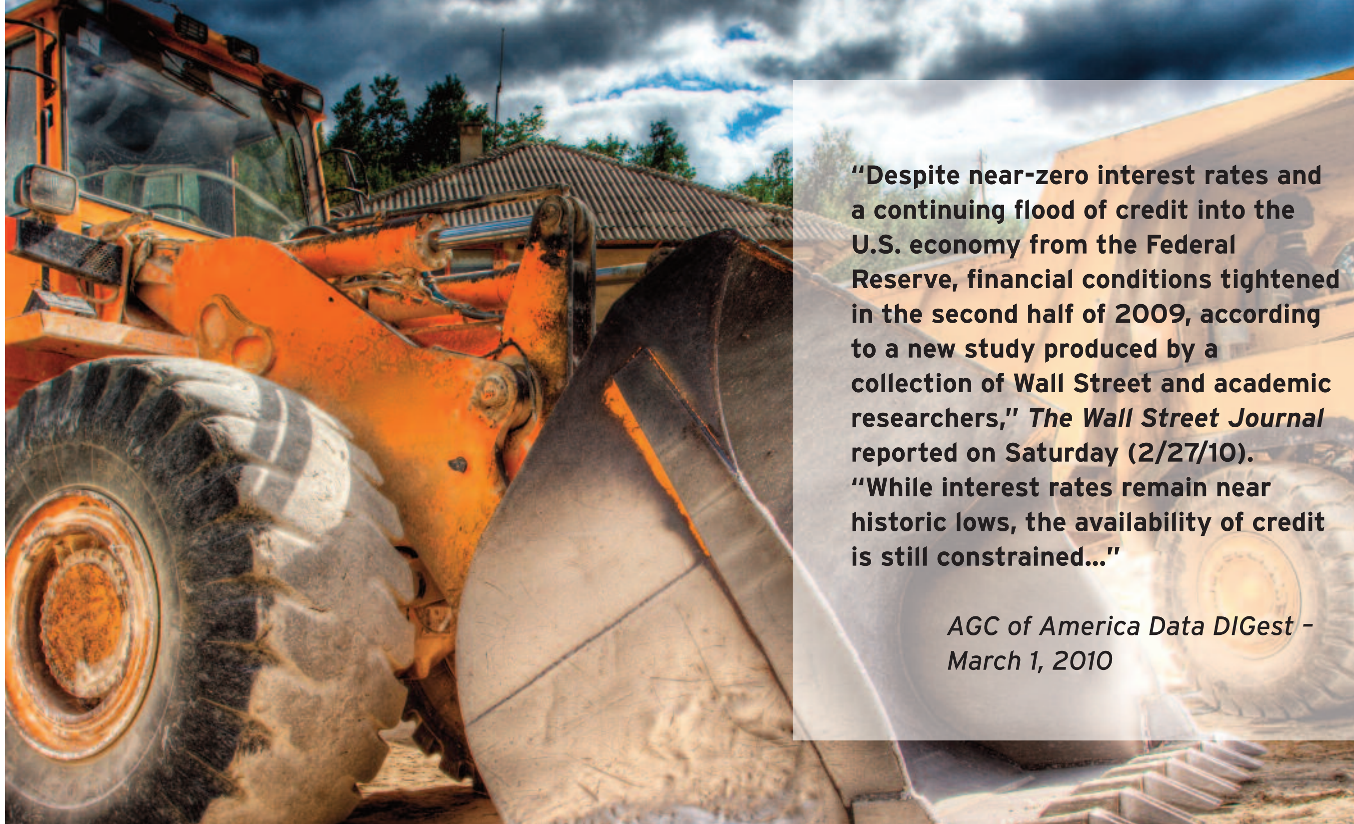
Sureties have been bracing for a loss cycle since the collapse of the credit markets in 2008. No one minds that a loss cycle has been delayed, but indications are that the delay may be ending, as the construction industry's fortunes continue to decline. For now, the markets are calm, but we suggest that Surety buyers prepare for the worst – and expect something close.

MARKET CONDITIONS

All indicators point to 2009 as a profitable year for Surety underwriters. Although yearend 2009 data is not yet available, it is likely the Surety industry experienced contraction in its top line for only the third time since 1997. Third quarter 2009 information from the Surety & Fidelity Association of America reflected a drop in written premiums, yearon-year, of approximately 8.3%. The good news is that the industry loss ratio as of September was approximately 43.2%, a level at which profitability is sustained. This loss ratio number is slightly elevated from 2008's year-end result. While lower premiums likely contributed to an uptick in the ratio, the figures also indicate increasing loss activity. Incurred loss dollars reported in September 2009 equaled 70% of loss dollars for all of 2008. Underwriters' expectations for losses in the second half of 2010, and into 2011, are increasingly bearish. Many contractors share this outlook.

The recovery of construction activity in the U.S. still looks to be a ways off. Increasingly intense competition has been compressing margins since the second quarter of 2009. Sureties remain wary that active construction sectors (health care, institutional and government), while offering their clients volume, contain more pricing risk for builders due to increasing bid competition. The fundamentals strongly suggest that the recovery of residential and commercial construction will be slow. Many state governments, facing significant deficits, will be challenged to match federal funds for road and bridge work. Contractors seeking federal work are finding the profit opportunities as limited as they are in traditional markets.

While Surety is largely dependent on the health of construction activity (which generates 65-70% of Surety industry revenue), capital support for Surety writers is drawn from the U.S. Property & Casualty (P&C) industry capital pool. The P&C

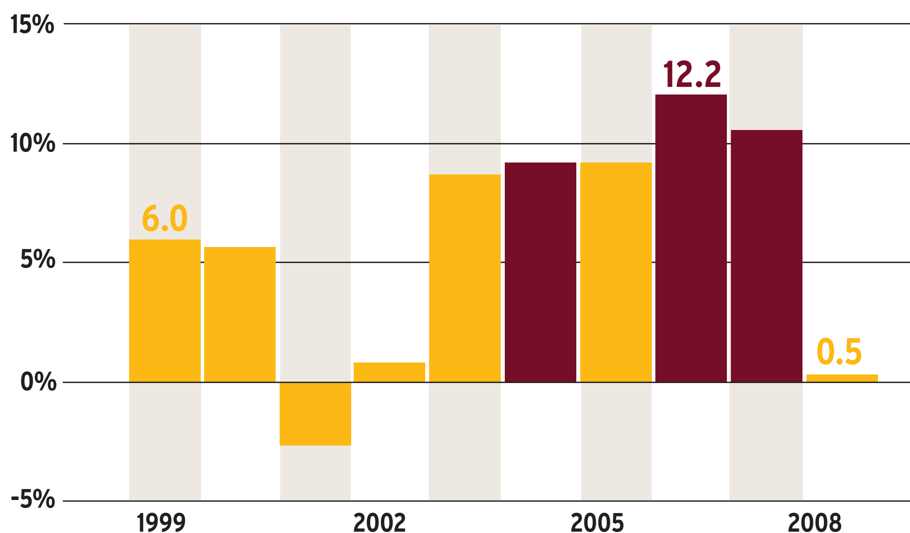


industry's return on capital has, historically, underperformed the average returns of the Fortune 500. Several years of low interest rates and the collapsing credit markets have not helped.

Sureties competing in this capital pool are subject to high standards regarding capital allocation and the prospective returns they offer. There is nothing in the current environment to suggest such scrutiny in the coming years will do anything but intensify, particularly if catastrophe losses remain low and Surety losses increase.

RELUCTANT CAPITAL MEANS VOLATILE CAPACITY

In comparison to the banking sector, however, the insurance industry has largely preserved capital through the turmoil in the credit markets and broader economy since late 2008.

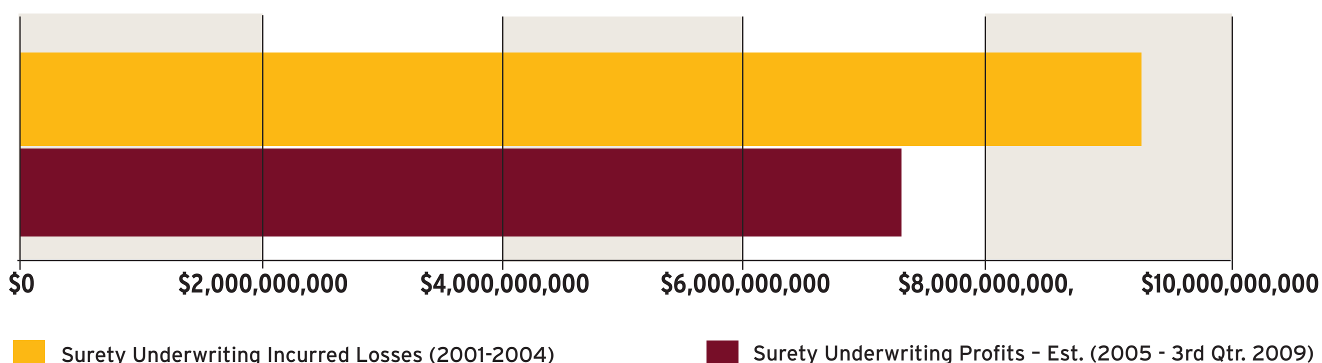


This chart tracks the performance of the U.S. Property & Casualty industry's return on capital from 1999 to 2008 – a period that included some of the largest insured loss events in the industry's history. Year-end 2009 information is not yet available, but in seven (yellow) of the preceding 10 years the industry lost money conducting its primary business activity – underwriting insurance risk.

SOURCE: Insurance Information Institute data

There is of course variance among carriers, and the level and performance of capital are the drivers of change (favorable or unfavorable) in insurer financial ratings. Rating changes, which normally occur with little or no warning, are (or should be) of great interest to large Surety buyers and the sureties themselves. Large Surety programs tend to require co-Surety structures (with two or more participants) to provide the required capacity for their businesses. Only four sureties currently play major co-Surety roles and these companies remain vigilant regarding their inter-creditor risk to their co-Surety partners. Inter-creditor risk assessment is driven by a surety's (or its parent group's) financial rating. Given these complexities, stand-by Surety relationships are a client's best means of preventing interruptions in Surety support from unexpected or uncontrollable factors.

Capital providers are well aware of the potential severity associated with the Surety line. As illustrated below, despite the consecutive run of record profitability from 2005 through the third quarter of 2009, the accumulated underwriting result from those years still does not fill the hole created by losses incurred in the preceding four years. Surety loss severity is inherently difficult to project with any actuarial reliability. Add in the high aggregate exposure inherent to the line and it becomes easier to understand the reluctance of capital providers to support Surety business. The Surety line doesn't offer the minimal certainty of return most capital providers seek or, more importantly, the patience of capital required to reduce capacity volatility for sureties.



YTD gross losses incurred by the Surety industry totaled $366.3 million at September 2009. Given recent history and the outlook for Surety loss activity over the coming 18-24 months, these loss numbers will not help the Surety industry regain the confidence of its capital providers.

SOURCE: Derived from Surety & Fidelity Association of America data

The market share of the four largest writers (as a group) has increased by approximately 50% in the past 10 years and now accounts for more than 60% of total industry written premium. P&C industry mergers or acquisitions are rarely driven by Surety considerations, but each time such an event occurs (and a Surety writer is involved) overall available Surety industry capacity tends to diminish.

Consolidation is an increasing factor in the construction industry itself. The challenges contractors will face in maintaining their balance sheets and a weakening U.S. currency are expected to promote attractive valuations for suitors. In certain instances, business continuity strategies will also contribute to M&A activity in the construction business. Where a prospective deal involves two firms with large Surety programs, however, the Surety industry's ability to provide the required aggregate capacity to the combined entity will be tested.

UNDERWRITING ENVIRONMENT

Sureties are trying to strike a balance between supporting clients in a very competitive environment and underwriting ahead of the loss curve that they expect will steepen in the coming months. Sureties' new business objectives for 2010 are, on balance, modest.

Underwriter scrutiny of contract terms and conditions remains intense. Damage provisions, schedule, warranty/facility performance and payment terms are areas of particular focus. In the public sector marketplace, a trend toward "gap" financing, in which contractors finance work for the owner – usually beyond project completion – until full payment is received, may cloud

balance sheet analysis (a key driver of determining the level of surety provided to a contractor). The aging and collectability of accounts receivable will affect sureties' evaluation of a contractor's analyzed working capital and, perhaps, equity. Experienced underwriters will often challenge a contractor's business plans and financial projections in ways that can be constructive.

Privatization schemes (PPP/PFI) are likely to grow more popular as governments struggle to raise money, either through taxes or debt markets. Some owners involved in public/private partnerships have expressed a willingness to accept letters of credit in lieu of surety performance guarantees. Some non-U.S. groups have seized these opportunities by offering a comprehensive package that includes development, design, finance and construction solutions.

Close examination of subcontractor prequalification, selection and performance management is a major underwriting priority. Whether secured by insurance or Surety risk transfer mechanisms, contractors can expect sureties to challenge their practices in a marketplace that is reflecting a heightened risk of subcontractor defaults. Many analysts expect subcontractor defaults to accelerate in the second half of the year, as banks curtail or withdraw working capital support based on financial information received in the first half of the year. Such a trend could portend the beginnings of a classic Surety industry loss cycle.

Trend lines in corporate bankruptcy filings and the restriction of available credit to refinance balance sheets may signal an increase in Commercial Surety loss activity over the near term. Many Commercial Surety bonds (such as License & Permit and Judicial Appeal instruments) are more akin to financial guarantees than performance obligations and, unlike most Contract Surety obligations, the opportunity for mitigation and salvage by the surety in the event of loss is minimal.

PRICING

No significant changes in overall industry pricing are anticipated in 2010, unless loss activity rises suddenly. Most sureties experienced a flat 2009 Surety reinsurance renewal season, despite concerns on the part of Surety reinsurers about prospective losses. The industry's overall reliance on reinsurance is less than it was 10 years ago. Major Surety writers have either forgone coverage altogether or structured their reinsurance agreements with very high attachment points. These high attachment points (i.e., higher retention on individual risks) require sureties to deliver low loss frequency (driven by underwriting discipline) in order to meet the return-on-capital expectations of management.

Users requiring large Surety capacity can expect their Surety rates to remain, on average, higher than those paid by middle-market buyers. This stems not only from the application of reinsurance costs to the pricing model of large Surety facilities, but from the fact that large buyers tend to be involved in large, complex projects that often include extended contract duration terms or other factors that drive project-specific pricing. Average contract values continue to rise – due to consolidating work into larger single projects – a phenomenon driven by limited project administration resources on the part of owners. Public owners are struggling to balance these pressures with the desire to let smaller firms compete for the work. Federal work increasingly includes provisions for partnerships between smaller firms that may not qualify for bonding, at least on large projects, and firms that can.

Sureties continue to utilize and refine credit model pricing. Contractors are encouraged to understand the credit model of their surety(ies) to ensure there

are no surprises in the pricing of any individual Surety bond. Such understanding might also encourage steps that would improve the results of a buyer's individual credit modeling and favorably impact their Surety pricing.

Personal indemnity remains a common requirement for middle-market contractor programs and for Subchapter S corporations. Collateral is also a common underwriting condition to support certain types of Commercial Surety bonds and, in selected instances, whole Commercial Surety facilities. Some sureties are requiring collateral as a component in some large, so-called "reverse flow" (involving U.S. subsidiaries of non-U.S. parent groups) contractor Surety programs. The sources and quality of the collateral acceptable to sureties are now more restricted and some sureties are capping aggregate collateral levels accepted from any one collateral source.

THE WAY FORWARD

A surety's value goes well beyond that of a normal credit provider. In a certain sense, sureties are a shadow investor in their clients' businesses and can be a source of broad perspective on the construction industry. Sureties provide contractors with a highly efficient form of contingent capital that allows contractors and other users to trade on multiples of their balance sheets, facilitating economic activity that otherwise would be delayed or impossible. Companies that remain committed to transparency and clearly presented financial reporting know that the shadow investor's support is an outcome of good business performance, not a driver of it. A focused investment of time in this crucial business relationship will facilitate support through the challenging times to come and enhance a company's ability to prosper when economic recovery finally, and truly, takes hold.

CONTACTS

Paul Healy
Willis Surety Practice
860 670 3396
paul.healy@willis.com

John Phinney
Willis Surety Practice
973 829 2947
john.phinney@willis.com

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