



INSURANCE & CONSTRUCTION INDUSTRY CONFERENCE

Washington State Convention Center
Seattle, Washington
August 12, 2004

“THE STATE OF THE SURETY INDUSTRY”

presented by

VERTEX ENGINEERING SERVICES INC.
WILLIAM J. McCONNELL JR.
Executive Vice President

HISTORY OF CONTRACT SURETY BONDS:

Although obscure forms of suretyship date back to 2750 B.C., the modern United States contract surety industry is 117 years old with the American Surety Company writing the first such bond in 1887. The Miller Act of 1935 instantly popularized this product by mandating bonds for all federally funded construction projects. Thereafter, many state statutes and local ordinances were passed requiring surety bonds from contractors on public improvement projects. It is now common for owners or lenders of large private construction projects to stipulate bonding as a contract requirement. In 2003, sureties earned approximately \$3.7B in premiums for commercial and contract surety bonds.

PAYMENT AND PERFORMANCE BONDS:

The two most common forms of contract surety bonds are the performance bond and the payment bond.

A performance bond guarantees the contractor's performance and the work to be completed through an agreement between a surety company and a contractor for the benefit of a third party. The contractor is referred to as the surety's "principal" and the third party is known as the "obligee". The performance bond amount and penal limit typically equal the value of the contract between the principal and the obligee. If an obligee rightfully defaults the principal the surety's obligations under the bond are triggered.

Current bond forms allow the surety time to investigate the termination and typically afford the following options if the default was indeed warranted: 1.) Forfeiture of the penal sum; 2.) Finance the principal to complete remaining work; 3.) Retain a completion contractor to complete remaining work; 4.) Tender a new contractor over to the obligee for a fixed price; or 5.) Finance completion by the obligee.

A payment bond, similar to the performance bond, is also an agreement between a surety company and its principal created for the protection of an obligee. The purpose of this type of bond is to shield the obligee from any project-related payment liabilities to subcontractors and suppliers the principal fails to satisfy. As a consequence, the obligee as well as the subcontractors and suppliers benefit from this risk management tool.

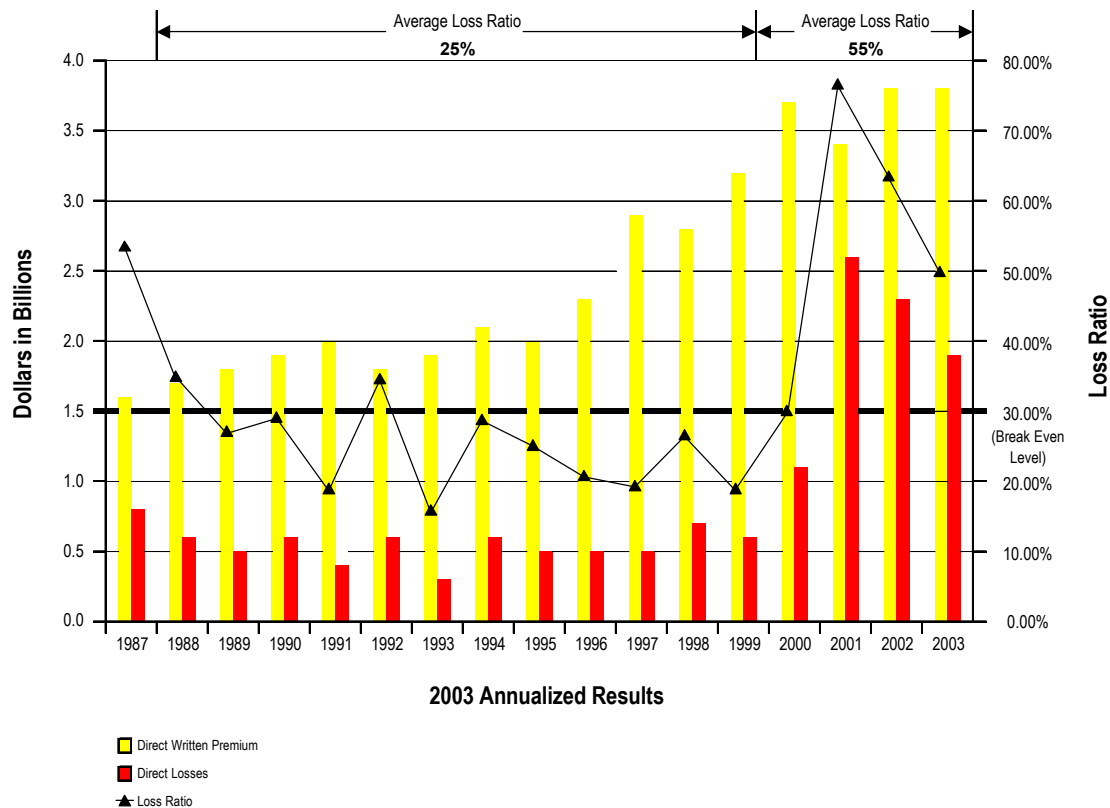
Upon payment of a claim, the surety has the right to reimbursement from the principal and any third party indemnitors. Courts have ruled that sureties have the right to equitable subrogation against its principal, even without a contractual indemnity agreement. In the event of insolvency, however, subrogation against the principal often yields inadequate remedy as little to no financial capacity remains. As such, sureties often require contractual indemnity from both the principal and third parties to guarantee and hold harmless the surety for losses sustained resulting from the principal's failure to perform.

16-YEAR SURETY CYCLE:

On average, in order for a surety to profit from its bond products, it must keep the loss ratio under 30%. For example, if a surety earns \$100 in premium, it can only afford to incur \$30 in loss. The remaining 70% represents the expense and overhead component that is typically made up of: 25% for standard broker commissions; 5% for outside legal and engineering fees ("LAE"); and 40% for overhead.

During the twelve-year span between 1988 and 1999, the surety industry's loss ratio averaged 24%. Although loss ratios were considerably lower in the early eighties and throughout the seventies, the industry remained profitable as written premiums more than doubled. Surety earnings were invested and healthy returns were achieved in the booming financial marketplace. Because of the tolerable loss ratios and high rates of investment return, sureties were pushing "cash flow" strategies where underwriting focused on volume and paid less attention to strict

Surety History Premium / Loss Ratio



underwriting fundamentals and proper indemnification security. The industry was considered “soft”, as it was fairly easy for contractors to secure ample bonding programs.

Eventually the soft underwriting practices created a backlash in the commercial and contract surety market, which when coupled with recent negative domestic and world events, has created unprecedented losses since year-2000. Between year-2000 and 2003, the loss ratio average more than doubled to 55%. Based on recent reserve postings, the industry will likely suffer its fifth consecutive year of losses in 2004.

MICRO ECONOMIC FACTORS INFLUENCING THE DOWNTURN:

There are multiple economic reasons for the increase in contractor defaults and associated contract surety losses over the past four years. These factors include:

- Petroleum inflation;
- China's steel demand has sent U.S. steel prices soaring, resulting in eleven bankruptcies of major U.S. steel manufacturers;
- Unmanageable debt load, ill-timed geographic expansion, and entry into non-core markets, has triggered an unusually high mortality rate among major contractors and subcontractors;
- Contractors have been operating on reduced profit margins ever since construction management contracts became widely fashionable. On average, contractor profit margins are close to five percent, which allows for very few mistakes;
- Public and private owners are running out of cash to the detriment of contractors. For example, companies such as WorldCom left contractors with payables up to \$40M that had to be converted to bad debt (one of those contractors was Vertex's parent company, Tetra Tech Inc., in 2001);
- Oblige payment cycles have been increasingly dilatory resulting in cash flow strains for contractors;
- Long term warranties and maintenance requirements are leading to unanticipated cost overruns and disputes;

- Environmental issues, including mold, lead and asbestos, continue to haunt contractors by necessitating costly abatement procedures;
- General contractors and owners are often required to waive bonding requirements for undercapitalized 8a companies, thereby increasing their own liability;
- Due to their bottom position on the “food chain”, prudent subcontractors are demanding retainage waivers that increase the prime contractor’s risk level and hamper cash flow;
- Due to the reduction in capacity of the reinsurance market, sureties have taken on more risk thereby increasing direct loss exposure.

MACRO ECONOMIC FACTORS INFLUENCING THIS DOWNTURN:

In early 1999, the Federal Reserve Bank severely over-reserved its cash level and authorized an inordinate amount of loans to banks for protection against the upcoming Y2K threat. Rather than sit on the excess cash for reserve protection, local lending standards were lowered and loan volume soared. When Y2K proved to be inconsequential, the Federal Reserve called in the excess loans sending the banking industry, and in turn the economy, into a tailspin. Shortly thereafter, corporate scandals at Enron and other trusted companies caused major losses in the commercial surety market. The tragedy of 9/11 reduced consumer confidence and triggered two costly foreign wars.

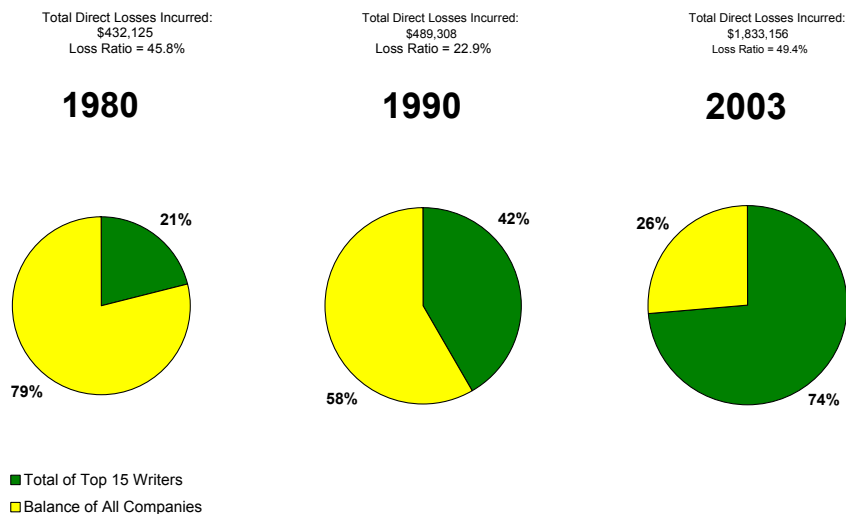
Although construction spending has increased over the past three years, growth is primarily a result of the residential housing boom triggered by the lowest mortgage rates in more than four decades. Residential construction is typically not bonded therefore it doesn’t boost revenue to the contract surety industry. Moreover, this housing boom is very sensitive to interest rate fluctuation and will most likely slow as rates continue to rise. Based the Bush Administration’s 2005 budget for construction, a substantial investment will be made in highway and transit

programs, defense related improvements and border patrol security efforts. Overall, government spending will continue to represent a significant source of construction revenue.

CONSOLIDATION OF THE SURETY INDUSTRY:

Between 1980 and 1990, the market share of the top fifteen surety corporations rose from 21% to 42%. Between 1990 and 2003, this percentage rose from 42% to a staggering 74%. Six of the top ten sureties in 1990 have since merged and one has elected to discontinue its surety operation. Why all the mergers? For starters, insurance companies are not subject to federal anti-trust violations; they are regulated on the state level where reviews are typically limited to required insurance and surety rate postings. Moreover, even if one corporation has a stronghold on one particular insurance sector or surety line, as a whole they will not monopolize the insurance industry based on the broad range of products.

The Consolidation of the Surety Industry



Today, St. Paul Travelers, the leading producer of surety bonds, owns close to 30% of the market. The surety departments, as is the case with St. Paul Companies and Travelers Property Casualty, often do not drive mergers as they only make up a small fraction of the collective book

of business. In any event, both insurance and surety mergers simply make sense on paper as companies generally have similar organizational structures therefore duplicative operations and fixed overhead can be substantially reduced while written premium is proportionally increased. Cherished organic growth, while always preached, is normally insufficient to satisfy stock market earning projections thereby forcing merger consideration.

PRICING OF SURETY BONDS:

On average, premiums for contract surety bonds issued to large-scale contractors (\$250M+ backlog) have increased by roughly 10% over the past few years. For small to mid size contractors, pricing has increased between 10-20%. Unless loss ratios are reduced below 30%, the surety industry will be forced to continue increasing rates. It is likely, however, rates will remain flat in the short term, as most sureties have already negotiated new reinsurance treaties.

'BACK TO BASICS' UNDERWRITING:

Since year 2000, the surety industry has advocated 'back to basics' underwriting where strict prequalification is revisited. Criteria includes: How much single project and overall capacity can the contractor handle; What is the contractor's financial health; Does the contractor have good character; Is the work within the contractor's realm of expertise; Is the project within the geographic region of construction familiarity; Is the obligee reasonable; and is adequate corporate and third party indemnity in place.

As many underwriters are relatively new to the surety industry (less than 12 years in the business), traditional underwriting experience is lacking. Moreover, since brokers work on commission it is inherently difficult to turn away business. As a result, 'back to basics' underwriting did not immediately take effect. Over the past eighteen months, however, sureties have grasped these objectives and bonding is now more difficult to secure than it has been in sixteen years. I see this "hardening" of the marketplace as an advantage to good construction companies, as they will have to compete against fewer unsophisticated contractors.

CAPACITY REVIEW:

In order for sureties to manage their risk, a large portion of potential loss is offset to reinsurance companies. Reinsurance levels typically differ between each construction account. The record losses over the past four years, combined with recent lack of sufficient return on investment, has resulted in a substantial decline in reinsurance capacity. In the late 90s, there were approximately fifteen providers of reinsurance; today the figure has been reduced to only seven: American Re; Arch Re; Everest Re; Gen Re; Swiss Re; XL Re and Renaissance Re. Many of these remaining companies recently reduced capacity limits after Standard & Poor's issued downgrades due to low profitability.

The largest faction affected by this capacity reduction is large contractors with \$250M+ of backlog. The majority of reinsurers feel more comfortable with regional and specialty sureties so the middle market has remained fairly stable. To fill this capacity void for large accounts, primary sureties are taking on more risk than they would typically like. If reinsurers can be persuaded to take on risk associated with accounts with significant backlogs, updated reinsurance treaties often demand additional reporting that will potentially slow underwriting decisions and increase costs. Consequently, contractors will more than ever need to establish close working relationships with their brokers and bonding companies.

HIGH RISK SECTORS:

The following construction sectors are considered high risk by underwriters:

- **STEEL:** Massive losses in the steel construction industry have resulted from unprecedented material cost escalation over the past three years. Eleven of the United States' largest steel manufacturers have filed for bankruptcy along with numerous steel erectors. General contractors have also been burdened with sudden inflation prior to buyout on existing projects. Over the past year, many escalation claims have

been submitted to owners to attempt to recover losses on materials. To date, few owners have accepted such submissions.

- **ENVIRONMENTAL:** Nearly every surety has prohibited the underwriting of large scale environmental related construction. AIG is one of the few sureties that understands this risk and is willing to consider bonding this line of work.
- **ROOFING:** The largest number of construction defect claims arise from water infiltration that is blamed on roofing contractors. Lengthy warrantee periods and the difficulty in identifying the source of water infiltration issues make roofing a high risk specialty.
- **DRYWALL:** Although previously not considered a high risk segment, the increasing number of mold claims has made underwriters wary of siding, drywall and framing subcontractors. With the rising popularity of mold resistant gypsum board, subcontractors are hopeful concerns will subside in the future.
- **MASONRY:** Masonry is another product where water infiltration is very difficult to detect as flashing is concealed. There has also been a massive increase in silica related claims as well.

SUBCONTRACTOR DEFAULT INSURANCE:

Over the past five years, large general contractors and a limited number of owners have elected to use Subcontractor Default Insurance (SDI), rather than surety bonds, on private construction projects. Currently Zurich's Subguard product is the only SDI insurance available although one other insurance company dabbled in the market for a short period of time. The SDI model is not proven at this point as losses typically occur several years after a policy is written. In a nutshell, SDI creates a relationship between a general contractor and the insurance company where the insurance company agrees to underwrite the risk that a subcontractor will default.

The SDI policy typically includes an extremely high deductible and upper tier coverage for catastrophes. The average premium for a SDI policy is typically 0.5% of subcontract costs but can more than doubled by the end of a project if a certain threshold amount of claims are filed. The users of Subguard feel the main advantage is having more control over the default process. Although Subguard has taken market share on private construction projects, it will most likely not affect the public construction sector as owners are very comfortable with surety bonds, which cannot be canceled and have a proven track record (and ample case law) for over 100 years. Moreover, as the loss cycle hits the SDI product, the terms and conditions may have to change in order for it to work financially.

PREDICTIONS FOR THE NEXT FIVE YEARS:

Several years ago, Warren Buffet, perhaps the shrewdest investor of the past 100 years, reviewed Kemper Insurance Companies' book of business when it required funding for continued operation. After a short investigation, he elected not to get involved in financing their surety operation as he felt the industry's surety model was flawed and couldn't provide a reasonable rate of return...sureties have no option but to harden.

A continued hard market is healthy (if not mandatory) for the surety industry as change is needed to yield profit. Although losses continue to result from the days of the soft surety market, and the 2004 industry loss ratio will likely be well north of the 30% break even level, a return to profitability is near. I predict healthy profits will be realized in 2005 and continue thereafter. Now that prime sureties are taking on larger risks on major accounts, a greater focus will be placed on contractors' financial health and manageable backlog.

As desperately needed profits return to the industry, reinsurance capacity will gradually increase. As interest rates continue to rise, however, sureties must resist the temptation to regress back to cash flow underwriting tactics. SDI insurance growth will likely subside as losses mount and policy language is revisited. Based on loss amounts, deductibles may rise as well.

Contractors will need to accept and take advantage of this hard market as it brings a desperately needed entry barrier to construction. As sureties elect not to underwrite projects due to contractors' excessive backlog or limited credit, contractors will look to strategic partnerships to bring more capital and experience to the table.