SURETY

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In our last *Marketplace Realities* Surety report in April, we predicted a storm would develop in the Surety industry following the dramatic economic events of late 2008. While the storm remains offshore for now, clouds are gathering, and landfall is all but certain.

Surety executives expect 2009 will be a profitable year for the industry, but at a level well below the record performance of recent years. Slowing revenues were evident in 2008, as written premium volume for sureties increased at a declining rate for the first time in seven years. The first two quarters of 2009 did not offer much encouragement. Industry written premiums were down by approximately 9%.[1] Many major Surety writers are projecting reduced premium volume for the full year and have begun addressing the expense side of the ledger in the face of declining revenue.

In terms of underwriting results, the good news is that the industry loss ratio at June was approximately 33%, a level at which profitability can be sustained. The bad news is loss activity is increasing. The June 2009 loss ratio figure is nearly double the level of June 2008 and the highest in nearly four years. While lower premiums contributed to an uptick in the ratio, incurred loss dollars reported at June equaled nearly 50% of the total combined industry losses over the *two prior full-year periods*. Underwriters currently expect losses to increase, both in frequency and severity, as the industry moves into 2010. Given contractors' general expectations of a very poor 2010, sureties expect 2011 may be worse yet.

Many top contractors reported record revenue for 2008 and they expect to finish out this year with strong numbers as they consume backlog built up in better times. But as jobs won during the boom reach completion, the reality of today's troubled market is settling in, leaving large firms nervous about what late 2010 and 2011 could bring.

—ENR Insider, September 10, 2009

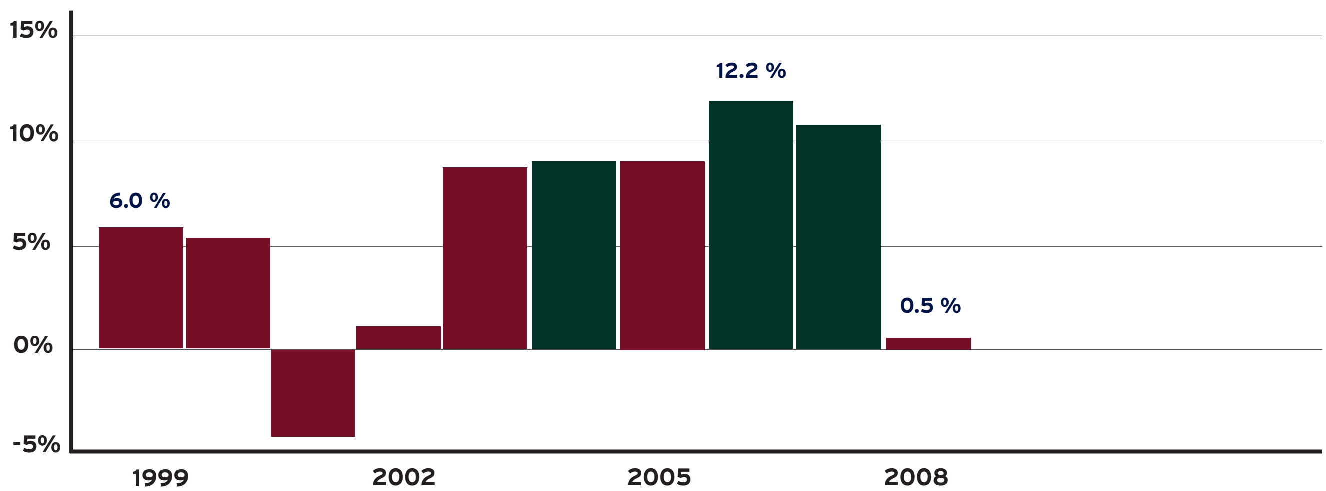
AS CONSTRUCTION GOES, SO GOES SURETY

Construction activity in the U.S., which began a dramatic decline in the third quarter of 2008, has continued to falter through the first six months of 2009. While many contractors began 2009 with sufficient backlogs and margins, they have been dealing with a quick intensification of competition for work since the second quarter. McGraw-Hill reports an uptick in construction starts in July compared to June,[2] but the

year-on-year results show a decline of more than 20% in non-residential construction. Ken Simonson, Chief Economist of the Associated General Contractors of America, notes total spending for both public and private non-residential construction dropped in July.[3] Most analysts are skeptical of the ability of the U.S. government's stimulus spending to drive a quick recovery, but acknowledge the public cash has cushioned what otherwise would have been an even more precipitous decline (although stimulus spending to date has accounted for only 6% of new construction starts).[4] The fundamentals strongly suggest that the recovery of commercial construction will be slow. Many state governments, facing significant deficits, will be challenged to match federal funds for road and bridge work. Sureties remain wary that sectors that remain active (health care, institutional, government) will not generate adequate margin for builders due to increasing bid competition.

Analyzing the Surety industry in isolation can be misleading. Surety is, of course, largely dependent on the health of construction activity, which generates 65-70% of Surety industry revenue. Capital support for Surety writers, however, is reliant on the U.S. Property & Casualty (P&C) industry capital pool. The U.S. P&C industry's return on capital was lackluster in 2008. Historically, this business has generated below-average returns in comparison to those of the Fortune 500. A multiyear period of low interest rate returns and the impact of collapsing credit markets gave insurers a double blow in 2008. Sureties competing in this capital pool are subject to high standards regarding capital allocation and the prospective returns they offer. The current environment suggests that scrutiny will only intensify over the next five years.

RETURN ON CAPITAL



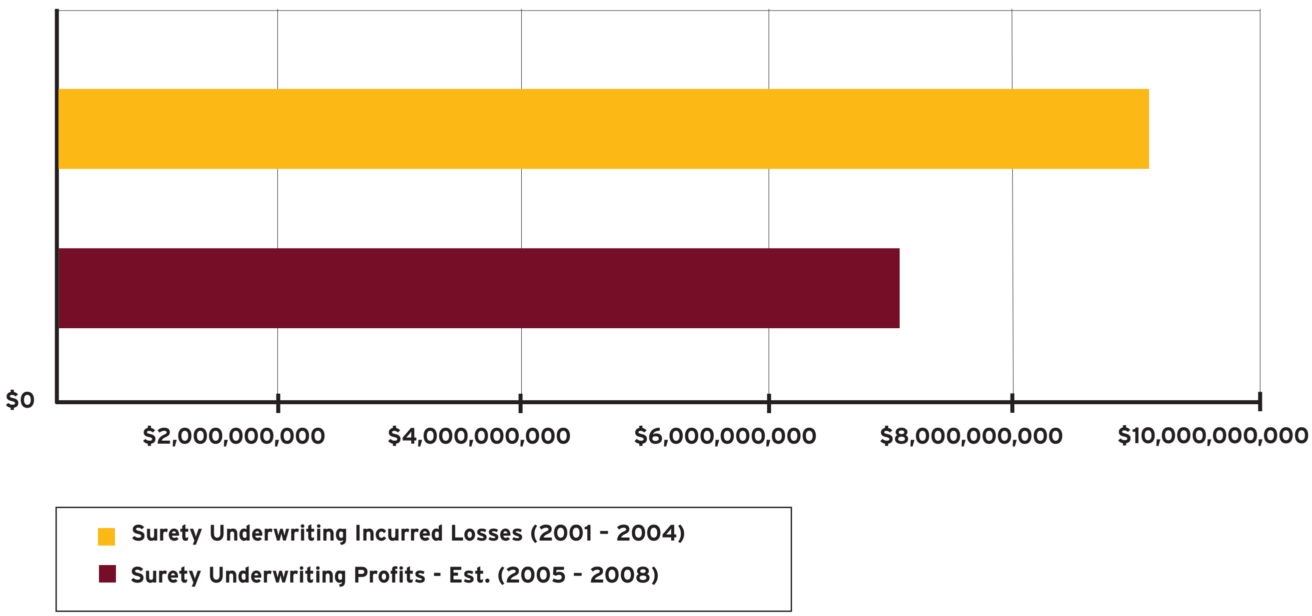
The chart above tracks the performance of the U.S. Property & Casualty industry's return on capital over the past 10 years – a period that included some of the largest insured loss events in the industry's history. The years shown in RED are those in which the industry, as a whole, generated an underwriting loss. It is worrisome that in seven of the past 10 years the industry has lost money conducting its primary business activity – underwriting insurance risk. Surety is a capital intensive business. Underwriting practices over the longer term, whether disciplined or not, will determine whether sureties achieve the required return on capital to remain attractive to capital providers. These hurdle rates are set with little room for flexibility...or forgiveness.

Source: Insurance Information Institute data

Capital providers are cognizant of the volatility and potential severity associated with Surety industry loss results. Some analysts are hopeful the expected loss cycle will be more moderate than history suggests. They argue that contractors' balance sheets have been bolstered during the most recent boom cycle and are better positioned to withstand the downturn. They also suggest that contractors, generally, are more proactive and sophisticated managers of their resources and are moving quickly to deal with reduced volumes in a way that will allow for a more orderly wind-down of backlog levels.

As illustrated below, despite the consecutive run of record profitability from 2005-2008, the accumulated underwriting results from those years does not fill the hole created by losses incurred in the preceding four years. Shadowing the industry today is the concern that capital providers may be less patient with loss activity than in the past. Further clouding the picture are the difficulty of reliably projecting Surety loss severity on an actuarial basis and the high level of aggregate exposures inherent to the line. In recent years, the Surety line clearly has not delivered the certainty of returns most capital providers seek.

SURETY RESULTS



YTD gross losses incurred by the Surety industry equaled $867.2 million at June 2009. Given current conditions and the outlook for surety loss activity over the coming 18-24 months, the Surety industry has a long way to go to fully regain the confidence of its capital providers.

Source: Derived from Surety & Fidelity Association of America data

In comparison to the banking sector, the insurance industry has largely preserved capital through the current financial turmoil. This has not, however, provided immunity to actions affecting the financial ratings of insurance groups – which can move with little or no warning. This uncertainty mostly affects large Surety buyers, as their Surety programs tend to require co-Surety structures (two or more participants) to generate the required capacity for their businesses. Only four sureties currently play a major role in this area, and these companies remain vigilant regarding their inter-creditor risk to co-Surety partners. This inter-creditor risk assessment is driven by a surety's (or its parent group's) financial rating.

Rising corporate bankruptcy filings and the restriction of available credit to refinance balance sheets may herald an increase in Commercial Surety loss activity over the near term. Many Commercial Surety bonds (such as license and 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.

Privatization (PPP/PFI) schemes may well attract more interest from public owners in a marketplace where government bodies cannot finance needed projects solely from tax revenues or where their capital market access is limited or closed. Some owners have expressed a willingness to accept letters of credit in lieu of surety performance guarantees for privatized projects. Some non-U.S. groups have demonstrated an ability to bring comprehensive development, design, finance and construction solutions to some of these opportunities.

CONSOLIDATION

In many industries, consolidation is a response to tough times. So it goes in Surety. The most recent major M&A deal affecting Surety was the combination of Liberty Mutual and Safeco last autumn, creating the industry's second largest writer. The market share of the four largest writers (as a group) has increased by approximately 50% in the past 10 years and these four sureties now account for more than 60% of industry written premium.

The impact of consolidation is not limited to the Surety carriers, but also includes their customers. Strategic considerations, along with weakening of the U.S. dollar, are anticipated to promote attractive opportunities for suitors. (The recent Balfour Beatty/Parsons Brinkkerhoff deal is an example.) Business continuity strategies may also contribute to M&A activity in the construction business. Where a prospective deal involves two firms with large Surety programs, the Surety industry's ability to provide the required aggregate capacity will be tested, particularly as economic conditions begin to improve for construction.

2008 – TOP 12 SURETY WRITERS
TRAVELERS
LIBERTY MUTUAL
ZURICH
CNA
CHUBB
HARTFORD
HCC
INTERNATIONAL FIDELITY
ACE
GREAT AMERICAN
ARCH GROUP
NAS / SWISS RE

WHAT'S CHANGED SINCE 1999	
FIREMAN'S FUND	*MERGED WITH ST. PAUL*
ST. PAUL	*MERGED WITH TRAVELERS*
RELIANCE	*MERGED WITH TRAVELERS*
SAFECO	*MERGED WITH LIBERTY MUTUAL*
FRONTIER	*EXITED THE BUSINESS*
AMWEST	*EXITED THE BUSINESS*
CRUM & FORSTER	*EXITED THE BUSINESS*
KEMPER	*EXITED THE BUSINESS*
XL SURETY	*EXITED THE BUSINESS*
AIG	*NO LONGER TOP 12*

The past 10 years have seen unprecedented consolidation among U.S. surety writers. Losses earlier this decade drove some of the activity, but parent group financial ratings also were a factor. On one hand, this consolidation has contributed to a measure of stability, but further consolidation, particularly among the top five writers, could have a significant effect on large capacity programs.

Source: Surety & Fidelity Association of America data.

UNDERWRITING ENVIRONMENT

The general insurance marketplace remains soft, even in an environment of poor investment income returns. Catastrophe losses in 2009 have been low, and competitive pressures have provided most contractors (with good loss experience) with attractive renewal terms. Sureties, in turn, are trying to strike a balance between supporting clients' efforts to acquire or maintain profitable work in a very competitive environment and trying to underwrite ahead of a loss curve sureties expect will steepen in the coming months. Sureties are being selective in writing new accounts for fear of acquiring a predecessor surety's unrealized problem.

The focus on contract terms and conditions remains intense. Despite overall soft conditions, contractors have lost the leverage of a seller's market. Damage provisions, schedule, warranty/facility performance and payment terms are areas of particular scrutiny. Underwriters are challenging contractors' business plans and financial projections, particularly in regard to fixed overhead expenses and debt service costs. Sureties want more detail about owner financing and the aging and collectability of accounts receivable in order to better assess their clients' credit risk and cash flow management disciplines. In the public sector, a trend toward "gap" financing of work holds the potential to cloud balance sheet analysis (a key driver of determining the level of surety provided to a contractor). Underwriters are trying to carefully assess the risks associated with contractors financing work for the owner – which usually involves full payment beyond project completion.

The examination of subcontractor prequalification, selection and performance management remains 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 strains in the subcontracting community and may soon see increased default frequency.

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 the programs of some large "reverse flow" projects (involving U.S. subsidiaries of non-U.S. parent groups). The sources and quality of the collateral acceptable to sureties is now more restricted, and some sureties are capping aggregate collateral levels accepted from any one collateral source.

PRICING

Except for pricing on large individual projects, no significant changes in industry pricing are anticipated in 2010, unless loss activity rises suddenly. One key reason is surety reinsurance. The current outlook is for flat reinsurance renewals in the coming season, despite concerns on the part of surety reinsurers about prospective losses. New players have entered the surety reinsurance arena in recent years and this will mitigate price increases for 2010. The industry's overall reliance on reinsurance is lower than it was 10 years ago. Major Surety writers have either foregone coverage altogether or structured their reinsurance agreements with high attachment points. These high attachment points require sureties to deliver low loss frequency (driven by underwriting discipline) in order to hit the return-on-capital expectations of management.

Users requiring large Surety capacity can expect their rates to remain, on average, higher than the rates for middle-market buyers. This is in part because large buyers tend to be involved in large, complex projects that often include extended contract duration terms or other factors. Prices for large individual projects are rising significantly – to the point where even some public owners are seeking means to waive Surety requirements on public work.

Sureties remain committed to credit model pricing and contractors are encouraged to understand these credit models. This will help avoid surprises in the pricing of individual Surety bonds. It may also suggest steps contractors might take to improve the results of the sureties' modeling and favorably impact their Surety pricing.

AN EFFICIENT FORM OF CAPITAL

Sureties are more than a credit provider. For contractors, they provide a highly efficient form of contingent capital that allows contractors (and others) to efficiently leverage their balance sheets. In a certain sense, they represent a shadow investor – a partner that can offer useful perspective on the construction industry. Companies that remain committed to transparency and clear financial reporting know that this investor/partner's support is an outcome of good business performance, not a driver of it.

One result of the current crisis may well be an increased emphasis on performance risk management in the coming months and, perhaps, the next few years. This could raise the bar for Surety requirements as the economy recovers. Well managed, disciplined construction firms will find their Surety relationships have become a greater competitive advantage than ever before. A focused investment of time in this crucial business relationship will enhance a company's ability to prosper when economic recovery takes hold.

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[1] Surety & Fidelity Association of America data.
[2] *Market Dynamics*, McGraw Hill, August 2009.
[3] *Daily Commercial News and Construction Record*, Reed Construction Data, September 4, 2009.
[4] Ibid.