

# SURETY

## BRACING FOR THE STORM

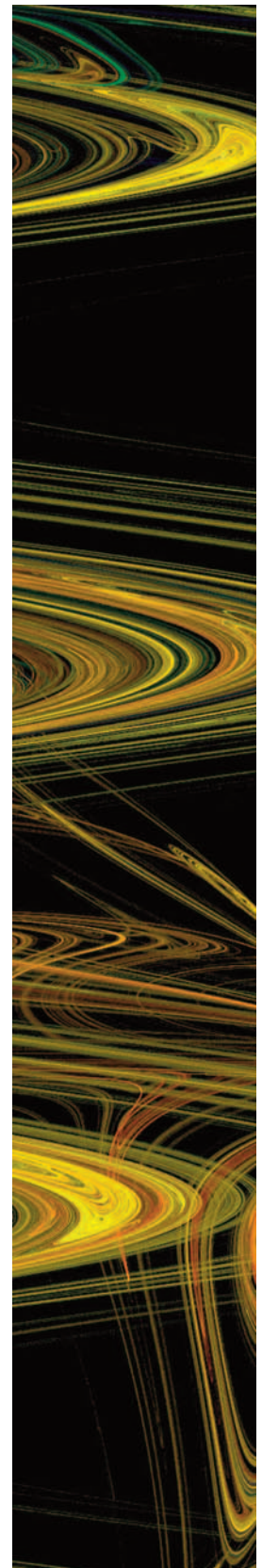
**In unprecedented times, there are no trend lines. Many have expressed similar sentiments recently, and they aptly summarize the challenges facing sureties and their customers. The anticipatory character of our title may therefore seem surprising. Some wonder, how can we plan for what comes next? Others may ask, isn't the storm raging already? Yes, of course. Willis expects, however, that one long-standing trend in our sector will continue: Surety premium revenues are usually a leading indicator of the beginning of an upward economic cycle, and surety losses are historically a trailing indicator on the down side. The effects of the current turmoil have yet to impact surety industry results, but history suggests they will...and soon.**

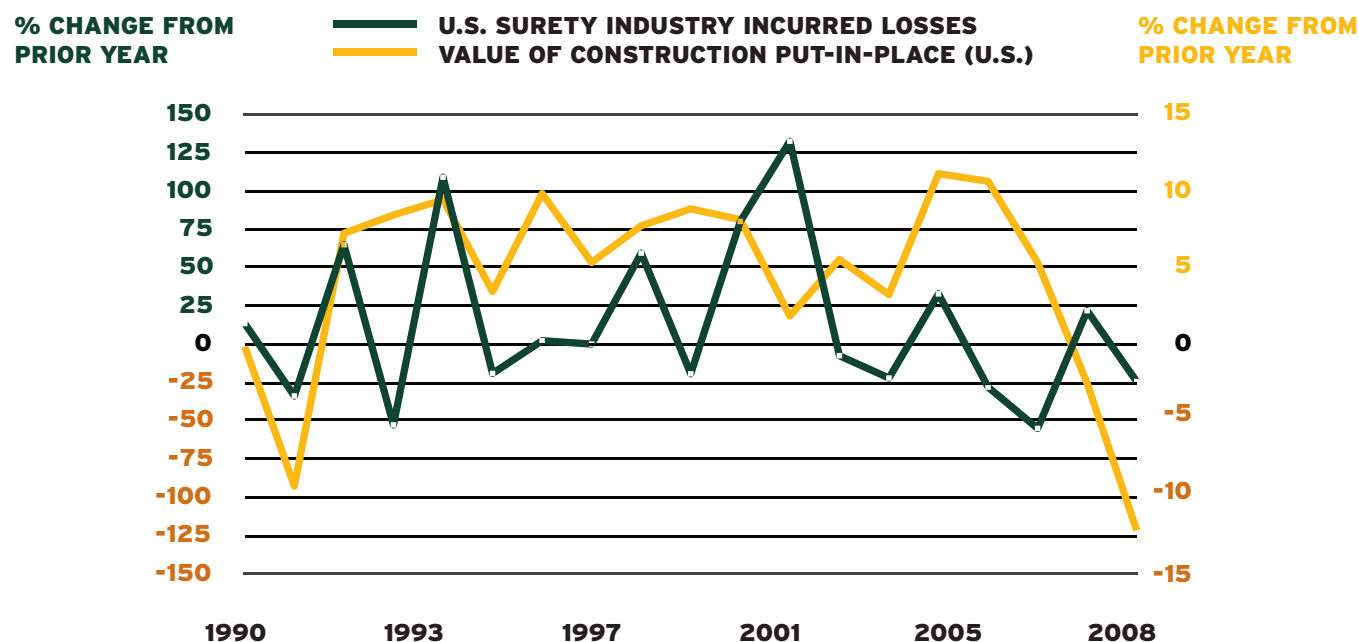
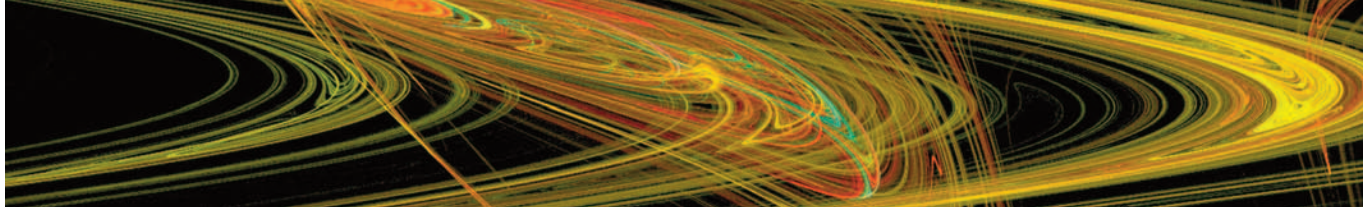
## MARKET CONDITIONS

Preliminary figures for 2008 show a profitable year for surety underwriters, the fourth in a row. The industry loss ratio of 13% represents a five-point improvement over 2007's record result. Written premiums were up by 2.5% year on year.

The outlook for 2009 may present a different picture. Based on the first quarter's activity, we expect a drop in industry premium levels for the first year-on-year period since 2001. Beginning in 2001, the industry incurred losses totaling more than \$10.9 billion over a five-year period. Some would argue this doesn't bode well for sureties in 2009 and 2010, as the economic outlook then was much more favorable than it is today.

The direct correlation between peaks in construction cycles and subsequent increases in surety loss activity is evident in the chart below. The industry's prosperity of 2004-2008 is not forgotten, but it is now irrelevant to underwriters and their sources of capital. For many, the experience of substantial surety losses in 2001-2004 remains a fresh memory. History suggests the industry is on the verge of a loss cycle and, possibly, a severe one. Whether severe or moderate by historical measures, increased loss activity will test the patience of those providing capital to a line that has demonstrated high loss volatility, and in the last cycle, higher severity.



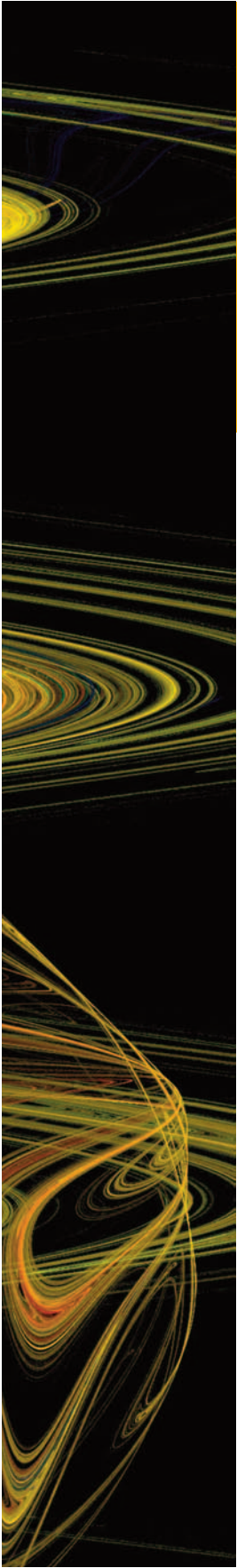


Following the 12% decline in construction activity in 2008, the AGC of America forecasts another 7% drop this year. If the order of magnitude reflected here is a guide for metrics, losses over the next five years could exceed – by 50-100% – the nearly \$11.0 billion in losses incurred by sureties in the 2001-2005 period. Moderating a very daunting outlook is the fact that contractor balance sheets were strengthened during the most recent boom period and, perhaps, have more sustainability than in past cycles. This, combined with the fact that backlogs are declining at a rapid rate, argues that the overall near-term loss level – while significantly escalated – may not be on the scale the metrics suggest.

Sources: Surety & Fidelity Association of America and U.S. Census Bureau data

The overall drop in construction activity since the third quarter of 2008 has been dramatic. After falling 12% in 2008, 2009 began with an additional 8% decline in the first two months<sup>1</sup>. Increased competition from firms migrating out of residential and commercial work into more robust sectors (health care, education and government) is eroding margins. Officials in Utah and Louisiana recently reported proposals for some stimulus-related work coming in 25% below engineers’ estimates.<sup>2</sup> As 2009 began, even previously resilient sectors (private higher education work, in particular) were starting to reflect weakness. Concerns a year ago about strains in the subcontractor community that were focused on labor availability, material cost escalation and quality control have now been outstripped by scrutiny of subcontractors’ ability to stay in business, as working capital facilities and interruptions to project funding have become more common. In light of these conditions, sureties are moving quickly to tighten underwriting standards.

The events of the fourth quarter of 2008 have put underwriters on watch for Commercial Surety losses. Commercial Surety business is written, predominately, for non-construction industry risks (Fortune 1000 firms, financial institutions, manufacturers, etc.) and the premiums generated constitute roughly 25-30% of annual surety industry revenues. Many Commercial Surety bonds (such as License & Permit and Judicial Appeal instruments) are more akin to financial guarantees than performance obligations. Unlike most Contract Surety obligations, the opportunity for mitigation and salvage by the surety in the event of a loss is minimal. Excepting certain periods, this line has been a consistent money maker over the years. The industry may be entering one of those exceptional periods.



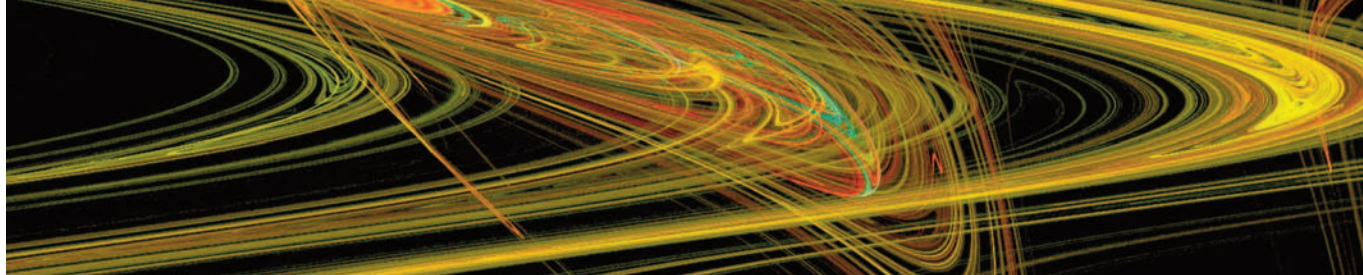
**"California's poor economy has led to surprisingly low bids on transportation projects across the Bay Area and state, as construction companies fight for their business lives to capture whatever work they can. Dozens of firms are vying for work that in the past might draw interest from a handful. From major highway construction to small sidewalk improvements, bids are sometimes close to half as much as public works officials had projected."**

*San Jose Mercury News, March 30, 2009*

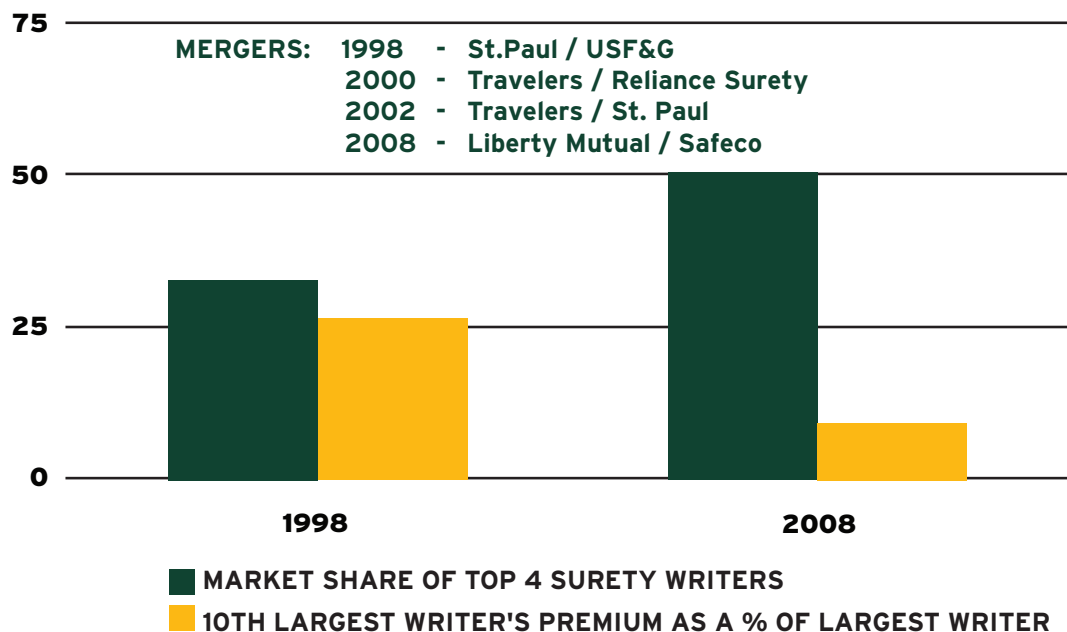
Corporate bankruptcy filings and the restriction of available credit to refinance balance sheets point to an increase in Commercial Surety loss activity over the near term. Collateral requirements for many Commercial Surety bonds (appeal bonds, non-cancellable obligations, etc.) are increasing. Underwriters are also closely reviewing the source bank of any collateral presented and accepting fewer lenders. This may create issues for clients, especially if collateral is required in a short timeframe and an acceptable bank source cannot be engaged. Ironically, financial institutions themselves that require certain types of bonds are being challenged to post acceptable collateral to sureties, as underwriters vet the source, viability and liquidity of any instrument presented to secure a bond.

As the chart below reflects, merger and acquisition activity has increasingly concentrated surety capacity at the top of the industry. Few mergers in the U.S. Property and Casualty industry are driven by surety considerations, as the industry encompasses only 1% of total U.S. P&C premiums. Each time such an event occurs, however, overall available surety industry capacity tends to decline. In comparison to the banking sector, the insurance industry is viewed as having reasonably stable capital support, but one only has to read the headlines to know insurers' balance sheets are receiving increased scrutiny from ratings agencies and other officials. We believe actions regarding financial ratings of insurance groups in the coming months may impair the surety industry's ability to maintain its current capacity. This will affect large surety buyers, in particular. These buyers tend to require a co-surety structure involving two or more sureties to generate the capacity needed for their businesses. Currently, only four sureties play a major role in this area. As consolidation occurs in the construction industry, the ability of sureties to aggregate the required capacity to support larger programs may be affected. Ratings actions that affect a co-surety participant are also a factor, as sureties' attention to the intercreditor risk of their partners has been heightened.

Capacity will likely be an issue with regard to a number of anticipated stimulus-related projects. Due to the limited public resources available for contract administration and oversight, projects are being consolidated, increasing contract values and attracting joint venture bids as a means to mitigate risk. Intercreditor risk and aggregate capacity issues might affect such projects. Buyers are counseled to engage sureties in a stand-by fashion to minimize the impact of an unforeseen rating agency action or to attract additional capacity support.



## MARKET SHARE %



*With the completion of the Liberty Mutual and Safeco Surety merger in the 4<sup>th</sup> Quarter of 2008, the market share of the industry's top four writers now stands at a shade below 50% – a level almost double that of 10 years ago. The top 10 writers accounted for more than 68% of industry writings as of December 2008. This concentration of capacity may help stabilize the underwriting environment. In an environment where further consolidation seems likely, however, this top-heavy imbalance will amplify the loss of capacity from any further consolidation, affecting surety.*

Source: Surety & Fidelity Association of America data

## UNDERWRITING ENVIRONMENT

In the past, a combination of slowing economic activity, diminishing investment returns and the exposure of capital to other risks put pressure on sureties to pursue volume. We saw this pattern in the wake of insured losses from 9/11 and recent hurricanes. This could happen again with regard to significant exposures now appearing in the D&O liability line, but we believe that history, in this case, will not repeat itself in the near term. The general insurance marketplace is hardening due to reduced capacity and the strong emphasis on capital preservation. Sureties are tightening requirements and being very selective in writing new accounts for fear of acquiring a predecessor surety's problem.

The focus on contract terms and conditions, meanwhile, remains intense. The new conditions in the construction marketplace are challenging underwriters to balance their clients' need for new work with a more aggressive stance by owners with regard to contractual provisions and schedule. Contractors have lost some of the leverage that existed only months ago when the market was more favorable to the seller of construction services than the buyer. With the prospect of declining revenues for their clients, underwriters are challenging contractors' business plans and financial projections, particularly as they relate to fixed overhead expenses and debt service costs.

Contractors can also expect questions regarding their own credit risk and cash flow disciplines when it comes to project funding. Inquiries by sureties about the aging and collectability of accounts receivable is increasing, as for the first time in memory, the viability of construction lenders is in question. Each week examples appear of projects where funding has been stopped mid-term, leaving builders with potentially uncollectable billings. We see many examples of strained public budgets sometimes manifested in an extended lag time to collect retainage on completed work.

An area where some sureties are expanding support is in international surety. This encompasses both reverse-flow opportunities within the U.S. marketplace and the supply of surety credit to companies in overseas markets.

In another trend worth watching, groups that offer comprehensive development, funding and construction capabilities are attracting the interest of governmental agencies at the state and federal level. For a number of these infrastructure and other public works projects, structured as PPP/PFI contracts, government officials have indicated a willingness to accept letters of credit in lieu of surety bonds. Some U.S. firms and a number of non-U.S. groups are well positioned for this market change.

## PRICING

Sureties experienced a moderate increase in reinsurance pricing and attachment points as the 2009 renewal season progressed. With two exceptions that do not utilize reinsurance, the requirement for significant retained risk (and the associated cost of capital required to do so) remains a budgetary consideration for most sureties. Despite this, there is little evidence of across-the-board price increases in the offing. Sureties continue to use credit modeling in pricing of individual client programs. Buyers of surety are encouraged to question their surety partners about the drivers in their credit models, both to find out what can be done to improve pricing and to anticipate price changes that can result from a change in the client's credit profile.

Personal indemnity remains a common requirement for middle-market contractor programs and for Subchapter 'S' corporations.

## THE WAY FORWARD

For many buyers or financiers of construction services, one probable outcome of the current crisis will be an increased emphasis on risk management and risk transfer. This will likely increase the requirement for surety on private construction work. Well-managed, disciplined construction firms will find their surety relationships providing a greater competitive advantage than ever before. Clear and timely communication with your surety partner, thoughtful contingency planning and a well-founded investment of time around this crucial credit relationship will enhance a company's ability to prosper, even in challenging and uncertain times.

## CONTACT

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<sup>1</sup> *Robert Murray's Monthly Report*, McGraw-Hill Construction, March 16, 2009.

<sup>2</sup> "Companies Pretty Up Prices to Win Stimulus Projects," *The New York Times*, March 28, 2009.