



2011 SURETY MARKET REPORT

The U.S. private sector added more jobs in April 2011 than any other month over the last five years; five thousand of those jobs were in the construction industry. Unfortunately, that addition barely impacted the industry, which currently has an unemployment rate of 17.8%, nearly double the national average. The Architecture Billing Index (ABI) continues to show negative trends with an April 2011 reading of 47.6.

In the first four months of 2011, construction spending was 8.4% lower than during the same period in 2010. Non-residential spending was approximately 39% below its peak, reached in January 2008 with \$400 billion in spending. The reduction in government spending and public works projects further exacerbates the already-suffering construction industry.

The unfavorable market makes surety bonds that much more important. With losses expected to increase, contractors will see an increase in the demand for bonding, and owners will have an increased advantage of having bonds. The construction industry can expect to remain sluggish through 2011, but plenty of surety capacity remains for qualified contractors. The industry experts look forward to 2012, when the federal government will increase spending on public projects to boost the economy going into an election year. →



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SURETY FOR AN IMPERFECT WORLD

SMALL

Even though they have been hit hard by the down economy, "small contractors' access to bonding may be at an all-time high," says Bob Cave, Chief Underwriting Officer, SureTec. In a way, small contractors have benefited from the challenging construction economy, adds Mike Noe, Executive Vice President, Construction Services, Travelers Bond & Financial Products. "Price and terms are very competitive due to the pressure of reduced writings as a result of the economic downturn in construction and continued favorable financial performance of surety carriers," he says.

Small contractors once struggled with a reputation of being "substandard" but now are viewed in a different light as small market accounts. "With the shift in market perception, availability of bonding is far more prevalent than in the past 30 years," says David Finkelstein, Executive Vice President, Arch Insurance Group. Several programs have been introduced specifically to assist small contractors in obtaining surety bonds. The U.S. Small Business Administration (SBA) Surety Bond Guarantee Program continues to expand. The Bonding Education Program (BEP)—a joint effort between the U.S. Department of Transportation and The Surety & Fidelity Association of America (SFAA)—aims to educate small businesses and assist them with obtaining transportation-related contracts. Furthermore, SFAA's Model Contractor Development Program (MCDP) continues to help small, minority and women contractors become bondable and increase their bonding capacity across the country.

Despite substantial support from these and other programs, "barriers to entry remain high for small contractors seeking to obtain the support of a surety," says Michael J. Cusack, Senior Vice President, Managing Director and Operations Board Member, AON Construction Services Group. The ability to demonstrate experience and committed capital is key. Without which, he adds, "Bonding companies have demonstrated an unwillingness to extend credit based on projected earnings and prospective growth of the balance sheet." Cave remains optimistic on opportunities for small contractors "interested in obtaining a long-term, mutually beneficial surety relationship." He says, "They should be ready to work with their surety and develop the type of information flow required to grow and expand their bond programs."

MIDDLE

There is plenty of surety capacity in this highly competitive market. Backlogs are down 20% to 60%, and large accounts have been forced to drop into the middle market to find work. "Based on the competition in this space, contractors will experience more underwriting flexibility from sureties on issues such as bond rates, work programs, minimum capital thresholds and personal guarantees," says AON'S Cusack.

Companies that made tough cuts and planned ahead at the beginning of the economic downturn have done well and should not have problems obtaining credit. "A contractor should be able to acquire surety credit on very reasonable

terms provided the company's financial position is stable and financial ratios are not out of line," says Henry W. Nozko, Jr., President, ACSTAR Insurance Company.

LARGE

The general conditions for the small and medium markets hold true for the large as well. Large contractors struggle to find new work as backlogs decline. "Many large contractors had the advantage of a healthy backlog going into the economic downturn to cover their G&A expenses," says Arch's Finkelstein. "Those accounts that were able to weather 2010 have felt the effects of the lack of new work in 2011," adds Larry Taylor, President, Merchants Bonding Company.

With most backlogs running out or depleted, less revenue and lower margins, bonding capacity is not a primary concern, according to AON's Cusack. "Firms are more focused on expense management, cash flow and balance sheet preservation," he explains.

MEGA

"Especially among the mega segment, the delivery of construction has become more complicated with more inherent risks," says David Hewett, Executive Vice President, XL Insurance. Despite tough economic conditions and lower yields, though, mega contractors have remained profitable. This segment has seen the most activity over the last few years with major infrastructure projects high on the priorities list for the U.S. and other countries. "The construction market's growth is very much tied to large multinational companies that are most qualified to address large infrastructure projects that currently dominate the construction activity," says Hewett.

Bonding capacity is not a major concern due to reduced backlogs and more surety companies providing capacity in this segment. Some firms rely on joint ventures to meet the needs of the owners. "The challenge is to find the right joint venture partner and allocate the project risks and surety capacity accordingly," explains Mike Bond, Head of Surety, Zurich North America.

CONTRACTOR FAILURE

Surety companies have noticed an increase in contractor failure in 2011, but it seems to be concentrated in the small and middle markets. Companies that planned ahead and adjusted their business plans accordingly at the beginning of the recession are not struggling as much. "How contractors fare is partially dependent on the type of work they pursue, where they are located and the size of projects they bid. The largest contractors have benefited from longer jobs durations, consolidation of projects and sufficient large projects across the country. Small to mid-sized contractors, however, face fewer local job opportunities, broader competition and more quickly diminishing backlogs and profit generation," says Tim Mikolajewski, President, Liberty Mutual Surety.

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Top 25 Writers of Surety Bonds—2010*

Companies	Direct Premium Written (Millions \$)
1. Travelers Bond	867.8
2. Liberty Mutual Insurance Group	751.2
3. Zurich Insurance Group	512.3
4. CNA Insurance Group	406.5
5. Chubb & Son Inc. Group	256.9
6. Hartford Fire & Casualty Group	177.2
7. HCC Surety Group	176.1
8. International Fidelity Insurance Co.	143.3
9. ACE Ltd. Group	109.5
10. NAS Surety Group	104.8
11. Great American Insurance Companies	98.3
12. The Hanover Insurance Group	92.9
13. RLI Insurance Group	84.8
14. Lexon/Bond Safeguard Insurance Companies	80.5
15. Chartis Group	65.4
16. WR Berkley Corp Group	63.9
17. Arch Capital Group	63.3
18. Merchants Bonding Co. Group	59.5
19. Westfield Group	59.1
20. Insko Dico Group	50.3
21. Alleghany Group	49.0
22. SureTec Insurance Co.	46.3
23. Cincinnati Financial Group	45.5
24. Old Republic Group	38.7
25. Bankers Insurance Group	36.7

*Includes contract and commercial surety

Source: The Surety & Fidelity Association of America (SFAA), "Top 100 Writers of Surety Bonds—United States & Territories, Canada & Aggregate Other Alien," 2010 (Preliminary). Additional information and reports are available for purchase from the SFAA website at www.surety.org. See Statistical Services, then List of Statistical Reports.

One of the biggest detriments to the construction industry is reduction in government spending. Fewer public institutions and less infrastructure are being built and/or repaired as states and the federal government, mired by budget deficits, cut funding for these projects. "Budget deficits and debt servicing costs are strangling each layer of government from investing in necessary infrastructure repairs/upgrades. Consequently, bid lists will remain long and margins short. Simple supply-and-demand economics will plague this industry throughout this year and into the next," says Anthony Romano, Senior Vice President, Chartis. "The recovery will require a recovery in the housing market, improved funding in state budgets, added federal stimulus and further improvement in construction lending," adds Travelers' Noe.

Market conditions in the private sector are not looking up either, especially in terms of construction. The *Wall Street*

Journal reports that in the first quarter of 2011, the housing market experienced its deepest decline since 2008. The U.S. Department of Housing and Urban Development, in its report of U.S. housing market conditions for the first quarter of 2011, reports that "single-family housing starts, permits and completions all declined. In contrast, multifamily building permits and starts rose, although completions fell slightly." For sureties and contractors alike, the increase in multifamily building permits and starts is a welcome change.

What about when the economy begins to improve? With changes in workload and heavy competition, Hewett warns that a tendency may be for contractors to "overextend a strained balance sheet to take on more projects in a recovery economy. This is the tipping point for many contractors," he says, "straining their financials and leading to additional failures." John Rindt, president of the National Association of Surety Bond Producers and executive vice president of JDW Insurance, agrees that strained balance sheets could be the downfall of contractors if they don't plan accordingly. "It is important that the agent, contractor and surety communicate often, articulating a business plan for survival. Such a plan typically will include a forecast to reduce overhead, restructure debt, sell equipment and a strategy to retain a strong relationship with your bank."

Some contractors, though, have managed to fare better than expected, as the recovery takes longer than most people anticipated. "A number of contractors have found ways to find work in a 'niche' and produce reasonable financial results," observes SureTec's Cave.

Going into 2012, the federal government is likely to increase spending on public projects to boost the economy in an election year. Using infrastructure financing to stimulate the economy will be a key factor to recovery, or at least stabilization, for the industry, says Arch's Finkelstein. He adds, "If, going into an election year, we see an increase in federal works projects, then the number of bidders will spread sufficiently and margins should rebound."

VALUE & PROTECTION

Executives agree that there is no more important time, given the industry conditions, to have a surety bond. "Even a minor delay or loss affects profitability," says XL's Hewett, "and there is little argument that surety bonds are more valuable than ever."

A surety prequalifies contractors and provides project owners, as well as prime contractors, with contractors and subcontractors capable of completing a project. Should problems arise that could result in contractor default, the surety can provide assistance—managerial, technical and financial—to the contractor. In the case of default, the surety bond protects the owner and general contractor from financial loss. "During these unprecedented economic times, where subcontractor failures have hit 80-year-old businesses that had sterling track records, it simply makes sense for general contractors to refrain from relying on relationships with subs

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and allow professional surety underwriters to back the subs' ability to do the job right," says Merchants' Taylor.

With the risk of contractor and subcontractor failure at its highest, the best way for general contractors to mitigate risks and ensure the project is completed as planned is to require that their subcontractors are bonded. "With razor-thin margins, owners and general contractors simply take on excessive risk when surety bonds are not utilized," explains Zurich's Bond.

A surety bond will further protect the prime contractor, should the subcontractor no longer be able to afford materials or labor costs. "Assuring that the budgeted costs are achieved and that their project will be completed and free from contractor/subcontractor liens adds confidence that far exceeds the cost of the protection," says SureTec's Cave.

Notes ACSTAR's Nozko, "It only takes one contractor failure experience for a private owner or a general contractor to appreciate the value of a payment and performance bond for all contractors participating in a project." Just as important, says NASBP's Rindt, "contractors need to be very cognizant of appropriate contract terms and conditions and be willing to walk away from situations that shift undue risks onto their shoulders or offer no profit margin on the job."

SURETY OUTLOOK

Unless the construction economy recovers this year, surety executives expect losses to continue through 2011 and into 2012. Loss frequency will increase over the next year but will be manageable, as they are expected from the small and subcontractor level. "Any significant loss activity always has

some impact on capacity," explains CNA's Hinkle. "However, the most sensitive area of capacity remains in the mega large contractor arena. Significant loss activity with a surety who is a major player in this segment could have a severe impact on overall available capacity for the mega large contractor." Significant loss in that sector is not expected, though. Because many large construction firms entered the recession with strong balance sheets, a plan to reduce overhead and backlogs, they have fared relatively well over the last few years in the sluggish industry. "All of these factors helped the construction industry, to a degree, minimize the impact of quickly burning through built-up liquidity and operating reserves. However, the lack of government and private sector spending and the impact this has had in terms of competition and margins will soon outstrip the valiant efforts put forth by construction leadership," says Chartis' Romano.

He and other executives attribute 2010's solid surety underwriting results not only to the factors listed above, but also to sureties' well-maintained underwriting discipline. "For sureties, controlling loss activity requires an adherence to underwriting discipline," explains Hewett. "This means looking closely at a contractor's financial statement, prior completion history and other aspects of operation, such as how subcontractors are chosen and managed." This discipline is what will keep the surety industry profitable, even as the recession lingers.

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EXECUTIVE VIEWPOINTS

What will be the top three issues for the construction surety industry over the next five years? Why?



Mike Bond
Head of Surety
Zurich North America

Risk management will be a key issue for construction companies. Owners will continue to seek cost-effective ways to deliver construction projects while looking to utilize strategies that have the effect of transferring risk to others. Contractors will need to be vigilant to identify those risks and make sure they are compensated for those risks accordingly. Secondly, as projects get bigger, contractors will need to align with strategic partners

to deliver services in effective ways. Those partnering agreements not only create risks but also significant opportunities. Finally, construction finance is more challenging than ever as the federal and state governmental entities struggle to finance much-needed and significantly delayed infrastructure projects.



Doug Hinkle
Senior Vice President,
Chief Underwriting
Officer
CNA Surety

Contractors will need to manage their own resources to make sure they have the right capabilities with the right overhead in order to be competitive in their chosen market segment.

Over the next five years, three key issues will be availability of work, adequacy of return on capital and a growing shortage of skilled labor.

In the short run, I believe it will remain a challenging construction market due to continued constraints in availability of work. The majority of states continue to deal with budget issues with more spending cuts to occur in 2012. In addition, there is growing pressure to significantly reduce spending at the federal level. Competition will remain intense for the work that is available.

The general economy and private sector slowly should continue to improve. As it does, federal and state tax revenues, in

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conjunction with spending cuts, will make for much stronger governmental fiscal positions. I am optimistic that also it will bring a meaningful improvement in construction spending and contractor growth opportunity.

Adequacy of return on capital will be challenged even when the industry begins to see an improved flow of construction opportunities. As the industry comes out of a protracted, difficult business cycle, the transition to growing profitably can be every bit as challenging as remaining profitable during downsizing when the industry goes into a difficult business cycle. A major reason for this is that profit margin recovery tends to lag behind construction market recovery. This lag can last 12 months or more.

When the economy does improve, growth in construction spending will bring to light another growing issue: adequacy of skilled labor. As the construction industry ramps up, it will do so in the face of an aging baby boomer group that is beginning to retire. This group represents a significant percentage of the overall construction industry workforce, and it will impact industry productivity.



David Finkelstein
Executive Vice
President, Surety
Division
Arch Insurance Group

The issues affecting the surety industry over the next five years will range based on contractor size, the macroeconomic construction marketplace and the overall global economy. For example, the mid-sized contractor—critical to the surety industry by providing spread of risk and stability through market cycles—will feel pressure to sell their operations to larger domestic and international corporations because their risk-reward equation may not justify continuing, or they will find themselves competing

with federally subsidized contractors. These contractors create more compression on the mid-sized contractor, resulting in a more expensive project for the public. This industry's ability to adapt to new macroeconomic construction delivery systems will be imperative for industry profitability. New systems will create the need for more creative methodologies to analyze risk. The global economy and its impact on all aspects of construction will have a large impact on surety. The surety product continues to grow as a means of securing construction globally. Foreign contractors continue to move into the U.S. market, and U.S. contractors continue to look for opportunities overseas, a new dynamic, increasing in visibility and ultimately impacting the industry.

Why have contractors and sureties weathered the economic storm so well and will that continue or will the other shoe drop? How have you and your contractors worked together to stay in the black in the last year?



Tim Micolajewski
President
Liberty Mutual Surety



Rod Williams
Chief Underwriting
Officer
Liberty Mutual Surety

Persistent government deficits and anemic private sector spending have stalled the expected construction recovery. With the economy slowly restructuring in light of unsustainable deficit spending and partisanship government, contractors see limited new work opportunities and must adapt their business models to be flexible in the face of inconsistent construction demand.

To survive, successful contractors should implement sound business plans, monitor key metrics and demonstrate flexibility to adapt quickly to changing environments. Managing overhead is critical. Sustainability requires thinning equipment fleets, reducing debt and managing bank lines to protect liquidity. Contractors and sureties must keep up with changing owner/obligee needs and be ready to adopt integrated project delivery methods, address green contracting and respond to public-private partnerships. Longer-term, keeping key talent while trimming excess staff is

important to positioning for the recovery.

Despite the poor economy, sureties are experiencing lower-than-expected defaults overall. Strong contractor backlogs entering the recession, government stimulus, responsible surety underwriting and improved customer-underwriter alignment has favored surety capacity. While excess insurance capital is adding competition, losses from record extreme weather and other natural disasters may drain excess capital from the industry. Nevertheless, financially strong sureties with responsible underwriting and strong customer relationship can be expected to maintain surety capacity and relatively sound contractors will find bonding support.



Anthony Romano
Senior Vice President
Chartis

The other shoe will most assuredly drop at some point. Everyone in this industry knows that the number of bidders pursuing work and the level of competition this creates forces margins into negative territory. Place the additional burden of having to accept more onerous contract terms and conditions in addition to stricter bond forms on contractors and sureties, and something has to give eventually; it can't be everyone else's contractor

that picked up that project for below cost. Finally, record backlogs and margins from prior to 2008 cannot hold out forever. Although an uptick in loss experience will occur within our industry results, we do not expect that we will return to some of

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the more damaging loss ratios recorded at the height of recent down cycles. We believe that much hard work, underwriting discipline and communication has transpired across each sector of our industry in order to soften the inevitable blow that we all believe is around the corner.



John Knox
Chairman and CEO
SureTec

2005-2008 may have been the most profitable years in the history of the construction business. The years following were the most profitable in the history of the surety industry. The results have attracted new capacity and competition at a time when revenues are flat and loss frequency may increase.

Historically, the surety industry has seen long periods of strong profitability followed by periods of loss, sometimes significant. Underwriting and risk analysis have become more sophisticated, which may help moderate such significant cycles.

As surety companies try to maintain revenue and find ways to expand or compete, history may repeat itself. Until then, competition for quality business should be positive for contractors. The amount of capital dedicated to the surety industry likely has never been stronger.

Many great sureties have remained profitable, even in tough economic times. Until the construction economy improves and public spending increases, even the best company's margins will decline. The market will remain highly competitive, with ample capacity/capital available for small, medium and large contractors.



Henry W. Nozko, Jr.
President
ACSTAR Insurance Co.

It is too early to conclude that contractors have weathered the downturn in the construction industry, which has shrunk to approximately \$760 billion, about half of what the industry was in 2006 at \$1.2 trillion. Many contractors may not be in actual default at the moment, however, 2011 could become very punishing. Statistically, the construction industry has not begun to recover and improvement may not occur until the latter part of 2012 or as

late as 2013. Many contractors, drained from the exhaustion of this deep and long recession, may not have sufficient reserves to reach the recovery when it occurs. Contractors are faced with razor-thin margins and onerous construction contracts. ACSTAR has worked extensively with our principals early on in the award process to modify or negotiate unreasonable clauses such as long-term warranty provisions, consequential damages, unreasonable retention clauses, broad form indemnification and over-the-top delay provisions. The thin margins that prevail in today's market are insufficient to absorb such risks.

Many contractor failures are not a result of bad estimates but rather bad contracts. A bad contract is worse than no contract. Avoiding unexpected and unplanned surprises at a time when they can be least afforded might be a good survival tool.

What new trends do you see in public construction, such as public-private partnerships (PPPs), Gap Financing, construction manager at risk (CM at Risk), etc., and why are surety bonds a critical part of those construction projects?



Mike Noe
Executive Vice
President,
Construction Services
Travelers Bonds &
Financial Products

Alternative methods of contractual and project delivery, such as PPPs, are becoming increasingly more prevalent. While the advent of PPP has been slow in the U.S. relative to its prevalence in Europe and Canada, there now is more focus on ways to privately finance large construction projects.

Travelers believes that surety bonds remain a critical ingredient to the success of construction projects for both public and private work. Losses due to the failure of a contractor default are preventable. The prequalification process provided by a surety like Travelers is an invaluable resource to owners requiring bonds for projects and to contractors requiring subcontractor bonds. The surety conducts a rigorous and in-depth investigation of the contractor's overall creditworthiness, financial strength and past and future ability to perform the project under consideration. The investigative process is backed by the assets and creditworthiness of the surety company's guarantee. It is a time-tested vehicle for evaluation and transfer of risk in an economical fashion.

Furthermore, a surety's prequalification is vital to the financial health of the owner and general contractor. Effective prequalification is particularly critical in today's economy and credit environment. The owner and general contractor has the assurance of the surety company's prequalification during the bidding process and the guarantee that the project will be performed according to plans and specifications within the time frame required.

Lastly, the owner and general contractor are further protected should the contractor or subcontractor be unable to pay for labor or material costs.



Larry Taylor
President
Merchants

We see all of the above increasing as well as Building Information Modeling (BIM) and joint ventures. The surety industry must adapt to these new trends by educating themselves on the risks these trends present. Project delivery methods are under constant review in attempts to determine if there are better methods than the tradi-

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tional design-bid-build process. In certain situations, such as large “mega” projects or PPPs, it may make sense for a public owner to work with a few select bidders. Public owners need to remember that it is their duty to see that taxpayer dollars are used in the most responsible and economical fashion. Surety bonds are critical in this process. The bonds also are necessary as a guarantee that subcontractors and suppliers get paid for work performed on projects funded, in whole or in part, by public funds.



David Hewett
Executive Vice
President
XL Insurance

Like any industry, the construction industry always is seeking ways to operate and deliver its service more quickly and cost effectively. The result is more complicated methods of delivery—from Design Build methods to Gap Financing to PPPs. There always are new risks with new ways of doing things. The underwriting process has to take into account various aspects of these new delivery methods to provide a bond or underwrite an insurance policy effectively. The ability of the

surety market to understand this risk and bring value to the transaction is more important than ever; therefore, an emerging trend in the surety market is a more collaborative and innovative underwriting approach. As we see construction delivery methods change, we also need to stand ready to change to contribute optimal value to construction projects. To do so, we are going to have to develop innovative solutions. This requires us to intelligently understand the risk and develop solutions that work for all parties. I would say most of us are tired

of just sitting around and waiting for a reversal of fortune for the construction industry. We need to think of new ways that we can contribute to contractors' success now and minimize the potential of future failures. That's why surety remains critical to this industry.



Michael J. Cusack
Senior Vice President,
Managing Director
and Operations
Board Member
Aon Construction
Services Group

In many ways, we believe that the industry's willingness to embrace alternative procurement in public construction will be a watershed event for the construction and surety industries in the United States. Bonding companies need to develop a clear understanding of the alternative procurement process and be willing to support certain exposures that are outside the typical boundaries of bonded performance and payment obligations in traditional procurement situations.

Alternative procurement has been a successful delivery method throughout much of the world. Since the federal and state government budget

shortfalls will continue to impede our ability to maintain and improve our social and transportation infrastructure, PPP and Gap Financed procurement models will be used more frequently by state agencies. Many states already have taken the legislative action required to allow for varying forms of alternative procurement. It is imperative that the surety industry has the vision to get out in front of this trend to ensure that the benefits of suretyship remain embedded in all forms of alternative procurement.

Federal Erosion of Payment and Performance Security Needs to be Stopped

**Lenore Marema, The Surety & Fidelity Association of America,
and Larry LeClair, National Association of Surety Bond Producers**

Tucked away in the defense appropriations bill in 2005 was a provision that now requires all federal procurement thresholds in Title 41 of the U.S. Code to be reviewed periodically for inflation based on increases to the Consumer Price Index (CPI). The threshold for construction contracts that must be bonded under the federal Miller Act should be excluded from these reviews since the Miller Act is a protective statute. Increasing this threshold exposes more small construction businesses to loss of payment protection on federal construction projects. The Miller Act was put in place for protection for subcontractors, suppliers and workers on the job and for the U.S. taxpayers, not as a procurement threshold related to the costs of construction.

Many subcontractors and suppliers on federal construction projects are small businesses that often find that their only avenue into the federal procurement arena is as subcontractors and suppliers. Surety bonds, in the form of payment bonds, ensure that they get properly paid, whether the general contractor on the project pays them or not. Such protections should not be compromised as a result of periodic adjustments for inflation. Each five-year review could result in an increase in the Miller Act threshold so that many more federal subcontractors and suppliers will be performing work on federal projects without the protection of payment

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Reducing Subcontractor Risk

By Michael P. Foster, Merchants Bonding Company

Construction is an extremely risky business. One of the greatest risks a prime contractor faces revolves around identifying, assessing and managing the risk of subcontractors. Our experience at Merchants indicates that when a general contractor fails, it usually is due to a problem with one or more subcontractors. Subcontractors are vital to the completion and success of a project, but one bad, unqualified subcontractor can cause all others to be delayed and could result in liquidated damages being assessed, as well as a myriad of other problems.

PREQUALIFICATION

The initial step in ensuring you have qualified subcontractors is to establish a prequalification process. On a publicly bid project, when it is minutes before the bid is due, this is not always possible; however, prequalification should be initiated long before the bid date and be constantly updated. We recommend that you establish a "file" on all prospective subcontractors. To start, your surety can provide you with a sample questionnaire that you can send to your subcontractors for completion. Most of the requested information is basic—what trade(s) they perform, who owns the company and how long they have been in business. You should inquire about past experience and find out who handles their surety program from both an agency and company standpoint. You may want to request a "general" letter of bondability. You also should inquire about their insurance and request safety records. You may want to inquire as to whether or not they qualify as a Minority Business Enterprise as well. This information should be readily available and can be helpful when trying to decide whether or not to use a quote you aren't sure about. If you have worked with a subcontractor previously, you should add comments about your experience with this subcontractor to the file.

IDENTIFYING KEY SUBCONTRACTORS

Once you have selected your subcontractors, it is critical to identify the "key" subcontractors. Some of the criteria that you need to know are:

- Was the subcontractor's quote significantly lower than the other bidders?
- Is the work unique? Can the subcontractor be easily replaced?
- If the subcontractor has problems, can I be assessed liquidated damages or lose a potential bonus?
- Does the subcontract make up a significant portion of the overall project?
- Is the timing of the subcontract critical to the overall schedule?
- Have we worked with the subcontractor previously?
- Is the subcontractor working for me on other jobs? If so, how is it performing?

MANAGING YOUR SUBCONTRACTORS

There is no better way to protect yourself against subcontractor failure than securing subcontract performance and pay-

ment bonds from a reputable surety company. A qualified surety has prequalified the subcontractor and is providing a guaranty to you that the subcontractor will perform per the terms of the subcontract and pay all of its bills. All general contractors should have a subcontractor bonding policy in place. You should consult with your agent and surety company on this policy. Some of the considerations should be the size of the subcontract, the size of the subcontract as a percentage of the overall project, your experience with the subcontractor (or lack thereof) and any other criteria that you determine are critical. Your policy also should detail who has the authority to make exceptions to the subcontractor bonding policy.

COMMUNICATION

Other additional steps you can take to manage your subcontractors are:

- Holding meetings with all subcontractors on a regular basis even before the project starts. All subcontractors should be aware of the schedule and understand the importance of staying on this schedule.
- Monitoring suppliers and second-tier subcontractors. You should secure a list of these from your subcontractors before the project begins and make sure they are being paid.

In the event of a problem, your subcontract will determine your options. It should be fair but also provide you with the ability to rectify issues in a timely manner. Make sure your attorney has reviewed your subcontract.

FOLLOW UP

It is important to follow up with documentation when the project is complete. Your key personnel should evaluate each subcontractor on the project. You need to decide who should do this: the project superintendent, the project manager, foreman or all three. We can provide a sample form that can be used for this purpose. Add these evaluations to the subcontractor files. We also recommend that you ask your subcontractors to evaluate you; a sample form can be provided for this purpose as well.

Our experience tells us that successful general contractors are the ones who are able to select and manage quality subcontractors. This does not happen by accident. It takes a great deal of effort and planning on the part of the general contractor. It is important for all general contractors to review their current procedures for subcontractor selection, management and follow-up to determine if improvement could be made in any of these areas. It will provide benefits well beyond financial considerations.

Michael P. Foster is the executive vice president of underwriting for Merchants Bonding Company. He serves on the Contract Advisory Committee of The Surety & Fidelity Association of America and is a member of the Government Affairs Committee for the National Association of Surety Bond Producers.



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The Surety Bond Producer's Pivotal Role in Creating a Contractor's Success

By Kathy Hoffman and Vanessa Stevens, National Association of Surety Bond Producers

Perceptive contractors realize that several positive forces assist them with their business. Certainly one is their surety bond producer, who specializes in providing surety bonds for their contracts and invaluable assistance with numerous issues. The bond producer is, in many ways, a contractor's partner in acquiring and maintaining the construction company's success.

M. Ross Fisher, VP/General Manager-Bond Department, The Hartford, says, "We have consistently seen the impact good counsel from a professional agent can have. They help the surety understand the unique circumstance of their clients and assist their clients in effectively presenting their business to the surety. This helps us provide the support a contractor needs to reach his/her business goals."

Emilio F. Alvarez, CPA, Partner, E.F. Alvarez and Company, P.A., says, "It is hard to imagine a surety world without the intervention of the agent. After working 37 years as a CPA to contractors, I believe that placing a given contractor with the right-fit bonding company for the circumstances is among the most important things the agent does for his/her client."

BUILDING PARTNERSHIPS

Bond producers build a long-term partnership between the contractor and surety by keeping abreast of the marketplace and staying in contact with surety carriers.

Producers monitor the status of local, state and national markets to provide to clients. Douglas Irvin, VP & Unit Manager of Surety Operations, Lockton Companies, LLC, says, "The downturn in the construction economy has forced many contractors to re-evaluate their business plans to remain competitive."

Producer Carl Dohn, President, Dohn & Maher Associates, says, "Bond producers must know the type of contracting business surety companies have an 'appetite' for; we discuss this with our underwriting team, the local underwriter and those in charge of underwriting on a regional and national basis."

Surety companies differ in many ways. Joshua Etemadi, Producer, Construction Bonds, Inc. a division of Murray Risk Management and Insurance, says, "Some underwrite on net worth of the company, some on working capital, some can work with tax returns and internal financials, others require three years of CPA-prepared financials and some work with certain types of contractors."

Todd Loehnert, Senior VP/National Contract Surety Practice Lead, Wells Fargo Insurance Services USA, Inc., says, "Some carriers place a lot of trust and authority in the field offices and others rely on the underwriting expertise of their home office." Jeffrey Reich, President, Florida Surety Bonds, Inc., says, "Both clients and sureties can change over time, and then adjustments have to be made so the fit is proper."

Etemadi says, "Some of our clients are concerned with rate rather than capacity, so we try to match them with a company that can give them a competitive rate. Other clients focus more on capacity, so we try to find a company that can handle their

increasing surety needs as opposed to focusing solely on rate. Some clients have quick turnaround requirements on bids and need a surety that can provide next-day service."

In addition, producers refer clients to various consultants, such as certified public accounting firms and banking institutions. Alan M. Rosenberg, CPA, Partner, Mountjoy Chilton Medley LLP, says, "Our firm's relationship with bond producers allows us to prepare a financial presentation that lets the surety carrier evaluate our client in the most positive manner to write the bond and establish a program which results in additional work and profits."

ASSISTING IN NUMEROUS WAYS

Many producers help their construction clients establish a strategic direction for obtaining surety credit and growth. Irvin says, "An experienced bond producer can assess the risks of a construction organization on an enterprise-wide basis and can be an invaluable part of his or her client's advisory team to evaluate opportunities and participate in the strategic planning process."

The producer assists the contractor in many other ways, including managing contractor risk, advising on joint venture partners, assessing subcontractors' credit and establishing continuity plans. Irvin says, "The producer's ability to analyze and present financial and work-in-progress data can provide his or her clients with meaningful insight." "Planning for their retirement can enhance surety credit and the overall value of the contractor's company," adds Dohn.

Producers also assist with establishing good communication. Producer Donnie Doan, VP, Bond Department, McQueary Henry Bowles Troy, LLP, says, "Contractors should communicate early and often, regardless of whether the results are good or bad and should have a knowledgeable construction CPA prepare its financials annually, at a minimum, and sometimes quarterly or every six months, depending on volume of work, as well as when specific needs arise."

Larry Mackowiak, CPA, Partner, Crowe Horwath LLP, adds that the producer "provides the connections between the surety company, CPA and construction company, enabling the flow of information and valuable communication that form a basis for solid decision-making."

Producer Peter Forker, President, The Forker Company, says, "We help our clients grow their business and keep it moving forward."

To find a bond producer, visit the National Association of Surety Bond Producers Producer Directory at www.nasbp.org. To find construction-oriented CPA firms, visit the NASBP Associate Directory at www.nasbp.org or at the Construction Industry CPAs/Consultants Association site, www.cipac.com.

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bonds. Periodic adjustments to address inflation should not be the reason to decrease the protection provided to the U.S. taxpayers by performance bonds, which protect the taxpayer from loss if the contractor on a federal project defaults.

Congress recognized that certain thresholds should not be subject to this periodic adjustment. The Davis Bacon Act, which is the prevailing wage law, already is excluded from the application of this periodic review to protect the payment of wages to laborers on federal projects. The same basis applies to excluding the application to surety bonds to protect payments to subcontractors and suppliers performing work on federal construction projects.

The Federal Acquisition Regulatory Council already has implemented the new review requirement and has increased the threshold for payment and performance security under the Miller Act. In 2010, the Council increased the performance bond threshold from \$100,000 to \$150,000. In 2005, the threshold for payment security was rounded up to the nearest \$5,000 in this same process, and the threshold was raised from \$25,000 to \$30,000.

Significantly increasing the number of contracts in which protection to small businesses and taxpayers is decreased is a bad idea but one mandated by the current statute. Like Davis Bacon, the issue with the Miller Act is at what level the federal government should provide payment protection

for subcontractors, workers and suppliers on the job and at what level should the federal government protect itself and U.S. taxpayers on the performance of a federal construction project. The Miller Act is a protective statute and should be exempted from the review of other procurement statutes.

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Impact of Construction Firm's Red Ink on Its Surety Program

By Mike Bond, Zurich North America

The turbulence of the United States economy in recent years has presented challenges to all construction firms. The credit crisis of 2008, falling local tax revenues and the resulting government stimulus package have created a unique set of circumstances for the construction community. Some contractors are emerging from the crisis leaner and more efficient but still profitable. Other firms continue to struggle and are posting disappointing financial results. Going forward, surety credit will remain vital to the growth and vitality of contractors. What is the impact of the recent financial turmoil on contractors' financial statements, and how can well-managed contractors succeed in this environment?

According to the U.S. Department of Commerce, the value of construction put in place in 2010 was roughly the same as in 2000, approximately \$814 billion, essentially wiping out all the growth from the boom years. From 2005 to 2010, residential construction declined by 65% from its peak. Other segments of commercial construction declined by 10% or more compared to the peak in 2008. In the midst of the crisis, the government responded with the stimulus program to inject hundreds of millions into the faltering economy. Many observers believe that while it helped some parts of the construction economy, the stimulus fell far short of its intended purpose of generating sustainable economic growth.

As the overall economic recovery lags, the construction economy trails even further behind. Conventional wisdom states that the financial statements of construction firms lag behind the general economy by 18 to 24 months. The financial results we see today have their roots in business that was put on the books in 2009.

Sureties only have just begun to receive and analyze the year-end financial statements for 2010. The statements show that the number of customers with net losses in 2010 has increased compared to 2009. Given the material decrease in backlogs, the heightened competition and the thinner margins, this was not unexpected. Initial results align with our expectations—smaller firms experience more problems than larger companies, and some specialty contractors appear to be hit harder than others.

There are positive signs of economic recovery in 2011 and a sense of optimism in the construction community. Clearly, surety credit will play a vital role for all contractors involved in the public market and commercial construction. We see customers in two categories regarding surety credit in 2011. First, there are companies that have a strong presence in their marketplace or niche and have done well despite the recent problems. Because of this profitability, sureties are working hard to meet the credit needs of these customers. These customers generally report that surety capacity is strong, and they have the support they need for 2011 and 2012.

The second category of customers is those that have not posted profitable results. Many in this class had focused on the private sector or were unable to quickly adjust their overhead and administrative costs to match the "new normal." For the remainder of 2011 and 2012, this group will require surety support more

than ever before in order to successfully compete for work in the government contract sectors.

If your firm posted unprofitable results in 2010, you must work extra hard to maintain and grow your surety capacity in order to acquire the type of work that you need to succeed.

- The traditional 3 C's of surety—character, capacity and capital—continue to be vital. Surety underwriters undoubtedly will focus on these factors when selecting the best customers, but contractors must focus on the 3 C's of communication, communication and communication. Follow the no surprise mode of communication. Keep your surety advised of your progress throughout the year, and do not wait until year-end results are finalized. Keep them posted about problems on jobs and difficulties with problematic owners. Sureties do not like to receive bad news, but what is worse is receiving bad news late in the game. That builds ill will with the surety at the time when you need its support most.
- Understand the capabilities of your firm, and make certain you have a business plan that makes sense in terms of size of jobs, geographic reach and sectors served. Take a fresh look at your expense structure, and make sure it matches with the opportunities that you realistically see in the next 18 to 24 months. Tough choices may need to be made (again), but it is vital to ensure your firm is as right-sized as can be until the economy gets to where we all hope it will. Articulate that business plan, make sure your entire organization understands the plan, communicate it to your surety and follow it.
- Be sure to completely understand any requirements identified by your surety, make certain those requirements are realistic and reachable and work to achieve those goals.
- Have the best team on your side to help you build and maintain the surety credit you need. That means that not only do you need a surety that understands you and is willing to support you, but also you need to work with a professional surety-oriented agent or broker, along with a CPA with construction knowledge. There is good reason why some agents specialize in the surety needs of construction firms like yours and why your best-in-class competitors use particular construction-oriented CPA firms. It is because of the value these professionals bring to their clients and the ways they help you present yourself to the surety marketplace in the most positive manner.

Red ink does not have to mean a reduction or elimination of surety credit. Many successful construction firms have worked their way through difficult times by building on their surety relationships. In times of market volatility and economic uncertainty, sureties respond most positively to customers with a strong business plan and who communicate in an open and honest manner.

Mike Bond is the head of surety for Zurich North America.

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As Opportunities Emerge, Strong Enterprise Risk Management and Innovation Rule the Day

By William J. Mills and Martha B. Gaines, XL Insurance

Is the construction sector on the rebound after the global economic recession that began in 2008? The construction industry and financial analysts are in some disagreement as to whether measurable recovery is under way, particularly as the stimulus funds from the federal government dissipate. Some, however, are suggesting that opportunities in the construction market are emerging. A March 2011 report from PricewaterhouseCoopers predicts growth in the U.S. construction sector at 7.8% through 2020, accounting for \$14.5 trillion in construction spending. Remarkably, the report predicts that global construction will outpace global GDP growth over the next ten years, forecasting that \$97.7 trillion will be spent globally in the next decade and that the sector will expand by an annual average of 5.2%, outpacing GDP growth, with China, India, the United States, Indonesia, Canada, Russia and Australia producing the major portion of the construction growth.

Both developed and developing economies recognize that improved infrastructure and energy are critical to continued growth and prosperity. As a result, opportunities are emerging in several construction markets, including:

- Energy infrastructure: nuclear, natural gas and renewable power
- Health care
- Infrastructure: roads, highways, bridges and transit and communication and utility infrastructure

In addition to these growing markets, opportunities will emerge in Alternative Project Delivery, including Public-Private Partnerships (PPPs), Gap Financing and Integrated Project Delivery. As the construction industry and its partners participate in these growing markets, both Enterprise Risk

Management (ERM) and innovation will play a crucial role and have the ability to positively impact the bottom-line growth of the industry.

Exposure to risk is endemic in the construction industry. Comprehensive and strategic ERM not only should seek to minimize negative risk exposure, but equally as important, also should identify those risks which can translate into profit and increased margin. Most contractors perform some form of ERM on a project basis. As we emerge from the global economic crisis and survey the new landscape, contractors must not only fully understand the transfer of risk that is taking place, but also must begin to aggregate their risks.

In this economic and political climate, one key risk facing the industry to which ERM must pay particular attention is the source of funding for construction projects, even in sectors traditionally seen as low-risk. As budget and funding constraints ripple through federal, state and local governments, it is critical to aggregate the risk of nonpayment, as well as slow or late payment. Contractors must be savvy in understanding how public owners are financing/budgeting construction projects. This is of particular concern with respect to change orders or claims. Equally, if not more, important than understanding the terms of the contract with respect to the performance of extra work and payment for such is a clear understanding of what contingency the owner may have to pay for extra work and the process the owner must follow to obtain additional funds should the contingency be exhausted. This information, coupled with risk assessment of the competency of the owner's project team and the adequacy of the design will allow contractors to define their

risk better, understanding that additional funding to compensate for the owner's and his or her representatives' poor design or poor management may be difficult.

Budgetary and financial challenges also are impacting—and to some extent re-shaping—certain sectors of the construction industry. Issues of budget and finance are at the forefront of the discussion of infrastructure construction. For example, each year the deficit between the receipts or sources of funding for the Federal Highway Trust Fund (HTF) and its obligations has grown, resulting in a shutdown of the HTF for two days in March 2010, requiring a \$20 billion



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transfer of funds from the "general fund." There is widespread disagreement as to how to restore the fiscal health and stability of the HTF to fund critical infrastructure projects. Moreover, there is disagreement not only as to the amount of infrastructure work that is necessary, but also what types of projects are important for our future. Certain estimates from the American Association of State Highway and Transportation Officials (AASHTO) suggest that the government is meeting only one-third of the roughly \$200 billion of infrastructure work required to maintain and improve the system.

There is a contentious national discussion occurring among politicians, environmentalists, trade associations and government officials and other stakeholders regarding funding for critical infrastructure projects. An option being discussed is granting states more latitude and flexibility in administering funds, thereby making both the projects and the process more efficient and increasing safety and performance. Construction of key infrastructure is a strategic imperative that cannot go unfunded, and the debate over the structure, terms and conditions of funding are upon us. The construction industry and its surety partners should be a part of this discussion, fully understanding the risk transfer and the opportunities that will emerge. In May, a bill was introduced in the Senate to fund an "infrastructure bank" that would allow, in part, states to leverage



federal money to attract private capital. The Administration also is proposing changes to the way in which infrastructure projects are selected and funded. As public owners face increasing financial challenges, alternative project financing

and the participation of private capital in such projects will continue and grow. In fact, several high-profile PPP transactions occurred in 2010. This new landscape presents an opportunity for globalization, mergers, acquisitions and strategic partnerships within the construction industry. It also will drive increased performance and enhanced efficiency in construction. Enhanced ERM will be essential in this environment to address the significant transfer of risk—to allow contractors not only to mitigate such risk, but also recognize, allocate and recover its cost. This opportunity will, in turn, drive innovation.

William J. Mills is senior vice president and Martha B. Gaines is vice president of XL Insurance's Surety unit. XL Insurance is the global brand used by XL Group plc's insurance companies and underwriting divisions offering property, casualty, professional and specialty insurance products throughout the world. More information about XL Insurance is available at www.xlinsurance.com.

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