

Surety has always been one of the most important trading relationships in a contractor's business.

Today, three major trends are driving an increased focus on surety:

- An overall increase in the percentage of work in a contractor's backlog coming from public owners that mandate bonding;
- More rigorous requirements from lenders—as a condition of project financing—for contractors to be bonded.
- An increase in the number of trade contractor defaults.

In today's competitive construction market where every job is important, no contractor can afford to miss a project because it is not approved for bonding. A stable surety relationship creates a competitive advantage for your firm.

Surety Market Overview— What does this mean for contractors?

Despite contractors experiencing reduced revenue, shrinking margins, and more difficult contract terms over the last several years, surety underwriters' loss ratios have been outstanding. In 2010, surety insurers paid out roughly \$0.18 for every dollar of written premium – spectacular results for this business line. Although some sureties have experienced heavier loss activity, overall it has been a great time to be in the surety business.

Year	Total Written Premium	Loss Ratio
2006	\$4,974,600,754	16.7%
2007	\$5,345,361,843	18.4%
2008	\$5,440,171,307	11.3%
2009	\$5,103,368,949	18.7%
2010	\$5,180,125,201	17.9%

In the midst of a prolonged soft market for other lines of insurance, these strong results are enticing additional capacity to enter the surety market. We see both new players and existing players seeking to provide capacity, as well as offering more accommodating terms and conditions on surety facilities. There is concern among seasoned underwriters that the weakened economy will eventually bring losses to their books of business, but there is also significant pressure from corporate management of many surety departments to grow a line of business that is currently performing extremely well.

So what does this mean for contractors needing surety credit?

You need to know the facts about the current market. It is a dynamic time in the surety industry, and even firms with long-term surety relationships need to be prepared for unexpected change. A number of events can have a significant impact on surety underwriting, including:



- Mergers and acquisitions: More consolidation, such as the 2008 combination of Liberty Mutual Group and Safeco Corporation, is expected in the future.
- Executive leadership changes: In the past five years, six of the top 10 surety underwriters have experienced a transition in CEO leadership.
- Reinsurance: Most major sureties have reduced their use of reinsurance in recent years, which means any losses are likely to more fully impact a surety's results.
- Competition: New sureties are coming into the market with aggressive capacity and rates.

- Loss activity; Marsh believes the loss ratios above mask the true distress that exists in the construction industry. Many contractors and numerous specialty trade firms have withdrawn from the business or wound down operations in an orderly way that did not impact surety underwriters. This will change in the coming months.

Your surety broker should be communicating these trends with you and developing contingency plans to avoid any disruption to the surety capacity your business plan requires. What is your plan for the unexpected? Has your surety broker provided you with clear plans to assure your firm has the bonding facility, terms, and conditions it needs to remain viable in this changing market? Just as pre-planning and diligence is critical to a successful project, so too is managing your surety program.

In today's market, there are opportunities to improve the terms of your surety program. Given the relatively soft surety marketplace, now is the time to aggressively negotiate rates, indemnity terms, capacity, and support from new surety underwriters. Maximizing the best terms, however, should not come at the expense of working with a financially stable surety company. Both can be achieved with the right negotiation process.

What is your firm doing right now to maximize your surety terms with the strongest players in the market? Do you know decision makers at these sureties and do they know your company? Are you with a surety market that is positioned to

be a survivor in an industry that is expected to experience an increase in loss activity?

How much surety capacity do I need? Today's surety underwriters use credit scoring models that help set your single job and aggregate surety capacity. Marsh's Surety Practice has developed a proprietary scoring model—similar to the process used by surety underwriters—to assist you in understanding what level of capacity is available for your firm in today's market. The process includes:

- Evaluating your internal and external financial statements against standard financial reporting guidelines to determine if you are providing the underwriter with the level of financial reporting they expect.
- Scoring your balance sheet, work in process, income statement, cash flow, and tangible net worth positions against ratios commonly used by surety underwriters in their underwriting reviews.
- Factoring in your banking, external credit rating, and prior work history into an overall score that measures your financial position against your desired surety capacity. The final score will separate your firm into one of four insolvency quartiles: Low Risk, Low/Mid, Mid/High or High.

Marsh's model helps you identify areas where you may fall below surety standards giving you time to address them before meeting with your surety company. The model also may show that you present an extremely low risk to the surety company for the level of capacity

desired, helping you negotiate the most favorable terms available in the market.

How do I evaluate my surety company to know if it is a strong player?

With your broker, review the financial rating and overall business outlook of the parent company. When making this evaluation, the first consideration is the credit rating of the company. Consideration should also be given to the lines of business a company underwrites and its track record for profitability in each line. It's okay to ask your surety about its plans for growth and profitability for 2012 and beyond and whether its business model is changing. There have been several cases where highly rated firms have seen credit ratings change almost overnight. The hard reality is ratings actions are normally taken with little or no warning.

How long has the senior leader in the surety group been in place? The senior leader sets the direction for underwriting decisions, and his/her creditability with the executive management of the company is an important factor in the capital that is allocated to the surety business. Obviously, the stability of a surety department is impacted when management does not allocate capital to accept risk.

How long has the local manager been with the company? A strong, experienced, local manager with a history of making sound recommendations will garner home office support for cases that may not fit the traditional underwriting methods.

What is the surety's book of business? What is the depth of the underwriter's experience with organizations similar to yours? If a surety does not underwrite other clients that perform similar work as yours, your business may stand out negatively. In a tight market, underwriters gravitate to the areas they know best.

What is the surety underwriter's loss ratio trend, both locally and nationally? Although it is a soft market in general, some underwriters have experienced increased loss activity and are beginning to "re-underwrite," while others have not. When accessing the underwriter through a local/regional office, be certain that that office has a history of solid underwriting results. You need to know if the underwriter has losses with clients that are in your same business segment, as underwriters generally tighten up underwriting criteria when loss activity occurs, they also may begin engaging in class underwriting, where specific types of contractors are re-underwritten as a class.

Lastly, and most importantly, you want to know the experience your surety has with other clients when the unexpected happens. When unexpected events happen, you cannot know exactly how your surety will respond, so you need to know its track record in supporting organizations in similar circumstances. What is the surety's reputation and history when facing a difficult scenario and is at risk for loss? Has it engaged the contractor in a "work out," or cut and run? Surety support in time of crises can make the difference in a contractor's survival.

Surety Best Practice Checklist:

- How does my account benchmark with other surety accounts? Within the market, do my line of credit terms match up to other similar contractors?
- How does the surety analyze my organization? Ask to examine the surety's financial analysis and credit modeling – its scorecard for extending credit. Understand how it works, and make sure it accurately reflects your financial results and condition. Compare it to Marsh's industry standards. Are you getting the most out of your surety provider?
- What is my surety's underwriting results? What is its business plan for the coming 12-18 months?
- What level of reinsurance support does my surety rely on to service its surety business? Have there been any changes to my surety's single project and aggregate program capacity? Many new markets may rely heavily on reinsurance to provide capacity. In a hardening market, sureties that rely less on reinsurance may provide more stable underwriting capacity.
- What are my surety's financial ratings? Have there been any recent changes to its ratings or its parent company's ratings?
- Have there been recent personnel changes at my surety?
- Do you meet with the underwriters on a regular basis?
- Do you have a stand-by surety facility established?
- Does your surety broker evidence real planning and think strategically?

Why Marsh

Marsh's Surety Practice offers you surety market insight based on the experience and wisdom of our professionals, relationships with the markets, and nationwide collaboration among our colleagues. Marsh provides you with expertise and significant market position, and we offer solutions and strategies that push the market in your favor. Marsh has a track record of preparing our contractor clients for changing conditions, and we can assist you in building the best surety strategy specific for your firm.

We understand your surety program is critical. Let us show you what we can do.

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