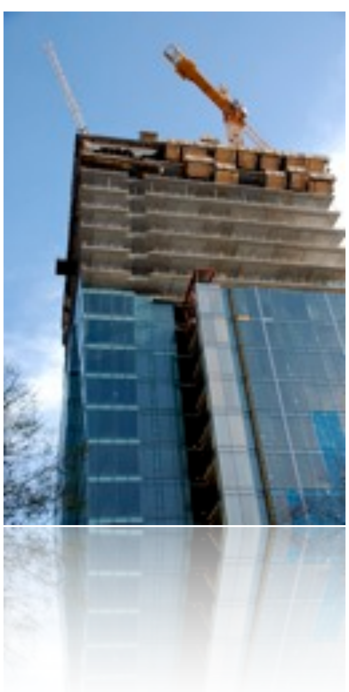
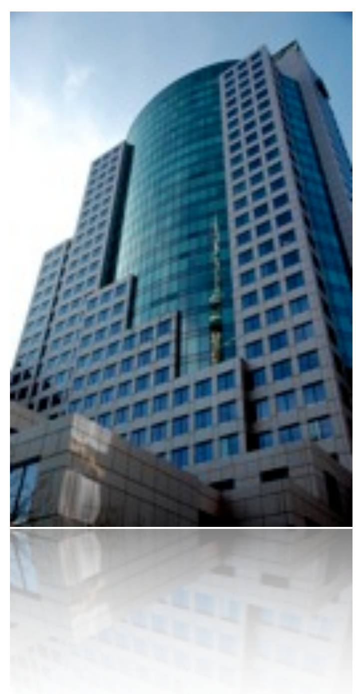
The Canadian Surety Industry, Traditional Construction Bonding And Contractor Default Insurance (Subguard®)





The Industry in Brief

Much has been written on the problems facing contractors in Canada with respect to obtaining construction bonds, both Performance and Labour & Material Bonds. We will not attempt to reconstruct that work, but to give a current analysis of where the industry is today, and what options are available to owners and lenders.

The issue is that today, there are fewer and fewer surety companies offering traditional bonds to the incredibly busy construction industry.

In the past, the "traditional" way of approaching surety was for an owner or its lenders to require each general contractor to provide a Performance and Labour & Material Bond for not less than 50% of the total "hard cost" contract price. So, for instance, if the total contract price with the general contractor were, say, $100 million, there would be a $50 million bond requirement for Performance as well as a Labour & Material Payment Bond.

During the 1970s, 80s and 90s, those bonds were easily obtained at a cost of around $4 to $5 per $1000 of contract price. Unfortunately today, the cost is at least $10 per $1000 and as much as $17 per $1000 for even the largest and best operated contractors.

As mentioned above, the problem has been exacerbated by the fact that there are very few acceptable sureties operating in Canada, some of the larger ones are U.S. based companies, where they have seen significant losses due to bankruptcy of contractors and sub-contractors. In addition, primary sureties, and their reinsurers, have adopted diversification in managing their portfolio's of surety risk and this has resulted in a migration by the industry to provide bonds for mid-sized projects, as opposed to the larger mega-projects (i.e., projects in excess of $100 million). As a result capacity has been reduced at the large project level and rates have increased.

All contractors, who can actually get bonds, and there are many who cannot, have a "ceiling" as to the amount of work they can undertake with respect to the bond limits, typically twenty-five to thirty times their asset base (Note: multiple for general contractors; subcontractors can obtain multiples of 7 to 15 times).

These limits remain outstanding throughout the work, even though much of the work may have been completed, because the bond amount never reduces until the work reaches total completion.

In addition, because of the above-mentioned capacity reductions, contractors that primarily work on large projects have had their aggregate program sizes reduced due to a lower appetite for large project business.

With the enormous amount of construction happening in Alberta and British Columbia, and now in Ontario, the larger contractors have met, or are close to meeting, their "ceiling" and have to pay a premium in addition to their standard bond rate in order to get additional bonding capacity.

Further, the "traditional" approach has been compounded by the fact that, if the general contractor had to produce a $50 million bond as indicated above, he would then turn around and require each of his significant sub-contractors to bond him for their performance. Hence, we had a situation where the projects were subjected to additional performance security costs that are not clearly evidenced simply through the cost for bonding provided by the general contractor (i.e., subcontractors will build their bond cost into their price). This is an added, unforeseen cost to the owner.

Historically this was the only way in which an owner and a general contractor could protect themselves for the performance of others.

If a general contractor defaulted, the Performance Bond was called and surety was supposed to step in and complete the project, up to the face value of the bond. The problem being that they were very slow to react. Further, the surety has a significant, apparent conflict of interest. He is the surety for his contractor, and yet he owes settlement to the third party to the contract, the owner and its lenders.

What has been happening is that, when called, the surety would vehemently defend the action, suggesting in every way possible that the contractor was not really in default, hence they would not step in and complete the project. Months, and in some instances, years went by before a settlement was made, leaving the surety industry with a significant black eye, and owners and lenders wondering what the benefits of bonding were all about.

The Performance Bond is supposed to complete the project in accordance with the construction contract, in most cases excluding liquidated damages.

The problem, again, is that, the owner has no say in the quality of the replacement general contractor and he, and his lenders, could get an inferior building as a result.

The Labour & Material Bond covers the non-payment of sub-contractors and suppliers, in the event of a default of the general contractor and his inability to pay. This could result in a privately developed facility being liened.

Subguard® - What Is It?

In 1996 Zurich Insurance Group developed a Contractor Default Insurance product, called Subguard®. This should actually be called sub-contractor default insurance, since that is all that it covers. Interestingly enough, the request for such a solution came from several general contractors that were specifically pointing to the lack of responsiveness in subcontractor bonds and the direct results these delays were having on their ability to achieve on-time, on-budget projects.

The Zurich group allowed a very small group of the largest general contractors in the United States of America, and then Canada, to participate in the Subguard® program. Unlike a bond, this product is an insurance policy, in other words, it agrees to indemnify the general contractor if one of his sub-contractors should default.

In order to make a claim under Subguard®, the general contractor has to call the sub-contractor into default, correct the problem by finding another sub-contractor to complete the work, and then request indemnification from the insurer.

There is a very good incentive for the general to get the work completed, because these Subguard® policies have a significant deductible, usually $250,000 to $1 million, and, typically, a 20% co-pay provision, in that the general contractor shares in the loss settlement with the insurer 20% to their 80%. This deductible and co-pay arrangement with Zurich is pre-funded by the general contractor at the inception of the policy.

It should be noted, most Subguard® programs have underlying retrospective agreements (a stop loss policy) with the insurer and this provides the insured, or any entities with financial interest in the policy, with dollar 1 coverage. In other words, once the stop loss amount is reached, all of which has already been pre-funded by the general contractor, the insurer is then obliged to pay all insured losses up to the policy limit, without any further deductions (first dollar cover from AA rated Zurich).

It really is a funded deductible which acts as the contractor's "skin in the game" to ensure adherence to best subcontractor best practices. The general contractor will be very cautious about whom he brings onto the site and how quickly he responds to difficulties with subcontractors that are on-site.

The "skin in the game" aligns the general contractors incentives with that of Zurich (i.e., prevent subcontractor losses and if they do happen mitigate them as quickly as possible). This in turn aligns with the interest of the project owner and lender. Clearly, he does not want any claims, any of which will affect his bottom line.

INTECH RISK MANAGEMENT INC.

The Pros and Cons of Subguard®

To our way of thinking, Subguard® is a good product.

It has been proven, in the U.S.A., to be very cost effective, i.e., about 50% of the cost of a "traditional" Performance Bond, and with timely settlements, making owners and their lenders happy.

However, one must look at what Subguard® does, and doesn't do to see if it is appropriate in every situation.

Construction bonds are issued for the duration of the project. Subguard® policies are practice policies which are renewed annually and depending on the underlying policy terms and conditions, will provide coverage for specific enrolled projects for the duration of the project.

As mentioned above, Subguard® indemnifies the general contractor for the designated failure of his sub-contractors. It does NOT cover any default by the general contractor.

Consequently, there is a need to have "gap" protection from the general contractor, for any self-performed work. Gap protection can come in the form of various solutions, including surety (a "gap" bond), a Letter of Credit or Parental Guarantee. Ultimately the owner and its lenders will determine which "gap" protection is ideally suited to their needs.

It should be recognized that, today, about 85% to 90% of all building construction is undertaken by sub-contractors, and this is where the real risk is, making Subguard® a most attractive product.

It needs to be noted, that the aforementioned limit is a practice limit, and applies to all of the declared work undertaken by the contractor all over North America. So, while a specific project may be considered somewhat benign, the contractor could well exhaust their limit on other job sites, rendering the Subguard® policy impotent.

In order to counter this situation, on a number of larger projects, the General Contractors have been required to provide a dedicated Project Specific limit to those job sites, so that, if the practice limit was eroded, there would be specific cover for those projects. Further, those specific limits could not be called into contribution on any other job site.

It is clear to us that, unless the surety industry does not wake up to the reality that they have been far from pro-active in the settlement of losses, and provide more meaningful protection to all of the stakeholders, the "traditional" bonding system could soon fall away.

With all of the major infrastructure work being carried out, or to be carried out, over the next five years in Canada, there simply isn't the capacity to bond these exciting projects. In addition, the current incarnation of the surety product's responsiveness and scope of protection leaves some owners/lenders with concerns as to its effectiveness on "time is of the essence" contracts.

Only one surety, at the time of writing, has done anything creative in this regard, and that is Travelers, the largest surety company in North America. They have developed a bond wording that, similar to the adjudication bonds issued in the United Kingdom and elsewhere, it comes with a "liquid" component, usually up to 10% of the face amount of the bond as a demand instrument.

The Alternatives

Subguard® is not a panacea. It is a tool, and a valuable one at that, to aid in the protection of major projects. It has the benefit of providing cover for liquidated damages, acceleration or extended overhead, has warranty protection for up to 10 years (i.e., latent defect cover), covers legal and professional costs and the cost of correcting defective or non-conforming work or materials, but provides no Labour & Material element for first tier subcontractors.

Labour & Material Bonds are also fast becoming a thing of the past. One only has to consider the lack of exposure to recognize this. Lenders control the flow of funds to a project, once they are satisfied that the work has been correctly carried out, and their cost consultants have confirmed such, and that the sub-contractors and suppliers have been paid. The only possible exposure could be for a couple of months' work or materials supplied, which have not yet been invoiced, when the general contractor defaults. We do not believe that this is, in today's well-run projects, a matter for serious concern.

We also see the European model being adopted as yet another alternative to "traditional" bonding. This involves the use of Letters of Credit, typically for at least 10% of the total contract price.

This method also comes with its risks as the owner and its lenders do have the liquidity, however, they are ultimately left with 10% of the contract value and no third party expertise on how best to complete the project. In that vein, both surety and Subguard® do provide third party expertise to project stakeholders.

We also see a greater use of risk management techniques, predetermined financial analysis, captive insurance facilities being used by really significant general contractors, a greater emphasis on project management systems, and an ever increasing use of cost consultants to ensure that the work is being carried out on time and on budget, and that everyone who has to be paid is, in fact, paid.

Clearly, with 85% or more of most major construction projects being in the hands of sub-contractors, a great deal of analysis of their operations is paramount, unless they have been pre-qualified under Subguard®.

In addition, risk controls could be put forward through contract to mitigate this fiduciary risk (i.e., segregation of accounts). Given most larger projects are usually bid by Joint Ventures, account segregation is already "baked" into the project.

In Conclusion

In conclusion, we would like to say that, while "traditional" bonding has had a 100-year career, it has ceased to be as relevant in today's construction industry where on-time has become paramount. There will continue to be a place for it in some construction operations, but not in the fast paced, infrastructure operations we are seeing across the country.

Subguard® and other products and tools will be used far more frequently, and effectively, and must be given sound consideration. At the end of the day, an owner and its lenders must look at what their exposure is to risk, and cover it in the most cost, and management, effective way.

Under current market conditions, we believe that Subguard® is an excellent product in the hands of the right people. And Zurich carry out a great deal of due diligence on the general contractor, before granting them cover. We believe that this is in everyone's best interest to have the general contractor pre-qualified, and to see those acceptable general contractors carrying out their own due diligence on the sub-contractors, to ensure, as best as is humanly possible, that the project will get completed on a timely basis.

Further, with respect to Subguard® lenders need to see:

- Financial Interest Endorsement to provide project stakeholders access to the policy.
- Consideration being given for Dedicated limits for the Project under Subguard®.

We have appended a simple chart showing the relative, major, differences between bonds and Subguard®, for ease of reference.

We look forward to reviewing our comments with all concerned.

Rory M. Roberts

Chairman & CEO

IN TECH Risk Management Inc.

T: 1-800-947-9666 x 2230 (North America)

rroberts@intechrisk.com

And

Sarah Roberts, BA (Hons). CRM., MBA

Managing Director

IN TECH Risk Management GmbH

T: +43 463 50 71 91 10 (Europe)

sroberts@intechrisk.com

IN TECH does not sell insurance in any form, nor is it associated in any way, with any insurance broker or insurer. The Company works independently, without conflict of interest, in providing meaningful insurance risk management advice and management.

February 8, 2008

Summary Table of Key Differences Between Surety and Subguard®

Issue	Surety	Subguard®
Parties to Policy	Three - Contractor, Owner and Surety	Two - Insured (usually Contractor) and Insurer
Policy Trigger	Contractor in default and acceptance by surety that Contractor is in default	Notice of default issued by Insured to Subcontractor
Control of Remedy	Surety controls remedy	Insured controls remedy
Limits	Usually 50% - 100% of contract value	Annual practice policy limits (per loss limit and aggregate):
		* depends on Insured's program parameters
		* Dedicated limits are available
Coverage	Surety has options on coverage provided and those usually includes:	Subguard policy covers:
	* Allow owner to complete and indemnify up to limit of bond	* Cost of correcting defective / non-conforming work (potential warranty cover for up to 10 years)
	* Control completion themselves, through awarding to new contractor or financing existing contractor	* Legal and other professional expenses
	Note: Surety anticipates they are only responsible for hard costs associated with completing contract (LDs, legals, acceleration, are usually not afforded through surety)	* Cost incurred to find remedy to default
		* Indirect costs - acceleration costs, extended overhead costs, and even liquidated damages costs associated with general contract (to $5,000,000 limit)
Retentions / Deductibles	No Deductible - Dollar 1 Coverage	Depends on policy terms and conditions. Most have retrospective program in place and insurer provides Dollar 1 Coverage. Requires policy review.

Responsiveness	Medium - depends on key factors:	High - Insured controls:
	* Surety Company involved	* Trigger of policy (default)
	* Clarity of default	* Choice of remedy for default
	* Whether principle (contractor) is insolvent or a going concern	
	* Clarity of project documentation	
	It is a three party agreement, which is reliant upon the contractor to indemnify the surety for costs associated with remedy. This does create potential for delays	Contractor and two party agreement provide for high degree of responsiveness
Cover pertains to:	Can cover general contractor and subcontractors, depending on owner's requirements	Covers subcontractors only