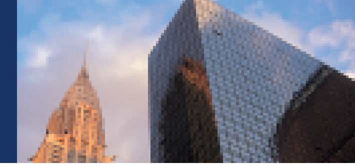
2008 SURETY MARKET REPORT



SURETY MARKET REPORT

In Today's Economic Climate, Surety Plays Even More Important Role

By Marc Ramsey, Surety Information Office

The U.S. nonresidential construction market is under pressure. With oil around $130 per barrel, sub-prime and mortgage losses still negatively affecting bank credit lending and an increasing number of states with growing deficits, the strong construction expansion seen over the past several years is quickly coming to an end. If prior economic downturns are any indication, fewer construction projects will lead to more bidders, lower profit margins for contractors and increased defaults. In this changing environment, the role of surety industry in prequalifying and bonding contractors becomes more important.

Economic pundits differ as to whether the U.S. economy is in recession or how long it will last. The current weakening state of the economy, however, is expected to increase risk for owners, their contractors and the sureties that bond them. Surety remains at its core a credit product and is subject to substantial volatility over time. Following significant losses early in the decade, the surety industry returned to the basics of sound underwriting, exposure management and project analysis. These actions stabilized capacity by restoring profitability and preserving the capital necessary to manage the product over time. Moreover, the excellent results posted by the surety industry in 2005, 2006 and 2007 position companies to ride out the current economic downturn.

What can owners and contractors expect from sureties in the near future? Overall, most surety executives expect 2008 to reflect good underwriting results as most contractors began the year with solid backlogs. The surety industry should be sustained by the nonresidential construction market that is projected to grow in nominal terms through 2008 and into 2009. As public works projects are completed and public funding for new projects continues to be limited, executives anticipate a slowing in nonresidential construction in late 2009 with nominal growth returning in 2010-11.

Two areas of concern are consumer spending and inflation. As gas prices push into the $4.00 range, the Michigan Index of consumer's confidence has hit 30-year lows. This translates to reduced spending and ultimately negatively affects construction as fewer retailers and manufacturers spend to build or expand stores and factories. For the government, less spending drives lower sales and income taxes, resulting in reduced longer term infrastructure spending. Rising inflation, or what some call stagflation – the combination of a stagnant economy and inflation – is further holding executives' optimism down.

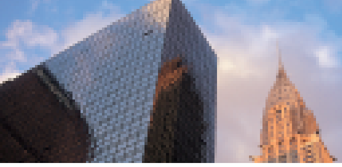
To survive and succeed in today's challenging construction marketplace, contractors are advised to continue doing what they do best, stay lean, procure materials and lock in prices and maintain profit margins. Project owners, meanwhile, are finding greater value in requiring surety bonds to protect their investments and are using a combination of their own prequalification process along with the surety's underwriting to assure the contractors they hire are capable of executing the work.

CONTRACTOR FAILURE

Contractor failures dropped from 28.5% in 2002-04 to 23.6% in 2004-06, according to BizMiner. Surety executives attributed the decline to a robust construction economy, disciplined underwriting, better job selection by contractors and improved profit margins. "After the recession of 2001-02 and managing the subsequent construction material inflation of the past four years, our contractors today are better capitalized, more sophisticated and better prepared to ride out a weakening economy," observes Dennis Perler, president, Liberty Mutual Surety. "Yet, even with sound contractors and responsible underwriting, the current economic trend points to higher contractor defaults."

Factors suggesting increased contractor defaults include increased competition, tightening credit terms, inflation and the weak U.S. dollar. While today's contractors are better businesspeople – with more sophisticated systems for estimating, monitoring and constructing projects – and sureties have implemented tools to better judge the credit and performance worthiness of their clients, the economy is still the primary driver of contractor success. "We can't control defaults any more than we can the weather," notes Rick Kinnaird, chair, The Surety & Fidelity Association of America (SFAA), and senior executive, surety, Westfield Group Surety. "We will see lower profit margins and less room for error. Some contractors will not make it."

Generally, most surety executives see increased risk coming but believe the construction and surety industries are better prepared to manage the cycle. Sureties note that contractors continue to carry strong backlogs with good profit margins well into 2008. This indicates that short-term default activity should remain low. While many sureties also believe that strong cash flow earned



during more robust times may be keeping some contractors afloat during the current downturn, they recognize the cash flow requires a sufficient number of new project being let to sustain the construction industry. "We believe that as the slowdown persists you'll see an increase in defaults, because part of what may have been keeping defaults at bay is cash flow," says Jim Altman, senior vice president and chief underwriting officer, Chubb Surety. "As that cash flow slows down people are going to have problems."

Thomas Kunkel, president and CEO, Travelers Bond, agrees, "The economy is no longer covering for the mistakes that some contractors make when times are good."

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The emerging trend of an increase in contractor defaults translates into more work-out risk for owners who do not bond projects. Owners that bond projects mitigate risk by shifting default exposure to sureties. Owners that do not bond retain heightened risk of contractor defaults and uncompleted projects. For sureties, an increase in contractor defaults means more surety losses, but perhaps not until late 2009 or early 2010, and likely not as severe as in prior loss cycles. "While we have not seen an increased level of defaults to date, it is still early," says Doug Hinkle, chief underwriting officer, CNA Surety. "We do expect to see increased loss activity."

Michael P. Foster, executive vice president, Merchants Bonding Company (Mutual), adds, "We do not think there will be a significant impact until 2009."

There has been some surety industry "profit slippage," as surety executives call it, but nothing significant. Executives anticipate accelerating slippage over the coming two years as competition heats up, but the industry should remain profitable as a whole as the economy transitions through the slowdown and begins its recovery.

"With investment returns down, the pressure is off from senior property and casualty management to turn dollars for the sake of investment returns," SFAA's Kinnaird says. "'Smart' growth is encouraged, but it is recognized that we need to make money from underwriting. We can no longer rely on investment dollars to offset, or temper, poor underwriting results."

Tim Mikolajewski, senior vice president, Safeco Surety, adds, "We are still bullish on the surety industry in 2009 and beyond. Clearly there will be challenges from a growth standpoint, since there will likely not be as many projects to bond, but profitability should remain solid. Underwriting should remain sound and capacity will be available to those contractors that deserve it."

CONSTRUCTION COMPETITION

Surety executives confirm that the overall economic slowdown is adding to contractor competition. Adding to this, the substantial drop off in residential construction is generating more competition as residential contractors enter the nonresidential sector. One indicator of the increased competition is the abundance of bidders, which has gone from as few as two to three in recent years to more than a dozen. "This is a combination of the slowdown in work coming out for bid and new market entries on small and mid-size public projects," SFAA's Kinnaird explains. "Construction has historically offered an 'ease of entry' for new players."

Many new market entrants come from the residential and small commercial market areas. While some of these contractors are successfully testing the water in the public bidding arena, many are unfamiliar with the policy and procedures involved with public work. Executives warn that insufficient experience and financial capacity can lead to inadequate pricing and quality of work issues. "The largest oversight that we commonly see from contractors moving from the private to public sector is that they often have a naive approach to the complexities of working with public owners," says William A. Marino, chairman and CEO, Allied North America.

"All stakeholders of a construction project," adds CNA's Hinkle, "are at risk if they choose to involve an unqualified contractor. Performance issues such as quality of construction and time for completion as well as proper payment of subs and suppliers can create significant additional costs, delays and litigation."

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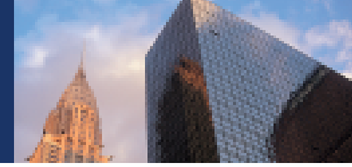
Surety executives caution project owners, developers and investors not to view this increased competition as an opportunity to take advantage of the market and get a cheaper product. "If they select the right architects and engineers they can manage the risk, but they have to be extremely careful," warns William Cheatham, president, Zurich North America Surety. "This is where the surety industry can bring enhanced value through its prequalification process."

"The owners, developers and investors' first line of defense in managing risk on a specific project is their selection of architect and engineers," Cheatham continues. "The surety industry enhances the integrity of project completion through the prequalification process in selection of contractors."

When a construction company engages with a new owner, location or different scope of work, the probability of encountering project-related issues rises. "Contractors working outside of their normal territory, or in new sectors within the construction market, will face the challenge of establishing



relationships with new owners, architects and subcontractors," says Michael J. Cusack, senior vice president, managing director and operations board member, Aon Construction Services Group.

Construction has many variables and hidden risks. Even with established contractors, risk exists. The risks are compounded when owners contract with new, unproven entities in a new market or territory. "Risk to owners increase exponentially when contractors lack local knowledge of and relationships with critical sub-trades, labor sources and suppliers," Liberty Mutual's Perler notes.

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New entrants may miss costs that lead to change order requests. Substandard performance may surface. The contractor may be inadequately financed. Experience may be lacking for the scope of work they are attempting. Access to qualified labor may not be available. Material and resource suppliers may not have experience with the new player, leading to material scarcity and difficulty in locking down prices. Additionally, banking relationships may not exist to cover payment terms on larger, or public, projects. "This is not to say new contractors can't make the switch to nonresidential work," SFAA's Kinnaird says. "Many of today's strongest nonresidential contractors have done that very thing."

The transition of labor from low- to mid-rise construction projects to high-rise structures also has had an effect in certain markets from a safety standpoint. Surety executives urge more safety education and training of labor transitioning to commercial construction for the industry to maintain a strong safety record.

A residential contractor who enters the nonresidential sector and obtains surety bonding makes an important statement to project owners about the construction firm's qualifications. "If an owner requires a contractor to be bonded, that means that contractor has gone through a prequalification process by a surety," explains Henry W. Nozko, Jr., president, ACSTAR Insurance Co. "If the residential contractor has gone through this vigorous process by the surety, the surety has deemed the contractor qualified to perform the contract."

The U.S. Census Bureau reports that the seasonally adjusted value of nonresidential construction spending grew 11.6% in April 2008 over April 2007. Nonresidential construction spending marked 25 consecutive months of double-digit growth, peaking at 18.1% in November 2007 over November 2006. In April 2008, lodging (41.8%), public safety (27.4%), manufacturing (25.7%), power (22.5%) and transportation (20.9%) construction performed the strongest.

"There is still a pent-up demand for projects, particularly in the infrastructure sector," Safeco's Mikolajewski observes. "State budget issues will cause a temporary slowdown in projects hitting the market, but those issues will be overcome as more creative project financing alternatives surface."

Much of the long-term economic outlook for the construction industry depends on the resiliency of the credit markets and the outcome of the presidential election. Surety executives say that without any meaningful infrastructure economic stimulus, the construction economy may experience a slump that could last 18 months to three years.

"The key to any successful business – construction or other – is to be able to adjust through various cycles and overcome obstacles," says Anthony Romano, senior vice president, surety, American International Group (AIG). "Being able to spot trends, maintain margin discipline, remain agile from a cost-structure perspective and adjust practices to coincide with differing situations is the key to remaining successful over various periods of the cycle."

With fewer jobs available and more players, competition in the nonresidential construction market may not slow for some time. "We've really not seen a material decrease in the backlog of our contractors," says Terry Lukow, executive vice president, Travelers Bond, Construction Services. "Granted, a lot of this work was procured last year."

"It depends where you are and the type and size of work you're bidding," adds Travelers' Kunkel. "In many areas it's still very robust. There are areas that are not as robust."

Aon's Cusack has noticed a decline in backlogs and reduced cash flow, "We are concerned that the liquidity crisis may lead to tougher credit conditions for contractors with respect to their working capital credit facilities. Any sector pull-back from financial institutions away from the construction industry will be detrimental to firms that need bank support to survive the slowing cycle."

ADVICE FOR CONTRACTORS

Most contractors work on fixed contract prices. Over the past five years, contractors learned to manage material inflation, and as global emerging economies, bid the costs of critical construction materials. A growing concern is an extended period of stagflation similar to that of the 1970s. With a stagnating construction outlook and continuing material inflation, contractors' ability to pass on material and labor costs is diminished just as the availability of less work increases pressure to lower contract bid prices. "Contractors should adjust their business plans to manage for fewer opportunities," suggests Liberty Mutual's Perler. "Reducing overhead and conserving cash will allow contractors flexibility to bid projects that can better support their operations."

ACSTAR's Nozko agrees, "Contractors may be stuck with thinner margins than they have been used to because construction costs are increasing rapidly. Contractors should be prepared to understand that their revenue will most likely be less than it has been. Contractors must prepare for less work by reducing fixed charges and overhead as much as they can, so their operating cost will be lower and they will be able to operate profitably at lower revenue."

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—Terry Lukow, executive vice president, Travelers Bond, Construction Services

While managing overhead is critical, just as important is the need to protect talent in the organization. "When the market turns more positive, you'll need that top talent," Safeco's Mikolajewski tells contractors. "Additionally, top talent always seems to manage projects well no matter what the market conditions."

Contractors also are encouraged to look for ways to improve project work flow and bottom line results. One example is to pay closer attention to material needs and working smarter at anticipating price increases. In other words, secure resources and lock in prices where possible.

"Bid the job, not the competition," Travelers' Lukow emphasizes. "We recommend our clients bid the job on their own terms, not like their competitors would bid on the job. If they keep that as a standard over time they have a good opportunity to do well."

It also is essential for contractors to maintain constant open communications with their surety agent and underwriter. These advisers must be aware of a contractor's short- and long-term business plans – and how they are prepared to support these plans.

"In the long run, contractors should stick to what they do best," Merchants' Foster recommends. "They need to maintain their profit margins. They need to review their overhead costs to determine if any reductions can be made to help them withstand what is most likely a temporary reduction in margins."

As a part of their overall business plans, contractors should have an option that involves the need to downsize their organization. "The increased number of bidders in certain segments of work is here to stay – at least for a while," CNA's Hinkle says. "Depending on the financial strength and staying power of any given firm, rightsizing the firm to better match available work is often necessary and will result in less financial stress long-term."

In addition, Aon's Cusack recommends contractors remain patient, "The two biggest issues for contractors in a slowing construction economy are avoiding the 'bad job' and vigilant management of overhead. Agreeing to take on a challenging job based on a thin margin and unreasonable terms and conditions usually drains resources, serves as a distraction to management and may often result in a financial loss."

IMPACT ON OWNERS & SURETIES

Sureties manage for the long term. By building balance sheet strength through adding to capital surplus and reserves in good years, the surety industry is prepared to pay losses in poor years. Bonded losses to sureties translate into dollars saved for public and private owners of bonded construction projects. "Project owners need only to look at the historical economic cycles and surety experience to realize what the surety industry has contributed as far as solutions to problems – solutions that owners wouldn't have access to otherwise," says Zurich's Cheatham. "The surety product is a proven method. Sureties have been in business for more than 100 years and our role has only grown in importance. Sureties provide a method of integrity to the bid process, which in today's compliance world is very critical."

AIG's Romano says there are scores of positive examples of projects that were successfully completed through the surety's involvement, "Although a surety's completion participation occurs only in a very small percentage of those projects that are undertaken, when we are called upon to respond, the need is generally significant and the stakes high."

"Is it not better to have the peace of mind that no matter the obstacle a surety stands behind your construction partner with the means and capability to help a project reach completion?" Romano asks. "In the final analysis of a project's cost, it really is a small price to pay for that peace of mind."

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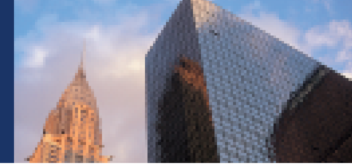
For both government and private owners, the surety safety net is there if needed, but the ultimate goal is to avoid contractor default and complete the job on budget and on time. "Project owners expose themselves to significant risk if they are not familiar with the skills and qualifications of the firms that they are looking to award work," Allied's Marino says. "A combination of an owner-driven prequalification process supplemented with bid bonds provides a reasonable level of assurance that firms submitting proposals have the necessary skills to execute on awarded work."

Other surety executives also emphasize that owners should think more about prequalification based on a contractor's background in addition to the surety's to minimize the probability of getting a marginal contractor on their job. "An owner needs to prequalify its bidders in a different fashion than they have before," Travelers' Lukow says. "Not just a bid bond. Resumes, what they've done in the past. They almost need an RFP to qualify to bid. That would help them immensely in separating the contractors with excellent experience."



Merchants' Foster concurs, "Owners should undertake an extensive review of any prospective contractors before they enter into a contract. In most cases owners are not experienced in this process and they can use the surety industry, and more specifically surety bonding, to assist in this process."

CONSOLIDATION

Of the $5.4 billion in contract and commercial surety written in the United States in 2007, the Top 5 surety companies wrote almost half, according to The Surety & Fidelity Association of America (SFAA). The Top 10 companies combined wrote two-thirds of all U.S. surety. There are more than 150 insurance groups currently writing surety bonds. Since 1994, 10 of the top 15 writers of all U.S. surety have merged or left the market.

The latest merger announcement occurred when No. 5 on the list of top writers, Liberty Mutual Insurance Group, acknowledged its intention to acquire No. 4 Safeco Insurance Group. The move would propel Liberty Mutual into the No. 2 spot behind Travelers Bond, ahead of No. 3 Zurich Insurance Group, No. 4 CNA Insurance Group, and the new No. 5, Chubb & Son Inc. This new Top 5 would write 55% of all surety premium written. While Liberty and Safeco executives were unable to discuss details, other surety industry executives say consolidation may affect the surety industry.

"Consolidation continues to take place in our industry," Chubb's Altman notes. "Although capacity was beginning to return to the surety market, consolidation could slow that growth. Going forward, it is difficult to assess what will happen. Previous experience has shown that consolidation has a tendency to reduce capacity."

"The moves for consolidation and mergers are more aimed at strengthening the market rather than diminishing it."

—William Maroney, president, National Association of Surety Bonds Producers (NASBP), and senior vice president, City Underwriting Agency Inc.

The specter of consolidation is always there. And, given the abundance of capital in the insurance marketplace, surety executives would not be surprised if another acquisition is announced by the end of 2008. However, executives observe that the process appears to be more controlled and statically driven by parent property and casualty companies than in recent years.

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SFAA's Kinnaird agrees, "These will probably continue, but at a controlled, slower pace. Capacity is out there. The concerns from past years have forced the industry to respond with very workable arrangements and alternatives."

Adds Maroney, "The capacity issue is more of a contrivance than a reality. The vast majority of work being performed is well-handled by the surety marketplace. The sporadic need to address the mega projects is being tackled as they develop and to date, all has been addressed accordingly."

In contrast to the upper end of the surety market, the smaller surety market also is seeing some movement. Just in the last several months, executives note, a number of smaller new markets have entered the business, while more established smaller carriers have redefined their approach to the business. "The entrance strategies of these new carriers could have a significant impact on the terms and conditions that are being offered to smaller and mid-sized contractors," says Allied's Marino. "Program structure remains largely unchanged for those contractors that utilize co-surety or are considered large users of capacity." ■

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TOP 10 WRITERS OF SURETY BONDS—2007*

Companies	Direct Premium Written (Millions $)
Travelers Bond	$1,017
Zurich Insurance Group	$449
CNA Insurance Group	$436
Safeco Insurance Group	$423
Liberty Mutual Insurance Group	$341
Chubb & Son Inc.	$303
Hartford Fire & Casualty Group	$223
HCC Surety Group	$163
Arch Capital Group	$127
ACE Ltd. Group	$119

*Includes contract and commercial surety

Source: The Surety & Fidelity Association of America (SFAA), "Top 100 Writers of Surety Bonds—United States & Territories & Canada," 2007 (Preliminary); www.surety.org