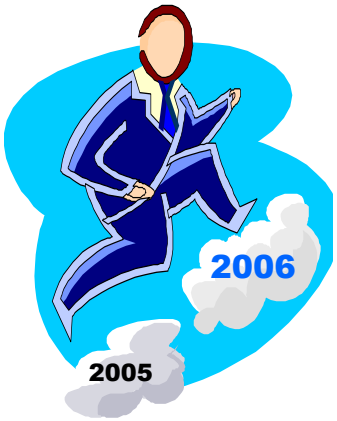
Construction Industry Update

MSP Construction Update 11/2005: "The Surety Market: Outlook for 2006" November, 2005

The Surety Market: Outlook for 2006

By Michael R. Strahan, CCFP

The surety market has been going through some tough times; the industry has lost money every year since 2000. The future looks more optimistic, however, as the Surety Association of America reports that for the first six months of 2005, the surety industry's direct loss ratio was 37%. (The direct loss ratio represents the percentage of collected premium that is paid in direct losses without considering the insurance company's overhead.)



Although the final 2005 year-end results for the surety industry will not be published for several months, we anticipate that they will be lower than in recent years, but it will likely still be a losing year overall.

A Look Back

Surety company results peaked in 2001, with a direct loss ratio of 83%. In 2002, the direct loss ratio for the industry dropped to 68%, and it continued to decline to 51% in 2003. In 2004, the surety industry was showing a strong trend of recovery until the six-month direct loss ratio results shot up again as a result of major loss reserve adjustments by one particular surety company. This loss reserve adjustment included the demise of one large national contractor's losses from several years ago. As a result, 2004 ended up posting a loss ratio of 60%.

Today's "hard" market is nothing new. In the 1980s, the surety industry also experienced tough times with the rest of the economy. Business failure rates were at record levels, interest rates were in

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double digits, and the economy slowed. By the mid to late 1980s, however, surety losses peaked.

Throughout the 1990s, the economy boomed, interest rates dropped, and surety results were profitable again. Surety bonding capacity was accessible, easy to obtain, and inexpensive, and favorable terms were available. Many surety companies relaxed underwriting to compete for market share. Excess surety capacity built up in the marketplace, and almost anyone could get a bond.

After a dozen years of profitability, the surety industry in 2000 experienced record losses. Besides increased contract failures of nearly $1.8 billion in combined claims in 2001 and 2002, major losses occurred in the commercial surety market with the demise of Enron, WorldCom, and others.

In reaction to severe losses, some surety companies went out of business or exited the market. Significant market consolidation continued to occur, with some markets reacting to capital constraints by restricting capacity, increasing rates, and taking a more disciplined approach to underwriting.

Sureties have "returned to the basics" of underwriting and have become far more cautious about bonding large programs and long-term and erroneous contracts. Underlying obligations in contracts – including the scope of work, bid spreads, bond forms, and financing – are scrutinized on many levels. Often an increase in premium rates, a surcharge associated with an extended warranty, environmental or design exposures, or reduced capacity is secondary to the mere availability of surety credit.

Today surety companies focus on evaluating the credibility of all information received by underwriters. A revived conservative underwriting approach to surety bonds has produced an increase in the frequency, quality, and amount of financial reporting required from those seeking bonds. Sureties also now focus more on profit-fade, under/over-billings on works in progress, impact on cash flow from the extreme use of bank lines of credit and other interest bearing debt, and a myriad of other key financial ratios.

A Look Forward to 2006

With 2005 loss results still higher than desired, it is certain that the surety industry as a whole will continue to maintain conservative underwriting guidelines until it again returns to profitability. Healthy contractors should continue to implement best practices and use the following strategies to obtain surety credit:

1. Build a positive, credible reputation and track record.
2. Nurture a successful, risk-reducing organizational culture.
3. Improve effective internal and external communication.
4. Develop surety relationships by Trusted Advisor meetings with the surety bond broker, CPA, banker, and attorney.
5. Employ strong financial and administrative personnel.
6. Formalize Standard Operating Procedures (SOP) for all activities.
7. Know your surety company's "hot spots" – key financial ratios, adequate cash balances, bank line of credit usage tolerance, etc.
8. Improve the quality and timeliness of financial reporting and bond requirements.
9. Over-capitalize the balance sheet to the work program needs.
10. Conserve cash and minimize interest-bearing debt.

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11. Aggressively drive a cash management plan – "Cash is King!"
12. Work off interest-bearing debt and increase the spread on bank lines of credit.
13. Upgrade accounting presentation and expand reporting – proformas, job costing / labor milestones, cash flow schedules, etc.
14. Scrutinize contract terms, bond forms, financing arrangements, warranties, and bid spreads.
15. Bond critical subcontractors.
16. Don't "buy" jobs.

With further potential consolidation in the marketplace, we can expect continued tight terms and conditions for surety credit in 2006. With the ten largest premium volume surety companies now controlling more than 60% of the marketplace, and the top five nearly 50% alone, it is likely that premium rates structures will continue to flatten, especially for larger programs.

Less negotiation will be available on terms such as acceptable scope and contract specifications, bonding subcontractors, full indemnity, and other underwriting requirements.

Contractors can expect sureties to look at their work programs more closely, which can lead to changes in the amount of capacity sureties are willing to offer. Although a surety company may have the capacity to support an increased work program, it may not have the same appetite for risk as it had in the past. Nevertheless, a contractor with a solid reputation, balance sheet, profitable work program, and experience should have no problem obtaining the surety bond credit it needs.

Overall, the surety industry is healthy and will continue to respond to the challenges and opportunities in the construction industry.

Mike Strahan is a Surety Account Executive for Cavignac & Associates.

Disclaimer: *This article is written from an insurance perspective and is meant to be used for informational purposes only. It is not the intent of this article to provide legal advice, or advice for any specific fact, situation or circumstance. Contact legal counsel for specific advice.*

Risk Control Corner

By Stuart Nakutin, AIC, WCCA, WCCP, CDMC

So I Delay Reporting an Injury – What Can It Cost Me?

Failure to report injuries promptly can cause denials or delays in providing needed medical treatment. These delays, in turn, can slow the injured employee's recovery and return to full work status. Thus, instead of saving money, an injured worker or an employer who delays reporting might actually incur higher costs and lower productivity for a longer period.

The sooner an injured worker gains assurance that he or she will receive fair treatment, the less likely that costly litigation will result.

Injured employees who do not receive timely care are more likely to seek medical treatment on their own, which can sometimes result in over-treatment.

A study found that claims not reported promptly can cost from 10% to 48% more than if they were reported within one week of the injury.

If the claims adjuster does not receive information early enough to investigate the circumstances of the claim thoroughly, then at 90 days from the date of knowledge the employer may be forced to accept liability for non-industrial injuries.

Many of the circumstances listed here can have a negative impact on your experience modification, thus driving up rates in future policy years.

Stuart Nakutin is Director of Loss Control, Claims, and Human Resources for Cavignac & Associates. He may be contacted by e-mail at snautin@cavignac.com or by phone at 619-744-0589.

Additional Insured Status vs. Indemnification
Do You Need Both?

By Jeffrey W. Cavignac, CPCU, RPLU, CRIS

Occasionally we're asked why we recommend that a contractor require of his subcontractor both additional insured status under the subcontractor's policy and an indemnification agreement running in the contractor's favor. Although this is usually brought up in connection with a construction project, it could apply to any situation in which one person contracts with another party.

Additional insured status and indemnification are both risk transfer mechanisms. The theory behind risk transfer is to make the party with the most control over the risk responsible for bearing the financial loss should it fail to prevent losses from occurring. Of course, the relative bargaining positions of the contracting parties also play a key role in determining who will bear the risk.

When contractors are added to their subcontractors' policies as additional insureds, they have direct rights under the policy. This includes defense coverage, which is paid in addition to the limit of liability. Furthermore, the coverage itself is actually quite broad. In certain circumstances, additional insured status will provide coverage broad enough to encompass liability arising from the sole fault of the additional insured.

Indemnity clauses are included in contracts to transfer the liability of one of the contracting parties (the indemnitee) to the other party (the indemnitor). Most of these provisions, when used in construction contracts, require the indemnitor to hold harmless, defend and indemnify the indemnitee from any and all liability except the indemnitee's sole negligence. (It is illegal in California to be held harmless from your sole negligence.) Indemnity provisions operate independently from the indemnitor's insurance, which may or may not cover the risks assumed by the indemnitor.

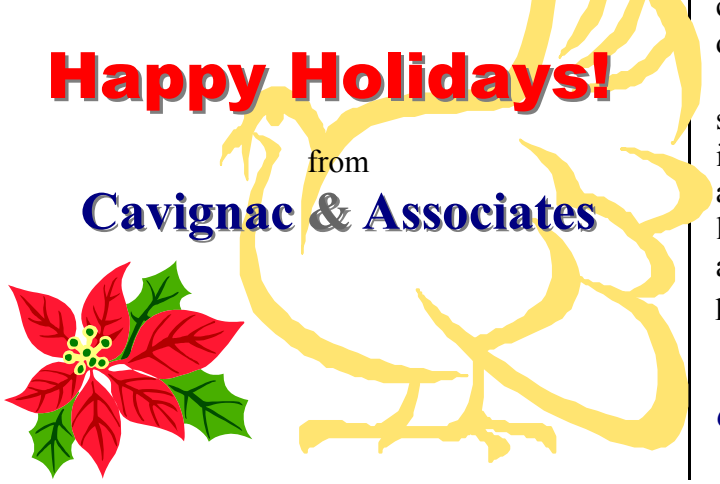
Most commercial general liability policies provide broad form contractual liability coverage. This basically allows the indemnitor to assume the tort liability of the indemnitee. Contractual liability coverage applies to the named insured indemnitor, and the insurer's obligation to pay runs to the named insured, not to the indemnitee. In other words, whereas the additional insured endorsement provides direct coverage, the contractual coverage triggered by an indemnification agreement is more of a reimbursement-type coverage.

It is also important to note that the additional insured status is restricted by the coverage itself, whereas an indemnity agreement can address broader issues that otherwise would not be covered by insurance.

Why do you need both? There are a couple of reasons. First of all, if you rely solely on additional insured status, and the policy is cancelled, there is no coverage. In addition, policy limits could be exhausted, or coverage may simply be excluded. The indemnification agreement, on the other hand, operates independently of the insurance contract, and can actually provide broader coverage than the additional insured status.

This in effect is what is known as a "belt and suspenders" approach. Thus, if contractual liability insurance applies, there may be no need to rely on additional insured status. Conversely, if contractual liability coverage does not apply for some reason, additional insured status can be relied on for the protection of the indemnitee.

Jeff Cavignac is President and a Principal of Cavignac & Associates.



Bonding Subcontractors

By James P. Schabarum II, CPCU, AFSB, CWCA

Requiring bonds on selected subcontractors is an effective tool to allow contractors to transfer their risk. Sureties expect contractors to have formalized criteria in place to determine thresholds that require subcontractors to be bonded. Below are some criteria to consider:

1. If the subcontractor is critical to the completion of the project
2. If the subcontract represents a significant portion of the work
3. If the subcontractor is the sole source for anything on the project
4. If the contractor is not familiar with the subcontractor's work
5. If there is a question about the adequacy of the subcontractor's labor pool
6. If the subcontractor's financial stability is a concern (it may not be able to meet payroll and other cash flow requirements of the project)
7. If work is being performed outside the normal geographical area
8. If the contractor is entering into a new type of construction
9. If there are tough economic times
10. If there is a significant bid spread

We recommend establishing a "Subcontractor Pre-Qualification and Bonding" policy that includes these points and is consistent with your company's risk tolerance.

Your firm should develop a matrix of factors that would dictate the pre-qualification or "bonding back" of a subcontractor.

For example, subcontractors with contracts of $100,000 would be required to complete a Pre-Qualification Form. Subs with contracts over $250,000 would be required to complete the Pre-Qualification Form and provide a bond unless they meet specified exception conditions. Subcontractors with contracts over $500,000 would complete the Pre-Qualification Form and provide a bond (***no*** exceptions).

Remember: When in doubt, bond back!

Comparing MSAs, HSAs, HRAs, and FSAs: Which Approach Is Best?

Article courtesy of Cavignac & Associates Employee Benefits Department

Employers are increasingly looking to consumer-driven health plans to help soften the blow of continually rising healthcare costs. Depending on the model, these plans typically include Medical Savings Accounts (MSAs), Health Reimbursement Arrangements (HRAs), Flexible Spending Accounts (FSAs), and most recently, Health Savings Accounts (HSAs). Some plans allow employees to use these accounts to pay for medical expenses that are not covered by insurance, while employers use others to provide employees with a fixed dollar amount with which they can purchase healthcare services or a health insurance policy on the open market.

The explosion of these types of plans — or at least the explosion of discussion about these types of plans as a potential cure for rising healthcare costs — has left many consumers and employers confused about the right approach.

Introducing consumerism into your health plan requires an evaluation of the benefits and disadvantages of MSAs, HSAs, FSAs, and HRAs. No one solution is right for every employer. In light of the complexities of choosing the right consumer-driven health plan, many employers continue to take a "wait-and-see" approach.

If your organization is considering implementing a consumer-driven health plan, your Cavignac & Associates representative can help you decide which plan is best for you.

Many employers today struggle with the challenge of providing an attractive compensation package at an affordable price. One tool available to meet this challenge is the Section 125 Plan. While different types of Section 125 plans exist, each provides the opportunity to save money by reducing both the employer's and employee's tax liability.