

Workshop W10

Wednesday, October 31, 1:30–3:00 p.m. and 3:30–5:00 p.m.

INSIDE THE MIND OF A SURETY UNDERWRITER

Presented by

Christopher T. Parker
Director—Surety Construction Group
Chubb & Son

Kevin M. Waldron
Director—Surety Construction Group
Chubb & Son

The ability to obtain bonds is a requirement for work on most public projects and a practical necessity on many private projects. This workshop examines both the objective and subjective aspects of underwriting surety credit. Learn how underwriters blend their objective analysis of a contractor's financial statements with their subjective assessment of the contractor's ability to meet its obligations. Find out what other factors may influence the decision to extend or withhold credit.

- Provides a brief update on the surety marketplace, including overall capacity, appetite, and restrictions.
- Outlines the surety underwriter's assessment of a contractor's bonding capacity, including key issues such as backlog and price escalation risks.
- Describes the surety's consideration of other factors, such as contract bond terms and conditions and the balancing of its own portfolio.



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Christopher T. Parker
Director—Surety Construction Group
Chubb & Son

Mr. Parker is copresenting Workshop W10, "Inside the Mind of a Surety Underwriter," on Wednesday afternoon. He has been with Chubb & Son for over 16 years serving in a variety of capacities in both the branch and home office. He has worked in the Dallas and Philadelphia field offices for Chubb and spent 5 years in the international area working with offices in London, Brazil, and throughout Asia.

In 2002, he served as Chubb Surety's first Portfolio Manager assisting in the development of credit and price modeling tools as well as working with a cross-functional team within Chubb to develop more consistent credit rating and capacity guidelines.

In 2004, he became an Assistant Zone Manager for the Northeast/Southeast Zone working with branches in a 13-state territory from Maine to Florida.

In 2006, Mr. Parker was named a Director of the Surety Division's Core Construction segment and is responsible for a 16-state territory in the Northeast, Mid-Atlantic, and Southwest regions.

Mr. Parker holds a B.S. in Finance and Economics and an M.B.A. in International Business from Temple University.

Kevin M. Waldron
Director
Chubb Surety

Mr. Waldron is copresenting Workshop W10, "Inside the Mind of a Surety Underwriter," on Wednesday afternoon. He has been employed by Chubb & Son for 11 years. Having worked in the New York and Home offices, his responsibilities have encompassed the U.S. domestic market along with 4 years of international experience.

Prior to joining Chubb Surety, Mr. Waldron started his career in the industry with Safeco Surety in New Jersey as an underwriter. After 3 years, he joined Chubb Surety and has served in various underwriting and administrative capacities in both the branch network and home office.

In 2006, Mr. Waldron was promoted to his present role as Director of the Construction Group in Chubb Surety's core construction business segment. He is responsible for underwriting and business development for five of Chubb Surety's regional branch offices.

Mr. Waldron holds a B.S. in Finance from Fordham University.

Notes

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Surety Underwriting

Inside the Mind of a Surety Underwriter

Presented By:

Kevin M. Waldron – Surety Director
Christopher T. Parker – Surety Director
Chubb & Son, Inc.
Warren, New Jersey



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Agenda

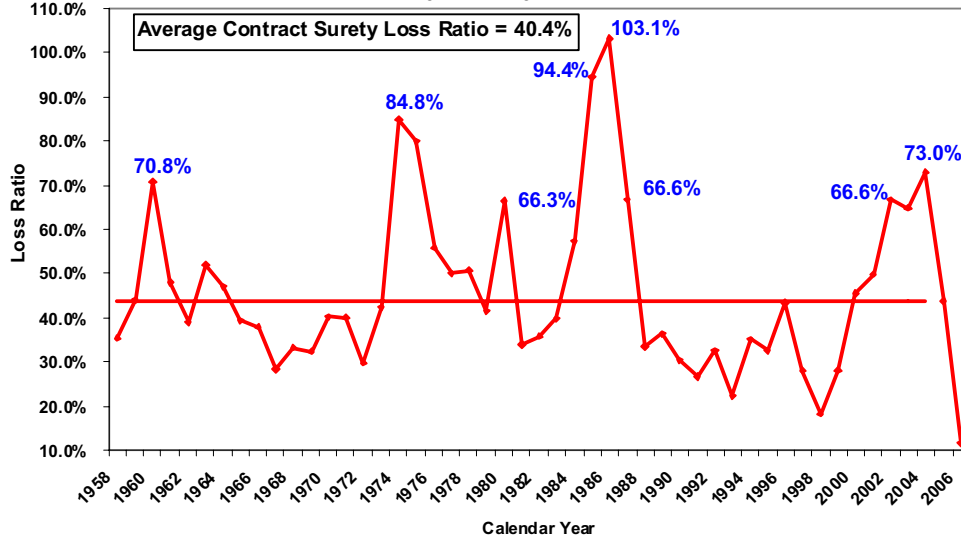
1. Brief Industry Overview
2. Risk Management & Credit Evaluation
3. Portfolio Management
4. Choosing your Professional Advisors
5. Q&A

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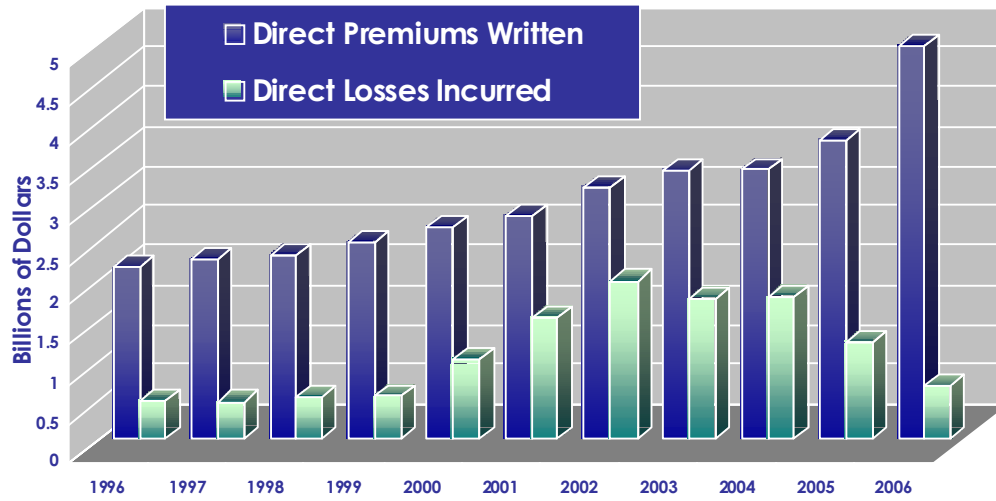
Industry Overview

Contract Surety Industry Loss Ratios CY 1958 - 2006

Source: The Surety & Fidelity Association of America



Industry Overview



Source: The Surety & Fidelity Association of America

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Industry Overview

Surety & Fidelity Association of America Top 15 Surety Writers 1994 vs 2006

1994		2006	
Surety	GWP (\$millions)	Surety	GWP (\$millions)
1 Reliance → Travelers	147.1	1 St. Paul Travelers	940.8
2 USF&G → St. Paul → Travelers	144.1	2 Zurich Ins Group	443.8
3 F&D → Zurich	142.5	3 CNA Insurance Group	417.8
4 St. Paul Group → Travelers	140.9	4 Safeco	359.7
5 AIG	111.5	5 Chubb & Son Inc	275.5
6 Aetna → Travelers	106.6	6 Liberty Mutual	260.4
7 Continental → CNA	100.7	7 Hartford	206.3
8 Fireman's Fund Gone	97.3	8 Arch Capital Group	142.2
9 CNA Insurance Companies	92.8	9 HCC Surety Group	131.0
10 Safeco	88.9	10 AIG	120.8
11 Chubb	77.7	11 International Fidelity	96.6
12 Hartford	74.0	12 Great American	89.3
13 Amwest Gone	70.2	13 NAS Surety Group → Swiss Re Americ	84.5
14 Capsure → CNA	55.3	14 ACE Ltd.	76.6
15 CIGNA Group → Liberty	49.7	15 Insko Dico Group	69.5

Companies that are gone in RED

Companies that merged or were sold are in BLUE

Companies that merger or were sold a second time are in GREEN

Risk Management & Credit Evaluation

1. Backlog Growth Relative to Balance Sheet
2. Cash Flow
3. Budgeting / Forecasting
4. Cost Controls
5. Contract Terms and Conditions
6. Bond Forms
7. OCIP, CCIP, MCIP
8. Succession Planning
9. FIN 46, FIN 48 Impact

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Risk Management & Credit Evaluation

1. Backlog Growth Relative to Balance Sheet

- *Construction Put in Place +20% ¹*
- *Material Cost Index +28% ²*
- *Labor Cost Index +13% ²*
- *Larger Single Job Sizes*
- *Profits Earned over 18-36 months so Current Balance Sheet can be Stretched*

1. Source: U.S. Department of Commerce; 2004 & 2005

2. Source: ENR Cost Report; 2002-2205

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Risk Management & Credit Evaluation

1. Backlog Growth Relative to Balance Sheet (con't)

Surety Focus

- ***Execution***
 - *History of Stable Job Profits*
- ***Disciplined Project Selection***
 - *Match Resources & Expertise with Opportunities*
- ***Plan for Balance Sheet Growth - WC and Equity***
- ***CASH FLOW***

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Risk Management & Credit Evaluation

2. Cash Flow

- ***Rapid Backlog Growth Can Strain Cash Flow***
 - *Project Start-Up Costs*
 - *Financing Retainage*
- ***Surety Focus***
 - *Cash Flow Positive Jobs*
 - *Strong Billing and Collection Practices*
 - *Build Up Cash Reserve to Handle Unexpected Problems*
 - *Minimal Bank Use/Availability of Bank Line*

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Risk Management & Credit Evaluation

3. Budgeting / Forecasting

- *Detailed Projections for Earnings, Balance Sheet and Cash Flow*
- *Ability to Consistently Meet or Exceed Projections*
- *Timely and Regular Communication*
 - *Increases Ability to Respond to Temporary Spikes in Backlog*

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Risk Management & Credit Evaluation

4. Cost Controls

- *Job Cost Accounting System*
- *Ability to Capture "Real Time" Cost Info from the Field*
- *Management Review Process*
 - *What Reports are Used?*
 - *Who Reviews Job Cost Records?*
 - *How Frequently?*
 - *What Action is Taken?*
- *Build Confidence in Cost Control System*

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Risk Management & Credit Evaluation

5. Contract Terms

- *Fair and Balanced Risk Allocations*
- *Reasonable Liquidated Damages*
- *No Consequential or Actual Damages*
- *Price Escalation Clause*
- *Broad Force Majeure Clause*
- *Opportunity to Remedy Default*
- *Dispute Resolution Process*

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Risk Management & Credit Evaluation

6. Bond Forms

- *Actual Default - Not Just Declaration of Default*
- *Preserve Surety's Right to Investigate*
- *Provide Options for Remedy/Response*
- *Limited to Bond Penalty*
- *No Automatic Increasing Language*

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Risk Management & Credit Evaluation

7. OCIP, CCIP, MCIP

- *Parties Covered and Coverage Provided*
- *Adequacy of Limits / Reinstatement*
- *Exclusions*
- *Hold Harmless if Coverage Exhausted / Gaps in Coverage*
- *Ability to Obtain Excess Coverage*
- *Contractor's Assessment of Program*

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Risk Management & Credit Evaluation

8. Succession Planning

- *Management / Operations*
 - *Identify Key Management*
 - *Incentives for Retention of Key Management*
- *Financial*
 - *Buy / Sell Agreement*
 - *Adequate Life Insurance on Majority Owners*
- *Mechanisms*
 - *Gradual Transition to Next Generation/Key Management*
 - *Old Co./New Co.*
 - *ESOP*
 - *Private Equity**
 - *Orderly Wind Down of Operations*

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Risk Management & Credit Evaluation

9. FIN 46 and FIN 48 Impact

- ***FIN 46***
 - *Show Consolidating Financial Statements*
 - *Explain Nature of Obligations on Behalf of the VIE*
 - *Present a Clear Picture of Operating Company Balance Sheet, Earnings and Cash Flow*
- ***FIN 48***
 - *Reduces Judgment in Assessing Deferred Tax Benefits/Liabilities*
 - *"More Likely than Not" Standard*
 - *Magnitude of Impact Unclear*
 - *Surety Discussion with CPA May Be Necessary*

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Portfolio Management

1. Aggregation
2. Credit Quality
3. Capacity
4. Term
5. ROE
6. Mega Projects
7. Low Penalty Bonds
8. Resource Allocation

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Portfolio Management

1. Aggregation
 - *Concentration of Risk*
2. Credit Quality
 - *Rating Models*
 - *Impact*
3. Capacity
 - *Surety / Contractor*
 - *Financial*
 - *Organizational*

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Portfolio Management

4. Term

- *Larger Projects = Longer Completion Time*
- *Longer Completion Time = Greater Credit Risk*

5. ROE

- *Project*
- *Customer*
- *Surety*
- *Corporate*

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Portfolio Management

6. Mega Project Underwriting

- *Joint Ventures*
- *Length of Contract*
- *Contract / Owner Risk*
- *Capacity Impact*
- *'Complexity' Factor*
- *Low Penalty Bonds?*

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Portfolio Management

7. Low Penalty Bonds

- *Market Trends*
- *Impact to Capacity*
- *Underwriting Considerations*

8. Resource Allocation

- *Complexity*
- *Time / Cost / Benefit*
- *Benchmarking*

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Choosing your Professional Advisors

- | | |
|---|---|
| <ul style="list-style-type: none">• Accountant• Lawyer• Broker / Agent• Surety• Banker | <ul style="list-style-type: none">• Experience• Reputation• Availability• Timeliness |
|---|---|

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Surety Underwriting

Inside the Mind of a Surety Underwriter

Follow-up contact details

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