Contract Surety Market Report

Empower Results®

Aon Surety—The State of the Contract Surety Industry, Performance Security, and Risk Mitigation

As the construction industry enters new and uncharted territory as to how the COVID-19 virus may impact the performance of construction projects and performance security, Aon's Surety Group is evaluating how the surety industry is responding to the current environment, and what our clients can expect in the coming weeks. We also look at how performance security may function in this new and unprecedented environment.

In this new COVID-19 environment, there is no shortage of challenges. The surety industry's response will evolve and flex to meet our client's challenges over the coming weeks and months. Aon's executive leadership team, in conjunction with the entire Aon Surety team, is closely collaborating with surety industry executives to understand their response to the current environment.

The Top 10 Areas of Focus for the Surety Industry:

1. The overarching area of risk for every customer in all segments of the contract and commercial surety market will be liquidity—and the concurrent need to dissect every risk to a customer's liquidity, including:
   - Cash and liquid assets
   - Availability of credit lines and reliability of credit sources
   - How lenders are responding to the crisis, and whether lenders are continuing to lend
   - The importance of positive cash flow, including whether clients are able to reduce overhead and other fixed expenses during this period
   - Slow or delinquent payment from public and private owners
   - Slow or delinquent payment from general contractors to subcontractors
   - Understanding how any stimulus package may positively impact the financial health of your organization
2. The immediate focus of the surety industry over the past several weeks involves sectors whose operations have been shut down causing immediate liquidity risk such as retail, hospitality, aviation, travel and cruise lines. These businesses have been severely impacted by COVID-19, and there are immediate concerns around risk of liquidity and contagion not only during the period of essential shut down of operations, but also continuing risks as operations resume.
3. The surety industry has significant exposure to these "at risk" sectors which may result in a negative impact to both the performance of the surety's portfolio for that sector, and the overall performance of the surety book of business. Loss in one sector of the surety book of business may drive more conservative underwriting in other sectors of the book of business.
4. We expect increased underwriting scrutiny across the surety industry, and an increase in the amount of information and communication that will be required going forward. Certain higher risk obligations may be impacted including:
   - Projects with longer durations
   - Liquid "Pay on Demand" surety bonds
   - Alternative financial guarantee structures

5. Communication with the surety is essential, and all surety markets are expecting active and transparent dialogue. Key areas of communication include:
   - Status of current active projects including whether ongoing construction work has been halted or delayed
   - Major disruptions to the supply chain for the delivery of materials
   - Labor disruption
   - Subcontractor performance issues, and whether performance issues are widespread
   - Difficulty in implementing COVID-19 safety measures
   - The impact of new safety measures on the overall performance of the project
   - Deviations in expected 2020 results
   - Effect of any delayed project awards and bids on financial performance
6. Understanding whether project owners are continuing to pay for performance, and whether contractors are incurring costs for delays and inefficiencies for which they are not being paid.
7. For developers (including those with subdivision surety needs), transactions with Joint Venture/Special Purpose Entity structures will face higher scrutiny of project fundamentals including understanding project financing. Terms and conditions of surety support may be affected.
8. Certain surety markets may adopt stress scoring models to evaluate how the current conditions may impact the overall financial and operational performance of its customers.
9. Communicating with the surety markets any anticipated delay in audited financial results, as well as establishing clear expectations as to when 2019 YE results will be available.
10. Reinsurance support for the primary surety markets is critical to deploying surety capacity, and as reinsurance renewals continue over 2020, loss activity will impact reinsurance treaty terms

How May Performance Security Respond:

How a surety bond may respond in the event of a failure of either the general contractor, or a bonded subcontractor in the current environment, is a complex issue.

- The Performance Bond is a tri party contract between the Principal, the Obligee and the Surety. The terms and conditions of the Performance Bond should be carefully reviewed and considered.
- Consider if there is a contractual provision in the underlying bonded contract which excuses the performance of the Principal of the Performance Bond. Specifically, check carefully contract clauses regarding force majeure and termination. If there is a contractual clause which excuses performance, then the Surety may not respond to a declaration of default declared by an Obligee making claim on the Performance Bond. The Surety can avail itself of the contractual rights and defenses of the Principal.
- Also consider whether the Obligee has performed its obligations under the bonded contract which is required when making a claim on the Performance Bond. The Obligee must not be in breach of its contractual obligations under the bonded contract.
- If there is no contractual provision in the bonded contract which excuses the failure to perform by the bonded Principal, and the Obligee has met its obligations under the bonded contract, the declaration of default and claim under the Performance Bond should require the Surety to meet its obligations under the Performance Bond.
- The insolvency of the bonded Principal, is typically a default under the bonded contract which would allow a claim under the Performance Bond subject to the laws of bankruptcy.
- In the event that Subcontractor Default Insurance covers the project, the analysis would be similar in that a determination of a proper subcontract default is required. The subcontractor must be in default of its subcontract obligations in order to trigger the Subcontractor Default Insurance (SDI) policy.
- It is also critical that all insurance coverages in place and available including, business continuity insurance, be reviewed and considered for potential recovery of loss.

Risk Mitigation:

There are several risk mitigation strategies that may be helpful.

- Carefully review contracts to understand contract clauses on Force Majeure and Termination, and how those clauses may impact the obligation to perform the contract and/or the entitlement to additional compensation.
- Other contract provisions to consider when performance has been impacted include: **Price escalation provisions** in both the general contract and the subcontract; and provisions covering **schedule, delay, claims or a request for equitable adjustment.**
- Frequent and transparent communication is likely the strongest risk mitigation tool. This includes collective discussions with your peers and construction industry associations on potential solutions to the most pressing issues. Many industry groups host weekly calls to discuss current issues related to COVID-19 and their impacts on construction projects and opportunities.
- Direct and transparent conversation with Project Owners and Lenders is critical to form a true consensus partnership to resolve project impacts and contractual disputes. This is an industry crisis that requires a holistic view on relief rather than an adversarial approach which may exacerbate short-term impacts and lead to increased insolvencies.
- Have frank conversations with your subcontractors to understand the challenges they face in developing effective risk mitigation strategies. File contractual notices where appropriate, but continue to support subcontractors as they deploy resources to site.
- Perform a full risk assessment of your subtrade exposure. Evaluate the concentration and aggregation risk of all subtrades engaged and cross reference for risk factors such as

  A.) credit quality (cash, borrowing availability, quality of receivables)

  B.) critical path

  C.) supply chain resilience (Tier 1, Tier 2, and lower tiers)

  D.) geography and jurisdictional conditions.

  - Continuous qualification of subtrades should be triaged on this basis and involve direct engagement and interviews with subcontractor leadership
- Monitor the financial condition of your current subcontractor base on an ongoing basis. The economic disruption of COVID-19 may continue to flow through a subcontractor’s financial statements for at least 24 months and as such, continuous prequalification of enrolled subcontractors is important. Be sure to assess the impact of COVID-19 on subcontractors’ other projects.
- Understand what incentives and assistance may be available to you and your subcontractors at the state, local and national level to help mitigate financial loss.
- Increased project documentation is critical. Managing any COVID-19 cost or schedule impacts “after the fact” will require contractors to substantiate them via detailed cost and contract documentation, as well as accurate schedule data. Keep track of daily project logs and update your project schedules on a frequent and regular basis. As possible, consider having redundant copies (print and electronic), as feasible.

Summary

Aon's executive leadership team will continue to collaborate with the executive leadership of the surety markets to develop and agree upon appropriate strategies in the current environment. We will continue to provide you with updated surety market intelligence and offer guidance and solutions to support your surety needs.

Most importantly, we are committed to serving our clients in these challenging times and maintaining an open dialogue with you and your sureties to achieve the results you need to drive your business.

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