



Subcontractor Default Insurance Fundamentals

60-Minute Presentation

Florida Bar - RPPTL
CLE Webinar
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Aon
Empower Results®

Nomenclature



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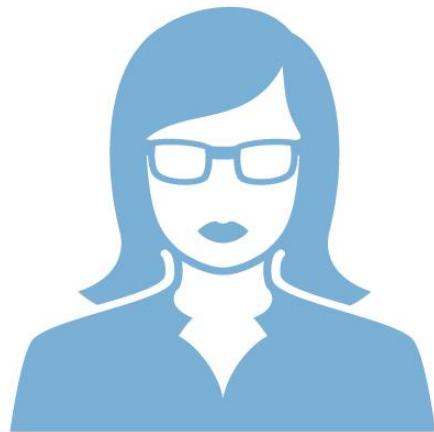
Aon is the largest manager of SDI volume. By applying our deep understanding of industry best practices, an Aon SDI program places you in the best position to achieve your goals. Whether you are targeting best practice in loss avoidance and mitigation, innovative technology solutions, competitive analysis, claim support, increased sales, or overall strategy development and process improvement, Aon provides executive planning support and program service. When it comes to putting the pieces of business and building together, we create the perfect fit.

Contractual Risk Transfer

The Owner requests the General Contractor to assume project schedule, quality, and budget risk within the Owner contract

Subcontractor performance is a significant risk to successful project completion

The Owner will not indemnify the General Contractor for this risk



Subcontractor Contract Default

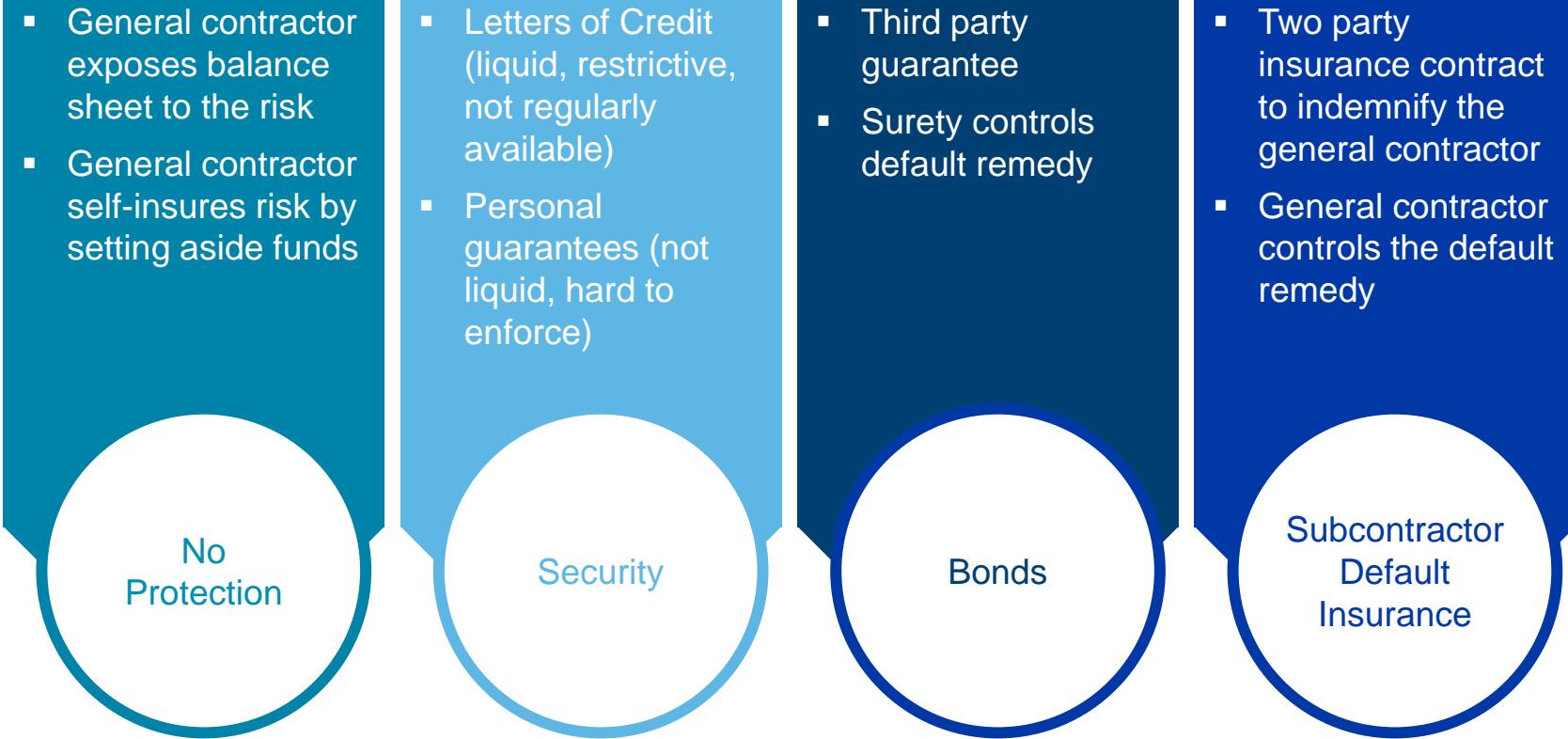
‘Material breach or a series of breaches of such magnitude the obligee is justified in terminating the contract.’

Bond Default Manual Third Addition, 2005

What is the price of a subcontractor default?



Risk Transfer



What is Subcontractor Default Insurance (SDI)?

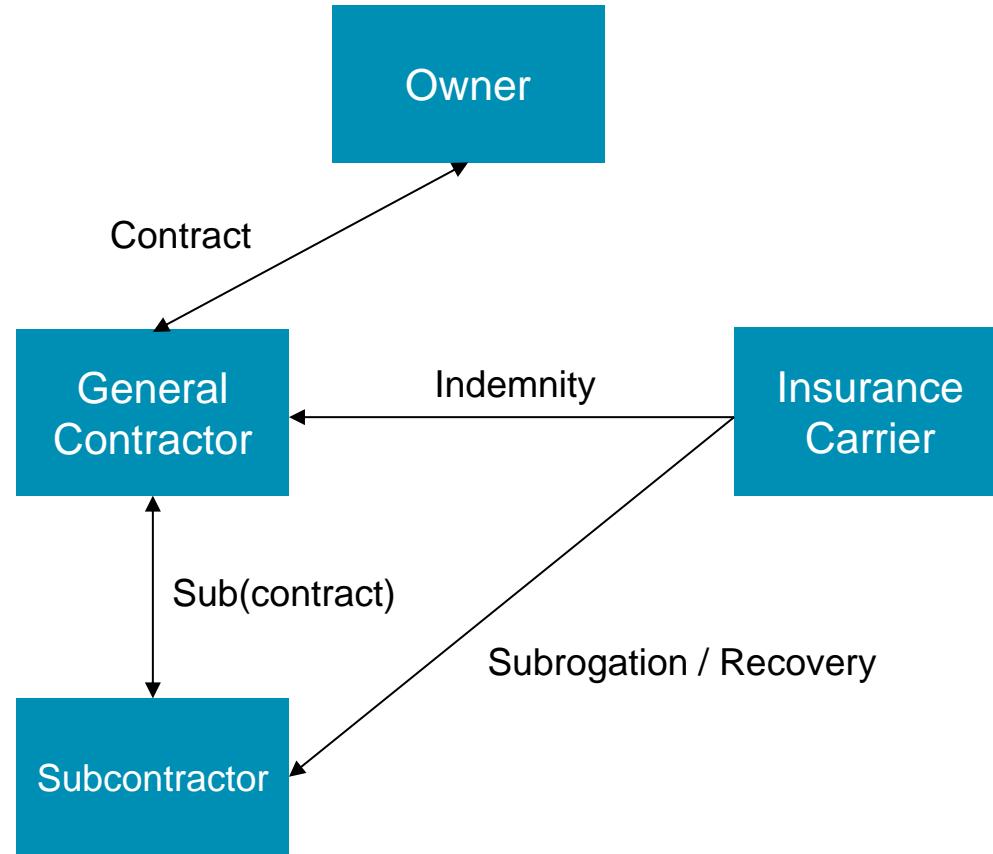
- ◆ Early '90's – sureties not paying claims. GC sureties requiring subs be bonded to shed risk.
- ◆ Mid '90's – Zurich invented the product "SDI" around underwriting the GC's ability to manage subcontracting risk
- ◆ Insurance alternative to subcontractor bonding
- ◆ First party, indemnification coverage with primary risk retained and catastrophic risk transferred
- ◆ 2010/2011 – Two new SDI carriers, Arch and XL/Catlin, with slightly different target markets and structure
- ◆ 2016 – New SDI carrier, Cove Programs (Lloyds)

Today

- Contractors purchasing SDI range from \$50 million to over \$5 billion
- 60%+ of the top 30 ENR Contractors*
- 50%+ of the top 100 ENR Contractors*
- 25%+ of the top 400 ENR Contractors*

* The % is higher if the contractors with low percentage of subcontracted revenue are not considered.

SDI Relationship Structure



What is Driving SDI Today?

- ◆ Lenders seeking more assurances the project will be completed on schedule
- ◆ Increased utilization of SDI by competition and acceptance by owners and lenders
- ◆ SDI benefits have become more apparent
- ◆ The cost of subcontractor risk continue to be massive:
 - Extended general conditions
 - Direct costs, liquidated damages, claims by other impacted subcontractors
 - Frustrated project team
 - Management distraction
- ◆ Surety products have not evolved



SDI Coverage Benefits

SDI Basic Coverage Overview

- ◆ Coverage of loss incurred by the general contractor to complete the defaulted subcontractor's scope of work
- ◆ Subcontractor default or termination triggers the policy; insurer has no right to challenge default
- ◆ Coverage limited by per loss and aggregate loss; applicable in excess of subcontract value
- ◆ Coverage subject to retention and co-payment by the general contractor; limits apply

General Policy Exclusions

- Fraud
- Acts of war / terrorism
- Nuclear events
- Architect or General Contractors' Errors and Omissions

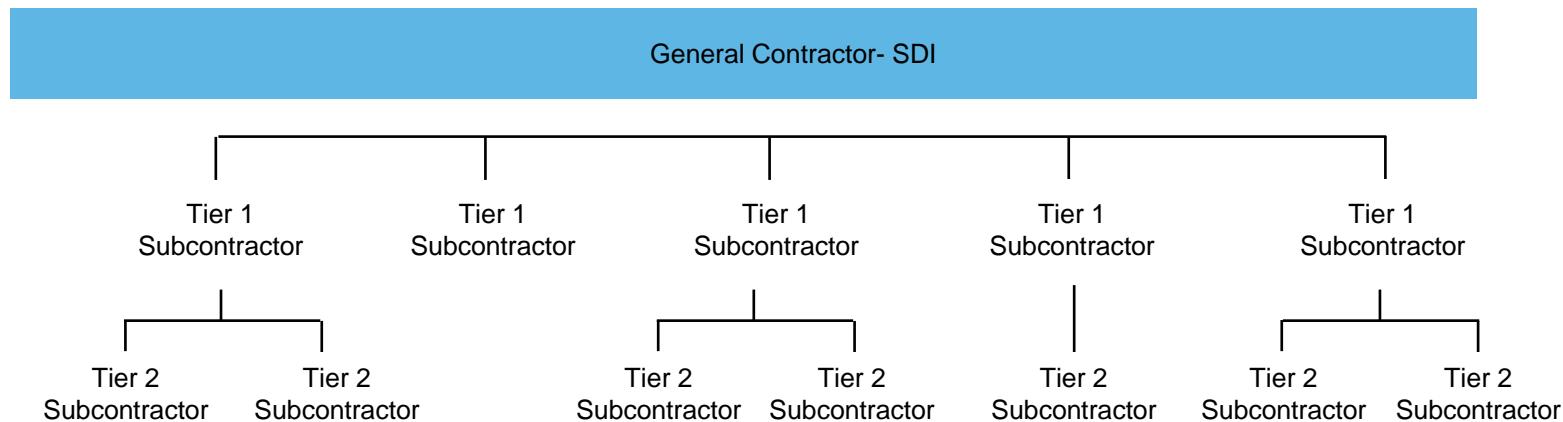
Benefits of SDI

- ❖ Contractor control over the solution
- ❖ Visibility into the outcome
- ❖ 100% subcontractor coverage
- ❖ MWBE program friendly
- ❖ Collaboration with insurance carrier adjusters through default on claim documentation
- ❖ Statute of repose coverage
- ❖ Avoidance of inefficiency and legal fees
- ❖ Increased margin with performing programs

SDI is Consistent “Top Down” Coverage

Characteristics

- One Insurer & policy (100% of subcontractors and suppliers are covered)
- Removed multiple bond forms, brokers, & attorneys
- Accepted by most lenders and rating agencies as equal to or better than subcontractor surety bonds



SDI Allows the GC to Control the Default Remedy

◆ Responsiveness

- General contractor can take immediate action
- Policy trigger is subcontractor ‘default’ according to subcontract
- GC has control of policy trigger (default) and scope remedy – works in best interest of project
- No need to provide justification of default to insurance carrier
- Minimizes disruption and costs (e.g. out of sequence work)
- Helps to ensure schedule is maintained, project is on time – on budget

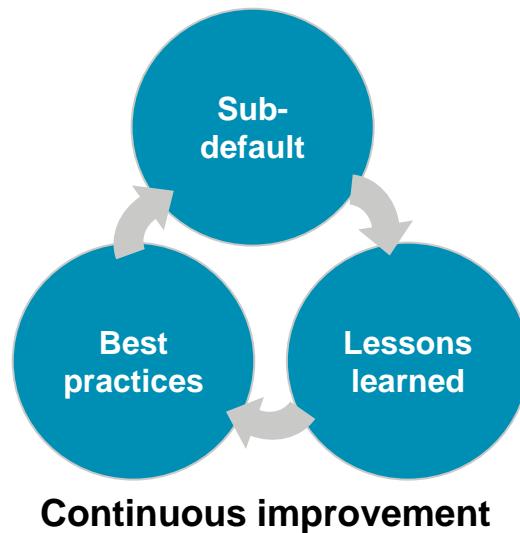
Other Related Benefits

◆ Indirect benefits

- Branding: SDI is only available to best in class contractors
- Access to risk engineering resources and SDI community
- The ability for the GC to quantify and perhaps profit from self-insuring a portion of subcontractor default risk encourages best practice in subcontractor selection and management

◆ Improved deal terms

- Owners are beginning to require/spec SDI (RFQ/RFP) as a reimbursable cost
- Lenders are providing improved finance terms with SDI





SDI Claims

When is a Claim Valid?



When a subcontractor is placed into 'Default'



When the subcontractor is at fault



When costs incurred in remedying a 'Default' results in a loss to the general contractor



When a claim is documented



SDI Trends / Obtaining an SDI Program

SDI Compatibility

◆ Partnership

- Insurance carriers are selective. SDI is not available 'off the shelf'
- The insurance carrier seeks to establish a long term partnership with the GC with shared SDI success

◆ Scope of work/GC philosophy

- Insurable Interest – 'At risk' construction
- GC risk culture and ability to assess counterparty risk

◆ The Assessment

- Review of GC reputation, potential volume commitment, market segments, geography, historical size of subcontractor contracts, subcontractor default history, financial and operational controls, as well as sophistication in how the GC manages growth

Aon Investments in SDI

- ◆ Knowledge in developing a platform for client internal SDI team structure
- ◆ Depth of talent and available resources available to you through our experience in both the construction and insurance industries
- ◆ Ability to leverage insurer relationships and SDI experience to provide clients with a program specifically structured for your risk culture
- ◆ Prequalification guidance and support
- ◆ Reinforce SDI enrollment objectives
 - Internal training for operations and technical services personnel
 - Customized SDI program internal users manual
 - White papers and statistical analysis based on extensive history as the leading volume broker in SDI
 - Actual experience in directly engaging with owners and lenders in SDI education
- ◆ Administrative efficiency and knowledge of your program through our national network of SDI client specialists
- ◆ SDI specific claims support and actuarial insights into industry losses
- ◆ Assistance with innovative solutions to current and future challenges

Aon Supports SDI Success

◆ Client Education

- Executive strategy development unique for each client
- Recommendations around financial and operational best practices
- Support the development of prequalification process' and customized program manuals
- Employee training from both insurance and real world construction experience
- SDI specific metrics and ongoing trends

◆ Underwriting

- SDI not available 'off the shelf'
- Deep relationships insurance carriers and understanding of underwriting appetite
- Preparation of underwriting submission
- Preparation for meeting with the insurance carrier and site audits
- Coverage optimization through negotiation

◆ Policy Management

- SDI specific actuarial support
- SDI claims preparation services
- Counsel to prevent policy mismanagement

Subcontractor Default Insurance (SDI) – 2016 Q2 Marketplace Summary

The Subcontractor Default Insurance (SDI) marketplace continues to deteriorate as more coverage restrictions and policy exclusions re-define historical SDI policy norms. Zurich, the dominant SDI insurance carrier, continues to communicate significant losses and in response issued a new Subguard® policy form in the spring of 2016. Zurich intends to lead the market with these changes; however, other insurance carriers have been slow to follow suit as general contractors take advantage of their more competitive policy terms. As a result, the underwriting of SDI has become increasingly more difficult with competing SDI insurance carrier resources struggling to keep pace with demand. While there have been no changes to the existing SDI policy forms outside of Zurich, both XL and Arch have communicated directional changes which further restrict their appetite and terms. There is an increased emphasis on SDI underwriting in order to obtain the broadest of available terms in a market where insurance carrier proposals are more nuanced with manuscript policy exclusions and other qualifications.

Currently, only Zurich and XL offer limits at a level acceptable to the larger general contractors. In June 2016, a new entrant into SDI, Cove Programs (Lloyds), placed its first SDI policy. Cove Programs recently communicated an end of summer goal of having limits competitive with those required by the majority of the larger Zurich and XL clients.

Category	Q2 2016 Direction	Commentary	2016 Outlook	Commentary
Pricing / Rates	↑	Rates continue to rise.	↑	Rate increases will continue to come into effect over the next three years as programs renew. Expect more tiered premium options based on project market segment and project coverage duration.
Limits	↔	No material change. Clients are maintaining limits purchased.	↔	No material change is expected.
Deductibles / Retentions	↑	Clients have elected to increase retentions to ease the pressure of the rate increase.	↑	Increased retentions will continue to come into effect over the next three years as programs renew.
Coverage	↓	Continued aversion to "for sale" residential portfolios and more limited coverage durations.	↓	This trend is anticipated to continue, along with limitations of exposure to certain trade classes.
Capacity / Appetite	↔	Capacity has increased with a fourth SDI insurance carrier option; however, risk appetite continues to be a challenge as insurance carriers further limit coverage terms.	↔	This trend is anticipated to continue.
Losses	↑	Claim activity increased significantly as losses continued to develop from coverage written during the 2010-2012 periods following the recession.	↔	Claim frequency and severity show signs of retraction as coverage becomes further distanced from the 2010-2012 policy periods.