

Bridge the gap on subcontractor risk

The current market means subcontractors are at increasing risk of going under, leaving main contractors in the lurch. A new insurance policy offers an alternative way to mitigate that risk. By **Simon Challis**



The recession ravaging Britain's construction industry means more firms in the building trade are disappearing each week. Main contractors are exposed to rising risks from failure of their subcontractors, so protecting themselves from this risk has become progressively more vital.

The typical approach is to buy a performance bond. But while this offers some protection against subcontractor failure, they typically cover only around 10 to 20 per cent of the overall value of the subcontractor's contract. "A bond does not provide protection against 'catastrophic' losses," says David Cahill, a Partner in Jardine Lloyd Thompson's Construction division.

For example, a 10 per cent performance bond on a £5 million subcontract would provide £0.5 million protection. A main contractor encountering a £3 million loss would therefore be exposed to the £2.5 million cost arising from the default.

For further protection, firms have taken

steps to mitigate the risk by adopting strong risk management procedures when letting subcontracts. This includes using fewer, but better quality, subcontractors.

The risk of failure

The risk of subcontractor failure has risen in the current tough climate, regardless of due diligence. Andrew Laird, Group Commercial Director of Wates Group, one of the largest building and construction companies in the UK, says: "Our biggest worry is 'left-field' issues: a subcontractor is performing well, they're making money, but other clients go under and don't pay them, leaving them with unpaid bills and their cash flow dries up. They could be good subcontractors doing well but the current environment kills them."

In addition, using fewer subcontractors means that one default could bring work on several construction sites to a grinding halt, causing a big loss for the main contractor.

There is now a third option for managing this risk, through insurance. Wates Group has

become the first UK company to buy a Subguard™ policy from Zurich Financial Services.

It offers greater peace of mind than performance bonds, covering far more of the risk. In the above example of a £3 million problem, a Subguard policy with an excess of £500,000 would allow recovery of £2.5 million. "This is essentially first party indemnity for balance sheet risk that hasn't been available until now in the UK," says Nils Sorenson, Product Manager for Construction at Zurich Global Corporate UK.

Subguard is not only triggered by the collapse of a subcontractor. "If the subcontractor doesn't fulfil the terms of his contract, let's say he withdraws from the site or tries to renegotiate the price, then that would trigger the policy. It offers broader coverage than simple insolvency protection," says Cahill.

Wates Group's advisers, Jardine Lloyd Thompson, persuaded Zurich to change Subguard policies in the UK to address

another weakness of bonds, which is that they do not tend to provide much post-construction protection. Bonds routinely last only for the duration of the construction period, despite the fact that the main contractor's liability to its employer may last for far longer. Subguard policies, on the other hand, last for six years after the subcontract period.

SUBGUARD™ VS PERFORMANCE BONDS: THE MATHS

- **A £5 million** subcontract suffers a £3 million loss
- **Performance bonds:** cover 10 per cent of the total deal value
- **Pays out** £500,000
- **Subguard:** covers the total cost of the problem with a £500,000 excess
- **Pays out** £2.5 million

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They also encouraged the insurer to amend the policy for the UK so that it can be assigned to the main employer in certain circumstances, such as if their main contractor becomes insolvent. "That is extremely attractive to them," says Sorenson. Cahill adds: "For a very modest increase in the contract sum, the employer can have this peace of mind." These changes mean the policy now better reflects the dynamics of the construction industry in the UK rather than in the US, where Subguard has been a feature for over a decade.

Those main contractors with managed supply chains are ideal candidates for Subguard, which insists on certain selection procedures in this area. "They have developed the controls that we value very highly. We see this market as highly attractive because a lot of the practices that we look for are often already in place," says Sorenson.

The underwriting involves an assessment of the processes for hiring subcontractors, which Laird says "was very good for us. It

was like having an external audit of our processes. We came out as having scored among the best they've ever seen in terms of the engagement and monitoring of subcontractors."

This feeds through to the price, with Subguard often working out to be as cheap as performance bonds. For Wates, the policy was actually cheaper than buying bonds.

It has also had an additional knock-on benefit of appealing to clients. "Our experience so far with clients has been really positive. Those who know we have it see us as being ahead of the game," says Laird. "Clients like to see their major contractor as being proactive; they want them to think about possible disaster scenarios and find ways to try to cover those. With this policy they see us as having done that." **RS**

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