Zurich Global Corporate
Comments on
Europe 2020 Project Bond Initiative

The solution proposed by the Europe 2020 Project Bond Initiative of providing guarantees or loans to project entities will definitely attract additional private sector financing of infrastructure projects. Any mechanism that transfers potential construction or operational risks from capital markets to other entities will have a positive affect on a project's investment-grade rating. However, the challenge of governments to attract private capital to finance essential infrastructure investment cannot be solved with a stand alone solution of guarantees or loans from EIB. There are other financial and performance solutions the EU-EIB should consider to attract needed capital for infrastructure projects. While each of these by themselves are not a total solution to the problem, combined they complement each other to allocate the risk to the appropriate party in the project transaction. This results in improved investment rating of the project and reduced financing costs. The success of the Europe 2020 Project Bond Initiative can be only be assured by addressing all available financial and performance options in a comprehensive risk mitigation package.

Zurich Global Corporate recommends Europe 2020 Project Bond Initiative include two specific performance support solutions that have a proven record of improving the credit rating of project transactions. One is a subcontractor default insurance, **Subguard,** and the other is **Adjudication Bond**. Unlike the proposed guarantees or loans from EIB, Subguard and Adjudication Bonds do not require the commitment of any EU funds. Yet, rating agencies have determined that both of these products provide credit support and contribute to project liquidity by transferring a liquidity-induced default to the performance support instrument. The result is the same as provided by the Europe 2020 Project Bond Initiative – Subguard and Adjudication bonds mitigate the risk of insufficient cash being available to deliver the capital asset on schedule, which raises the credit quality of the underlying asset. The end result is that this "credit enhancement" opens the financing of the underlying project to a larger capital market.

Subguard

Subguard is a subcontractor default insurance that indemnifies a main contractor from a subcontractor default due to either payment or performance. Over the last 15 years, more than 150 policies are in force in the US, Canada and Europe. It is used by 50% of the top 100 and 25% of the top 400 US contractors in the construction of schools, hospitals, prisons, office buildings, hotels, and other commercial buildings. It is widely accepted in the construction market by employers and lending institutions.

The fact that the Canadian PPP market requires Subguard to be used by the main contractors is a testament to the acceptance and benefits of the product.

The following are some of the key aspects of Subguard that are relevant to improving the credit quality of a project transaction:

1. Full policy limits are available to indemnify a main contractor for a subcontractor default (up to GBP 25 m per loss, GBP 50 m per project and GBP 5.0 m indirect sub-limit). This compares to a typical subcontractor bond providing coverage for only 10% of the subcontract value.
2. Main Contractor controls the default process per the terms and conditions of the subcontract agreement and determines the best remedy to cure the defaulted subcontractor. This requires no insurer approval and keeps the project on schedule and within budget.
3. Coverage is provided for construction period <u>plus</u> 6 years post-substantial completion.
4. Financial strength of subcontractors is improved by eliminating the need for subcontractors to provide bonds. (See attached <u>Construction News</u> article dated 10 March 2011, "Adversarial on-demand bonds return")
5. Provides balance sheet protection to the main contractor in the event of a catastrophic subcontractor default.
6. Indemnity benefits of the policy can be assigned to the employer or financial institutions in the event of main contractor insolvency.
7. A 15-year track record of paying over 600 claims.
8. Claims are paid within 30-days of receipt of acceptable proof of loss.
9. The policy pays first and appeals later in the event of a wrongful termination.
10. Product is backed by Zurich Financial Services Group rated A+ by AM Best and AA- by Standard & Poor.

Adjudication Bonds

Zurich Global Corporate UK has been at the forefront of specialist Surety bond market for more than 65 years and more than 12 years experience with PPP/PFI projects on an individual and syndicated basis. It too is backed by the same Zurich Financial Services Group noted above.

The following are some of the key aspects of Adjudication bonds that are relevant to improving the credit quality of a project transaction:

1. Surety bonds guarantee obligations of the Main Contractor in favour of the SPV (and generally its financial institutions as assignees) in the event of a payment or performance default by the Main Contractor.
2. Adjudication bond will not reduce the Main Contractor's lines of bank credit.
3. Adjudication bond is an adjudicated bond. Once the adjudicator has determined that the Main Contractor must effect payment due to a default, the bond becomes a 'pay-on-demand' instrument. This payment may be subject to subsequent adjustment through the courts only after payment has been made.
4. Appeal of an adjudication decision to the courts can only take place after the Main Contractor has made the payment determined by the adjudicator.

5. This ‘pay-on-demand’ is also available through the adjudication process to the Employer (SPV) or its assignees (financial institutions) in the event of the insolvency of the Main Contractor.
6. Adjudication has proven to work well in regions that have an established adjudication process. For example, awards in the UK are generally made within forty two days of the process being initiated and adjudication awards are subject to mandatory enforcement.
7. The Surety will make payment of any sum due within five working days.
8. These ‘pay-on-demand’ benefits of the Adjudication bond ensure the completion of the project construction to allow prompt commencement of service and generation of income stream to service the debt obligations of the SPV.
9. In circumstances of a total default and termination of the project, the Adjudication bond will secure (up to the agreed limit of the bond) payment of any balance due to the SPV from the defaulting Main Contractor which sum will be available to the funding institutions as assignees.
10. Product is backed by Zurich Financial Services Group rated A+ by AM Best and AA- by Standard & Poor.

In summary, Subguard and Adjudication bonds can improve the cash liquidity of the project transaction, which can contribute to a better credit rating and reduced financing costs. The benefits of both of these products are referenced in the attached Rating Methodology dated December 2007 from Moody’s Global Project Finance, “Construction Risk in Privately-Financed Public Infrastructure (PFI/PPP/P3) Projects”, Appendix C: Typical Performance Supports with North America – Subcontractor Insurance and United Kingdom – Adjudication Bonds. These products can be used individually on a project, but the real benefit of improving cash liquidity occurs when the products are used together. And projects can have access to both of these products immediately without waiting until 2014 for implementation.

To ensure the success of Europe 2020 Project Bond Initiative, Zurich encourages you to give serious consideration to include not only Subguard and Adjudication bonds but also address other financial and performance supports in your consultation paper that are currently available to the construction industry.

Respectfully,

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