



WHITE PAPER



What Contractors Need to Know Before Starting a Subcontractor Default Insurance Program

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Executive Summary

Subcontractor Default Insurance (SDI) has evolved from a niche alternative to subcontractor bonding into one of the most sophisticated risk management tools available to contractors today. Many of the industry's most successful contractors utilize SDI as part of a broader enterprise risk management strategy designed to provide greater visibility into subcontractor risk, increased flexibility in procurement, and enhanced protection against the financial and operational consequences of subcontractor default.

Despite its growing adoption, SDI remains widely misunderstood. Organizations often begin the evaluation process focused on premium, coverage terms, or carrier selection. In reality, the long-term success of an SDI program is rarely determined by the policy itself. It is determined by the contractor's ability to effectively identify, evaluate, monitor, and manage subcontractor risk.

While SDI is frequently discussed as an alternative to subcontractor bonding, the more important consideration is understanding and managing subcontractor default risk itself. The cost of risk does not disappear simply because a contractor utilizes payment and performance bonds, SDI, or even self-insurance. Each approach represents a different mechanism for financing and managing the risk.

For many organizations, the SDI evaluation process provides an opportunity to better quantify their subcontractor default exposure, assess the effectiveness of existing risk management practices, and identify opportunities to strengthen internal control. In that regard, the value of the process often extends well beyond the solution selected.

Successful SDI programs are built upon disciplined subcontractor risk management processes and an organizational commitment to proactive risk oversight. Organizations that approach SDI as a strategic business initiative rather than simply an insurance transaction are often best positioned to realize its benefits.

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Questions Every Contractor Should Ask Before Pursuing SDI

- Do we have a documented and consistently applied prequalification process?
- Can/do we obtain meaningful financial information from our subcontractors?
- Do we have the proper resources to continuously monitor subcontractor performance?
- Does our subcontracted volume support an SDI program?
- Do we have the right advisor guiding the process?

Organizations that can confidently answer “yes” to these questions are often better positioned to begin evaluating SDI opportunities.

Contractor Readiness: The Most Important Underwriting Factor

Many contractors begin their SDI journey by asking which carrier is the best fit for their organization. A more important question is whether the organization is prepared to succeed in an SDI environment. The most successful SDI programs share a common characteristic: operational maturity.

While financial strength remains important, underwriters increasingly evaluate how contractors identify risk, make decisions, document processes, and maintain accountability throughout the organization. Contractors that demonstrate consistency in procurement, project controls, subcontractor oversight, and executive governance are generally viewed more favorably than organizations relying on informal or decentralized processes.

This distinction becomes increasingly important because SDI effectively transfers subcontractor risk assessment responsibility from the surety to the contractor.

As a result, successful implementation often requires organizational alignment across operations, finance, risk management, procurement, and executive leadership.

Organizations considering SDI should view readiness as a strategic initiative rather than a prerequisite checklist. Organizations evaluating SDI often discover that the process itself creates value. Through collaboration with experienced advisors and SDI carriers, contractors gain access to industry benchmarks, underwriting perspectives, and best practices related to subcontractor management. These insights frequently help organizations strengthen existing processes regardless of whether an SDI program is ultimately implemented.

Understanding Today's SDI Marketplace

The SDI marketplace has matured significantly over the past three decades, yet it remains one of the most specialized segments within the construction insurance industry.

Unlike more traditional casualty lines where dozens of carriers may compete for the same risk the SDI marketplace remains concentrated among a relatively small number of carriers. While this concentration has helped maintain underwriting discipline, it also means that contractor and carrier alignment becomes critically important.

Not all SDI carriers evaluate risk the same way. Differences often exist regarding:

- Annual enrollment expectations
- Construction sector preferences
- Geographic appetite
- Single subcontractor capacity
- Aggregate program limits
- Growth objectives
- Claim's philosophy

Annual Enrollment Expectations

Enrollment volume remains one of the first considerations during market selection.

Some carriers focus almost exclusively on organizations generating substantial annual subcontract volume. Others may support smaller organizations if operational maturity and financial strength are evident.

Contractors should evaluate both current enrollment and anticipated growth when assessing marketplace options.

Capacity Considerations

Capacity discussions extend beyond aggregate program limits. Contractors should evaluate how carriers' approach:

- Large subcontractor exposures
- Mega-projects
- Joint ventures
- Emerging subcontractor utilization
- Geographic expansion

The optimal carrier relationship should support future strategic growth, not simply current operations.

The Foundation of Every Successful SDI Program: Prequalification

Disciplined subcontractor prequalification remains the foundation of successful SDI programs.

Most underwriters would agree that prequalification represents the single most important risk management component of an SDI program. While policy structure, carrier selection, and claims management all contribute to program success, the quality of subcontractor selection often has the greatest impact on long-term results.

Under an SDI framework, evaluation of financial strength and performance capabilities are the responsibility of the contractor. As a result, carriers expect contractors to demonstrate a structured methodology for identifying, evaluating, approving, and continuously monitoring subcontractor risk.

The most effective prequalification programs combine both financial and operational assessments to develop a comprehensive view of a subcontractor's ability to successfully perform its contractual obligations.

Financial Prequalification Methodology

Financial review is often the most visible component of prequalification, but it is frequently misunderstood.

The objective is not simply determining whether a subcontractor is financially healthy today. Rather, the goal is to evaluate whether the organization possesses the financial capacity and stability necessary to successfully complete future obligations under a variety of project conditions.

Strong financial prequalification programs typically evaluate several key areas.

Liquidity and Working Capital

Liquidity remains one of the most important indicators of a subcontractor's ability to absorb operational challenges. Contractors often view metrics such as:

- Current ratio
- Working capital trends
- Cash availability
- Access to banking facilities
- Line of credit utilization

Subcontractors operating with limited liquidity may be particularly vulnerable to schedule disruptions, labor shortages, material cost increases, or project delays.

Profitability Trends

Consistent profitability often provides valuable insight into management effectiveness and operational execution. Reviewing multiple years of financial performance can help identify:

- Margin erosion
- Revenue volatility
- Aggressive growth patterns
- Deteriorating operating performance

Trend analysis frequently provides greater value than a single-year financial snapshot.

Backlog Analysis

Backlog can be evaluated not only from a volume perspective but also from a quality perspective. Important considerations include:

- Concentration risk
- Geographic distribution
- Project complexity
- Customer diversification
- Remaining duration of work

A large backlog may initially appear positive but can create significant risk if it exceeds the organization's operational capacity.

Leverage and Debt Structure

Understanding debt obligations provides insight into financial flexibility. Areas of focus may include:

- Debt-to-equity ratios
- Equipment financing obligations
- Personal guarantees
- Debt maturity schedules
- Covenant compliance

Highly leveraged organizations may have less ability to absorb unexpected project challenges.

Cash Flow Analysis

Many subcontractor failures occur despite reported profitability. For this reason, evaluating cash flow is often equally important as reviewing income statements.

Strong prequalification programs seek to understand:

- Cash generation trends
- Collection practices
- Accounts receivable aging
- Reliance on favorable billing cycles
- Working capital management practices

Cash flow challenges often emerge before broader financial distress becomes visible.

Financial Red Flags

While every organization is unique, common warning signs may include:

- Declining working capital
- Significant revenue growth without infrastructure growth
- Consistent negative cash flow
- Heavy customer concentration
- Deteriorating margins
- Increasing leverage
- Late financial reporting

The objective is not to eliminate every subcontractor presenting risk, but rather to understand and appropriately manage that risk.

Operational Prequalification Methodology

While financial review often receives significant attention, many experienced SDI professionals would argue that operational evaluation provides equal, or greater, predictive value.

Subcontractor defaults frequently originate from operational failures long before financial deterioration becomes evident.

A subcontractor may possess a strong balance sheet yet still struggle due to inadequate management resources, labor shortages, poor project controls, or lack of relevant experience.

For this reason, operational prequalification should be viewed as a core component of the evaluation process.

Management Assessment

Leadership quality remains one of the strongest indicators of future performance. Evaluation areas often include:

- Ownership structure
- Executive experience
- Succession planning
- Project management capabilities
- Organizational depth

Organizations heavily dependent on a small number of key individuals may present elevated risk.

Workforce Stability

Labor availability continues to be one of the most significant challenges facing the construction industry. Contractors should evaluate:

- Workforce size
- Employee retention
- Union relationships
- Recruiting capabilities
- Labor productivity trends

Even financially strong subcontractors may struggle if they cannot maintain an adequate workforce.

Relevant Project Experience

Past performance remains an important indicator of future capability. Reviews should consider:

- Similar project types
- Comparable project size
- Delivery methods
- Geographic experience
- Client references

Organizations expanding beyond their historical expertise may require additional scrutiny.

Safety Performance

Safety performance frequently serves as a leading indicator of operational discipline. Evaluation criteria may include:

- EMR trends
- OSHA statistics
- Safety programs
- Training initiatives
- Corrective action processes

Strong safety cultures often correlate with strong operational cultures.

Quality Management Systems

Quality failures can create significant project disruption and financial exposure.

Contractors should seek to understand:

- Quality control procedures
- Inspection processes
- Documentation practices
- Deficiency management protocols

A proactive quality culture often reduces both performance risk and default exposure.

Technology and Reporting Capabilities

As projects become increasingly complex, contractors are placing greater emphasis on a subcontractor's ability to provide timely and reliable information. Areas of review may include:

- Project management systems
- Financial reporting capabilities
- Schedule management tools
- Documentation procedures

Organizations with stronger reporting capabilities often provide greater visibility into emerging risks.



Continuous Monitoring: The Difference Between Good and Great SDI Programs

Perhaps the greatest misconception surrounding prequalification is that it ends once a subcontract is awarded.

While prequalification establishes the foundation of an SDI program, many would argue that project-level subcontractor management ultimately has the greatest influence on long-term program performance.

Subcontractor default risk does not remain static after contract award. Financial conditions change, labor availability fluctuates, schedules become compressed, and project demands evolve. As a result, the effectiveness of field operations, project management teams, and leadership in identifying and responding to emerging concerns often becomes the determining factor between a manageable issues and a loss event.

Historically, a substantial portion of SDI losses have been driven not only by the direct cost of completing a subcontractor's work, but also by indirect impacts such as schedule disruption, extended general conditions and acceleration costs. For this reason, contractors should place equal emphasis on proactive risk mitigation during the project execution as they do on initial subcontractor selection.

Leading SDI programs routinely perform ongoing monitoring through:

- Updated financial reviews
- Field performance evaluations
- Schedule monitoring
- Payment analysis
- Safety reviews
- Management interviews

The ability to identify changing risk conditions before they become default events is often what separates mature SDI programs from average ones.

Ultimately, prequalification should not be viewed as an administrative requirement or underwriting exercise. It should be viewed as a strategic risk management discipline that supports stronger project outcomes, improved subcontractor performance, and long-term SDI program success.

The SDI Journey: From Internal Evaluation to Long-Term Program Success

Once an organization has determined it is operationally prepared for SDI, the focus shifts from readiness to execution. The SDI journey typically begins with an evaluation of program feasibility, market positioning, and long-term strategic objectives.

The most effective SDI programs are built on a foundation of operational discipline. Before engaging insurance markets, contractors should evaluate whether their existing subcontractor management practices can support an SDI environment.

This initial evaluation often involves stakeholders from operations, procurement, finance, risk management, and executive leadership. Organizations should examine how subcontractors are currently selected, how financial information is collected and analyzed, how performance is monitored during construction, and how risk-related decisions are documented and communicated.

For many contractors, this stage becomes an important discovery process. It frequently highlights strengths that can be leveraged during underwriting, as well as opportunities for improvement that should be addressed before approaching the marketplace.

A specialized broker assists through the readiness phase and feasibility.

Experienced advisors can help organizations benchmark their current practices against industry standards, identify potential underwriting concerns, and evaluate whether operational enhancements may improve market receptivity. In many cases, the advisor's role is to help the contractor understand how underwriters will evaluate the organization long before the first underwriting meeting occurs.

After coverage becomes effective, attention shifts toward continuous improvement and long-term program management.

Subcontractor risk is dynamic. Market conditions change. Labor availability fluctuates. Financial conditions evolve. Project complexity increases. As a result, the strongest SDI programs continuously evaluate and refine their risk management practices.

Leading contractors routinely reassess prequalification standards, monitor subcontractor performance trends, review claims activity, and benchmark program performance against organizational objectives. They view SDI not as an insurance product, but as an ongoing risk management framework that evolves alongside their business.

While operational discipline and strong risk management practices remain the foundation of every successful SDI program, contractors do not have to navigate the process alone. Experienced advisors can play a critical role in helping organizations evaluate readiness, navigate the marketplace, and optimize long-term program performance

Why Specialized Representation Matters

The SDI marketplace is unlike virtually any other insurance segment. Success depends on far more than market access.

Experienced advisors provide readiness assessments, underwriting strategy development, benchmarking, claims advocacy, market intelligence, and program optimization. The strongest advisors help contractors build sustainable risk management frameworks that support long-term growth.

“The right SDI advisor does more than access markets—they help build a sustainable risk management framework that can scale with the contractor’s business.”

SDI and Project Stakeholder Acceptance

Organizations evaluating SDI occasionally express concern regarding owner, lender, or project stakeholder acceptance. While these concerns may have been more common during the early years of SDI adoption, the marketplace has matured significantly.

Today, SDI is widely utilized on many of the industry's largest and most complex construction projects. Owners, lenders, and project stakeholders have become increasingly familiar with the product and its role in managing subcontractor performance risk.

Conclusion

As subcontractor risk continues to evolve, SDI is increasingly being viewed not simply as an insurance product but as an enterprise risk management strategy.

Organizations that invest in strong prequalification, disciplined operational controls, continuous monitoring, and long-term governance are often best positioned to realize the full benefits of SDI. Contractors that approach SDI strategically can strengthen project outcomes, improve resilience, and support sustainable growth.

About American Global

American Global is one of the largest privately held insurance and surety brokerage firms in North America, specializing in all aspects of construction risk management. We support contractors, owners, and developers throughout the entire scope of their project and across every milestone of their business, protecting against the risks and exposures specific to the construction industry. We have placed insurance, surety and subcontractor default insurance programs for some of the most reputable general contractors and construction management firms in the nation. American Global has multiple offices across the United States, Canada and Italy, to serve clients throughout North America, Latin America, and Europe.

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