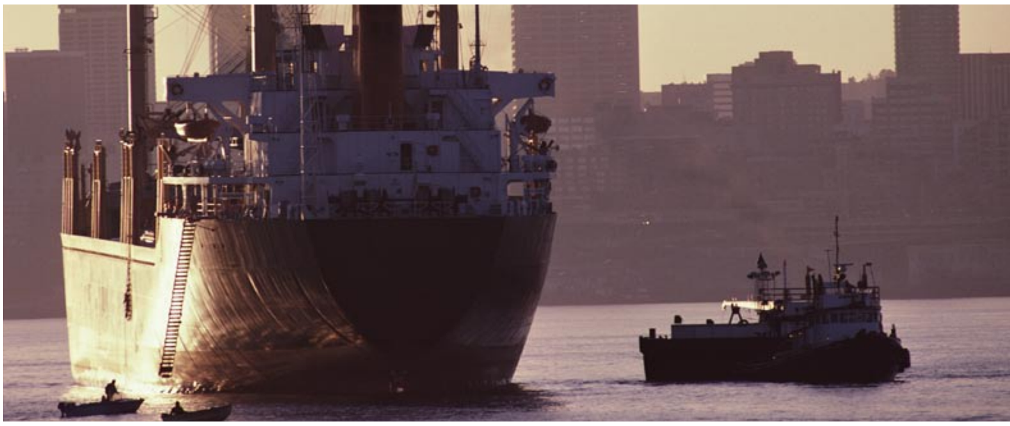
Marine Practice

MARSH

MARSH MERCER KROLL
GUY CARPENTER OLIVER WYMAN

Protection and Indemnity pre-renewal review 2009

With the Protection and Indemnity (P&I) Clubs' annual reports and accounts due for release on 20 February 2009, this document analyses the trends and developments within the marine P&I market throughout 2008, and identifies the impact on Club finances, and the consequences that will be felt by owners.



Introduction

A review of the Clubs' reports and accounts as closed in February 2008 presented a mixed bag of information.

At first sight, the Clubs seemed to have weathered the sharp upturn in claims experienced in the 2006 and 2007 policy years by the Pool and Hydra without too much damage to their funds. The identifiable dip in Free Reserves and Free Reserves per Gross Ton in the financial year to February 2008 is clear to see, but the Clubs' financial strength absorbed the sharp yet unforecast increase in net claims without undue alarm.

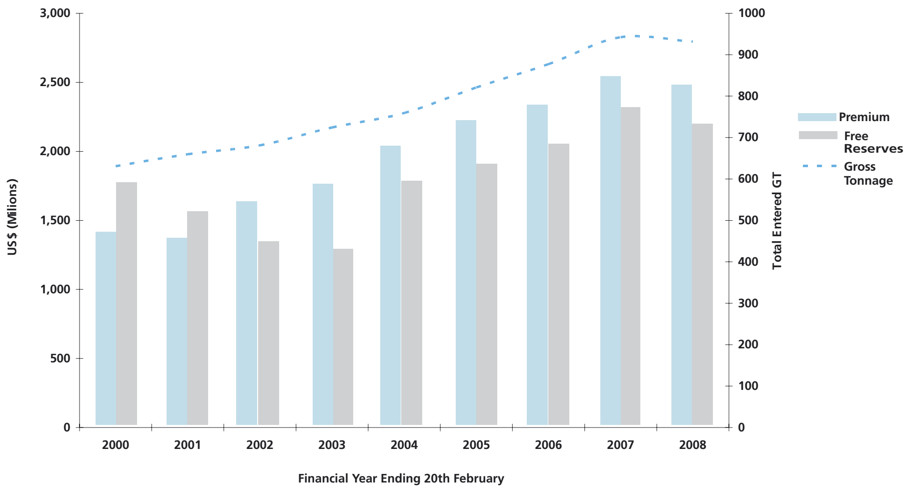
Upon closer examination, the pure underwriting results of the 2006 and 2007 policy years were already showing adverse figures, and figures that were negative enough to raise real concerns in future unless some remedial action was taken.

Identifiable trends

All the Clubs have seen growth in both Owned and Chartered Tonnage, which across all Clubs had experienced an eight percent compound annual growth rate in the five years since February 2003.

Call Income had correspondingly increased, but this growth only came in proportion with Tonnage, without the application of the theoretical increment for the Clubs' General Increases as shown in figure 1.

Figure 1: International Group of P&I Clubs
Growth over Time



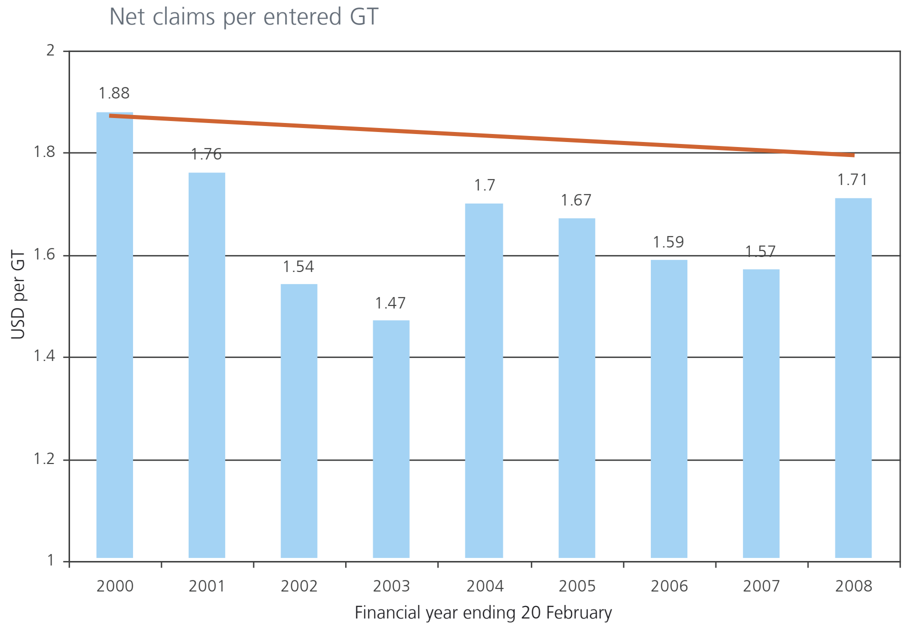
The Clubs have rebuilt their Free Reserves since 2003. Nevertheless, whilst Free Reserves held by the Standard & Poor's (S&P) 'A' rated Clubs increased at an average of just under 15 percent compound since February 2003, we have noted wide variation between Clubs, with the UK Club's reserves only increasing at 5 percent per annum, suppressed by continuing underwriting deficits.

Claims

Readers will have become familiar with the causes of 'Claims Inflation' and we will not reiterate these yet again. In summary, the five year growth in net claims incurred by the Clubs is close to 11 percent per annum.

That stated, this increase in claims can substantially be explained by the increase in tonnage and it is interesting to note that Net Claims per entered Gross Ton (GT) is on a clear trend downwards[1] which would be even more pronounced but for the year ending February 2008.

Figure 2: S&P 'A' rated Clubs (ex. Skuld)



Most Clubs reported further increases in the number and value of retained claims, being those under USD7 million. One of the leading Group Clubs, Gard, has experienced "an increase in the volume of reported liabilities [that was] higher than in the budget for the year, even when adjusted for business volume growth"[2]. The Standard Club has also noted that its members' own claims are running "higher than last year"[3] and this can be seen in the upturn in claims per GT for 2008

Largely as a result of the expectation that the claims experience suffered by the Pool would continue at significantly higher levels than hitherto, all the Clubs were driven, in the run up to the 2008 renewal, to seek big increases in the amount they budgeted for their contributions to the Pool. The UK Club and the North of England, in the announcement of their General Increases, went as far as putting a value on their estimates of the cost on the membership of the increased expense of Pool claims.

[1]Skuld excluded because 55 percent of entered GT is chartered
[2]Gard AS Circular No.8/2008
[3]Standard Club 2009 Renewal Circular

Table 1: International Group Pool – aggregate of notified claims excess of Club retentions to max USD50 million

Policy Year	Notifications in USD millions after stated months from inception					
	6	18	30	42	54	66
2003	41.5	131.7	138.4	137.8	139.0	127.2
2004	43.6	258.6	279.4	293.6	289.3	
2005	2.3	184.3	221.8	233.9		
2006	78.2	434.2	456.3			
2007	84.7	319.5				
2008	23.5					

2008/9 Pool claims, both in terms of frequency and severity, are running at levels very similar to the 2006/7 year, which went on to suffer so badly in the last quarter of the year. Since October, claims have started to accumulate and a removal of wreck claim is now expected to be added for the full USD43 million. At the time of writing Marsh understands (through discussions with the International Group) the two Pools have incurred just over USD100 million in claims in the aggregate.

The above triangulation is as presented in Steamship Mutual's Mid-Year Review and only records claims incurred in the Lower and Upper Pools. It makes no provision for the Club's liability arising out of Hydra's 25 percent share of the First Excess of Loss Layer. Other Clubs have re-asserted their expectation that combined with this last element and some deterioration recently noted, the ultimate settled Pool liability for both 2006 and 2007 will be as high as USD650 million each year.

Certain Clubs such as UK, Gard, and Britannia have noted a declining level of confidence in their ability to predict final claims outcomes alongside the deterioration in old year claims, particularly personal injury claims and, accordingly, have added to their provisions for known claims and IBNR at February 2008. Others, Standard Club, and Steamship Mutual for example, felt that they could release old year provisions as having been over-stated. Only time will tell if this action will be proven to have been prudent.

Finally, Clubs have been able, for reserving purposes, to discount claims to the current net present value of claims that will be payable in the future. The all time low base rates and returns on equities will suppress the rate at which claims can be discounted. We have not tried to quantify what the effect of this might be, but it will indubitably put further strain on Clubs' results at 20th February 2009.

Free Reserves and Total Assets

Free Reserves across the whole Group fell back five percent in the year to February 2008, although the aggregate Free Reserves of the S&P 'A' rated Clubs marginally increased.

On the other hand, on the basis of Free Reserves per Owned (approximating to Mutual) GT basis, there was an appreciable drop off in the financial year up to February 2008 after having suffered from a bulge in claims activity as well as some of the 2006 and 2007 Pool and Hydra as described above.

Marsh tracks the trended performance of each of the Clubs using various key measures:

- Free Reserves per Mutual Gross Ton
- Free Reserves as a percentage of Call Income
- Total Assets per Mutual Gross Ton

With this data, comparisons can be drawn between the performance of each Club against the average and those of their peer group.

Conclusion

At 20th August 2008 most Clubs could have been described as being in reasonably good health. Arguably too reliant on increases in the value of the funds earmarked to pay claims, and open to criticism for not having achieved rate increases when owners could have afforded them to have produced sounder underwriting results. Nevertheless, they had survived the claims spikes of 2006 and 2007 without suffering long-term damage.

What was to lie ahead of them in 2008, however, made the volatility of 2006 and 2007 look modest.

Investment of Club assets

This element of the Clubs' financial reporting is going to make dismal reading in February 2009 when the assets of each Club will be 'marked to market'. Assets last suffered erosion back in 2002, since when most Clubs have seen their advisers deliver strong financial performance, at least enough to enable the Club managers to advise that technical losses have been more than covered and surpluses have been earned and added to Free Reserves. This year will see dramatically different results reported.

Most Clubs have an agreed policy with regard to the proportion of the assets that should be invested in equities. Standard even mention a Board imposed obligation to have held a minimum of 30 percent in equities. UK Club, on the other hand 'came out' of equities in October 2007, but state that they will still incur an unrealised decline of up to USD30 million in the value of their claims funds, largely attributable to loss in the value of funds held in Pound Sterling, Yen and Euros which have all devalued against the U.S. Dollar, reversing the trend of the past few years[4].

Looking back seven years ago (following the market correction post the dot.com boom), various Clubs resolved that they could not expect to rely on the investment of their assets to subsidise their underwriting, but the will to respect this discipline seems to have been eroded and in plotting each Club's movement in Free Reserves in comparison with their Investment Gains, it is only very rarely that the former exceeds the latter. **Few are the years in which the Clubs have turned in positive balances from the combination of their underwriting and expenses.**

Arguably, this is the way a Mutual should be run. Few owners would dispute the adoption of 'as close to at cost as possible' policies until surprises such as those seen in 2008 arise.

The fact that Clubs state their models permit them to underwrite for an underwriting ratio in excess of 100 percent advertises their reliance on a positive financial return to be able to grow to their Free Reserves, always assuming this is the Club's intent.

The 2008/9 year will see an end to the seemingly remorseless march upwards in economic activity (and the pressures it has imposed on shipping). It will, however, also tell of significant losses to the Clubs' cherished Free (or Contingency) Reserves, which act not only as their shock-absorber in years of unexpected claims volatility, but also the key component in meeting the Individual Capital Requirements anticipated by the implementation of Solvency II[5].

Gard attributed the mid-year loss they announced of USD49 million largely to the depletion of the value of their assets. North of England have hinted that they anticipate a depletion in their assets of approaching five percent of the value at 20th February 2008 and in anticipation of a flat investment market in 2009, have incorporated a 10 percent surcharge as a mandatory element of their General Increase to substitute for the expected loss of capital appreciation.

---

[4]There will be a benefit in U.S. Dollar terms of the cost of management expenses (UK Club estimate USD8 million).

[5]Date for implementation already delayed once to 2012, and thought to be further postponed.

West of England attribute a loss of USD80 million in asset values as at early November (a loss of 14 percent in value since February 2008) to the cause of levying necessary unbudgeted supplementary calls. The proportions of their assets invested in equities and Absolute Return Funds were not unduly high in comparison to their peer group. They have been the first to 'go public' with up to date numbers[6].

Applying a depletion rate of 12 percent to other Clubs' assets, the following could be the impact on Free Reserves:

Club	From USD at 20 Feb '08	to USD at 20 Feb '09
Gard	515 m	398 m
Standard	226 m	156 m
Steamship	186 m	105 m

Other Clubs that have expressed concern for the impact of losses in value have been the London Club and Shipowners. Britannia on the other hand are said to have had the prescience to have hedged their equity portfolio, so should be protected from the worst effects of the financial turbulence.

Most Clubs had reduced their exposure to equities by the end of November 2008, but the environment remains unpredictable, fluid, and volatile, making predicting even the short-term future highly speculative, inhibiting a return to the equity markets.

[6] http://www.westpandi.com

A premium base that has been the subject of self inflicted erosion

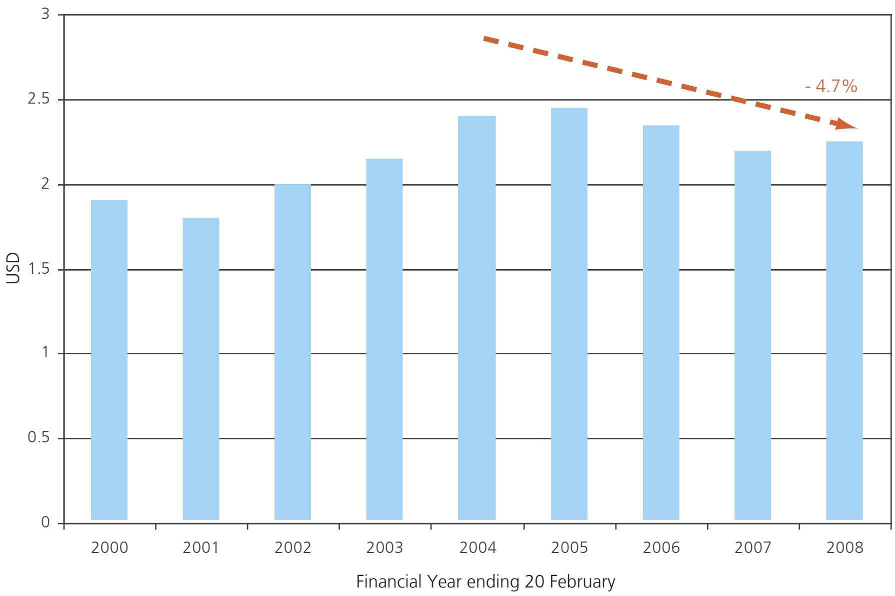
We are able to present evidence of the effect of 'The Churn'. This is the process by which multi-Club owners have been able to exploit, upon acquiring new tonnage either from a yard or second hand, one of the few areas of out and out competition between their Clubs.

First, the owner or broker promotes a 'duel' by tendering the new acquisition to his holding Clubs. Almost invariably the new tonnage is acquired at a marked discount to similar tonnage already entered.

Second, as old tonnage is retired, it has been replaced by more modern ships at discounts of as much as 60 percent, the older tonnage having paid successive General Increases.

In both cases, the Club's average USD call per GT reduces.

Figure 3: S&P 'A' rated clubs: Average cost of entered GT[7]
(owned and chartered)



Observation:

- Would it be excessively cynical to suggest some coincidence in the less than solid underwriting performance of certain (anonymous) Clubs, and the knowledge that in excess of a third of their entered tonnage is less than five years old?

[7] Data compiled from Clubs published reports

Reinsurance

Worldwide reinsurance capacity

The combination of Hurricane Ike, which is producing worse claims than originally anticipated and the depletion of Reinsurers' own capital, which cannot have escaped the recent global investment market downturn, will mean that available capacity will be stretched in the coming year.

Marsh expects many reinsurers (not least AIG) to reduce their commitments to rebalance their portfolios in the knowledge that capital will no longer be newly available to enable an entity to trade forward following a major catatastrophe, as was the case following hurricanes Katrina, Rita and Wilma in 2005.

Bronek Masojada of Hiscox commented in an article on Advisen's news pages: ". . . people are getting more cautious because of the financial hurricane, so demand is going up. . . .I see it continuing . . . If you think about the cost of access to capital, look at the spreads people are having to pay to borrow money. And that is applying to insurance as well because insurance in a way is a capital substitute. When the price of capital is low, insurance suffers. When the price of capital is high insurance benefits." The underlying message is clear and has been delivered in similar vein in a Press release by Munich Re[8]: prices are on the increase for all reinsureds.

Group excess loss rates

After six years of comparative stability for all but Passenger Vessels, Marsh predicts the International Group Excess Loss rates will suffer a double digit percentage increase at this renewal.

The first USD500 million layer will, for the first time, post adverse underwriting figures at renewal for the five years up to and including 2007. The deterioration in back years' results is to be noted – a figure of USD270 million has been mentioned since renewal in early 2008, some of which, it is strongly felt, could, or even should, have been declared at the time of last year's renewal and taken into account then.

Three years out of the past five are expected to settle in excess of 125 percent of earned premium, capped by 2007 where the incurred loss ratio will easily exceed 205 percent.

The biggest loss recorded has been the Hebei Spirit, a stationary VLCC struck by a barge whose tow parted. Clubs will apply CLC limitation at approx USD145 million, above which substantial further claims will be paid, not least the defence of the Master who has been long detained.

The wreck removals of MSC Napoli and New Flame are prominent.

Lloyd's underwriters and professional reinsurers are waiting to see the new terms and will assess the adequacy of the rating as against the newly perceived levels of exposure. And those who are involved in the first layer,

[8] http://www.munichre.com/en/press/press_releases/default.aspx

need have no fear that if they decline the offer they might not see the higher layers. With a limit of USD3 billion to arrange, all lines are going to be welcome.

We have suggested that Dry Cargo owners should budget for up to a 15 percent increase in Group Reinsurance Rates. However, tanker owners can expect less favourable treatment.

Abatement protections

These are arranged on an individual Club basis, some on annual contracts, others on longer term aggregate arrangements. The increased volatility of the 2006 and 2007 policy years inevitably means adverse underwriting results with the consequence of increased costs and/or retentions, or a combination of the two.

If the individual Club retention is lifted (as we believe will be the case if not in 2009, then in the near future) a greater reinsurance limit will have to be bought or cover will attach at a higher excess point than previously, or some combination of these two. Irrespectively, more costs are to be loaded into the premium calculation.

Impact

All of the above means that Acceptable Loss Ratios are squeezed down as ever greater amounts of premium have to be earmarked for reinsurances and Pool claims.

We anticipate the Clubs will review a series of options to mitigate the increased rates that might be charged by the reinsurance market:

- increased Club retentions
- increased Pool limits so that reinsurers come on risk excess of USD75 million or higher (to escape the demand for pay back?)

Both of which would exacerbate the exposure to volatility on Clubs' finances.

- And wasn't it in part the volatility of the 2006 and 2007 Policy Years that contributed to the need for a second successive year of high General Increases?
- And will this not make meeting the Capital Assessments tests for Solvency II even tougher to pass?

We understand the idea of an increase in Pool limits has been discarded this year, having been surprised it was ever seriously debated.

Double Tapping

The Clubs have sought to pass on increases in the Group Excess Loss premium allocations over and above their General Increases – which themselves are charged on a composite premium, including the Group Excess Loss premium allocation.

Over the past few years this has not been an issue for tankers and dry cargo vessels where adjustments have been of such a negligible nature that the additional costs have been deemed irrelevant.

Using the example of a Suezmax Tanker, entered with a Club that is seeking a 15 percent General Increase plus the Marsh estimate of USD0.09 per GT increase in the excess loss charge:

- the member will actually pay an increase of approximately 22 percent

Plus

- the Club will benefit from an increase in retained premium of 29 percent

We have been advocating greater transparency in this respect: we incline to the way West of England charge their General Increases – charges are against Club retained premium only.

Pool

The Pool limit has already been mentioned and it is expected to remain static this year.

We do expect, after much pressure from the UK Club, Gard and Standard Club, a restructuring of the Pool such that:

- the Upper Pool is merged into the Lower and the calculation of all Pool contributions will be based on the existing Lower Pool formula, i.e.:
    - one third Tonnage
    - one third Premium
    - one third according to individual Club's loss experience

This will be favourable to UK Club, for example, where their Upper Pool exposure was approximately 18.5 percent and is expected to fall to around 14.5 percent.

- the period over which a deficit is recovered will be reduced through
    - the lifting of the cap in the loading imposed on a Club for having introduced an adverse balance to the Pool

  Plus

    - Shortening the period over which contributions are made

Others expected to benefit from these changes are Standard and Britannia, while those likely to be adversly impacted will be found amongst the smaller Clubs such as West of England, American, and Swedish Club, due to their claims record.

Summary

There is a profusion of elements combining to make the coming renewal fascinating and, to call the final outcome for many owners, highly problematic. Much will depend on the underlying health and circumstances of the individual Clubs and strategies will be prepared with this in mind.

- A resolve to 'get the underwriting right' is going to be key for many Clubs. Managers will not be able to go on writing to a 108 percent loss ratio expectation in the anticipation that their losses will be recovered from the performance of the investment of Club funds

- The erosion of the value of Clubs' assets will impede the progress made towards meeting the capital tests behind Solvency II and will necessitate a determined and extended re-building of Free Reserves over the next few years.

There is little doubt in our minds that the significant fall off in the value of Club assets is going to dominate this renewal round.

Thereafter – and looking ahead to 2010:

- a new pattern of world trade will result in a reduction in the premium base: vessels are being laid up, some new buildings will not be delivered to the original purchasers, there is likely to be less pressure on officers and crews, commodity prices are falling, charterers' activity is already being cut back.

  On the other hand, experienced Club claims handlers have seen increases in crew injuries in a downturn in activity and the frequency of steel claims, for example, goes up as a 'make do' attitude in a period of high demand is replaced by the ease with which cargo claims can be pursued against owners for water damage etc.

  Conclusion – a trend downwards in exposure is unpredictable and so has to be considered as remaining high through 2009:

  - how quickly the financial markets return to a sounder footing: the turmoil not only effects Club finances but is also inhibiting trade for the lack of liquidity

  - back year claims deterioration

  - 2008 and 2009 Pool outcomes

  - the attitude of Regulators and Ratings Agencies

Conclusion

Five Clubs have made unbudgeted supplementary calls – but for a variety of different reasons:

UK Club	■ identifiable underwriting deficits in Policy Years 2006 and 2007[9] ■ Probable deficit in 2008 as well Plus ■ the need to protect the USD100 million Hybrid Capital issue ■ Saved by the negligible equity exposure
London Club	■ Underwriting losses, Pool claims and the negative impact of the 'credit crunch'
Swedish Club	■ Deficits in 2006 and 2007 policy years Plus ■ three major losses introduced to the Pool sharply, mean that Pool contributions will rise ■ Supplementary Calls to be used to ring fence 2009 and future membership from the additional costs of Pool contribution over and above the levels prevailing prior to the incidence of the claims, i.e. to maintain competitive prices
American Club	■ Modus Operandi
West of England	■ Depletion of value in the Claims fund plus impact on Free Reserves ■ Continuing underwriting deficits, which were not 'fixed' following the 2006 announcement of Supplementary Calls

The severity of the effects of the financial turbulence is such that we do not assess any Club as being immune from levying Supplementary Calls. It will be a tribute to the financial resilience of those Clubs that survive the last three years in a position not to have to replenish their capital. To a degree, it will prove the case the Regulators have been making that Free Reserves need to be of sufficient size to be able to withstand the buffeting Clubs have recently experienced.

[9] http://www.ukpandi.com/ukpandi/infopool.nsf/HTML/Club_RandA

We expect:

- With no Club immune from the need for an unbudgeted Supplementary Call amid the financial market turbulence, these could still be levied on the 2007 or 2008 years

  Owners entered with those Clubs that have not made unbudgeted Supplementary Calls will be called upon by the managers not to haggle over the General Increase

- More movement of tonnage than has historically been the case whilst owners will seek to 're-balance' the split of their entries to reduce their exposure to the possibility of future unbudgeted Supplementary Calls

- The selection of the alternative/destination Club to be a more rigorous process than in earlier years

- Less or, possibly, no discretion in the application of Club Rules regarding Release Calls, particularly from those Clubs that have increased their Release Calls as a barrier to exit

Club selection:

Which are the Clubs where the fundamentals are sound?

- Not necessarily those Clubs that have suffered more than others from the external influences of the financial markets: investment strategy is endorsed, even determined, by the Club's Board

  The levying of Supplementary Calls must not be considered, given the circumstances of an individual Club's investment strategy, a 'bad thing' in itself. It might be unpalatable at the time but it is a legitimate short-term step to re-building the Club's assets. The alternative can be expected to be several years of stringent renewals to re-establish reserves from underwriting profit.

  The key is to understand why the Supplementary Call was needed.

  - Which are the Clubs that have shown themselves to have been capable of building up their Free Reserves in the rising market to enable resilience in the face of an external shock?

  - Which are the Clubs that have only survived on the back of investment appreciation?

  - Which are the Clubs that have a sound record in managing their prior years' claims?

  - How resolute is the management of the Club? Will they retain the loyalty of the membership? How successful will they be in imposing the General Increases that have been deemed necessary by the Club's Board?

  - How susceptible have they been in the past to the effect of the 'Churn'?

To close:

The suddenness in onset of global economic downturn has taken all those in the shipping market by surprise and is going to cause stresses in 2009.

The co-incidence of this downturn with the collapse of the financial markets is going to exacerbate the stress. So it will come as little comfort to plot out the past P&I market peaks as having occurred with similar timing

Table 2: Successive renewals of Average General Increases

Post 9/11		
2001	8.7%	a sprinkling of Supplementary Calls
2002	20.2%	
2003	21.6%	
2004	12.8%	
Early '90s		
1989	8.7%	Various unbudgeted Supplementary Calls - some as high as 100 percent - 1988, 1989, 1991 and above all 1990
1990	22.6%	
1991	33.3%	
1992	35.8%	
1993	13.6%	

The current round of Supplementary Calls and General Increases appears modest compared to past cycles. This evidence suggests that the current group of Club managers has been better prepared than historically to sustain some big knocks.

Free Reserves will be much reduced:

- has it been Club Boards who have endorsed or promoted a policy of restricting the growth of Free Reserves to the point they could have absorbed the volatility seen in 2008?

Or

- the managers who have suppressed prudence for fear of their Club losing tonnage to competitors?

Irrespective, the Clubs are driven to retrospective rating adjustments. Survival is the first instinct and then comes the obligation to re-build for the future. Worst of all is the timing of this for ship owners in a fast falling freight market.

We believe nobody is more aware of this than Marsh as your brokers.

International Group general increase history

P&I Club	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
American	5.0	10.0	12.5	25.0	17.5	10.0	10.0	10.0	20.0	29.0
Britannia Steamship	0.0	10.0	15.0	15.0	10.0	7.5	5.0	5.0	23.85	12.50
Gard	5.0	10.0	25.0	15.0	7.5	5.0	7.5	5.0	10.0	15.0
Japan	0.0	10.0	0.0	10.0	0.0	0.0	0.0	10.0	20.0	21.2
London	5.0	10.0	27.5	25.0	15.0	12.5	12.5	7.5	17.5	15.0
North of England	5.0	10.0	25.0	25.0	17.5	12.5	7.5	7.5	17.5	17.5
Shipowners Protection	0.0	0.0	20.0	15.0	0.0	0.0	0.0	5.0	10.0	10.0
Skuld	0.0	10.0	30.0	25.0	15.0	7.5	5.0	2.5	7.5	15.0
Standard	0.0	7.5	12.5	25.0	20.0	12.5	5.0	5.0	15.0	15.0
Steamship Mutual	5.0	10.0	25.0	25.0	20.0	12.5	5.0	9.0	15.0	17.5
Swedish Club	0.0	7.5	25.0	25.0	15.0	10.0	5.0	7.5	15.0	15.0
UK Club	0.0	7.5	20.0	25.0	17.5	12.5	12.5	7.5	17.5	12.5
West of England	5.0	10.0	25.0	25.0	13.0	12.5	5.0	5.0	15.0	19.2
Group Average:	**2.3**	**8.7**	**20.2**	**21.5**	**12.9**	**8.8**	**6.2**	**6.7**	**15.7**	**16.2**

Basis: Changes in estimated total call, plus International Group Excess Loss Rate adjustments, plus some obligatory deductible increases.

Supplementary Calls announced at 15 December 2008		Policy years		
		2006	2007	2008
Expressed as a percentage of Advance Calls	American	–	25	25
	London	35	35	25
	UK Club	20	25	20 est.
	West of England	20	35	45
	Swedish	35	35	Deferred

For more information please contact:

marinepractice@marsh.com

or visit us online at:

http://www.marsh.com

Marsh, the world's leading insurance broker and risk adviser, has 24,000 employees and provides advice and transactional capabilities to clients in over 100 countries. Marsh is a unit of Marsh & McLennan Companies (MMC), a global professional services firm with more than 55,000 employees and annual revenue exceeding $11 billion. MMC also is the parent company of Guy Carpenter, the risk and reinsurance specialist; Mercer, the provider of HR and related financial advice and services; Oliver Wyman, the management consultancy; and Kroll, the risk consulting firm. marsh.com / marsh.co.uk.