P&I Clubs’ Balance Sheets Strong But Performance Under Pressure Amid Strong Competition

Pricing is under pressure ahead of the February 20, 2019 deadline for the marine protection and indemnity (P&I) renewal for ship-owners. Competition in the sector remains strong, exacerbated by a growing fixed-premium market. At the same time, the P&I clubs’ ship-owning members continue to face challenging commercial conditions and are looking to reduce costs.

The P&I sector is dominated by the members of the International Group of P&I Clubs (International Group), which collectively insure approximately 90% of the world’s ocean-going tonnage. Of the 13 clubs, 12 have announced that they will not apply a general increase to P&I premium rates for the 2019/20 policy year. For the 2017 and 2018 renewals no general increases were announced.

As mutual insurers operating for the benefit of their members, the 13 principal clubs must balance the need to maintain their financial stability with the economic constraints of their membership. With free reserves across the International Group at a high level, bolstered by several years of positive earnings, balance sheets are strong and clubs are finding it difficult to justify general increases to members.

One club, the West of England Ship Owners Mutual Insurance Association (West of England), has announced a general increase for 2019. In its circular to members, the club noted the expectation that its free reserves will fall to a little below USD 300 million at year-end 20 February 2019 and that it does not expect to meet its target of achieving a three-year average combined ratio below 100%. Concerns underpinning the decision to announce a 5% general increase included rising trends in claims across the industry, the erosion of premium levels over recent years to a level considered unsustainable, as well as volatility in financial markets.

These performance pressures are not unique to the West of England, and it is likely that the free reserves of some other International Group clubs will be down when they report year-end February 2019 results. Strong investment performance has bolstered free reserves in recent years, but equity markets have been volatile over the 2018/19 reporting period, increasing the likelihood that exposed clubs will report overall investment losses for the year. If combined with another year of underwriting losses, clubs may be under pressure to introduce general increases for the 2020 renewal to support solvency buffers.

AM Best also notes that the absence of general increases from most of the clubs does not necessarily mean that rates will not rise for poorly-performing business at the 2019 renewal. Renewals in the sector are driven increasingly by analysis of individual loss records and risk exposure, with more clubs using deductibles to control exposure.

Underwriting Performance Deteriorates as Call Income Falls

The International Group reported an underwriting deficit of USD 42 million for the 2017/18 financial year, based on the combined accounts of the 13 principal clubs of the International
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On the same basis, the combined ratio rose to 101% from 96% in the prior year (see Exhibits 1 and 2). Performance varied significantly across individual clubs, with more than half reporting an underwriting loss.

The policy year 2017/18 was the first since 2013/14 that the clubs returned a combined underwriting loss. This was despite incurred claims remaining below the five-year average of approximately USD 2.5 billion (See Exhibit 3). Incurred losses rose marginally, by approximately 1.4%, while expenses were stable. However, call income fell by around 4% compared to 2016/17, negatively affecting underwriting performance.

Only two clubs, Shipowners’ Mutual P&I Association and Assuranceforeningen Skuld (Gjensidig) (Skuld), have achieved underwriting profits in each of the past five years. Both clubs have benefited from average loss ratios below 75%, which compares to a five-year average of 78% for the combined International Group.

For 2018/19, AM Best expects the clubs to return another combined underwriting loss as competitive market conditions due to overcapacity have continued to negatively impact call income.

The level of net incurred claims has been relatively low over the past three years, although there was a small uptick during 2017/18 (See Exhibit 3). The cost of claims has been increasing due to an upward trend in ship-owners’ liability limits and technological advances that now allow deep water wreck removal. However, the frequency of small to medium-sized claims has been below the medium-term average, helped by a fall in the age profile of vessels, technological advances in navigation, investment in loss prevention, and increases in club deductibles. In addition, a slowdown in world trade has led to fewer voyages by ships, lower cargo volumes and less
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competition for experienced crews, all of which are likely to have reduced the number of claims.

However, for 2017/18, data indicate that seaborne trading grew at a faster pace than the previous five years, supported by growth in the world economy of more than 3% (in global gross domestic product (GDP) terms). AM Best believes that this may have contributed to the small increase in net incurred claims over the same period.

The clubs’ combined expense ratio has risen steadily over the past five years (see Exhibit 2). However, expense trends vary and some clubs have maintained a steady ratio in spite of declining call income. The service offered by clubs is an important differentiator and demand for superior claims handling, knowledge of local markets, loss prevention advice and other services restrict the clubs’ ability to reduce expenses.

Investment Performance Affected by Equity Market Volatility

Boosted by strong equity markets, investment returns for 2017/18 were the best since before the 2008 global financial crisis. Twelve out of the 13 clubs reported a profit after tax for the year, with investment earnings generally offsetting underwriting losses. Overall, the combined net result for 2017/18 was a profit of USD 488 million, underpinned by non-technical earnings (mainly investment returns) of over USD 529 million.

AM Best notes that P&I clubs tend to have a higher appetite for investment risk than other non-life commercial insurers, with members taking a long-term approach to investment earnings and willing to tolerate year-on-year volatility. Overall, the proportion of investments allocated to equities (including mutual funds) has been fairly stable, standing at approximately 18% at year-end February 2018 (see Exhibit 4). Investment strategies diverge significantly across the International Group. For instance, American Steamship Owners Mutual P&I Association and UK Mutual Steam Ship Assurance Association have a relatively high appetite for equities. In contrast, the investment portfolio of Japan Ship Owners’ Mutual P&I Association consists almost entirely of cash and fixed-income securities.

Those clubs with a higher weighting to risk assets benefited from a good level of realised and unrealised gains in the 2017/18 policy year. However, financial markets have been volatile in 2018/19 and the investment earnings of these clubs are likely to be down for the year ending February 2019. Going forward, earnings are likely to be affected by continued equity market volatility. Also, as fixed-income securities and cash account for approximately 78% of the clubs’ investments, near-term returns will remain constrained by the prevailing low-interest rate environment.

Fixed-Premium Offerings – A Source of Competition and Diversification

The mutual market continues to face competition from commercial insurers providing fixed-premium cover, either directly or through managing general agents (MGAs). The main direct market participants are British Marine, owned by QBE, and MS Amlin, part of the MS&AD
insurance group (whose P&I offering was formerly branded Raetsmarine). Both offer limits up to USD 1 billion. MGAs offering fixed-premium cover include Lodestar and Hanseatic.

Lodestar’s principal capacity provider was RSA, but the insurer gave notice on the deal during 2018, announcing its withdrawal from delegated authority P&I. Lodestar, which was acquired by Ryan Specialty Group in 2018, now provides cover up to USD 50 million backed by Aspen. An additional USD 450 million is provided by way of an excess of loss policy placed with Lloyd’s syndicates and the company market.

Hanseatic was also acquired in 2018 by Thomas Miller Specialty. This deal, which completed in October, followed the broker’s acquisition of Navigators Management (UK) Ltd.’s fixed premium P&I portfolio (backed by Lloyd’s syndicates) in February 2018. Hanseatic’s capacity is provided by a consortium of Lloyd’s syndicates. The two acquisitions are part of Thomas Miller Specialty’s plans to expand its fixed-premium P&I position.

In addition, the majority of clubs in the International Group have introduced their own fixed-premium offering, usually targeted at smaller ships. The importance of such offerings to an individual club largely depends on the ship size segment in which it is operating.

The traditional mutual P&I cover offered by the International Group remains the preferred choice for large vessels operating internationally due to the high limits available and the ability of clubs to issue “Blue Cards”. These certificates provide a guarantee that ship-owners have adequate insurance in place (a condition of port entry), relieving them from additional local requirements.

Offering fixed-premium cover is just one example of P&I clubs diversifying into risks that cannot be pooled. A range of business models is evident within the International Group, with some clubs like Gard P&I and The Swedish Club writing substantial hull and energy (H&E)
books, and others, such as West of England and Japan Ship Owners’ Mutual P&I Association, taking a more cautious approach to diversification.

Skuld and The Standard Club set up Lloyd’s syndicates in 2010 and 2015 respectively. However, performance since inception has been disappointing. Skuld’s Lloyd’s Syndicate 1897, which is managed by Asta Managing Agency Limited, started writing marine, energy, cargo and liability business from January 1, 2011, but has reported losses on an annually accounted basis in each year. The Standard Club’s Lloyd’s Syndicate 1884, managed by Charles Taylor Managing Agency, entered into run-off for the 2019 year of account following losses reported on an annually accounted basis in each year of operation.

AM Best notes that business diversification can be beneficial to the stability of overall technical earnings. In years when the P&I account performs poorly, good results from the H&E account can compensate, and vice versa. Being able to offer a broader range of products can also enhance relationships with brokers and clients. However, expansion outside mutual P&I business can put member capital at risk, if growth is not accompanied by a prudent approach to underwriting.

**Favourable Reinsurance Renewal**

Overall, clubs in the International Group cede around 20% of premiums written. As part of the International Group pooling arrangement, participating clubs mutually reinsure one another by sharing claims in excess of USD 10 million (for the 2019/20 policy year). Additionally, the group buys reinsurance cover up to USD 3.1 billion in the open market. By negotiating as a group, the clubs are able to achieve better terms on their reinsurance protection than would be possible on an individual basis.

The International Group’s general excess of loss (GXL) reinsurance contract for the 2019/20 policy year was renewed with an improvement in terms that resulted in rate reductions across all vessel categories. This primarily reflected favourable large loss experience in recent years and surplus capacity in the global reinsurance market. Both the individual club retention and attachment point on the GXL contract remain unchanged at USD 10 million and USD 100 million, respectively. The changes made in the 2018/19 reinsurance renewal were kept, with individual clubs continuing to retain 7.5% across the upper pool layer which extends from USD 50 million to USD 100 million, with the group’s captive, Hydra Insurance Co. Ltd. (Hydra), reinsuring the balance.

The total capacity and upper limit of the GXL programme, as well as the capacity of the overspill protection, remain the same as the previous year. However, the limit of the first layer of the programme increased to USD 750 million from USD 600 million and the limit of the second layer increased to USD 1.5 billion from USD 1.1 billion. The limit of the third layer was unchanged at USD 2.1 billion. In addition, the private placement participation within the first layer has increased from 15% to 20% and a USD 100 million annual aggregate deductible (AAD) within the 80% market share of the first layer of the GXL was introduced, which will be retained by Hydra.

Changes made to the International Group’s reinsurance programme over the past two reinsurance renewals (2018/19 and 2019/20) increase individual clubs’ risk retention, either directly through their 7.5% participation in the upper pool layer or indirectly, through Hydra’s exposure. Although the increase in risk retention is understandable as free reserves are at a strong level, AM Best notes that it is likely to increase the volatility of underwriting earnings.
Individual clubs will continue to purchase their own reinsurance protection to cover claims below their USD 10 million retention. The level of protection purchased depends on each club’s risk appetite, and is influenced by the size of its capital base and its ability to absorb large losses.

During 2018, the International Group conducted an open market tender for the brokerage of its GXL programme. The tender concluded with the re-appointment of Miller Insurance Services, with AON Benfield added as co-broker on the International Group’s reinsurance programme.

**Brexit Adding Cost and Uncertainty**

UK-domiciled P&I clubs have historically utilised the European Economic Area (EEA) passporting system to conduct cross-border business throughout the EEA. However, when the UK withdraws from the European Union (EU) (and after the end of a transition period, if any), passporting rights that currently exist between the UK and the EEA are expected to cease. Once passporting rights are lost, UK-domiciled clubs will no longer be able to issue insurance contracts in the EEA.

In response, the clubs writing EEA business through UK-domiciled entities have been making arrangements to ensure that they can continue to service their EEA members when the UK leaves the EU. However, only two clubs had announced the authorisation of their subsidiaries by mid-February 2019. North of England Protecting & Indemnity Association’s subsidiary, North of England P&I DAC, received authorisation from the Central Bank of Ireland in January 2019. In the same month, The Standard Club’s subsidiary in Ireland also received authorisation.

The other International Group clubs writing EEA business through UK-domiciled entities are all in the process of setting up authorised subsidiaries in various EU locations. UK Mutual Steam Ship Assurance Association and Steamship Mutual Group are both setting up subsidiaries in the Netherlands, while Britannia Steam Ship Insurance Association and The London P&I Club have chosen Luxembourg and Cyprus respectively as the domiciles of their EU subsidiaries.

**Capitalisation Continues at Strong Levels**

The Clubs entered the 2018/19 year with record levels of free reserves following several years of good operating performance (see **Exhibit 5**). Although there may have been some erosion of capital during the 2018/19 policy year, due in part to financial market volatility, AM Best believes that balance sheet strength remains strong and that the majority of the clubs have robust capital buffers (see **Exhibit 6**).

Over the past five years, P&I clubs have improved their understanding of their risk-based capitalisation, encouraged by the implementation of Solvency II in the EU during 2016.

Clubs now have better insight into the impact that different
realistic scenarios have on their capitalisation, and most have clearly defined appetites for underwriting and investment risk. AM Best views the clearer articulation of risk appetite positively, as well as the general improvement in governance and enterprise risk management (ERM) standards throughout the International Group.

At a group level, nine of the 13 clubs report a solvency capital requirement (SCR) under Solvency II. At the end of the 2017/18 fiscal year, the clubs’ SCR coverage ratios varied from 158% to 266%, with six of the clubs achieving a ratio above 200% (see Exhibit 7). A significant contributor to these strong coverage ratios is the capital credit given to the clubs’ ability to make additional calls to members.

The ability to make such calls represents a proven source of financial flexibility for the P&I clubs and is viewed as a key strength. Supplementary calls constitute tier 2 ancillary own funds under Solvency II, subject to supervisory approval, and AM Best recognises this source of contingent capital in its analysis of clubs’ balance sheet strength.

However, the impact of levying such calls can be damaging to a club’s relationship with its members, not least if a club is alone in levying a call or if a call is made when ship-owners face difficult economic conditions. Therefore, the clubs need to take into account the volatile nature of P&I business and their exposure to riskier asset classes, as well as their members’ appetite for one-off capital contributions, when determining their target free reserve buffer over regulatory capital.

The accumulation of free reserves in recent years has strengthened clubs’ overall risk-adjusted capitalisation. However, it has also led to pressure from both their members and from brokers acting on behalf of those members for clubs to reduce prices. This, combined with a challenging
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Underwriting discipline to ensure financial strength is maintained. But, with interest rates still low and equity markets volatile, clubs need to increase their focus on claims environment, characterised by volatile loss experience and inflationary pressures on the cost of claims, means that clubs are struggling to achieve underwriting profitability. In AM Best’s view, there is a buffer in current levels of capitalisation to absorb these performance pressures. But, with interest rates still low and equity markets volatile, clubs need to increase their focus on underwriting discipline to ensure financial strength is maintained.

Exhibit 7
P&I Clubs – Key Figures 2017/18

<table>
<thead>
<tr>
<th>Company Name</th>
<th>Gross Premiums Written (USD millions)</th>
<th>Profit/ (Loss) Before Tax (USD millions)</th>
<th>Capital &amp; Surplus/ Free Reserves (USD millions)</th>
<th>Solvency II Solvency Capital Requirement (SCR) Ratio (%)</th>
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Notes:
1 Includes marine & energy business.
2 Combined accounts

Source: Best’s Statement File – Global, Best’s Statement File – Solvency II, AM Best data and research
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