Aon Risk Solutions
Global Broking Centre | Marine & Energy

P&I Mid-Year Bulletin
2018

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Market Commentary – All is well but there are challenges ahead

Having recently passed the mid-year point, we would like to take the opportunity to comment on both the financial position of the International Group and what to expect in February 2019. This bulletin also examines the fixed marketplace and provides a detailed analysis on club management structures.

It is naturally too soon to forecast 2017/18 with any certainty, but recent underwriting results are proving to be a mixed bag. In pure technical underwriting terms, the best performer was Britannia, with a 79% combined ratio, while the worst performer was London Club, with a combined ratio of 118%.

These results signal that claims are on the rise following what have been several benign years. However, the picture has been softened somewhat by welcome investment returns. We know that major claims are still a concern but attritional claims have been, and continue to be, managed more proficiently than in past years. Our P&I Passport highlights each clubs' performance in further detail.

Given the hardening in the reinsurance sector, and with it an increased appetite to retain risk, there is now even more pressure to get the underwriting right. Furthermore, we know there continues to be some deterioration in back years. Nevertheless, the swelling free reserves are evidence that the International Group is in good financial shape.

General increases to return

We have little doubt there will be some “talking up” of the market following recent soft renewals. Naturally we are a long way off February, but it will be a brave club that dares to post a general increase. However, increases will be back on the radar soon. One only has to look at how premiums have dwindled against tonnage in the past 12 months to gain some indication of the challenges ahead.

2016/17 GT 1,188M Premium (net call income) USD 3,954 M

2017/18 GT 1,227M Premium (net call income) USD 3,737 M

A 3.28% increase in GT and a 5.49% reduction in net call income across the International Group

This reduction in underlying net call income against an increasing tonnage base emphasises the pressure on returning positive underwriting results when core premium is being squeezed.

We have and will continue to champion mutual P&I and the continued lowering of deferred calls and capital returns are testament to the system. This income drop does, however, add more pressure to those clubs

Challenges ahead

The International Group is always at the forefront of managing key issues that the maritime industry faces and no doubt the ongoing sanctions will be yet another thorn in its side. There’s not a great deal of clarity just yet, but trade restrictions continue to apply and we may need revisit the issue of US insurers participating in reinsurance programme/s.

In our last bulletin, we highlighted that the International Group was yet to embrace a more collective approach to the sharing of information and IT. We are not suggesting clubs live in a time warp, far from it; but considering the pace at which the whole insurance industry is evolving, we suggest that a makeover in certain areas would both enhance the product and save costs. Indeed, could a collective programme have been sought on Brexit positioning?

The next few years may call for some careful navigation; but all is well and once again free reserves within the Group have never been higher.

Fixed P&I: survival of the fittest

The same could not be said of the fixed P&I arena. We have previously predicted that it will be a case of survival of the fittest and changes have been rife in the fixed market. Navigators was bought by Thomas Miller, augmenting its fixed premium offering, Osprey Underwriting. The MS Amlin group has shed a number of high profile personnel. Lodestar Marine was sold to Ryan Speciality Group, meaning it said goodbye to its well-respected claims team as this function has been brought 'in house'. There is also a strong suggestion that one or two other providers may be sold.

It is important to remember that the International Group has not let grass grow under its feet and each club now offers fixed premium, mostly to smaller units. A number of these trade individually, others under the club name. Either way, the clubs enjoy a better reception than some of the independent fixed providers.

MS Amlin and the long-established British Marine Limited (QBE) have the advantage, along with clubs, of being able to absorb costs while other independent providers do not have the necessary infrastructure. The latter are at the mercy of their insurance backers, being mostly Lloyd's and the London commercial market place. Heavy losses have been well reported, with a number of syndicates reducing personnel and even pulling out of marine altogether. It's no surprise there is a huge focus on product line and profitability and this raises questions over sustainability.

With the vast majority of world tonnage turning to the International Group to insure their vessels for P&I risks, which aims to provide cover at cost, there is little left to satisfy the hunger of the fixed market. Market share is an issue even more challenging than commanding the right pricing.

Historically the long tail nature of P&I business has never sat well with insurers so continuity is essential. The responsibility to provide acceptable security to enable vessels to trade freely is paramount.

Charterer's liability

If insurers struggle with fixed P&I premium levels, the Charterers' Liability market is not far behind. This sector has seen growth simply because more charterers are now choosing to buy cover in the first place. This trend, however, appears to be bottoming out and we see a similar scenario, with the International Group increasing its appetite for this class. A great volume of this business is not protected by the International Group Agreement and, therefore, there is no mechanism to keep rates buoyant. Yet again, commercial insurers figure heavily in supporting these vehicles so the same caveats to sustainability will prevail.

If anything bucks the trend, it is Freight Demurrage and Defence (Legal Expense cover) which, given the litigious world we live in, stands up well. While the fixed market does provide this class, it is more prevalent within the International Group.

A great deal of this success is a result of the clubs' respective defence teams. A number of experienced and valued hires has made this class mandatory for many. The International Group as a whole has done extremely well in keeping outside costs to a minimum and thus offering this integral service at cost effective levels.

For some providers of owners and chartered P&I, the future may not be plain sailing and some further consolidation is inevitable. Please refer to our P&I Passport for more information.

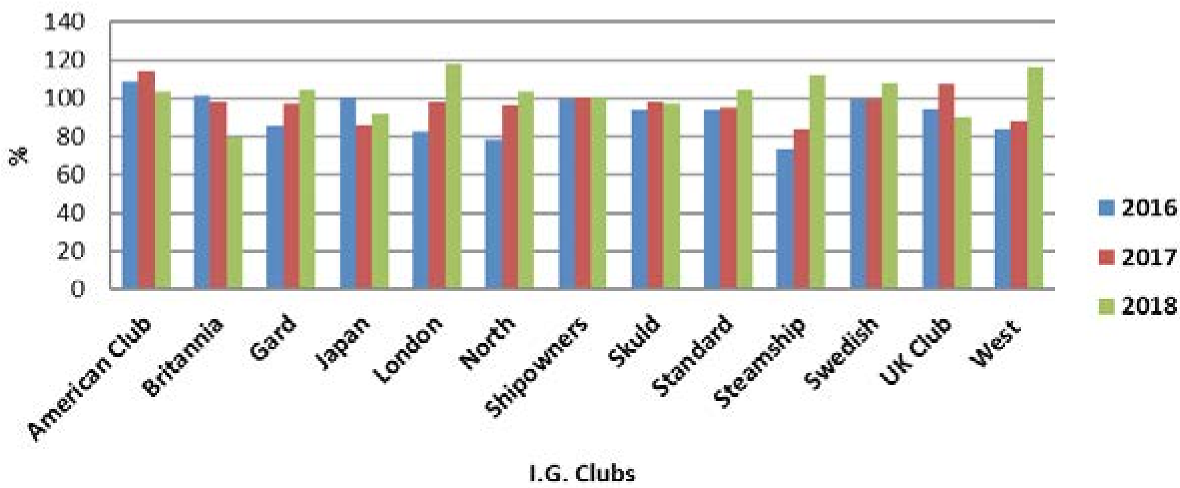
Financial results

All the International Group P&I Clubs have now released at least a summary of their financial performance for the year ending 20 February 2018. The results make for interesting reading, with a real disparity between the best and worst performing clubs. Investment returns played a more significant role than they have in recent years. However, the key theme remains that every club in the International Group today enjoys record levels of free reserves. Despite protests that the 'churn' is reducing rates to unsustainable levels and claims that an increase is on the cards, all the clubs have more money than they did at this time last year.

The Churn

In the P&I world, 'churn' is where new tonnage comes on risk at lower or more competitive rates than existing vessels, which have been through many renewal cycles. This means that as older vessels are sold or scrapped and new vessels enter the fleet, club premiums will inevitably reduce.

Combined ratios (%)

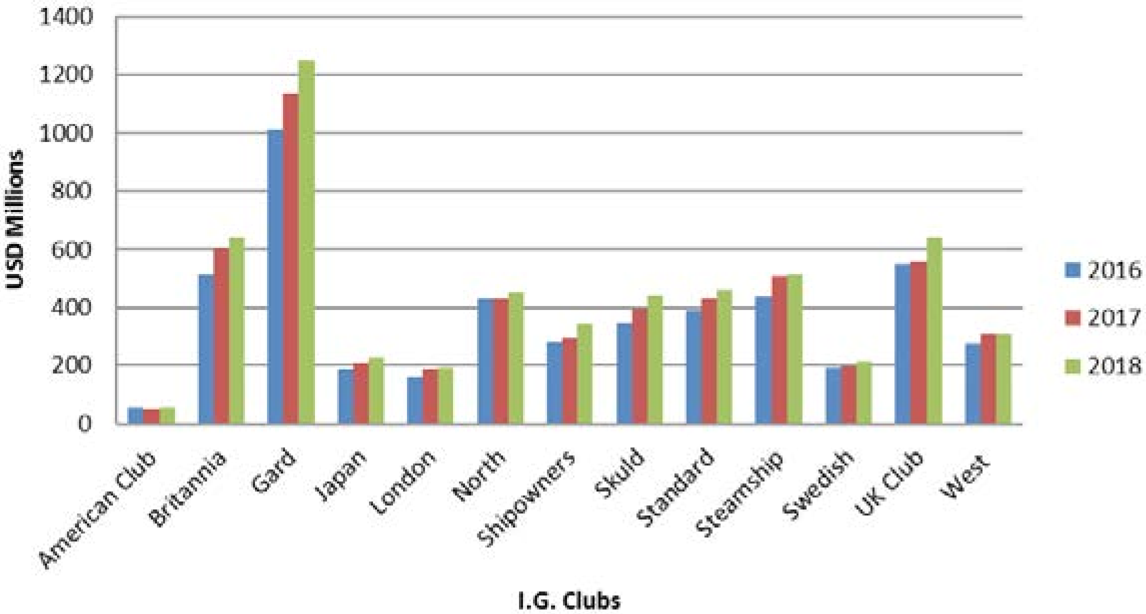


Combined ratios reflect the underlying underwriting performance of each club. A combined ratio is calculated by measuring a club's incurred claims plus expenses against premium, less reinsurance. It should be noted that combined ratios do include releases of prior year reserves and are therefore not always an entirely accurate snapshot of a club's performance in any individual year.

Since the global financial crash in 2008, the aftermath of which saw many clubs having to make supplementary calls, there has been a focus among clubs on underwriting to a combined ratio of around 100%, or break-even. This conservatism was based on the belief that investment returns could not be relied upon to subsidise poor underwriting. It was the result not just of board mandated strategy but also pressure from the Regulator and rating agencies.

For the last few years however, the clubs have been successful in underwriting to breakeven, or in many cases a profit. After a couple of years without general increases, this model is beginning to creak and this year we can see some high combined ratios, indicating loss-making books. The worst performing clubs are the London Club and West of England, with combined ratios of 118% and 116% respectively, while the best performers are Britannia at 79% and the UK Club at 90%. With the underwriting performances of some clubs significantly above 100% and the 'churn' set to cause further damage to clubs' premium income this year, there will inevitably be a few clubs that would like to ask for general increases at the 20 February renewal. Whether it will be commercially acceptable for them to do so is another question. Aon suspects not and we do not anticipate that any clubs will ultimately look for a general increase at this renewal.

Free reserves (USD millions)



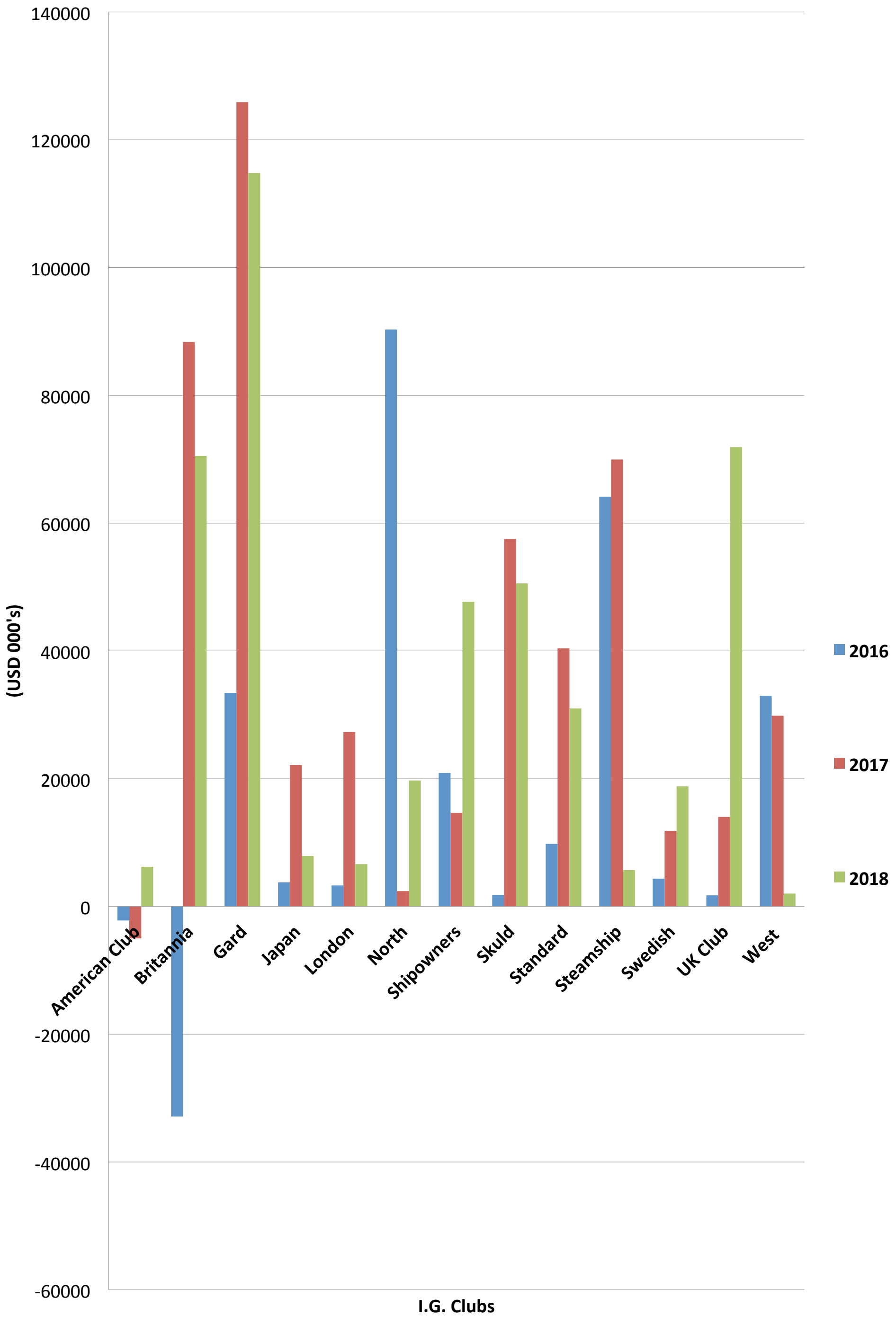
Another year and another round of sizable increases in free reserves for all P&I clubs. It has become a familiar story and one with which some members are becoming frustrated.

Unsurprisingly, the biggest increases in free reserve have been made by clubs with strong underwriting results. We can see the UK Club's free reserves increasing by USD 82 million and Britannia's by USD 40.5 million. However, there were also some huge increases for clubs that had fantastic investment returns, such as Gard at USD 114.2 million and the Shipowners' Club with USD 47.7 million.

It should be further noted that in July the UK Club announced that it had decided to redeem its USD 100 million hybrid capital bond. Free reserves will remain at USD 540 million but the club will no longer have the benefit of the additional USD 100 million of hybrid capital. The club will retain its AAA capital adequacy rating from S&P. In Aon's view this is a sensible decision as the Hybrid capital had become a hindrance to the club in recent years.

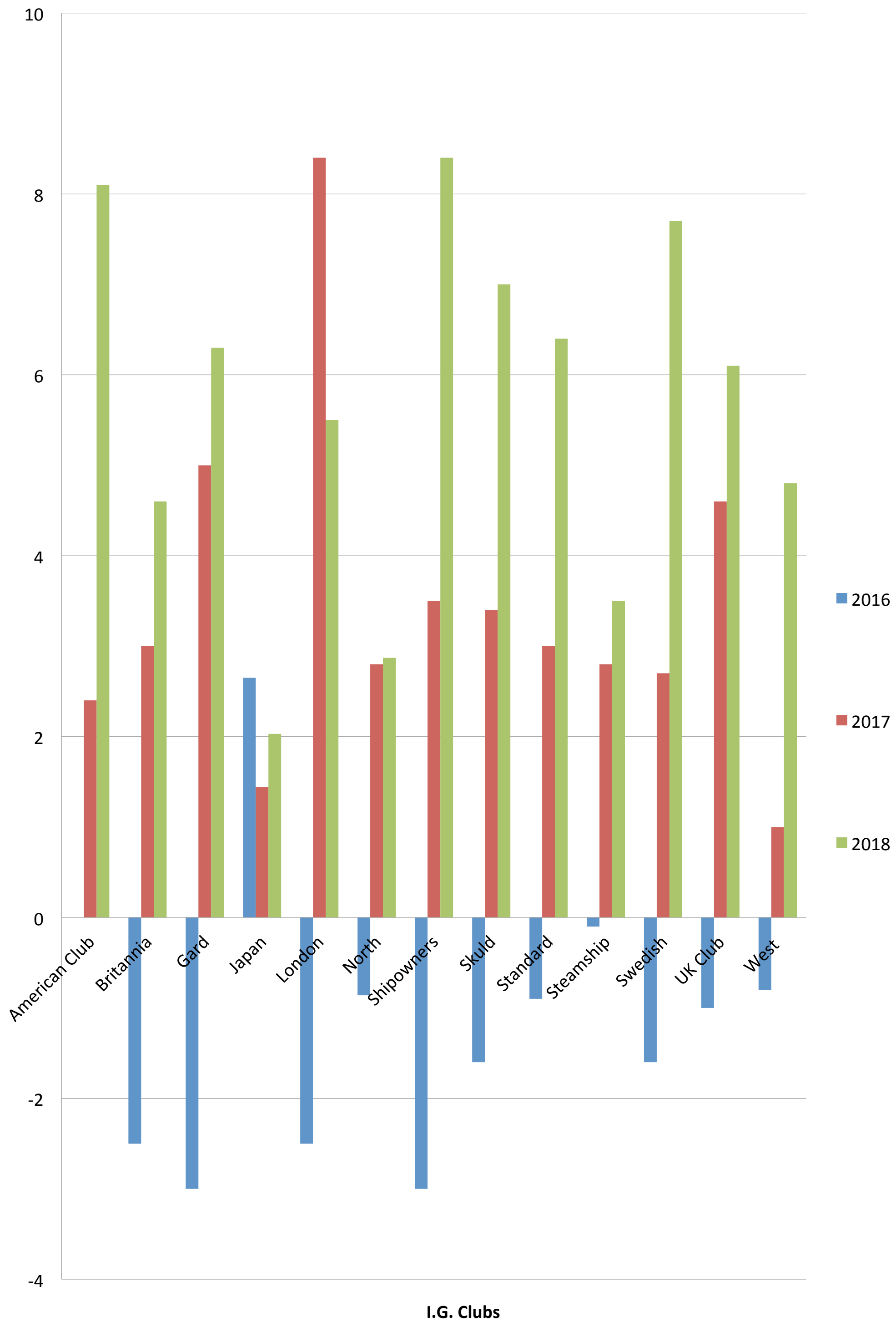
These investment returns are the real the story at this renewal. As we have discussed above, in recent years clubs have taken a conservative approach to underwriting and, with a lack of investment returns, these underwriting profits have led to free reserve growth. This year it is a different story as it is investment returns that have led to a growth in free reserves at many of the clubs. However, whether clubs have boosted their balance sheets via underwriting profits or investment returns is of little consequence. The point is they have amassed a considerable amount of wealth and it is Aon's view that, until there is a reduction in the level of free reserves held by the clubs, any talk of general increases should be challenged.

Overall result after investment income (USD 000's)



The graph above further reinforces our commentary, showing each club's overall financial result for the policy year, including investment income. In recent years, most clubs have enjoyed surpluses and this year is no exception, with each reporting a profit. The best results belonged to Gard at USD 114.8 million surplus; UK Club with USD 71.8 million and Britannia's USD 70.5 million. At the other end of the spectrum, the smallest surpluses were found at the West of England with USD 2 million, Steamship Mutual at USD 5.6 million and the American Club at USD 6.1 million surplus.

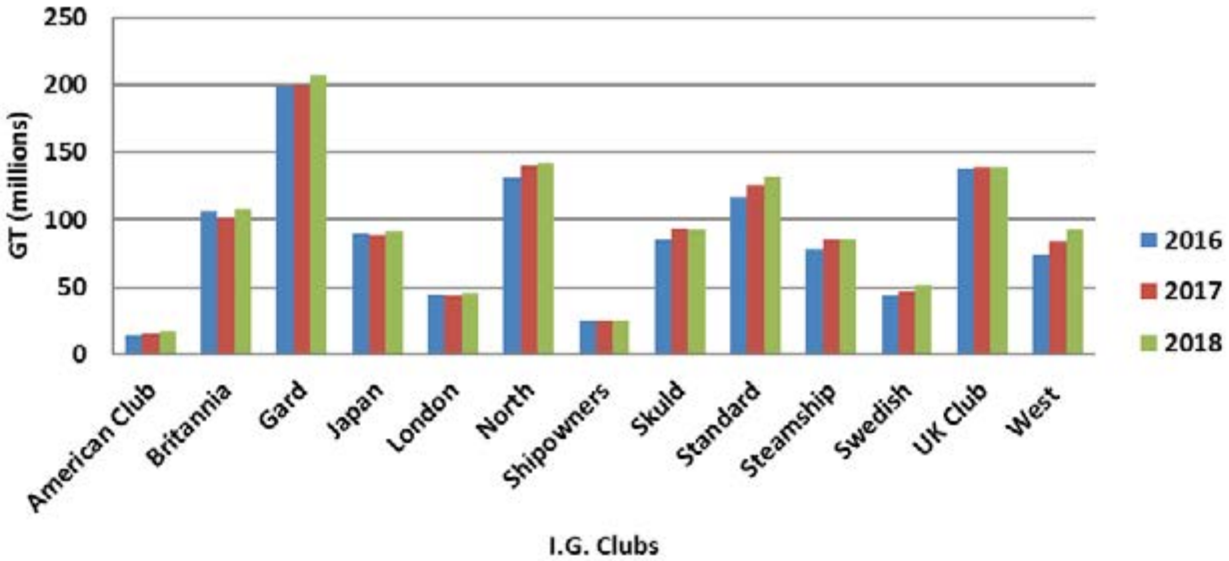
Investment return %



Investment income has been the saviour of many clubs in the year ending 20 February 2018. Without such strong returns, these clubs would have been posting reductions in free reserves and we may well have been closer to a hardening P&I market.

Gard has posted a huge investment return of USD 143 million, which reflects the amount of money the club has available to invest. In percentage terms the returns of the American Club (8.1%) and Shipowners' Club (8.4%) stand out as outstanding results benefitting their members.

Owned Tonnage (millions)



Growth in gross tonnage is often used as a means to measure a club's success. While there is of course value in this metric, because a successful club should attract new members, it is unwise to rely entirely on its accuracy as a barometer of club performance. There are many reasons why a club grows and not all of them are positive. It is important to analyse why and how a club is growing, alongside the preferences of each client, to establish whether a club is really well suited to an owner.

Aon carefully discusses the merits of each individual club with clients and the development of the Aon Club Quotient (ACQ) adds a level of science to these conversations. The ACQ enables our team to assess clients' individual profile and needs and make suggestions about which club/s are a best fit for their requirements. (Please contact those listed under contacts, or your usual Aon contact, if you would like to know more about the ACQ).

We have set out above how tonnage has developed at each club over the past year. Growth in world tonnage has slowed, but tonnage is still increasing and all clubs have grown over the last 12 months, with the exception of Skuld. The West of England has continued its impressive performance, as owners view the club as an attractive destination with its improved finances. Gard continues to attract significant new business, no doubt primarily as a result of its exceptional performance in under calling the deferred call; while Britannia has enjoyed support because of its innovative 'dividend' policy and also due to the club taking a more aggressive underwriting approach in areas such as Greece.

In-depth analysis – Club management

Club Boards are almost exclusively composed of representatives from shipping companies. These individuals have a primary role, which is either overseeing the companies that they own or serving the company that employs them (in roles such as CEO, CFO and so on). It is, therefore, necessary for the Board to delegate a number of its functions.

While clubs do not differ in this respect, there is a clear disparity in how they have established and maintained these management companies. Broadly speaking, there are two key ways to run a mutual insurance association.

On one hand the mutual may set-up and fund its own management company to run the affairs of the club. Alternatively, the mutual could pay a third-party management company to do this on its behalf.

The management of the 13 International Group Clubs is a combination of the two options, as follows:

Third party managed Clubs

- American Club: Shipowners Claims Bureau
- Britannia: Tindall Riley
- London Club: A Bilbrough & Co
- Standard Club: Charles Taylor Plc
- Steamship Mutual: Steamship Insurance Management Services
- UK P&I Club: Thomas Miller

In-house managed Clubs

- Gard
- Japan P&I Club
- North of England
- Shipowners Club
- Skuld
- Swedish Club
- West of England

Which option is best for members?

This question can itself be broken down into a few constituent elements. We address them here by sharing some typical comments which are made in relation to the issue and exploring the validity of these assertions.

"It is cheaper for clubs (and, by extension, members) to use an in-house management company"

It is difficult to answer this question conclusively, but a good starting point may be the Average Expense Ratio (AER).

The AER formula is the five-year average of the following figure, represented as a percentage:

$$\frac{\textbf{Operating Costs}}{\textbf{(Premium income + investment income)}}$$

The concept was introduced to P&I in 1999, following pressure from the European Commission for the clubs to enable direct comparisons of operating costs between themselves.

Policy Year	**2010-11**	**2011-12**	**2012-13**	**2013-14**	**2014-15**	**2015-16**	**2016-17**
American	16.50%	18.30%	19.30%	19.30%	21.60%	24.20%	25.70%
Britannia	8.09%	8.49%	8.49%	8.03%	8.43%	9.12%	9.42%
Gard	11.40%	13.00%	14.10%	11.30%	11.40%	11.84%	12.02%
Japan	6.27%	6.18%	5.69%	5.73%	5.25%	5.18%	5.46%
London	8.07%	9.00%	9.63%	8.36%	8.78%	9.52%	9.51%
North	11.90%	12.60%	13.10%	12.50%	12.40%	12.40%	12.00%
Shipowners	19.00%	20.00%	20.00%	18.00%	20.00%	21.00%	22.00%
Skuld	12.10%	12.40%	12.30%	12.30%	12.90%	12.80%	12.80%
Standard	13.30%	13.40%	13.20%	10.90%	11.40%	12.20%	12.40%
Steamship	12.00%	12.30%	12.40%	11.30%	11.80%	12.10%	12.10%
Swedish	11.60%	13.00%	13.30%	12.10%	13.00%	13.30%	13.30%
UK	9.16%	9.46%	9.47%	9.35%	9.66%	10.17%	10.22%
West	13.66%	14.75%	15.43%	14.24%	14.86%	15.50%	15.15%
AVERAGE	**11.82%**	**12.53%**	**12.80%**	**11.80%**	**12.42%**	**13.03%**	**13.24%**

The AER is a good idea in principle.

However, it can only be a very approximate guide to the relative operating costs of clubs. The measure may have more value in identifying trends within particular clubs but it would be an oversimplification to conclude that the club with the lowest AER is the most efficient and the club with the highest the most inefficient.

By way of example, it is very difficult to compare the Shipowners Club (SOP) and Britannia, because the make-up of the two clubs' membership is very different. SOP has the largest number of entered vessels in the International Group but they are all small vessels. The administration that is required to service this membership is considerable. Conversely, Britannia has far fewer vessels and yet more premium; whilst the club's managers, Tindall Riley, also manage some other mutuals and so may benefit from certain economies of scale, this will be discussed in more detail below.

In addition, by including investment income in the calculation, the Commission perhaps unintentionally introduced a variable which is no longer relevant for the purposes of assessing a manager's competence today. A lower investment income can yield a 'worse' AER, compared to another club. However, if the managers have been instructed by the club to follow an extremely conservative investment plan, is it fair to penalise them for this in the AER calculation?

The table on p.14 demonstrates that the Japan Club has the lowest AER, whilst the highest is the American Club at 24.20%. These two clubs are at the extremes of the market: the Japan Club has much lower expenses, primarily because of concentrating mostly on the Japanese market; whilst the American Club has much higher expenses as it is a small club with an international membership of primarily small shipowners.

It is interesting, for the purposes of this article, to observe that there does not appear to be a discernible difference between the third party managed and in-house managed clubs in terms of the AER. While the lowest ratio belongs to the Japan Club, it is too much of a leap to conclude that in-house management is the cheaper alternative for clubs. For example, the UK Club, who employs a third-party manager, has an AER of 10.17%, whereas North of England, who has in-house management, has one of 12.40%. The Standard Club, which is also managed by a third party, has a AER at 12.20% while Skuld's AER, which has in-house management, has a 12.80% AER.

As we are unable to draw much in the way of conclusions from AERs, we turn to other differences, which are harder to judge and require some interpretation and conjecture.

"Managers with multiple businesses may help dilute costs through economies of scale."

An argument that is sometimes ventured by the third-party managers in their favour is that the costs of centralised services may be spread across all the businesses that they oversee, rather than being for the P&I club alone.

If we take Thomas Miller as an example, it uses the same IT, HR, office space and accountancy teams for the UK Club, TT Club and ITIC . It shares costs across those mutuals, which should mean, in theory, that the cost to the UK Club is less than if it had to replicate each of these functions itself.

There is some weight to this argument, although it should be noted that many of the clubs that are internally managed have also diversified and enjoy economies of scale as a result. Gard, for example, has a broad marine and energy offering, whilst employing a similar number of people to Thomas Miller. It is therefore able to take advantage of similar cost savings.

"Third-party managers are obliged to make a profit for shareholders."

This is a slightly sweeping statement but is true in different forms for all the third-party management companies.

The need to deliver dividends and growth for shareholders is perhaps more obvious for a company that is publicly-listed like Charles Taylor. However, Thomas Miller and Tindall Riley are private limited companies and also need to deliver dividends and demonstrate value to their shareholders.

Might it follow that, in efforts to maximise returns, these companies would use absolute minimum resources to service their clubs? In doing so, they would increase profits, even though the club may enjoy a lesser service. Alternatively, might they seek to charge a higher management fee, increasing their profitability but taking more money away from the club?

The answer to both these questions must be a qualified 'Yes'.

Of course, a third-party manager must control costs and, if possible, grow revenue, all in the name of increasing profits. However, there is a natural check and balance of sorts in place in the shape of the club as the customer.

If the service is scaled-back to the point that the club perceives a drop in standards, it would presumably make the managers aware of this. Services would then need to improve, or the club might look to renegotiate the fee or, as is less likely, replace the managers. The same principle would apply to a disproportionate increase in the suggested fee; if the club did not feel that they were getting value for this, they could push back on it or require a better or wider service in exchange.

In a sense, a capitalist balance is in place with regards to third-party manager arrangements.

Compare this with the in-house club manager, which is perhaps more akin to a state ownership or communist model (if we are using this analogy).

If a management company is in-house, its costs are covered by the club. Whilst there is likely to be an agreement between the club and the manager as to service levels and costs, is the in-house management company likely to be as motivated as the third-party manager to find cost savings?

It has been assumed by some, perhaps unfairly, that an in-house manager might not be so efficient and does not need to be as careful with costs, leading to a higher bill for the club. This, combined with the lack of economies of scale, might render the in-house arrangement inferior.

However, even if we accept that the in-house arrangement does not focus so much on keeping costs down, they also do not need to add a profit margin and so the total cost might be very similar.

In addition, if cost is less of an issue for an in-house manager, might the service be better as a result, due to investment in talent and systems? As the in-house manager does not need to focus on profit, a request for a bigger budget from the principal must surely be motivated only by a desire to increase the quality of service.

Aon’s experience is that service levels certainly differ considerably between clubs, although we do not perceive much of a link between the service quality and the management arrangements. The relative advantages and disadvantages of each approach seem to balance themselves out in this respect.

“Third-party managers make decisions and recommendations which suit the managers more than the club.”

This is perhaps the most contentious point in relation to club management arrangements and we venture into this area with some trepidation.

As we have touched on in the preceding section, an independent management company is owned by shareholders, either public or private. Whilst the company would have duties to its principal (the club), the officers of the management company also owe duties to the company’s shareholders. This would typically include making the most of profits and delivering dividends.

With this in mind, it is possible that situations may arise where the interests of the club and its third-party manager may not be completely aligned.

Recent examples might include:

- Tindall Riley establishing the Carina facility

The move by Tindall Riley to establish the Carina fixed premium facility was an interesting development. The value to Tindall Riley was very clear, since the move increased the manager’s revenue as it serviced the binder.

However, in doing so, it utilised some of the systems and people who had been focusing on Britannia business. What was the value to Britannia in this scenario?

Tindall Riley, when challenged on this point, has asserted that the use of ‘Britannia’ staff and systems was minimal and that Britannia members benefit in the long-run due to economies of scale as Carina grows its membership.

- Thomas Miller and Tindall Riley trying to merge the UK Club and Britannia

It is received wisdom within the P&I industry that the proposed merger of UK Club and Britannia was driven in part by senior management at Thomas Miller and Tindall Riley.

With the biggest P&I club in the International Group under its combined management, the new management company would be worth a lot of money. It could feasibly then be sold privately, floated on the stock exchange or perhaps dividends might simply have increased.

The benefit to the managing companies is, therefore, clear; but is the benefit to the clubs equally so?

Britannia's members did not appear to see the value in it. The merger was rejected, although not before significant funds had been sunk in exploratory studies.

- Charles Taylor and the Standard Club's investment in a Lloyd's Syndicate

The Standard Syndicate (1884) was established in 2015. The Standard Club itself provided approximately 40% of the start-up costs, with Charles Taylor investing only 5%. As has been well-reported, the Lloyd's Syndicate has not performed well and so returns for investors have been poor.

However, whilst Charles Taylor will not be enjoying much of a return on the 5%, its investment in the staff and systems which serve the syndicate has performed much better. In short, Charles Taylor now has another revenue stream and is being paid to manage 1884, whilst retaining the ability to manage other syndicates in the future.

The above points may be valid, but they are not the full story. The duties of the managers to the club are clear and we do not seek here to assert that they have been breached in any way; only that the potential for conflict is equally clear and must be properly managed.

Failed mergers are not only the province of the third-party manager. The Skuld and Swedish Club merger failed back in 2006 and both companies are managed in-house.

Similarly, Skuld established a Lloyd's syndicate (1897) and this has performed just as poorly as the Standard Syndicate.

Conclusion

It is evident that there are advantages and disadvantages to both in-house and third-party club management.

From a cost perspective, there does not appear to be conclusive evidence in favour of either arrangement; a third-party club is motivated to make a profit but also usually enjoys larger economies of scale.

Quality of service is difficult to measure objectively and there is no convincing evidence in favour of either model in this respect.

In terms of duty to principal, the agency, contractual and fiduciary obligations of a third-party manager are, in essence, no different from those of an in-house manager. However, there are occasions when the interests of the third party managing company and the Club may not always be completely aligned. Considered review and legitimate challenge of decisions should, therefore, be a constant feature of the relationship between a club and its third-party managers.

We close by postulating that, when it comes to selecting a P&I partner, the characteristics of the club and its representatives are far more important considerations than the way in which the management company is structured.

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