

October Review 2013

ABLE SOLID STEADY
CAPABLE CLARITY
GUARANTEED COVER
PERFORMANCE
EFFECTIVE EQUITABLE
READY CAPABLE RO
FAIR GUARANTEED
CLARITY EQU
EQUITABLE SOLID

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FINANCIAL OVERVIEW

\$1.6 | **\$473**

Total assets
\$bn

Free reserves and hybrid capital
\$m

\$3.86 | **113%**

Free reserve and capital
per gross ton

Combined ratio

INTRODUCTION

At this half year, free reserves remain at a healthy level of \$473 million. The reduction of \$21 million reflects the higher claims experience of 2013, offset to some extent by continuing improvement in the most recent policy years and a modest level of investment income.

At this stage in 2012, the Club signalled that it was experiencing a more elevated claims environment, with the value of claims below \$0.5 million increasing slightly and a higher level of activity in notified claims in excess of \$0.5 million. This was in stark contrast to the exceptionally low claims experienced in the 2011 year, which enabled a mutual premium discount of 2.5% announced this time last year. In the Review of the Year, published in May, it was noted that 2012 was probably more representative of a normal claims year.

The unprecedented growth in size of the world fleet in the boom years and the impact on rates of the so-called 'churn effect' has resulted in a period of historically low levels of premium. The experience of 2012, and the early signs from 2013, suggest the bottom of the claims curve has been reached and claims are once again on the rise.

As reported elsewhere in this review, an even higher level of claims is now evident from the first six-month figures from the 2013 policy year. While slow economic activity is still reflected in the continuing low claims numbers, the Club has experienced an increased number of 'larger' claims within the retention and produced two of the claims notified to the Pool, so far this year.

The Club's commitment to sound financial management is based on the twin principles of maintaining a prudent level of capital and free reserves that meets solvency and rating agency requirements, while ensuring a disciplined approach to underwriting to achieve balance over the cycle. It is therefore inevitable that premiums must be increased in line with the trend of rising overall claims that – 2011 aside – is now being confirmed.

FINANCIAL HIGHLIGHTS

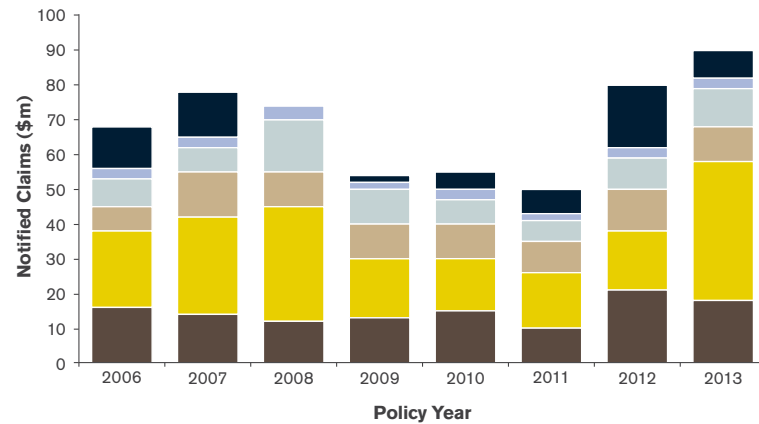
FINANCIAL STRENGTH

CLAIMS VALUES AND COMPOSITION

- Total cost of claims in the first six months of 2013 is greater than previous years at the same stage of development.
- Large casualties biggest factor in the overall growth in claims.
- In 2013, large claims (over \$0.5m) contribute two thirds of the total claims cost.
- Pool costs have fallen following the reduction in the Club's share.
- Crew illness claims have demonstrated a long-term inflationary increase of approximately 12% per annum.

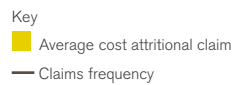


Net notified claims at 6 months for policy years 2006-2013 (\$m)

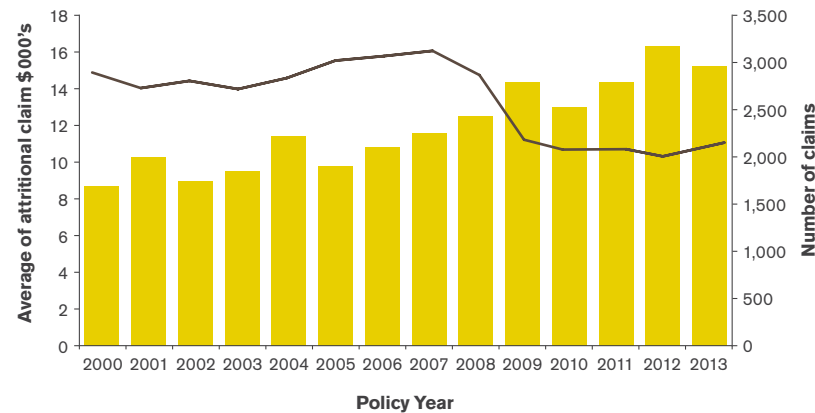


CLAIMS FREQUENCY & VALUE

- Claims frequency dropped sharply in 2009.
- The average cost per attritional claim has increased by 30% since 2006.
- The total cost of attritional claims is similar to 2006 despite the lower frequency. (Figure 4, page 5).
- This graph shows average cost of an attritional claim. Figure 4, (page 5) shows total notified attritional claims.

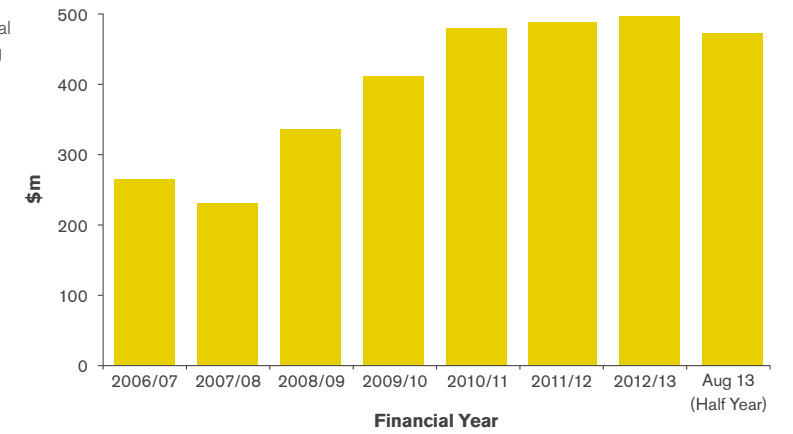


Attritional Claims (<\$0.5m) -average cost and claims frequency at 6 months for years 2000- 2013



- Higher claims experience in 2013 has led to the first fall in capital since 2008.
- The Club continues to hold sufficient capital to meet regulatory requirements and rating agency targets.

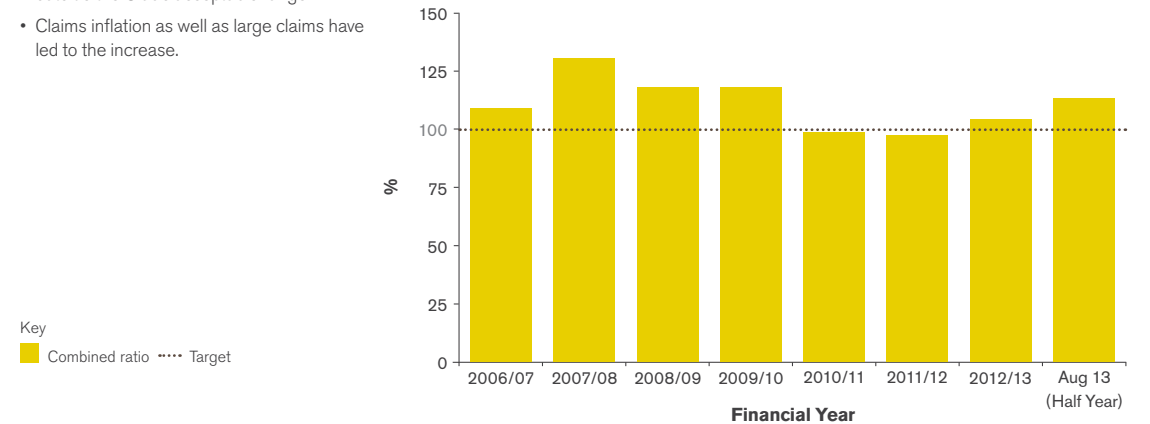
Capital and reserves for financial years 2006 – 2013



UNDERWRITING DISCIPLINE

- Combined ratio of 113% at the half year is outside the Club's acceptable range.
- Claims inflation as well as large claims have led to the increase.

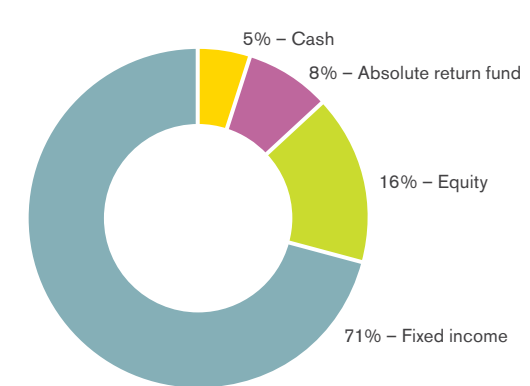
Combined ratio for financial years 2006 – 2014



INVESTMENT PORTFOLIO

- Prudent investment portfolio with 76% of assets held in cash or fixed income securities
- Equity element of the portfolio has performed well over the first six months of the year.

Asset portfolio split at end August 2013



CLAIMS

The performance of the 2012 and 2013 policy years indicates claims have resumed their upward trend.

After 2011, which was an exceptionally good year, 2012 showed an increase in claims values, even though the frequency of claims continued to reflect the impact of recessionary pressures on shipping. At the year end it was clear that 2012 had seen an increase in the larger claims and in particular, in the number of Pool claims. The current policy year is, at six months development, one of the most expensive claims years of any out of the last 15 years. This is being driven once again by an increase in the number of large claims, although in contrast to 2012 most of the claims are within the Club retention.

Figure 1: Net notified claims at six months.

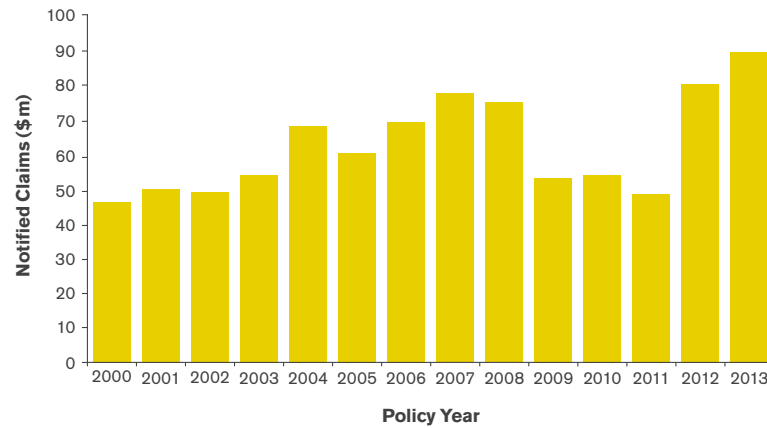
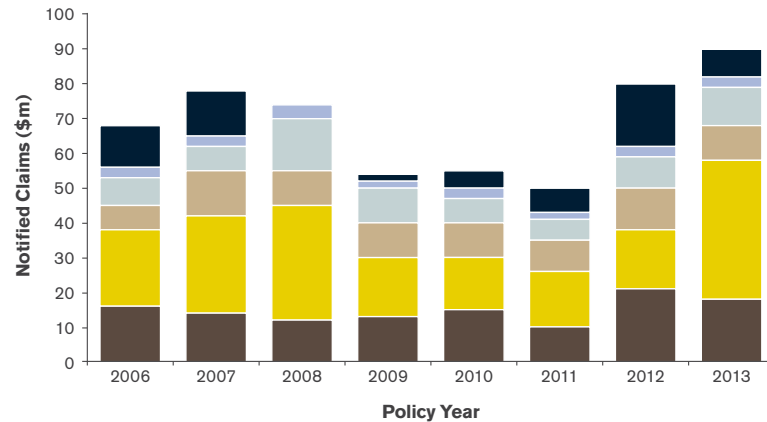


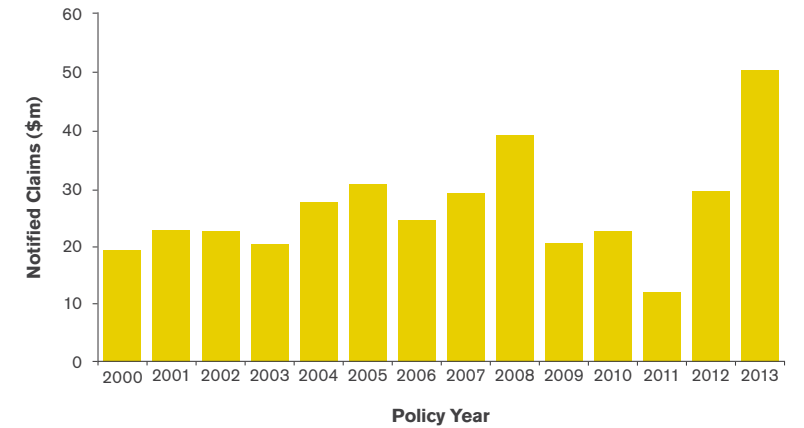
Figure 2: Net notified claims at six months for policy years 2006 – 2013 by Category.

Key
 Cargo (Dark Blue), Casualty (Yellow), Illness (Light Blue), Injury (Light Green), Charterers (Light Blue), Pool (Dark Blue)



The breakdown of the notified claims by risk type (Figure 2) shows the impact of the Pool and cargo claims on 2012 and the Club's own exposure to casualty claims in 2013. In contrast to the high Pool costs for the 2012 policy year after six months, in 2013 the Pool is relatively subdued so far.

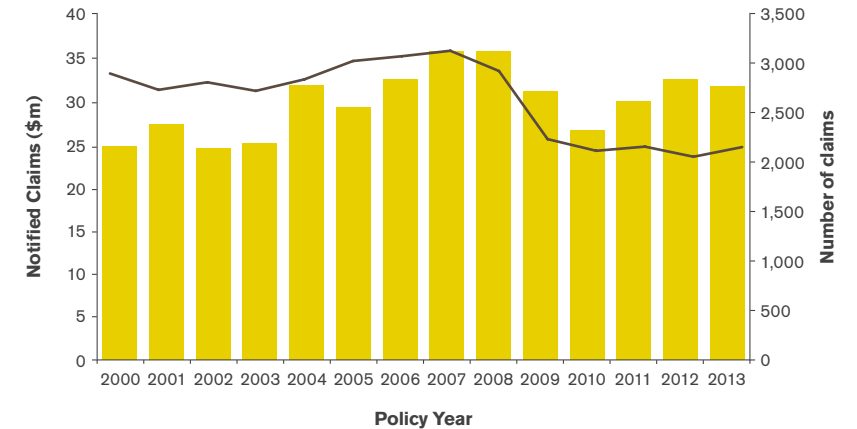
Figure 3: Large claims (>\$0.5m) notified claims at six months.



Although it is early in the 2013 policy year, the frequency of large claims in the first six months, particularly those over \$3 million, has been greater than in any other recent year. The total cost of notified large claims (those over \$0.5million) for the current policy year is more than 25 per cent higher than any year in the previous fifteen and represents 63 per cent of the total claims cost for the period despite being only one per cent of the total claims by number.

Figure 4: Attritional claims (<\$0.5m) notified claims and claims frequency at six months.

Key
 Notified claims (Yellow bars), Claims frequency (Black line)



Attritional claims correlate closely with world trade and the levels of shipping activity. In 2009 there was a significant reduction in the number of claims following the macroeconomic downturn. Subsequently, the number of claims, which fell by nearly 30 per cent, has remained low.

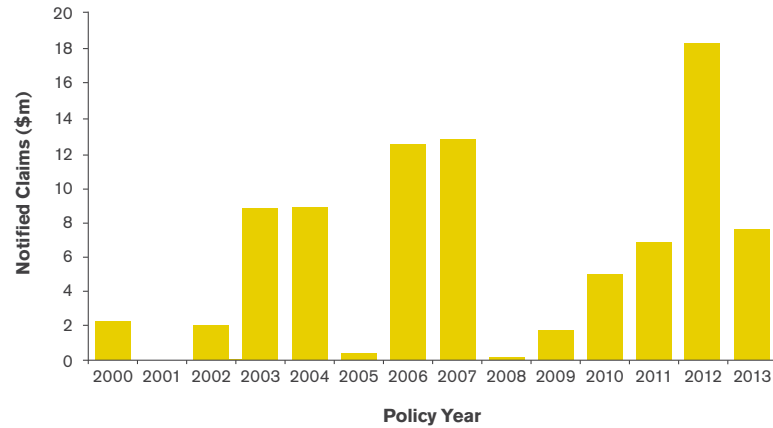
The total cost of claims fell markedly in 2009 and 2010 as a result of the reduction in frequency. However since then the cost has started to rise. Despite continuing lower claims frequency the most recent 2012 and 2013 policy years look likely to have a similar cost to the 2006 policy year, which was just before the claims peak in 2007 and 2008.

If recovering markets prompt a swift return to the higher numbers of claims experienced before the economic downturn, the impact will be compounded by the new higher cost per claim observed over the last three years and the gap between premium and claims will continue to grow.

POOL CLAIMS

The 2012 Pool remains very expensive.

Figure 5:
Net notified pool claims
at six months.



Two of the claims notified to the Pool incurred during the first six months of 2013 were brought by the UK Club.

The development of Pool claims is particularly random during the year and therefore difficult to predict. The 2012 Pool remains very expensive and a significant recovery is anticipated from the Club's Pool reinsurance. The Club's record on the Pool continues to be exemplary, with a loss record at the year end of 71 per cent. This has produced a surplus on the Club's Pool record on the new Pool formula of \$169 million, substantially reducing the UK Club share of the 2013 Pool.

UNDERWRITING

The Club has continued to increase mutual tonnage since renewal, with 122.5 million GT on risk.

The net growth results from a relatively high turnover of tonnage with 6.4 million GT coming on risk and 4.1 million GT going off risk through sales and scrapping. In welcoming new entries and new Members, the Club strives for the highest quality membership and does not sacrifice standards for growth's sake. The Club remains vigilant and to date in 2013 has declined to quote for just over 7.5 million GT, the highest yearly rate in a decade.

Over the last two years, many Members have renewed their fleets so reducing the age profile of the Club to its youngest for several decades. Market rates on newbuildings tend to be more competitive than older tonnage. The younger age profile has reduced premium per ton for the Club as a whole – the so-called “churn effect” – therefore general premium levels need to increase based on claims experience or as a vessel ages.

For many Members, subdued earnings and a lingering shipping recession remain an unwelcome fact of life. However, as was said in last year's October Review, the Club needs to keep premiums moving forward in line with the actual claims experience and to address underlying claims inflation, as well as a future pick up in claims frequency from what have been record low levels. If premiums were to stand still now, substantial premium corrections would be required when claims frequency return to more normal levels as shipping markets recover. In essence, the choice is between relatively modest premium increases in the short term or more substantial and painful increases in future. The Board does not view the latter option as being in the best long-term interests of Members or the Club. Nor, in an environment of rising claims costs and volatile investments, can the Club rely on investment income to resolve deficiencies in underwriting performance. It therefore remains important that the Club maintains its underwriting in balance.

REINSURANCE

Once again the International Group reinsurance renewal will be dominated by the extreme loss making year of 2011.

Since November last year the claims for the 2011 year have deteriorated by almost \$500 million. Although predominantly driven by the COSTA CONCORDIA claim, this deterioration includes a \$50 million increase in the cost of the RENA wreck removal off New Zealand. On the positive side, earlier years on the contract have held up well and there has been a significant recovery on the 2004 policy year, of \$15 million.

As was the position last year, the reinsurance market continues to be very concerned about the removal of wreck claims and is working closely with the International Group to see what steps can be taken to reduce the risk of cost escalation in these types of claims in the future.

The question of allocation of reinsurance costs is also the subject of debate and will be reviewed as usual by the Reinsurance Subcommittee of the International Group at this renewal. This review will look at the need for, or desirability of, increasing the range of vessel types currently used for reinsurance allocation.

The Club will also be renewing its own comprehensive reinsurance programme which is designed to protect the Club from the worst effects of a significant increase in claims. This programme is assessed using the Club's internal model and forms part of the risk management programme. It has already proved its worth with a significant potential recovery on the Club's share of the Pool in 2012.

INVESTMENTS

The first half of the financial year saw a positive investment return of \$7m, which is equivalent to a 0.6 per cent return.

A strong return on equities offset the weakening of fixed interest markets as bond yields rose on the market expectations of a tapering of quantitative easing.

The Club's investment policy has continued to remain cautious with 76 per cent of total assets invested in fixed interest and cash.

Since the half year, the Club's return has increased and is on track to achieve the Club's target 3 per cent return for the year.

CAPITAL MANAGEMENT

The Club's financial position remains strong with the free reserves and capital standing at \$473million and total assets of \$1.6 billion at 20th August 2013.

The Club aims to maintain a solid capital adequacy position and targets the AA range on S&P's capital model. This level of capital adequacy ensures that the Club will have sufficient capital for Solvency 2 purposes. S&P's rating approach is not solely concerned with capital levels. Underwriting performance is a key factor in their rating of all P&I clubs. Therefore ensuring underwriting discipline is maintained is an important factor behind the Club's current rating of A- (positive outlook).

This year the Club successfully conducted a consent solicitation on its hybrid capital bond and achieved a lower coupon of 7.5 per cent. The hybrid capital continues to be an important part of the Club's capital planning as it is an efficient way of reducing the amount of Members' money that the Club needs to hold and also counts for regulatory and rating agency requirements purposes.

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