UK P&I CLUB

October Review 2010

UK P&I CLUB IS MANAGED BY **THOMAS MILLER**

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1885-2010

Financial Highlights

- General increase for 2011 set at 5 per cent
- Free reserves and capital increased to $419 million at 20th August
- Improving overall claims position particularly on 2009 and also 2008
- Reserve release of $34 million at half year, whilst maintaining the same level of reserving confidence
- Investment income in line with forecast return of 4 per cent for the year
- 2009 policy year combined ratio of 102 per cent
- A- (stable outlook) S&P rating

Chairman's foreword

I am pleased to be able to report continuing improvement to our restored financial position over the first six months of the year. Our free reserves and capital have increased to $419 million at the half year point. Most encouragingly, we have seen confirmation of the fall in claims on the 2009 policy year which we had expected to see and a more modest improvement also in the 2008 policy year. Now that it is possible to have a clearer picture of the 2009 policy year claims development at 18 months, we have been able to reduce the claims ultimate for that year. Combined with the improvement in 2008, this has enabled the Club to release some $34 million from the reserves whilst still maintaining the same level of reserving prudence. Further details of where this improvement has been seen is contained in the detailed commentary on claims development in this review.

It is one of our planned targets to reach a combined ratio of 100 per cent and we are closing in on that level with 105 per cent for the 2008 policy year (excluding supplementary call) and 102 per cent for 2009. Of course 2010 is only halfway through and it is too early to form a confident view of its outcome but the experience to date is not dissimilar to 2009 - reserving is inevitably still at a cautious level at this stage.

Investment income over the first six months has also been positive, with September in particular being a very good month, and the investment return is so far comfortably on track to meet our relatively conservative forecast of a 4 per cent return over the full year.

Against this encouraging financial picture, your Board at its recent meeting had to consider the position for the future and after full consideration, decided to set a general increase of 5 per cent for the 2011 policy year. This decision was taken in the light of the inflationary increases we have seen in claims since much of the improvement experienced recently comes from lower numbers of claims not from lower values. Indeed, we have seen average claims costs continue to increase and this is further exacerbated by a weaker dollar. Furthermore if we are to achieve our balanced underwriting goal of a 100 per cent combined ratio, this modest increase is in our view necessary to offset the impact both of ordinary claims inflation mentioned above and the likelihood of claims increasing more rapidly at some point in the future if market conditions generally improve further.

Having restored the Club's capital position through the measures taken over the last two years, it would be folly to allow that renewed strength again to be dissipated by a new surge in claims levels. The awareness of the speed at which claims can escalate during an economic recovery also led to the introduction of the Club's new reinsurance strategy to protect us against unexpected increases both in retained and pool claims which I reported in my year end statement.

We are also working towards a new Solvency regime in Europe - Solvency 2 - which will require us to maintain a stronger capital position than the current regulatory regime. Our progress in preparing for Solvency 2 is going well. The new regime involves more than mere capital requirements since it focuses on the entire risk management of the organisation, including the arrangements for governance.

In this connection, the work of the Board's Strategy Committee which meets eight times a year has become increasingly important to the effective governance of the Club and I am grateful to all the Directors who serve on this Committee for the time, energy and commitment they have been giving. The Deputy Chairmen - Eric André (who also chairs the Audit and IPIR financial committee), Alan Olivier (who represents the Club on the Thomas Miller Board) and Patrick Decavèle are members of nearly all the Board committees and their support and wise counsel is invaluable. Aside from those mentioned above considerable demand is made on the time of all Directors and I would like to thank them all for the contribution they make to the oversight and successful running of our Club.

Dino Caroussis *Chairman*

Financial Overview

General increase for 2011 set at 5 per cent

2011 General increase

The Board has set a five per cent general increase for 2011. As last year, the commercial environment combined with lower claims and a more stable investment performance means that the general increase can be set at a modest level. It would be unwise, however, not to set a general increase at all. Firstly, there is still claims inflation. Secondly, past experience of similar points in the claims and shipping cycles show that claims escalate much faster than retail inflation when the world economy begins to recover. The Club must remain vigilant that claims do not outstrip premium when the economic cycle changes.

Historically, the general increase was intended to ensure that premium ratings were inflated to cover the underlying claims inflation, which was often moving more quickly than the standard retail and consumer indices. In recent years, the general increase has been used by many clubs to cover shortcomings in the overall level of premium, in addition to inflation. This has led to the concept of the general increase becoming debased and the view that it is unnecessary if overall premium levels appear adequate.

However, the UK Club believes that retaining the general increase in its purest form, i.e. to cover inflation, is both justified and desirable. The underlying inflation, if not captured by a general increase, would have to be covered in some other way within the underwriting model. Under the approach adopted by the UK Club, the rates for all Members are first inflated by the general increase and then adjusted to reflect the record and risk presented by the fleet for the forthcoming year. In other words, the system in addition to providing for inflation also allows for the individual fleet rate to be adjusted for record and risk. This allows for both net reductions and net increases on the current rate after the application of the general increase.

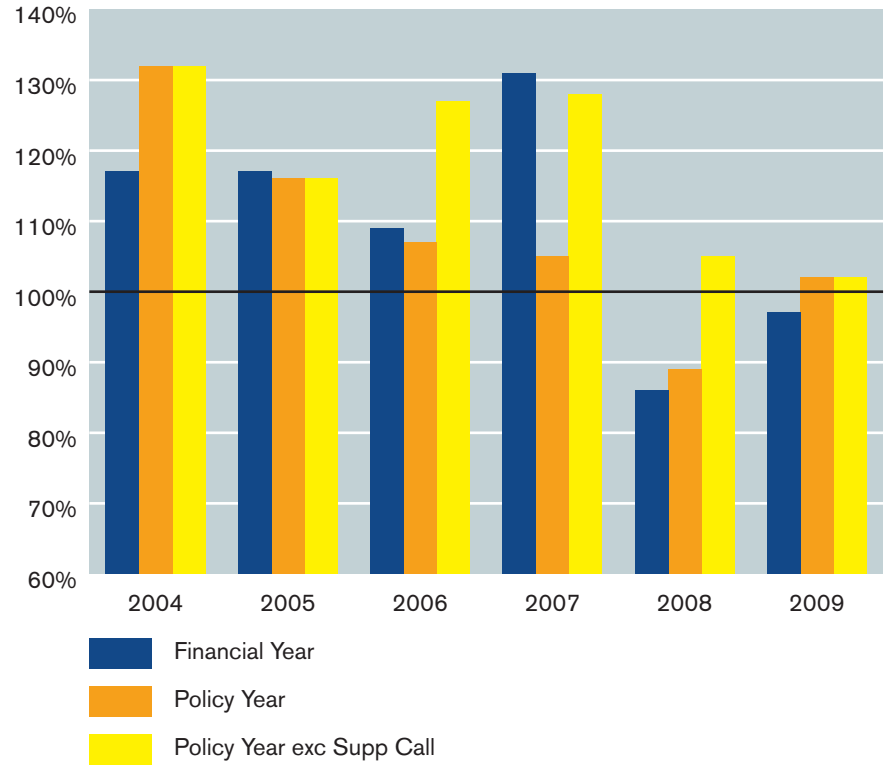
2009 policy year combined ratio of 102 per cent

Combined ratio

Figure 1 shows the evolution of the Club's combined ratio on a financial and policy year basis from 2004 through to 2009. During this period steady progress has been made to reduce the combined ratio consistent with the Club's long-term target level of 100 per cent.

Excluding the impact of a supplementary premium the combined ratios for the 2008 and 2009 policy years were 105 per cent and 102 per cent respectively.

Figure 1: Combined ratio history 2004-2009



Deductibles

The standard deductible for 2011 policy year will remain at $5,000

Last year, the Club changed the practice of publishing standard deductibles within the Rules to the current practice where the Board at its October meeting sets the Club's deductible policy for the forthcoming policy year. The Rules for the 2010 policy year were amended accordingly, and the Board increased the standard deductible for all types of claim to $5,000 per event.

The standard deductible for the 2011 policy year will remain at $5,000 (or the dollar equivalent in other currencies). The standard deductible will include fees, costs and expenses and will be applied per event.

Members will still be permitted to elect different deductibles from the standard at an appropriate premium adjustment, but will be encouraged to agree the standard as a minimum. The Managers may also propose higher than standard deductibles as part of the renewal terms for Members with adverse claims records.

Investment performance & policy

Investment income in line with forecast return of 4 per cent for the year

The investment return for the year to the end of August is $17 million equivalent to a 1.6 per cent return. Markets have been very buoyant in September and early October enhancing this return significantly at the time of writing. The investment policy is unchanged from that at the year end. The present distribution of assets is approximately 77 per cent in cash and fixed interest, 15 per cent in equities and 8 per cent in absolute return funds. Most asset classes have outperformed the respective benchmarks for the year to date. The Club's investment portfolio continues to reflect its risk appetite and tolerance but also reflects the investment manager's views of the likely future performance of the different asset classes.

Reduced US dollar cost of management

The Club has built on the successful hedging strategies of last year with agreements that hedge the main proportion of sterling based management fees out to 2012 at favourable rates below $1.50: £1.

Free reserves & capital

Free reserves and capital increased to $419 million at 20th August

Prior to the Board meeting in October 2010 the Club's total capital stood at approximately $419 million after a surplus of $10 million for the year to date. The continued increase in the Club's capital base is encouraging and has been achieved whilst maintaining a consistent and prudent approach to reserving.

Standard & Poor's

The Club's current rating is A- (Outlook: Stable)

A- (stable outlook) S&P rating

Release calls policy

In 2008 the release call policy and the level of the release calls on the open policy years was changed to reflect the level of uncertainty over the outcome of these open years. Release calls will continue to be set in line with the new policy. The formula for release calls which applies from October 2010 is set out in Table 1.

Table 1: Release calls formula

2008 5 per cent of mutual premium
2009 10 per cent of mutual premium
2010 15 per cent of mutual premium plus any outstanding instalments of mutual premium
2011 20 per cent of mutual premium plus any outstanding instalments of mutual premium

Solvency 2 – preparing for the future

Currently, the Club comfortably exceeds all the FSA's solvency and regulatory requirements as well as those of other regulators. The Club's project on achieving compliance with Solvency 2 is well underway and making encouraging progress. Inevitably the broad scope of this regulation has involved a considerable amount of work both by the Managers and also active engagement with the Board and its Committees over the last 18 months. The Club is looking to bring the new regulatory framework into normal business as usual procedures so that it becomes embedded in the Club's operations rather than being treated as a separate regulatory matter. The Club has already benefited from the FSA's individual capital assessment regime, a forerunner of Solvency 2, in making significant business decisions on investment policy and reinsurance purchase which have added considerable value to the Club and at the same time reduced risk. When combined with the results of proactive capital management in raising hybrid capital, the Club is in a strong position for the implementation of Solvency 2.

Claims Overview

Improving overall claims position particularly on 2009 and also 2008

In the six month period under review, between February and August 2010, the overall claims position has improved. The 2008 and 2009 policy years show the greatest improvement but most years are developing favourably.

When the 2008 reserve was set, the shipping boom was at its peak and claims inflation and frequency, particularly in personal injury claims, was at its height. This, accompanied by late deterioration on prior policy years, required a level of prudence within the reserve of a relatively immature year. Fortunately, the experience since this date has been favourable with evidence that much of the initial adverse development may have been due to an increase in the speed of notifying claims as well as a greater level of caution at setting initial case estimates based on previous experience. In contrast, it was expected that the 2009 year would see a fall in claims due to the lower level of shipping activity. The extent and timing of the fall in claims was highly uncertain and the initial forecast for the ultimate claims on that policy year was $290 million. Following 18 months of favourable development within the Club's retained claims, accompanied by a benign year for Pool claims, the reserve has been lowered to $260 million.

The reduction in the ultimate claims projections for recent policy years is mainly due to a fall in claims frequency. Table 2 below shows the number of claims after six months' development and clearly shows that since 2008 there has been a significant reduction in the number of claims.

Table 2: Number of claims at six months' development by category by policy year

Policy year	Cargo	Casualties*	Illness	Injury
2008	1,095	372	519	363
2009	787	389	448	251
2010	805	330	416	210
2010 as % of 2008	74%	89%	80%	58%

** Collisions, pollution, etc.*

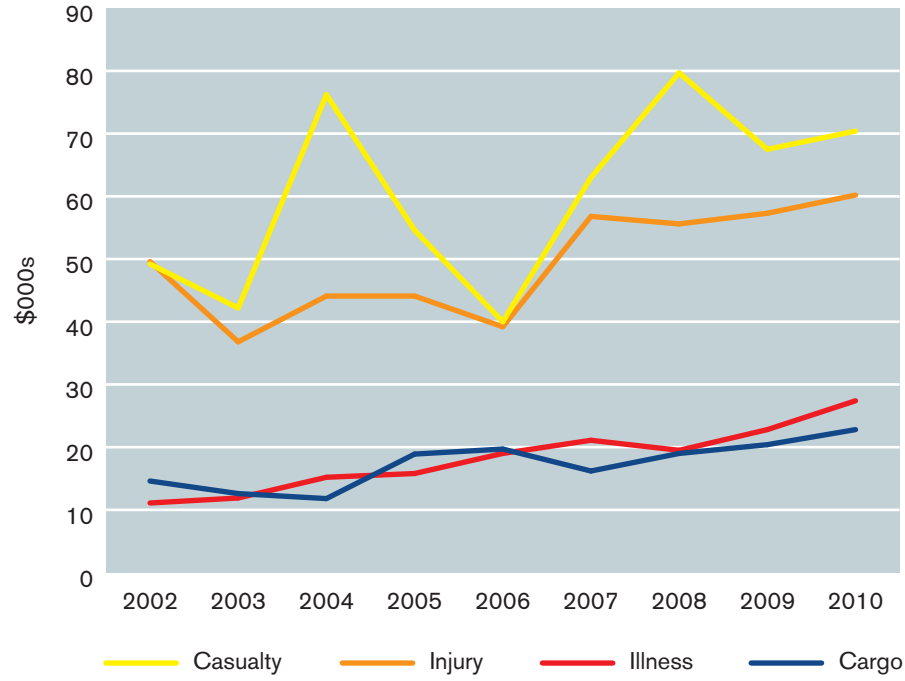
Whilst the number of claims has fallen, claims inflation has risen significantly. This is demonstrated in Figure 2 and Table 3, which show the average cost per claim (ACPC) by claims category and the observed inflation in these categories over a twelve year period. This analysis shows illness claims have the highest rate of inflation. For each category this observed inflationary trend varies from 5 to 11 per cent with little sign of any deflationary effects from the recent recession. Indeed taking the trend over the last three years would indicate that claims inflation is running even higher than the longer run observed inflation trend.

Table 3: Observed inflation by category

Cargo	5%
Casualty	8%
Injury	5%
Illness	11%

Whilst the number of claims has fallen, claims inflation has risen significantly

Figure 2: Ultimate average cost per claim (ACPC) 2002-2010 policy years



Claims development

Figure 3 below shows the composition of the policy year claims ultimates between Pool and non Pool claims for the UK Club as at 20th August 2010.

The claims ultimates have been adjusted following the latest reserving review. The current year, 2010, at just six months development reflects a prudent approach to forecasting the ultimate claims on a year which is still very immature.

Figure 3: Composition of policy year ultimates between Pool and Non Pool claims as at 20th August 2010 ($m)

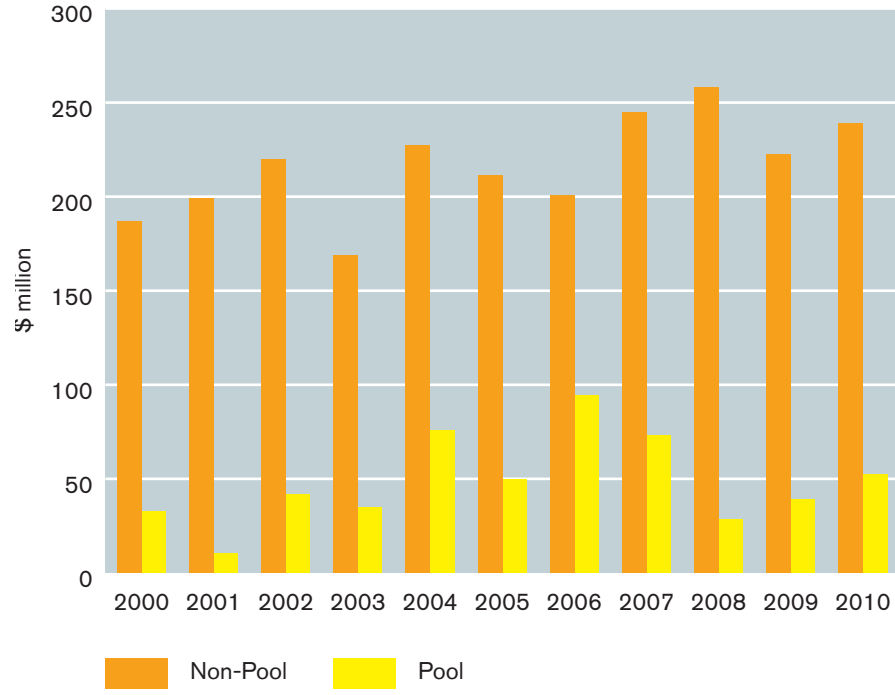
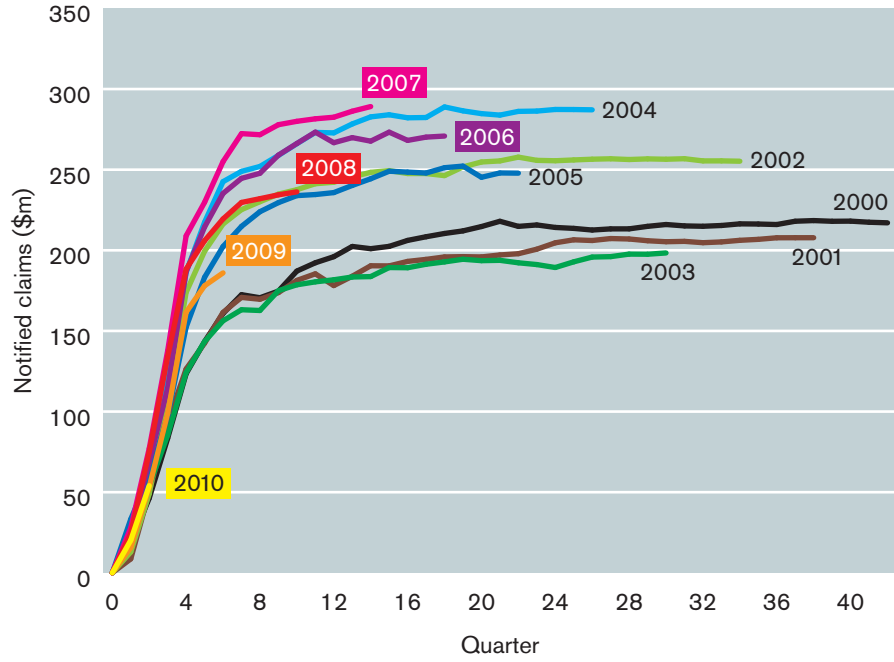


Figure 4 shows the overall claims notified position for the Club. This graph includes all estimated and paid claims (retained and Pool contributions) for the years 1998 to 2010 inclusive and clearly shows the improving trend on the 2008 and 2009 policy years. At this stage 2010 appears to be tracking 2009, but it is too early to form a definitive judgement on the outcome.

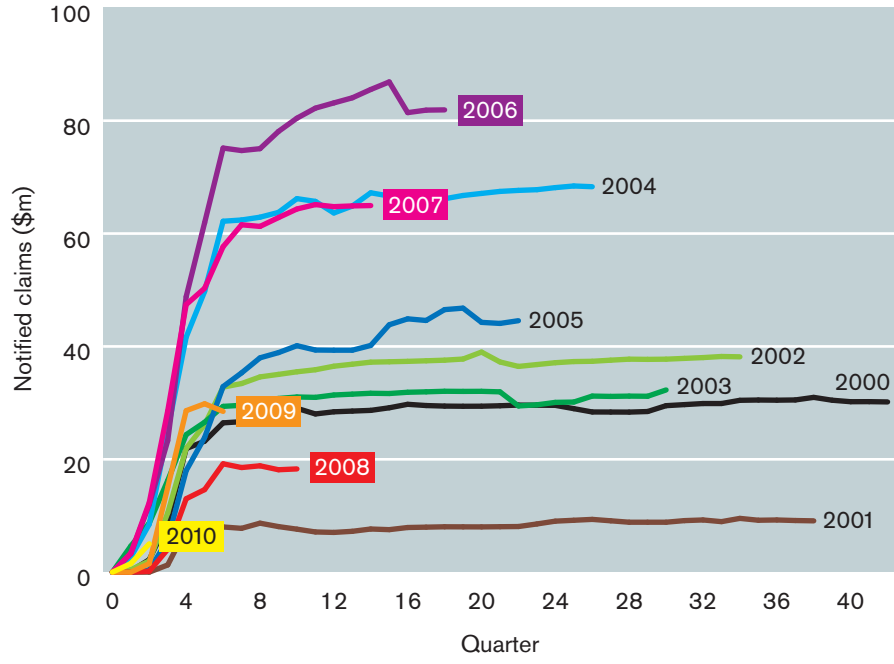
Figure 4: Net notified overall claims 2000-2010 policy years as at 20th August 2010 ($m)



Pool claims

Figure 5 illustrates the volatility of the Club's contributions to the Pool, from a recent high of $94 million in the 2006 policy year to the favourable level of $28 million for the 2008 policy year.

Figure 5: Net notified Pool claims 2000-2010 policy years, as at 20th August 2010, updated for Pool share allocations ($m)



The development of Pool claims tends to slow markedly from the 6-8th quarters. However, it is particularly notable that the 2009 year has seen incurred claims fall from the 4-6th quarter, resulting in a reduction in the projected ultimate claims for that year. Other policy years have also seen marginal improvement. At the half year point, the 2010 policy year had four claims with a net incurred value of $5 million (UK Club share) compared to $1.5 million for the 2009 policy year at the same stage of development. By October 2010, this had grown to seven claims (See Table 4 below).

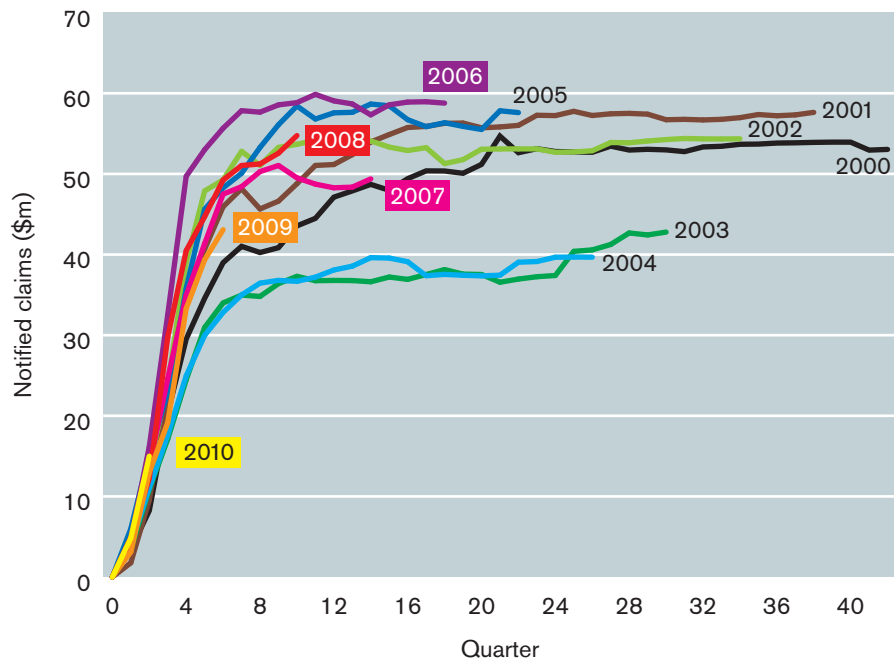
Table 4: Number of Pool claims

	Known at 20th August each year	Estimate as at October 2010 Board
2005	2	26
2006	3	45
2007	7	24
2008	1	9
2009	4	21
2010	4	7

Claims within the Club retention (excluding Pool claims)

Cargo

Figure 6: Net notified cargo claims, 2000-2010 policy years, as at 20th August 2010 ($m)

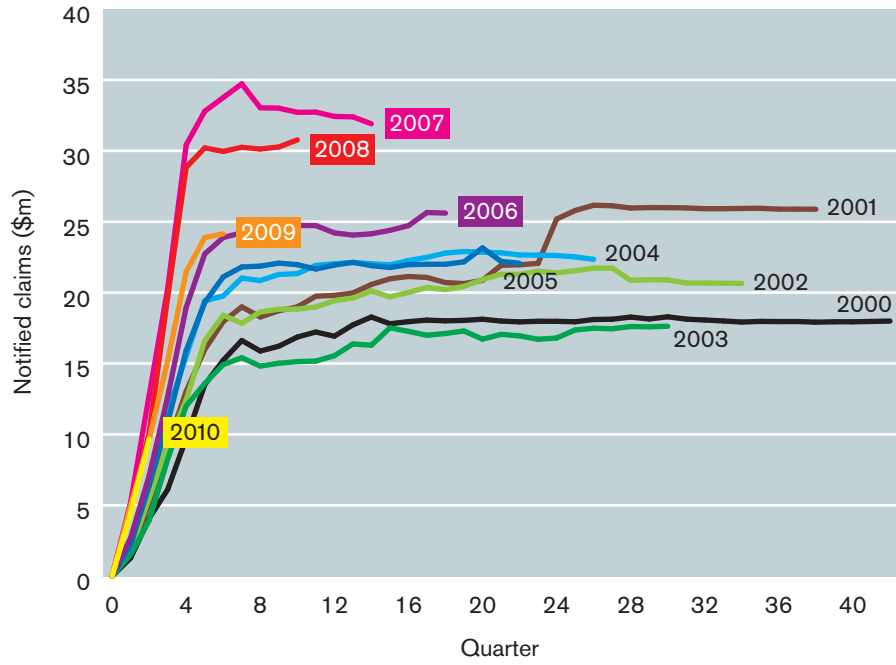


Over the last six months, cargo claims have seen a slight overall deterioration with the 2005 and 2008 years developing more quickly than expected. The number of claims on the 2009 policy year dropped by 20 per cent compared to 2008 and the 2010 policy year has continued at a similar level to 2009, although with a higher average cost per claim.

Personal injury and illness claims

The 2009 policy year had shown a marked fall in the number of claims across all categories with a material change in personal illness and injury. This trend has continued into 2010 with the number of claims significantly lower than all years to 2008. The sharp drop in claim numbers has driven an overall reduction in claims costs despite a continued rise in the average cost per claim which, over a ten year period, is showing a 10 per cent compound growth. With this level of cost inflation, a reversal of the current trend in claim numbers, due to increasing shipping activity, could result in a significant increase in overall cost of this category of claim in the future.

Figure 6: Net notified illness claims, 2000-2010 policy years, as at 20th August 2010 ($m)



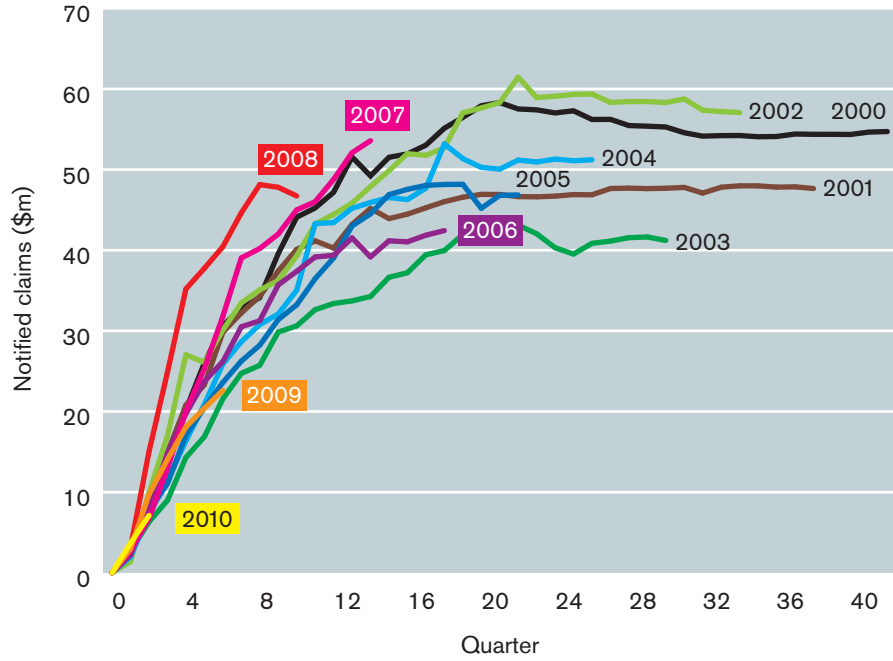
Illness claims (illustrated in Figure 6 above), in contrast to the injury claims set out in Figure 7 overleaf, tend to have a shorter development period. This reflects the fact that most illnesses are resolved satisfactorily and do not result in long term disability or death payments, and on the whole do not result in large medical expenses.

The reserving experience over the last six months has seen improvements across a number of policy years. The most marked change in this and the injury category has been the tailing off in the net incurred claims for 2009.

Injury claims

The injury category has a noticeably different development pattern to illness. This is because injuries take longer to assess, often require medical or rehabilitative care, and final recovery by the injured person may take years. The category is also more sensitive to medical cost inflation. Figure 7 overleaf sets out the Club's position after the half year reserve review.

Figure 7: Net notified personal injury claims, 2000-2010 policy years, as at 20th August 2010 ($m)



The fall in the incurred claims in the 2008 policy year is very unusual, and is one of the main reasons for the significant adjustment to the ultimate claims forecast for that year as a whole. This policy year saw reductions in estimates from February 2010 on a few large claims, which has continued now for two quarters. The 2009 policy year also has an improving trend in this category.

2011 Renewal

From November 2010, individual Member loss records will be available via the Club's online underwriting system, Underwriting Online in the Members' area of the UK Club website (www.ukpandi.com).

UK P&I CLUB

Thomas Miller P&I Ltd
London
Tel: +44 20 7283 4646
Fax: +44 20 7283 5614

Thomas Miller (Americas) Inc
New Jersey
Tel: +1 201 557 7300
Fax: +1 201 946 0167

Thomas Miller (Hong Kong) Ltd
Hong Kong
Tel: + 852 2832 9301
Fax: + 852 2574 5025

Thomas Miller (Hellas) Ltd
Piraeus
Tel: +30 210 42 91 200
Fax: +30 210 42 91 207/8

www.ukpandi.com