

## **October Review 2012**

**100%**

**100% Clarity**



## Financial Performance

The UK Club continues to be one of the strongest clubs financially in the International Group.

The Club's funds have continued to strengthen in the first half of 2012 with free reserves and capital increasing by US\$8 million to US\$494 million. With the Club's owned tonnage at 20th August standing at over 116 million gross tons, this represents free reserves and capital of US\$4.23 per gross ton and a free reserve ratio of over 167 per cent. The UK Club therefore continues to be one of the financially strongest clubs in the International Group. An improving claims performance on back years together with a positive investment performance in the first six months of the 2012 policy year contributed to the increase in free reserves and capital. As reported elsewhere in this October Review, the Club is experiencing an increase in the cost of claims for the 2012 policy year, as anticipated in the Review of the Year 2012.

> \$1.6bn

Total assets

\$494m

Free reserves and capital

\$4.23

Free reserves/gross ton

167%

Free reserves ratio

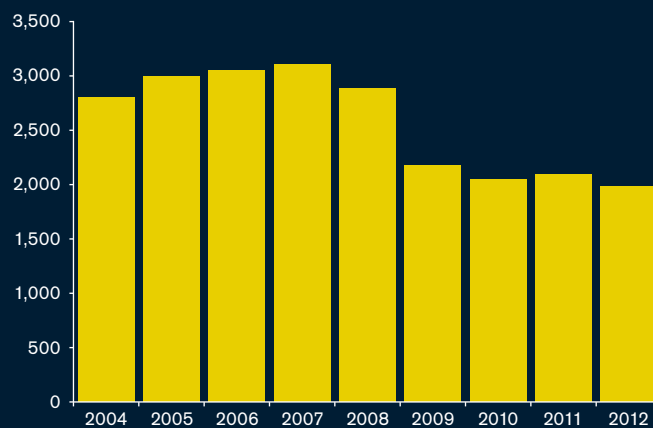
# Financial Highlights

On a financial year basis, the last two years have both resulted in combined ratios below 100 per cent.

## Claims frequency

- Claims frequencies remain low due to recession
- Frequency of claims in excess of \$1 million has increased in 2012 to date
- Expected to increase when shipping markets recover

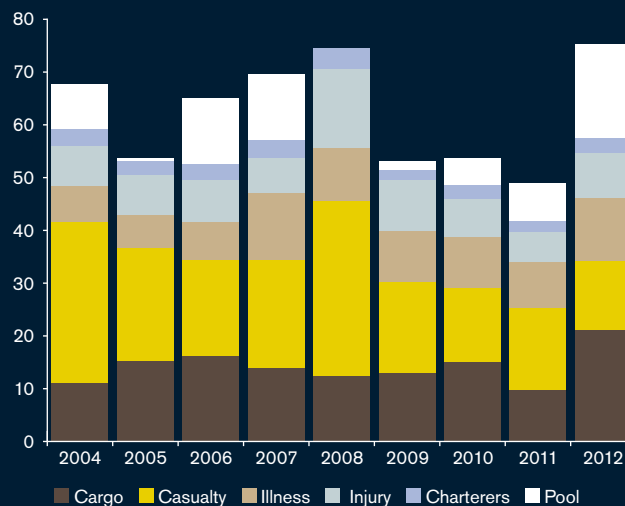
Number of claims after 6 months



## Claims values

- 2012 claims higher than 2011
- Claims over \$1 million running hotter in 2012
- 2012 most expensive for Pool claims for many years
- UK Club's good record on Pool maintained with \$100 million credit balance
- 2011 policy year – an exceptionally good year

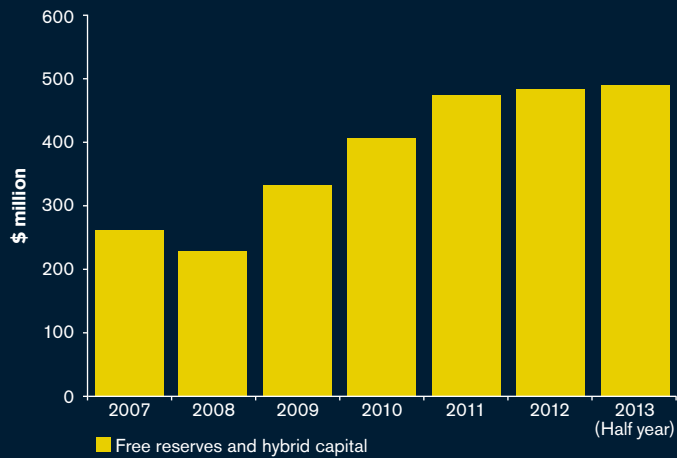
Net notified claims at 6 months for policy years 2004 – 2012 (\$m)



### Financial strength

- Free reserves and capital increased to \$494 million at half year
- Free reserves and capital of \$4.23 per gross ton
- Capital adequacy in target range of AA on S&P capital model
- S&P rating A- (stable)

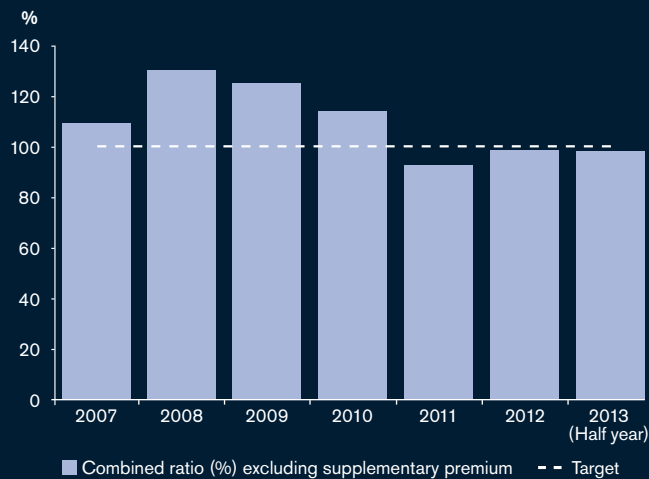
Capital & reserves for financial years 2007 – 2013



### Underwriting discipline

- Last two financial years deliver combined ratio below 100%
- 2013 financial year expected to deliver result below 100%
- Average of past 4 policy years below 100%
- Club tonnage 116.7 million gross tons at half year
- Underwriting discipline maintained

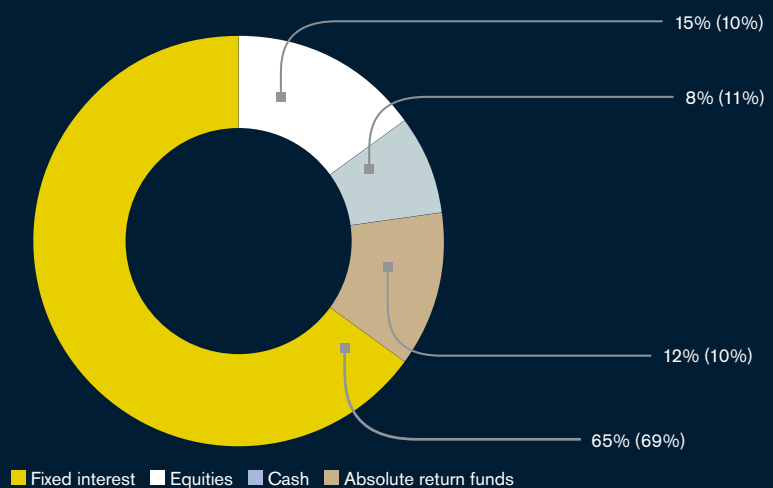
Combined ratio for financial years 2007 – 2013



### Investments portfolio

- Investment policy remains cautious
- Focus on preservation of capital
- Equity holdings increased to 15% to seek better returns
- Positive investment return in first half of year
- Further investment gain since 20th August 2012

August 2012 Asset Portfolio (February 2012 percentages in brackets)



# Underwriting

**It remains important that the Club maintains its underwriting in balance.**

The Club has maintained its disciplined approach to underwriting and risk selection as evidenced by a further solid underwriting performance with the last four policy years now showing an average combined ratio below 100 per cent. On a financial year basis, the last two years have both resulted in combined ratios below 100 per cent. If the 2013 financial year continues to develop as expected, then we anticipate that a third successive year of breakeven underwriting will be achieved.

The Club continues to enjoy strong support from members and the wider market with further growth in tonnage since 20th February 2012. At 20th August, the Club had grown to 116.7 million gt of owned mutual tonnage (112.4 million gt: 20th February 2012). Nevertheless, the Club is maintaining a conservative approach to growth declining on average approximately 15 per cent, by tonnage, of all business shown because that it does not meet one or more of the Club's underwriting criteria.

The Board and managers are well aware that shipping markets in almost all sectors of the industry remain depressed with a poor medium term outlook for the next 18 to 24 months. However, with a backdrop of increasing claims costs despite a shipping recession, 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 frequencies 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 should 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

It is clear that there will be an increase in the cost of the International Group's reinsurance programme for the 2013 policy year. The two very expensive casualties in 2011 policy year, the COSTA CONCORDIA and RENA gave rise to significant claims on the Pool and International Group's excess of loss reinsurance. There will be pressure from reinsurers for an increase on the contract for the 2013 policy year. The Club will also be renewing its own comprehensive reinsurance covers which protect it from the worst effects of a significant increase in claims costs. The Club's own reinsurances are performing as intended for the Club and form part of the overall risk management programme.

# Investments

**The Club's investment policy remains cautious with a focus on preservation of capital.**

In the first half of this policy year to 20th August, the UK Club enjoyed a positive investment return of US\$10 million (equivalent to a one per cent investment return at the half year) which is in line with the benchmark set by the Board. The Club's investment policy remains cautious with a focus on preservation of capital. Holdings of equities were increased from 10 per cent to 15 per cent to take advantage of the opportunities for better returns available in the equity markets this year. There was a similar decrease in the Club's holdings of bonds where government bond yields had reached record lows.

Since the half year, the Club has enjoyed a further positive return on investments which, if maintained through to 20th February 2013, would provide a further investment bonus to the Club's balance sheet. In the volatile investment environment that currently exists though, there is of course no guarantee that it will be possible to maintain this investment performance through to the end of the year.

# Claims performance

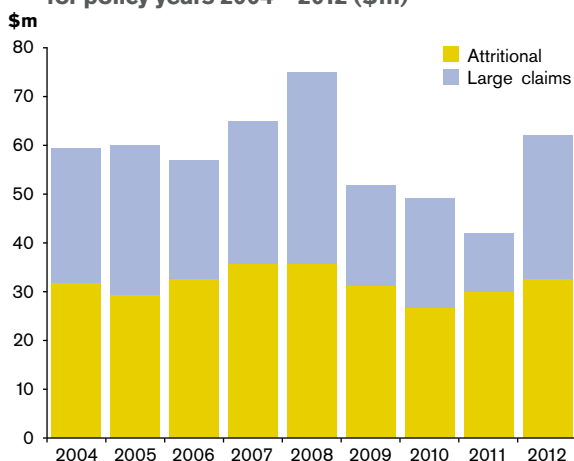
**2012 will be a year of more costly claims for the UK Club.**

The expected trend of reducing claims frequency due to the shipping recession has continued into the 2012 policy year. However, unlike 2011, the Club has experienced a number of larger claims within its own retention in the range of US\$500,000-US\$8 million. Coupled with this, the Pool has been more active with seven claims notified at the half year stage with an estimated cost to the Club of US\$18 million (2011: US\$7 million at six months). However, the UK Club continues to enjoy an extremely good record on the Pool with a credit balance in its favour of approximately US\$100 million. For the 2012 year the Club increased its reinsurance cover for Pool protection. The Club's Pool contribution percentage continues to decline due to its excellent record. At the six month stage, the Club had not had a Pool claim in the 2012 policy year.

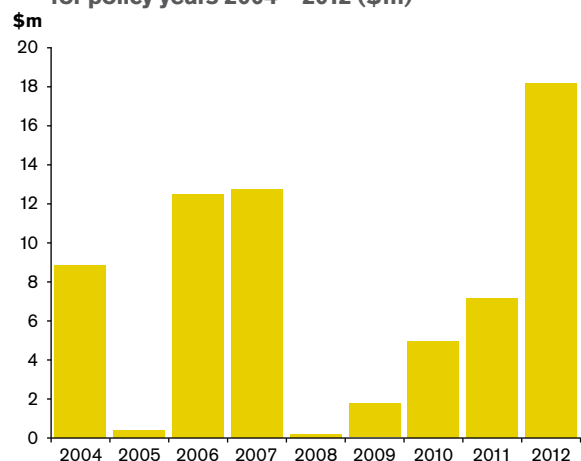
It appears that 2012 will be a year of more costly claims for the UK Club with net notified claims at the half year stage totalling US\$80 million (2011: US\$49 million at the same stage). The increase in claims now being experienced in 2012 must therefore be addressed for the Club to maintain its underwriting in balance.

A further factor driving the cost of claims is the effect of underlying inflation on some types of claim. Looking back to 2008 when the recession began, it is apparent that whilst claims frequencies on the whole have decreased, the average cost per claim has risen. In 2008, the average net cost per claim to the Club for all claims between US\$1,000 and US\$2 million was just under US\$23,000. By 2012, this had increased to over US\$30,000.

**Net retained claims at second quarter for policy years 2004 – 2012 (\$m)**



**Net Pool claims contributions at second quarter for policy years 2004 – 2012 (\$m)**







**The improved position of the Club is the result of the collective work of the Board, managers and the strong support of members.**

### **Capital**

The Club's capital is strong with assets of over US\$1.6 billion and free reserves and capital of US\$494 million at 20th August 2012. It is likely given the trends on claims and investments that the increase in capital at the half year stage may well continue to the year end. The Club aims to maintain a strong level of capital targeting the AA range on S&P's capital model. In achieving this level it ensures that it has sufficient capital for Solvency 2 purposes including a buffer above what is expected to be the Solvency Capital Requirement. The Club continues to hold US\$100 million of hybrid capital as part of its capital structure. The hybrid capital is recognised as capital in the Club's balance sheet by the Financial Services Authority and Standard and Poor's alike. By contributing to the Club's solvency and rating agency requirements, it reduces the amount of members' own money the Club needs to hold.

### **Club reorganisation**

As reported previously, the Club is in the process of reorganising its corporate structure as part of its preparations for Solvency 2. UK (Bermuda) will cease to be members' primary insurer and will instead become the reinsurer of UK (Europe), which will become members' primary insurer. The purpose of the reorganisation is to reduce the number of separately regulated entities, strengthen governance, reduce compliance costs and efficiently manage the Club's solvency capital requirements.

The proposal to proceed with the reorganisation was passed by a vote of the membership at the Annual General Meeting this month. The next step will be to obtain approval for the restructure by the courts in London and Bermuda. The restructuring of the Club is due to complete early next year in time for the beginning of the 2013/14 policy year.

### **Solvency 2**

The Club's other preparations for Solvency 2 continue and it recently submitted an internal model for approval by the Financial Services Authority. The Club remains on target to meet the implementation of Solvency 2.

### **Governance**

Since the last year end, the Board has met as a whole and in a number of working committees, with a keen focus on the governance of the UK Club. The improved position of the Club is the result of the collective work of the Board, managers and the strong support of members. The UK Club is dedicated to being the leading ship owner controlled provider of marine liability insurance.



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