International Group (IG) P&I Market Financial Commentary

2018/19 Financial Year Results

November 2019

Highlights

- Premium stable
- Routine claims relatively stable, greater volatility of larger claims. Incurred claims increased by 3.6%
- Deterioration in P&I market combined ratio (market average 2018/19: 110%, 2017/18: 104%)
- Considerable range in investment returns announced by individual clubs, but a market average return 0.3%. (A large reduction in average return compared to 5.5% prior year)
- USD 233 million P&I market underwriting loss in 2018/19
- 5.2% reduction in market free reserves
- Continued wide variance between best and worst performing clubs

Highlights

Consistency of overall market results, but widening variance between the best and worst performing clubs in the IG

The speed of increase in overall market claims levels abated somewhat in 2018/19, with incurred claims only increasing by 3.6% across the P&I market (8.1% in the previous year). Paid claims similarly increased, though by more modest levels. Gross and net paid claims increased by 0.1%, and 2.4% respectively.

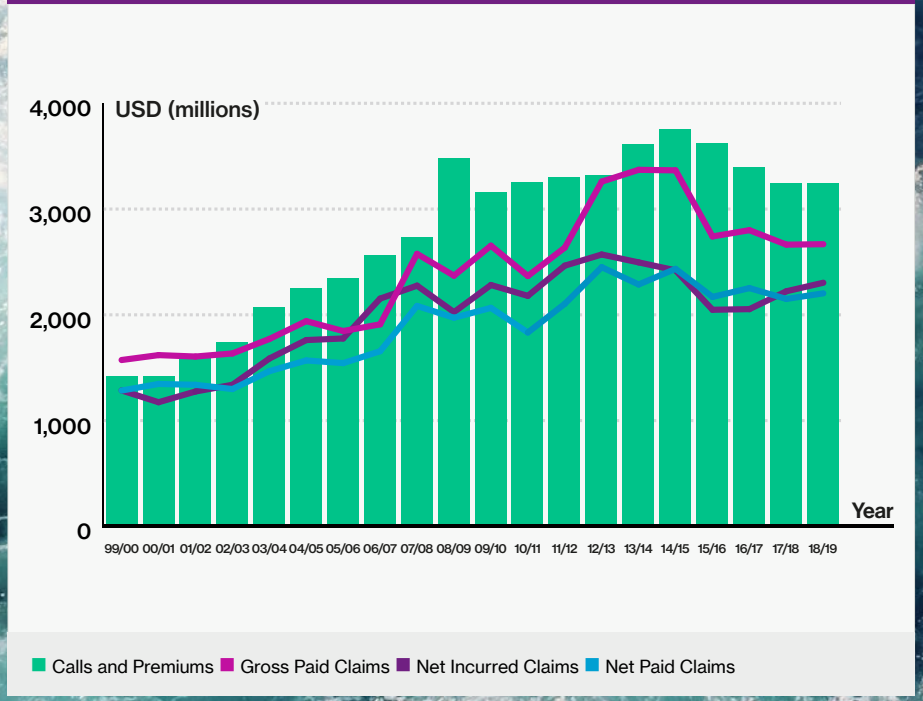
There appears to be almost no change in the reported premium levels in the P&I market between 2017/18 and 2018/19. Removing the impact of premium rebates and capital returns however, the underlying result is that premiums reduced by 2% over the last reported year (the fourth year of premium reductions across the market).

Claims volatility has been discussed in previous reviews over the last decade. The graph demonstrates this pattern. Since the late 1990's claims inflation was relatively predictable and progressive. There has however been a marked increase in claims volatility since 2006/07. This trend is shown most starkly in the gross paid claims results but the fluctuation in net paid and net incurred claims is similarly less predictable over the most recent 12 years.

The increase in incurred claims over the last two years is likely to be another indication of the volatility in P&I claims. The trend of the underlying attritional claims (those less than USD 500,000) across the market is remarkably stable. The overall increases in incurred claims are being driven by the less predictable larger claims.

The graph displays the progression of gross paid claims, net paid claims and net incurred claims compared to total premium paid into the market, over the last 20 years.

Paid Premiums vs. Gross Paid Claims, Net Paid Claims and Net Incurred Claims



Underwriting loss deepens

With underlying premium eroding and claims increasing during the 2018/19 financial year, it is no surprise that the P&I market underwriting loss worsened over the same period.

The overall market combined ratio in 2018/19 was 110%, deteriorating from 104% in 2017/18.

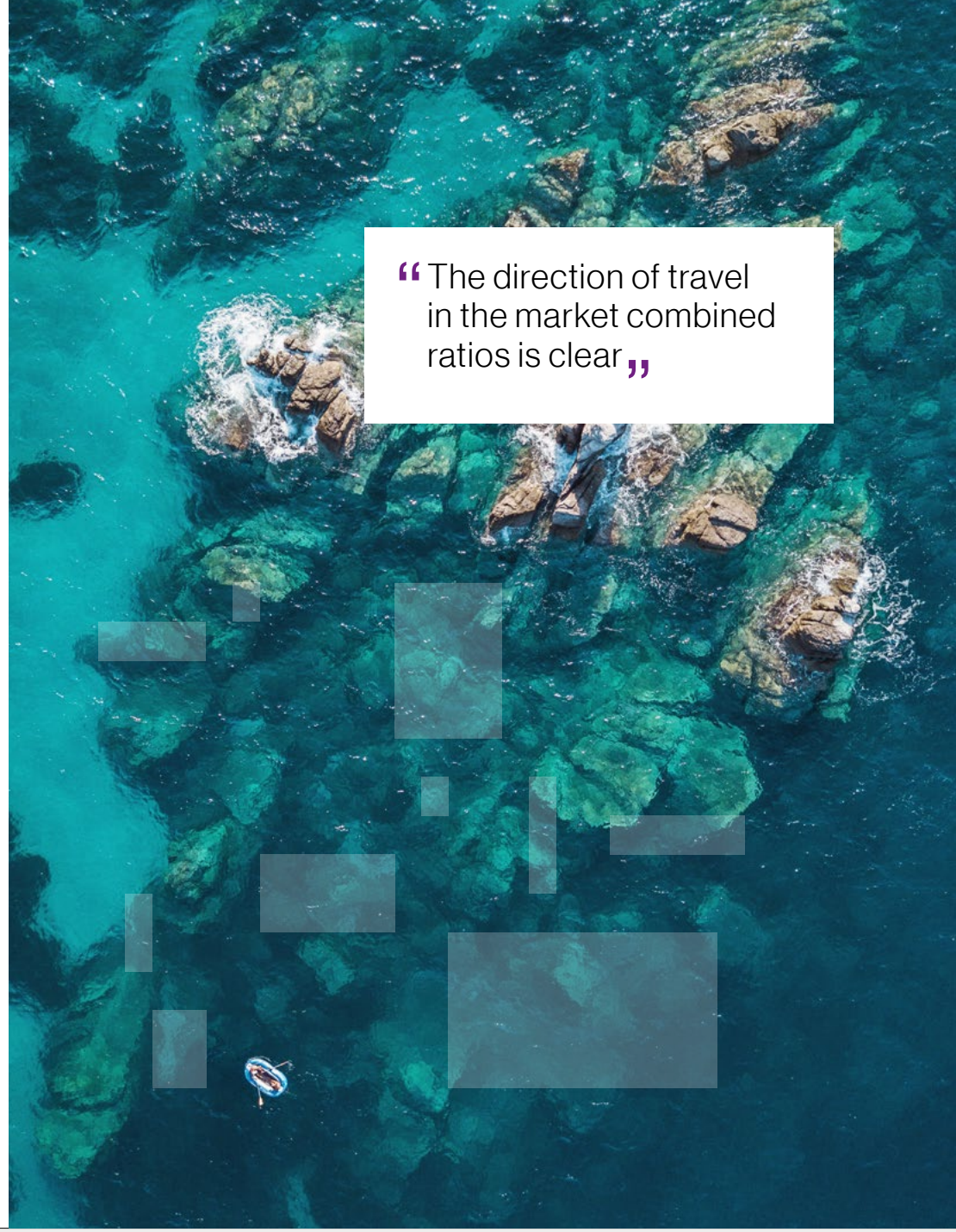
When reviewing the 'underlying' underwriting result however, this shows an even worse deterioration.

In 2017/18 six IG clubs made some form of premium rebate or capital redistribution, in 2018/19 four clubs followed a similar pattern. If these were all retained as 'premium', instead of being rebated, then the overall market combined ratio in 2017/18 would have been 99% (i.e. just better than break-even); but would have deteriorated to 107% in 2018/19. I.e. an underlying 8% deterioration rather than the 6% decline evidenced simply in the reported figures.

Whichever figure is taken however, the direction of travel in the market combined ratios is clear.

The pattern over the last four years:

- 2015/16 market combined ratio 88%
- 2016/17 market combined ratio 93%
- 2017/18 market combined ratio 104%
- 2018/19 market combined ratio 110%



> "The direction of travel in the market combined ratios is clear"

Minimal investment income

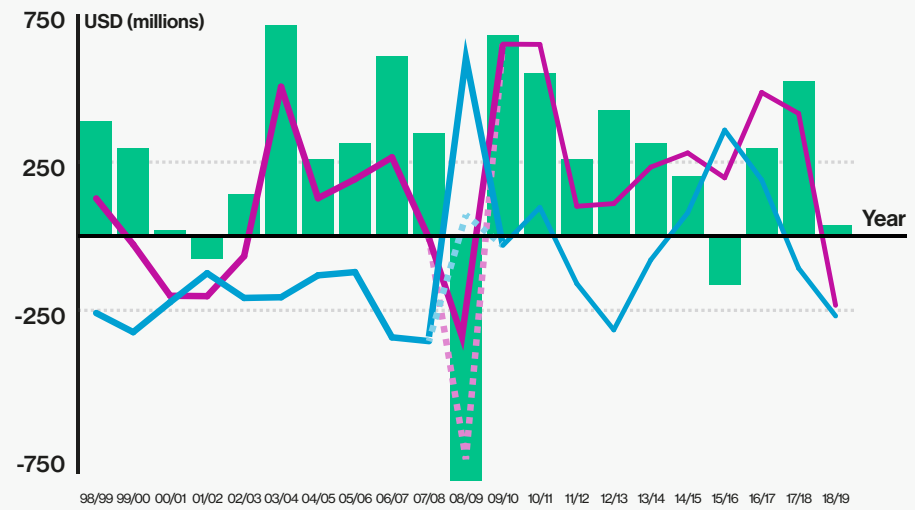
Investment income for most clubs did not materially help in ameliorating the underwriting losses. Largely due to global equity markets dropping over 10% in December 2018, average investment returns across the P&I industry were minimal in 2018/19. The average return across the P&I market was 0.3%, a considerable drop from the 5.5% equivalent investment return in 2017/18.

Inevitably widespread underwriting losses combined with nominal investment returns led to a substantial overall loss to the market. The USD 233m overall market loss in 2018/19 contrasting starkly with the USD 414m overall surplus the previous year.

The graph shows the progression of underwriting, investment and overall result for the market over the last 20 years.

N.B. to reflect the underlying underwriting result, the solid lines show the results as reported, the dashed lines display how the underlying trend would have looked without the unbudgeted calls from 2008/09.

Overall Result – Including Investment Income (Underlying trend - 'as if' no unbudgeted calls in 2008/09)



Investment Income ■ Overall Surplus for Year (Deficit) ■ Underlying underwriting surplus (Deficit)
as if no unbudgeted supplementary calls

First annual drop in P&I market reserves since 2008/09

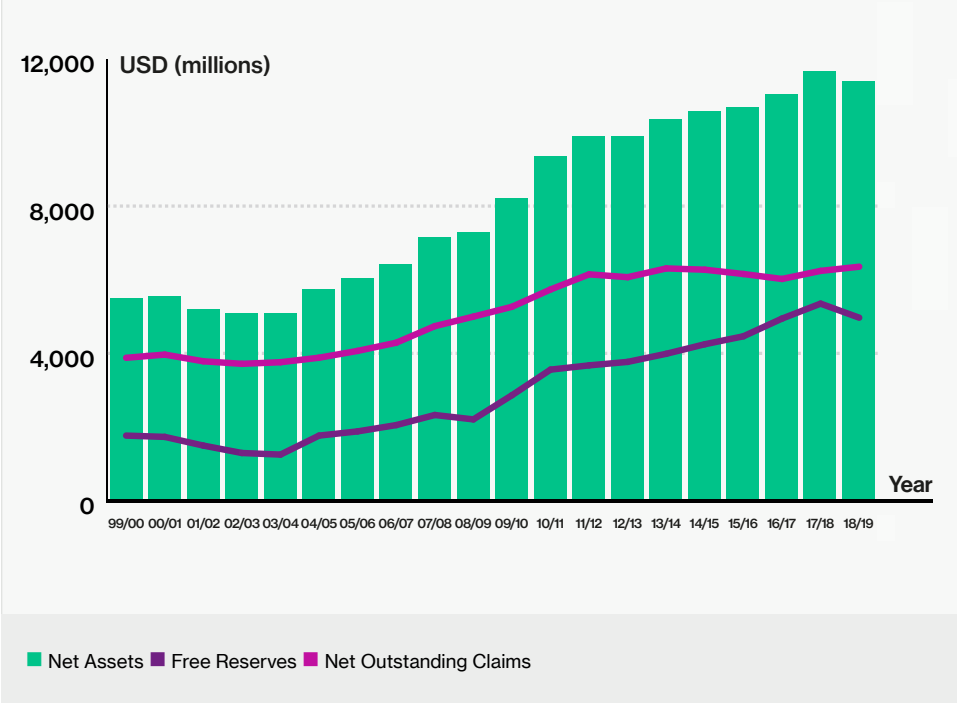
The combined P&I market free reserves reduced by 5.2% in 2018/19, to just over USD 5 billion.

The combined market free reserves at 20 February 2019 was however still marginally higher than the position at 20 February 2017 (the 5.2% reduction in free reserves basically just offset most of the gains made in 2017/18) and represents the second highest level of net assets and free reserves in the IG system.

The combined market free reserve in 2019 is also still nearly 2.2 times larger than the position following the global equity crash in 2008. Even though the world continues to face uncertain times and volatile stock markets, the P&I market is considerably more resilient in 2019/20 than it was in 2008/09.

The graph displays the progression of net assets, outstanding claims and free reserves for the entire market over the last 20 years.

Development of Assets and Free Reserves



Wide variation in individual club underwriting results

As we have commented in previous P&I market reviews, there is a significant variance between the best and worst performing club in the IG.

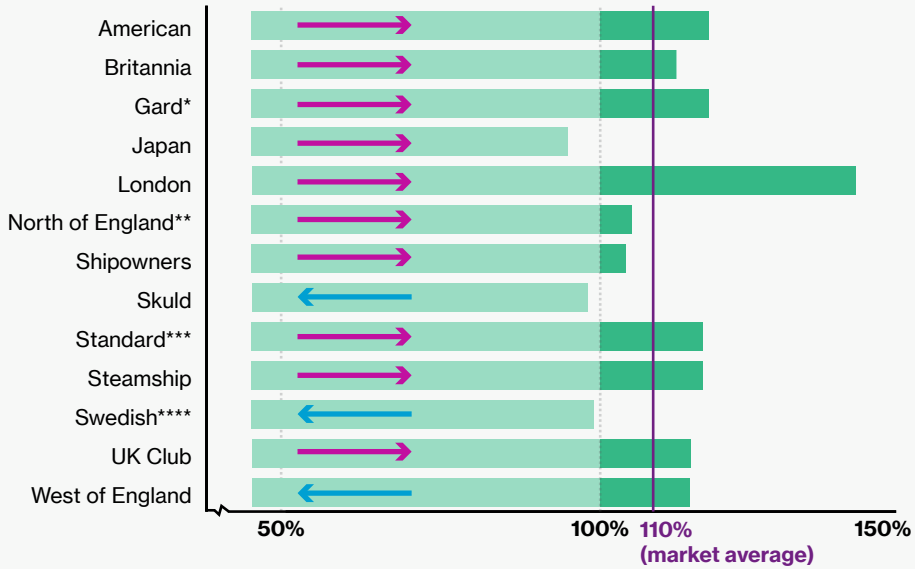
While there has undoubtedly been a broad improvement in the financial strength within the market over the last 10 years, some clubs have fared significantly better than others over this period.

Combined ratios are a direct comparison of clubs' underwriting performance. The 2018/19 net combined ratios for all the clubs are set out in the graph.

Only three of the 13 IG clubs reported an improvement in their financial year underwriting results, with the majority of club reporting materially deteriorating underwriting figures.

The variance between the most positive and the most adverse underwriting results is broadening, in 2018/19 there is a 45% difference between the best and worst results across the IG market (in 2017/18 this variance was 25%).

Combined Ratios – 2018/19 Financial Year (Incurred claims+Expenses)/(Premium-Reinsurance))



* Gard Group (P&I only 116%, P&I only ETC basis 106%, as if no IT impairment 94%)
** North Group; *** Standard Group (excluding Syndicate 100%) **** Swedish Club Group

Combined Ratio ■ Excess of 100% (underwriting loss)
■ Average (110%) ■ Ratio deteriorated from 2017/18 ■ Ratio improved from 2017/18

Combined ratio highlights

- Market average combined ratio of 110%, deteriorating from 104% in 2017/18.
- The underlying result showed greater deterioration to 107%, from 99% in 2017/18
- Only 3 out of the 13 clubs reported underwriting surpluses (in contrast to the 5 clubs in 2017/18)
- Most clubs underwriting performance deteriorated in 2018/19, only 3 clubs improved their underwriting result
- Continuing wide variation in underwriting performance between individual clubs

Combined Ratio Definition

The combined ratio is essentially the net loss ratio for the club and is defined as follows:

$$\textbf{Net combined ratio} = \frac{\textbf{(Net incurred claims + operating expenses)}}{\textbf{(Premium – reinsurance costs)}}$$

- A combined ratio of 100% represents an underwriting break-even position
- Anything in excess of 100% would be an underwriting loss
- A combined ratio less than 100% would represent an underwriting surplus.

> "Wide variation in underwriting performance between individual clubs"

Investment strategies in an uncertain world

As mentioned earlier, 2018/19 was disappointing from an investment income perspective for the IG market.

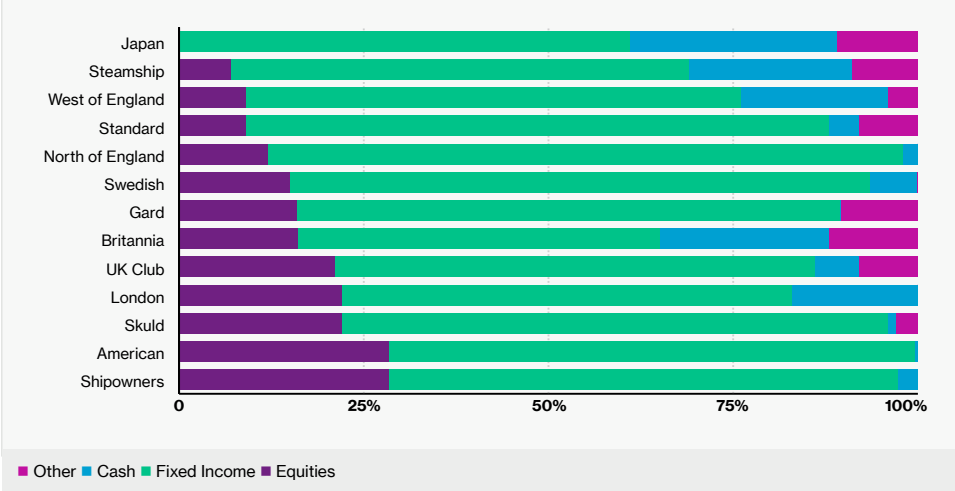
Within the uninspiring average investment return across the P&I market of 0.3%, the range of individual clubs' returns was notable. These ranged between a 3.9% positive return and a 8.5% loss.

Those clubs with financial years with a year end at 31 December 2018 were particularly hard hit by the market dip earlier in that month; the Shipowners' and Swedish clubs fall into this category. Most clubs with a 20 February 2019 financial year end benefited from a bounce-back in the equity markets by that point.
The allocation of assets held by each of the clubs as at 20 February 2019 is shown in the first chart.

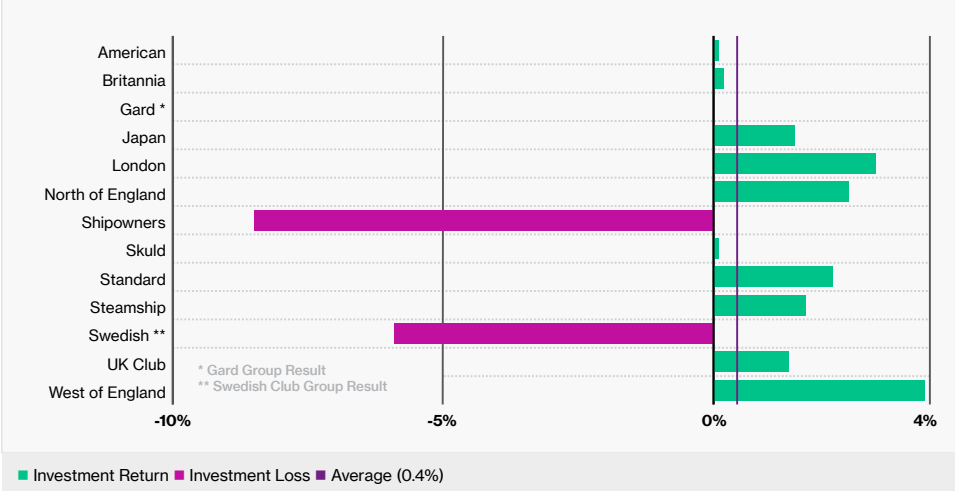
The average equity holding across the IG market as at 20 February 2019 was 16% of total investments (very similar to the 2017/18 financial year). In 2007/08, before the 2008 equity market crash, the average equity holding across the market was nearly 23%. Immediately after the 2008 crash, the average equity holding by clubs in 2008/09 had reduced to 12% across the IG market. This percentage progressively increased until 20 February 2014 when the average equity holding across the market was 17%, though this has abated slightly and stabilised around 16% in the most recent five financial years.

The second graph shows the percentage return on investment achieved by each club in the 2018/19 financial year.

Investment allocation



Percentage investment returns

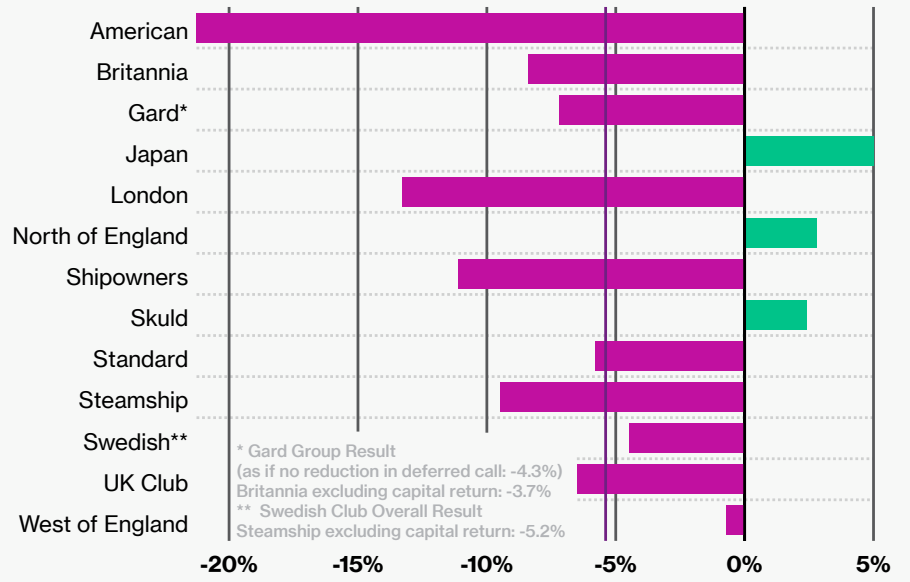


Investment strategies in an uncertain world

The final graph in this section outlines the percentage increase or decrease in each club's free reserves as at 20 February 2019. This in effect summarises the combined effect of each club's underwriting and investment results for the financial year, when compared to their own free reserves.

> "Percentage increase or decrease in each club's free reserves summarises the combined effect of each club's underwriting and investment results for the financial year"

Percentage change in free reserves



Claims trends

Since 2003, Willis Towers Watson's P&I reviews have routinely highlighted trends towards greater volatility in overall claims levels.

The market has seen inflationary increases on small and medium sized claims averaging less than 2% per year over the last 19 years. Around this relatively low level inflationary background however, the number and size of very large claims has varied enormously. This unpredictability of very large claims, combined with increased club and IG retentions, has created enormous volatility in total claims levels in the market.

This is exemplified in recent years where an absence of a significant number of high value claims has been the primary driver in the very positive results.

A sharp reduction in total claims levels is very much a part of the overall picture of volatility, as demonstrated by the years with double digit increases in claims levels. In these 'unlucky' years (2003/04, 2004/05, 2006/07, 2009/10 and 2011/12) the material increases in the number of high value claims were key drivers in the overall negative underwriting results in those years.

The background to this has been discussed at length in previous reviews and is developed further in the IG Reinsurance section of our review.

N.B. The comments relate to the combined financial year results of the individual clubs in the International Group. The only club excluded from this analysis is the Swedish Club, which reports on a basis materially different from the rest of the market. As the Swedish Club represents less than 2.5% of the IG P&I market, its omission does not affect the overall analysis materially.

> "Willis Towers Watson's P&I reviews have routinely highlighted trends towards greater volatility in overall claims levels"

Expectations for the 2020 renewal season

The adverse market results have led to some challenging decisions for clubs in the lead up to the 2020 renewal season.

The market is evidently facing deteriorating underwriting results and the uncertain world economic climate does not give enormous confidence for reliable investment income.

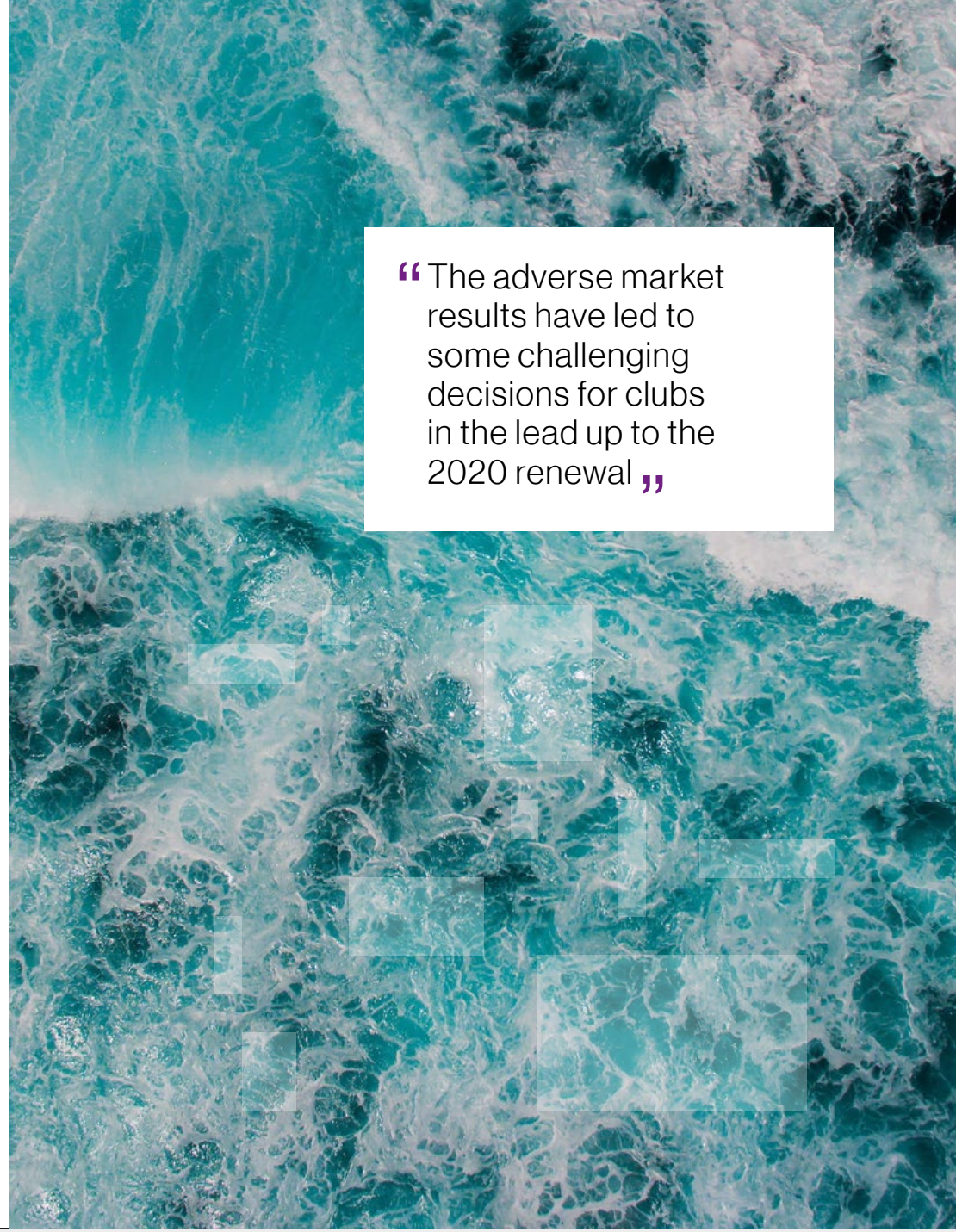
Despite these operational challenges, the IG market overall is still in a strong financial position in terms of the capital adequacy.

There is however a huge difference in financial performance between the strongest and weakest clubs in the IG. A few of the clubs have extremely robust capital positions however at the opposite end one or two isolated clubs have challenges to address in their free reserves.

This is likely to present an interesting contrast. From an operational point of view almost all clubs will need to increase premium levels to balance their books in the coming years.

Our expectation is for a small number of clubs to not announce a figurative general increase (though have an internal target) with most of the market announcing increases around 7.5%.

Reflecting the capital positions of the strongest clubs, a minority will continue returning premiums, not charging full deferred calls or rebating capital over the next 12 months.



> “The adverse market results have led to some challenging decisions for clubs in the lead up to the 2020 renewal”

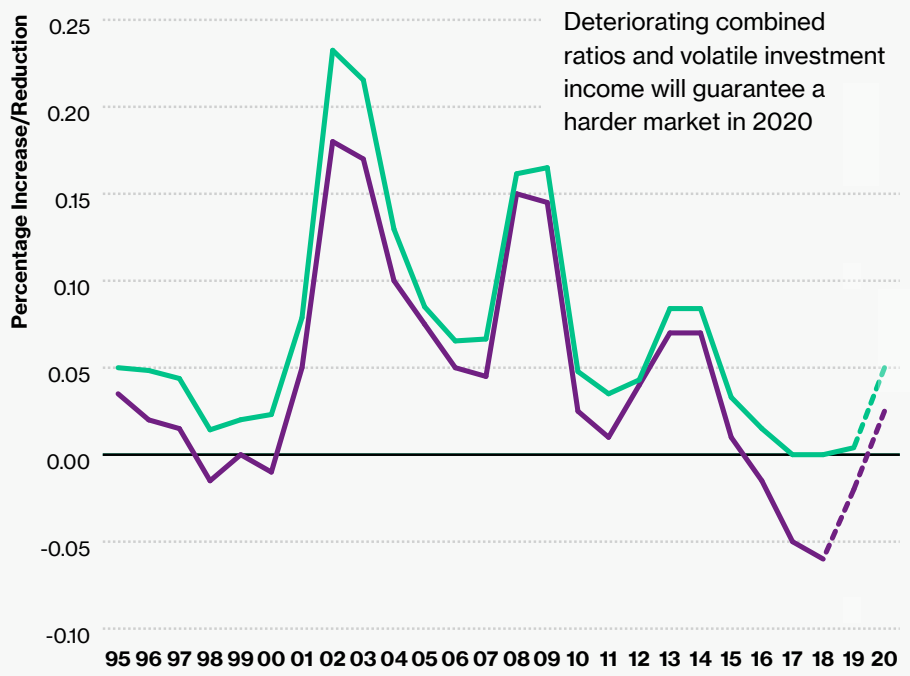
Expectations for the 2020 renewal season

Another corollary of the strong capitalisation in the market is that maintaining material release calls continues to be unjustified. Willis Towers Watson has long lobbied for the elimination of release calls and over the last ten years there has been a steady gradual reduction in release call amounts (with a minority of confident clubs reducing them to zero). Whilst we would expect this trend to continue, our fear is that in preparation for a hardening P&I market some clubs may choose to delay or reverse this trend.

Similarly, several clubs will again try to increase deductibles as part of the renewal 'package' (even if only to be used as a negotiating point combined with announced general increases). We again expect the approach of routinely applying deductibles to costs, fees and expenses to embed further across the market.

Following another year of relatively low incidence of P&I claims into the IG reinsurance programme, there will again be scrutiny on reinsurance cost. We expect that increased size of the world fleet combined with the improved loss results from the IG will outweigh the general 'hardening pressures' from the wider reinsurance market, this will be expanded on in the IG Reinsurance section of our P&I review

International Group (IG) P&I market cycle Where next? – projected expectations for the P&I market



Expectations for the 2020 renewal season

- Wide range of general increases, but most clubs to announce general increases around 7.5%
- Capital and/or premium will continue to be rebated by a minority of the strongest clubs. Possible unbudgeted calls at the very weakest end of the market.
- Anticipating a hardening market, some clubs will increase release calls as a potential deterrent to tonnage changing club
- Upward pressure from the reinsurance market, balanced by positive reinsurance loss picture across resulting in only marginal, if any, changes to IG reinsurance costs

Comparative analysis of individual clubs

In this section a number of references are made to variances in financial performance between individual clubs.

Willis Towers Watson's P&I clients have access on request to more comprehensive comparative analysis of individual clubs.

Contacts

Ben Abraham
D: +44 (0)20 3124 7786
M: +44 (0)7799 415806
ben.abraham@WillisTowersWatson.com

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