MANAGING DIRECTOR'S SOAPBOX

What they don't tell you...

The IG Reinsurance Contract - Is a Call for Change Justified?

Pressures are being brought to bear from a number of (perhaps vested) parties regarding the IG reinsurance placement. It seems to Wilson Europe at least, that the Lloyd's and other reinsurance markets play a crucial role in enabling the PandI Clubs to operate successfully, providing relevant cover that is fit for purpose. A representative from one of the world's largest corporate Shipowners is rumoured to have written to the Chairman of the Group, urging for fundamental restructuring of the placement. In our view, the reinsurance placement has been successfully and continuously placed with the Lloyd's market for six decades. One can therefore only assume the Clubs and the Reinsurance Sub-Committee have been content to recommend the product the markets have consistently provided. It has delivered confidence to the Shipowners, Governments and Authorities worldwide.

A number of the largest reinsurance brokers are also said to be leveraging pressure on the Clubs, and indeed some Clubs themselves, it is said, are also adopting a supportive role in challenging the current IG reinsurance structure. This is perhaps to curry favour with some 'mega' brokers, and to enhance the Clubs' own financial results, by reducing competition and driving smaller Clubs out of the system through mergers, takeovers or extinction!

Miller Insurance have successfully placed this cover since its inception. As a consequence of this contract, Miller are not allowed by the IG to market or handle direct P&I business / clients to avoid placement conflicts. This clearly reduces their own business opportunities! Miller have structured a very comprehensive placement, that has proved over time fit for purpose and at a highly competitive cost.

Senior IG representatives are regularly pronouncing that the IG Reinsurance Sub-Committee has again "achieved significant GXL savings and the Shipowners should be appreciative". Costa Concordia is still fresh in everyone's minds, including no doubt the reinsuring underwriters who paid claims totalling more than $1.5 billion. However, the reductions achieved from GXL underwriters at the 2017 renewal amounted to a welcome circa $25 million. Clubs on the other hand, have been quietly growing their free reserves collectively to at least $5.3 billion. This represents nearly a doubling / $2.5 billion growth in their free reserves in a decade. It is not too difficult to see where 'the treasure is buried' and where the real opportunities for savings lie.

Some of the proponents in favour of putting the IG Reinsurance contract out to tender justify their views by arguing that this contract has never been put out to tender previously. The same of course is true of most Club managers for more than 125 years!

So is a call for fundamental change in the IG reinsurance placement and structure justified? We don't think so!

> *"The Lloyd's and other reinsurance markets play a crucial role in enabling the PandI Clubs to operate successfully, providing relevant cover that is fit for purpose."*

The Consequences of Depriving Members' Loss Records of Premium

The International Group has now accumulated free reserves of $5.3bn (perhaps significantly more!). The Clubs have been 'squirrelling' away funds over a decade, largely by conservatively reserving their IBNRs (incurred but not reported) claims estimates. These anticipated expenditures are built into the Members' 'acceptable loss ratio' formula. This has the effect of reducing the Members' breakeven figure, and thus assisting the Club Underwriters in holding the (premium requirement) line when being pressed by Brokers and/or Members for premium reductions. Some Clubs are also holding unrealistic estimates for their ultimate Pool contributions, which again pushes up the cost a Member is required to pay for their cover.

The recently released Club Reports and Accounts (analysed in some detail under Section 3 of this report) suggests that most Clubs' underwriting is largely at breakeven. In some cases, substantial investment income has enabled the Clubs to give meaningful discounts or even waive (in the case of Gard) their final instalment / deferred call. This action potentially has an adverse affect on the mutual Members' loss record performance. This is as a result of depriving the record of premium which may result in a need for unexpected penalty rate rises at subsequent renewals. Clubs have always declined to recognise investment income in a member's loss record, but some now seem to be adopting this policy, which potentially destabilises the underwriting trend of the records. It should not be forgotten that policy year returns are a 'one off' allowance, whereas rating adjustments are perpetual!

> *"Surplus funds, particularly achieved by investment income, should be rebated to the mutual membership by capital returns and not by discounting call premium"*

Surplus funds, particularly achieved by investment income, should be rebated to the mutual membership by way of capital returns and not by discounting call premium. These returns can be reflected in the Member's loss record, but as is the case with Steamship Mutual, the loss records should be assessed on the original estimated mutual premium... agreed and charged at the beginning of the policy year, and the underwriting should not be affected by stellar investment income performances!

Release Calls - Are they Appropriate?

Release calls; should they be applied, are they really necessary, and at what level should they be set?

Following the last European Commission review of the IGA, their only meaningful concern was that of release calls. The Clubs were told to relax their requirements in order to encourage a more competitive environment and less restricted movement. The individual Club policies are seemingly both inconsistent and lacking in transparency. However they potentially have one aspect in common - to 'lock in' Members. The Shipowners Club sets its release call requirement at nil, which is entirely appropriate given their strong finances. Gard on the other hand, in spite of their enormous free reserves, set their release call requirements at 20%, 15% and 5% respectively for the preceding 3 open policy years. This is in spite of the Club waiving the deferred call requirement for 2016 of 25% and having never exceeded their supplementary call requirements in 25 years!

There is of course an alternative option for members to put in place a bank guarantee, often required to be provided by a first class London bank. This alternative is cumbersome and expensive to arrange. Some large corporates can usually influence Club Managers not to impose their official Club criteria, and perhaps fearing loss of future opportunities allow corporate letters to be provided instead without cost.

> *"The Clubs are currently in a very strong financial position and whilst release calls in some cases do have a place and is a principle of the IGA, they should however, be fair and reflective of the true financial situation of the Club at the time of their intended imposition"*

The Clubs are currently in a very strong financial position and whilst release calls in some cases do have a place and is a principle of the IG Agreement, they should however, be fair and reflective of the true financial situation of the Club at the time of their intended imposition. At this time, when no Club (exclusively underwriting P&I) should need additional unbudgeted calls, it is quite wrong in our view to require a release call penalty, and certainly not in excess of say 5% of the Club's genuinely anticipated total mutual premium at the time that the release call is intended to be imposed!

In our view, release calls should only be a genuine tool to protect the Club in uncertain times / circumstances, or to enable a Member wishing to leave, to voluntarily opt out of future Club financial liabilities, by paying a reasonable penalty to do so. Release Calls must not, as is often the case, be used to intimidate or threaten a Member to stay who wants to leave!

Reduced Competition - Anticipatable Consequences

A few of the largest Clubs in the International Group continue to have ambitions to see the number of Clubs in the Group reduce significantly. Two Clubs now account for 30% of the tonnage in the Group and 3 Clubs 40%. The International Group insures c.90% of the World's merchant fleet. This largely represents the same owners as those making up the Hull & Machinery Insurance market worldwide, where of course more than 60 Hull underwriters compete for the same pot of business. We continually hear how competitive / cheap the Hull and Machinery insurance market is, and this is perhaps tangible evidence if needed, that competition brings lower rates.

The largest Clubs tend to have more rigid entry and operational policies unlike their smaller brethren, who tend to be more flexible and 'lighter on their feet' when dealing with their members' needs. This is perhaps not surprising, as in most businesses the larger they are the less flexible their operational approach. There is also a growing practice of the largest Clubs all too frequently conducting customer surveys, which perhaps suggests that there is a disconnect between senior Club management and their Members and brokers. Medium sized Clubs do not generally undertake these surveys - perhaps because they have a better understanding of their own strengths and weaknesses, not needing to rely on customer feedback generated from often carefully crafted questions, designed to deliver desired responses for ultimate positive reporting to their Club Boards.

The International Group has nearly doubled in size over the last 10 years (both in free reserves and gross tons). Following the failed merger of the UK and Britannia Clubs, there are again alternative reinsurance structures being proposed, designed to substantially raise the IG Pool retention levels. The covert goal amongst the few pressing for change is to bring about a reduction in the number of Clubs in the Group, and for the 'remainers' to enjoy a larger slice of the IG pie - brought about by much reduced competition.

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A big bugbear for the largest Clubs is that each Club in the group has one vote, regardless of size... one Club one vote! This situation is frustrating for the largest Clubs, who are irritated and somewhat impotent in being able to achieve their domination goals.

The diversity of the Group and indeed the world's merchant fleet is such that there is room for all the current participants... and indeed more players if they were allowed to join the Group. Most Clubs are already significant buyers of facultative reinsurance products, offloading risk in the commercial profit making market, at often significant and in some cases unnecessary additional cost to the Club / its membership. In fact the largest Clubs often have less appetite to absorb risks that other Clubs are comfortable accepting! Reinsurance brokers tend to be very supportive of the call for of a reduction in the number of IG Clubs - as this will inevitably create a greater demand for more lucrative facultative reinsurance contracts. There is no doubt in our mind that a reduction in the number of Clubs will bring about reduced competition and service. As P&I brokers with a substantial portfolio, we regularly see 'David and Goliath' situations, where smaller and/or perceived weaker Clubs are able to provide more competitive rates and terms, where under other circumstances 'Goliath' would not be willing to provide the same but for the competition!

It may even be the case that larger Clubs' overhead costs are proportionately higher, perhaps spending disproportionate time and resources on new projects and diversification, all of which incur expensive R&D costs - as indeed is the case with last year's failed UK Club and Britannia merger / takeover. Average Expense Ratios, which are an official declared measure of the cost of running a Club, do not evidence that larger Clubs are more cost efficient than their smaller IG partners!

Do we believe the number of IG Clubs should reduce? The answer is no, as long as the Members continue to support their Clubs and the Clubs deliver high levels of service cost-effectively!

Should Clubs reject 'Interactive Rating' in favour of 'Public Information'?

Standard & Poor's boldly announces in TradeWinds that the "profitability" of the PandI Clubs is set to fall in the wake of a "soft renewal" (2017) and a resultant decline in premium income. In case no one has told S&P… PandI Clubs are supposed to be non-profit making organisations! Perhaps it is now time for Clubs to stop their use of the rating agencies and particularly their 'interactive rating', which is provided by the agencies at great cost to the Clubs both in terms of fees and resources, which has the effect of pushing up premiums! The agencies have been encouraging and often rewarding Clubs with higher ratings if they become multi-line insurance providers.

> *"We at Wilson have asked of the Clubs over recent renewals "how much reserves do you really need?" We have never received a coherent answer!"*

Several Clubs have pursued this agenda but unfortunately continue to make considerable underwriting losses from their Lloyd's market activities, which requires the use of members' money / Club reserves to underwrite non-PandI risks in this highly competitive, alien environment that in truth they don't properly understand. It is the mutual Members of the Club that are the financial guarantors of this diversification. Poor results will adversely impact on Club reserves and ultimately mutual Members' premiums! One 'A' rated Club is rumoured to be experiencing this situation presently, where Lloyd's underwriting losses and other exposures may mean that their Tier 1 capital is deemed insufficient.

Is it not now time for the Clubs to take a long hard look at whether they really need to use these (fee-charging) agencies to provide Clubs with an 'interactive' rating? Solvency II and Pillar III have now largely made the rating agencies' services redundant! Public Information (an analysis of the Clubs audited Report and Accounts) should suffice!

Interactive rating either overtly or covertly pressurises Clubs into ever increasing their free reserves and upfront premium requirements. We at Wilson have asked of the Clubs over recent renewals "how much reserves do you really need?" We have never received a coherent answer! The combined Clubs' reserves of the IG are now reported to be in region of $5.3 billion. We believe however the likely sum could be closer to US$6 billion. All of this has been achieved over a decade of the worst shipping crisis / freight markets in a generation. The over-reserving has largely come about as a result of Clubs over-reacting to perceived pressures from rating agencies and Solvency II requirements.

Interactive rating has created an unnecessary and bureaucratic 'race to the top' of the PandI financial league table. Given that Solvency II is now the regulatory requirement for European Clubs (only 2 Clubs outside), what real purpose do the agencies serve when they too are focusing on Club capital adequacy?

We therefore believe the Clubs should now reject 'Interactive Rating' and avoid the unnecessary and expensive costs it incurs!

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