Marsh Specialty

# P&I market bulletin

October 2022

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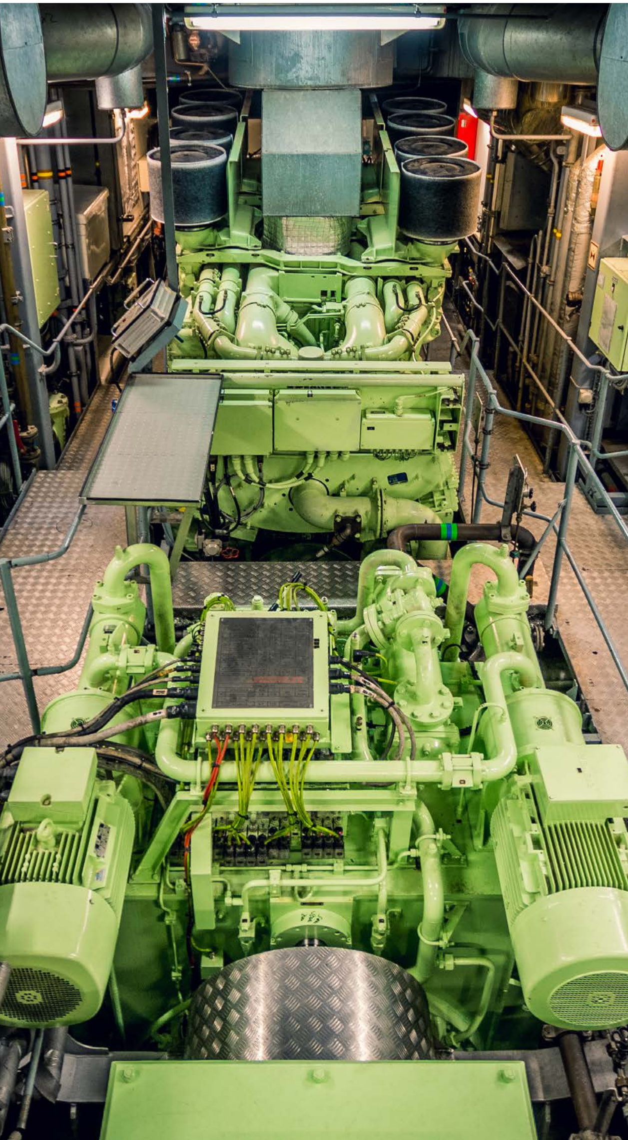
# Introduction

With the autumn P&I club board meeting season underway, most clubs will soon announce that they will include in their approach to the 2023 P&I renewal season a general increase, a premium levy to be applied to all members regardless of performance. Other than as a remedy for imperilled capital strength, which is not an issue for the P&I clubs as a whole, Marsh Specialty does not advocate for general increases. Most clubs do not share our view.

In this bulletin, for the benefit of club members not party to the decision-making process, we offer insight into the roles of P&I club managers and their boards, as they determine the requirement for, and extent of, a general increase.



## Club policy year reviews and call recommendations

Each club will have a slightly different approach to how it makes its call decisions, but the major factors taken into account and the overall process will be similar.

## Understanding the process

Club managers will draw up the proposals, usually led by the underwriting and finance departments, after which they will consult the club chairperson. A club sub-committee, or similar body, will then consider the proposals with a view to making a recommendation to the board. Occasionally the board may disagree with the recommendations.

Some weeks before the autumn board meeting, club directors will receive a detailed report explaining the call proposals or recommendations, providing them the opportunity to seek clarification and prepare questions.

The manager's report will make recommendations in respect of all open years and the next policy year, as well as recommendations regarding release calls and deductibles.

It is important to note that directors are expected to take decisions for the sole benefit of the club, ignoring any impact that their decisions might have on their own company interests.

## Factors taken into account

In setting call rates for the new policy year, directors consider a number of key factors, including:

- The current level of the club's overall funds.
- Income (calls and investments).
- Expenditure (the likely level of retention and pool claims, reinsurance, and operating costs).
- The club's free reserves.

## Income

The primary impact on call income for the next year will be tonnage. The managers will therefore seek to quantify any anticipated growth or losses, and the possible negative effects of the churn.

Predicting future investment income is more speculative, and independent investment advisors are asked to provide projections based on their experience and forecasts. Most clubs have a relatively low risk appetite when it comes to investments. In any case, clubs' portfolios are highly diversified. Nevertheless, results from one year to the next can be volatile. Despite any 'smoothing' in the financial statements accomplished by using longer-term investment rates, a club's overall financial position is affected by the actual return, and is an area of uncertainty.

## Expenditure

Expenditure is dominated by the cost of retention and pool claims. Projecting future claims levels – in both closed and open years – is necessarily speculative. Fortunately, experience over many years has proved to be a relatively good guide for the future. Sophisticated modelling can be used to test any forecasts by direct reference to a club's underwriting risk models.

## Operating costs

Operating costs consist predominantly of the fees paid to the club's managers and are usually relatively stable and predictable. The principal driver here will be inflation or an exceptional charge, for example a failed IT system.

## Free reserves

The level of a club's surplus resources – reserves – will be a key driver in the decision-making process. Clubs hold more capital than they are required to (above their regulatory capital), preferring a greater degree of prudence. The target level of reserves is defined as a cap – or economic capital benchmark – and is calculated in accordance with an individual club's economic capital strategy.

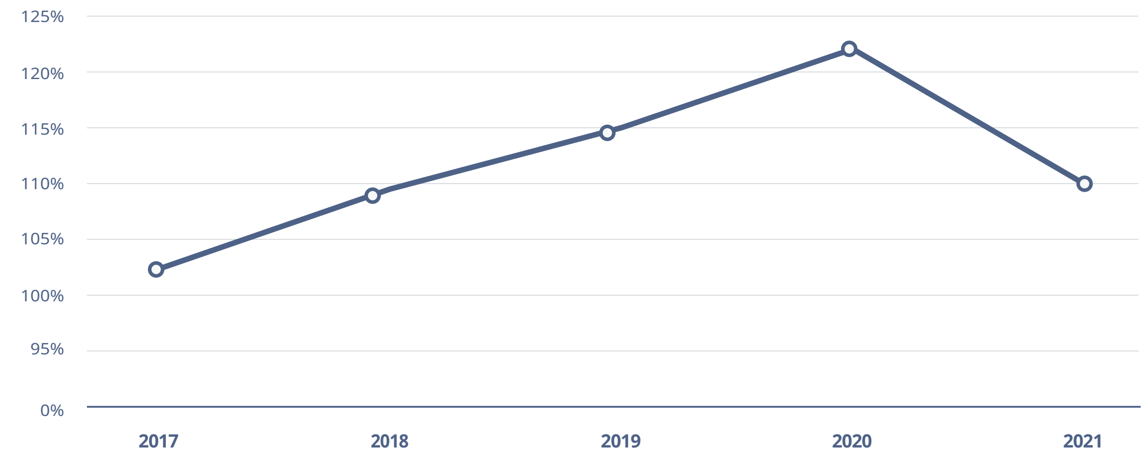
The extent to which a club's reserves lie above or below its economic capital benchmark at the time a decision on calls is to be made will have a considerable impact on whether a general increase is deemed necessary or appropriate.

Any presentation to directors will therefore include figures showing the effect that the call recommendations will have on the club's reserves.

# Underwriting position (income)

Aside from the issue of fairness, the technical case for general increases in P&I premiums seems less convincing than ever. The market average combined ratio is again under control, as the clubs achieved premium increases over recent renewals.

## 01| Combined ratio average below 110% in 2021




Having peaked at over 120% in 2020, the average combined ratio of the P&I clubs in the 2021 financial year was below 110% (see Figure 1). Given the clubs claim to have achieved significant increases at the 2022 renewal, it is not unreasonable to conclude that, in overall terms, the P&I market is now at or close to balance. On average, therefore, the case for general increase is not expected to be supported by current underwriting performance.

## Claims incurred (expenditure)

There are also signs that P&I claims are levelling off (see Figure 2). Total net incurred claims fell slightly in 2021, compared to 2020. At the time of writing, there have been no new claims notified to the pool for 2022 (the collision between OS 35 and a tie-up LNG seems to be largely a problem for the fixed premium P&I market).

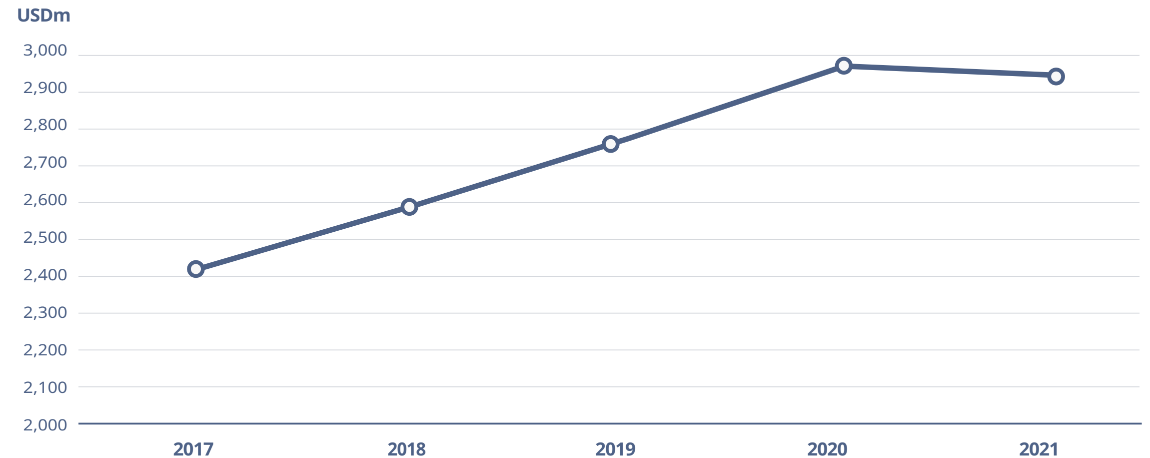
There has been some deterioration of the 2020 pool, which will impact the slim chance of an 'as before' renewal of the Group contract given that approximately half of the deterioration resulting from the WAKASHIO grounding claim will fall on the International Group's reinsurers. Otherwise, given the coming northern hemisphere winter, it is improbable that clubs will not experience any pool claims during the current policy year. At the same time, it seems unlikely that the pool, will experience the $635 million incurred in 2021, and less likely still the $820 million incurred in 2020 and the over $1.5 billion in 2019.

## Surplus capital (free reserves)

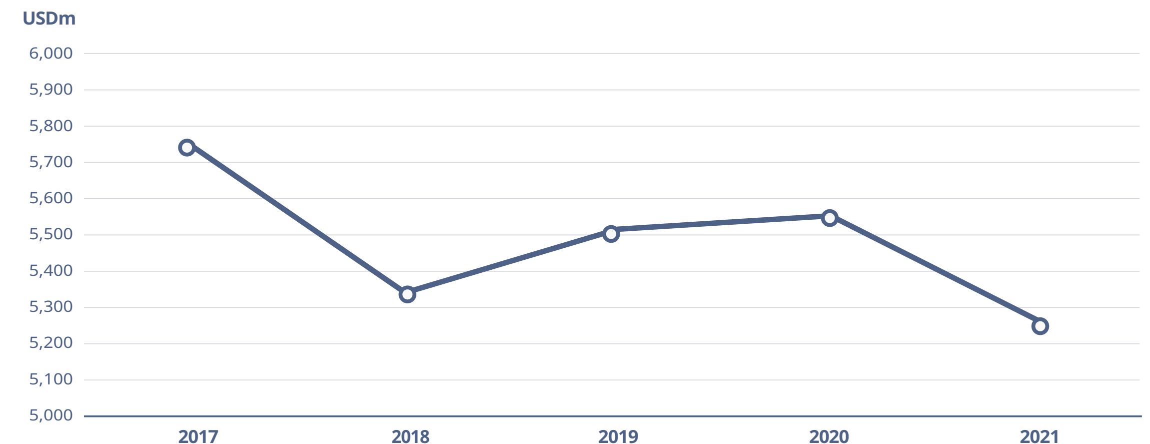
Overall club surplus funds, or members' equity, has remained nearly constant for a number of years at around the $5 billion to $5.5 billion mark (see Figure 3). Following an underwriting loss for the 2021 financial year and flat investment income, 2021 saw a small drop in the total, but by a small margin compared with the overall number. The overall financial well-being of the mutual P&I system is secure – most of the clubs enjoy surplus capital at the level required for a Standard & Poor's AAA rating.

As above, the clubs collectively registered an underwriting loss for 2021 of about 10% of net premium income, and, unusually, booked a flat investment return. So, how is it possible that overall surplus funds were not impacted to the same extent? In small part, there was the anomaly of London Club's additional supplementary calls, but the reduced impact of underwriting losses generally involved the release of prior year reserves.

### 02| Incurred claims fell in 2021




### 03| Surplus funds remain strong



All clubs reserve claims conservatively, meaning the eventual release of reserves is all but inevitable. This approach is hardly unique to the mutual P&I system, being a standard – even required – method for the insurance industry. Highlighting this is not a criticism. Rather, given that the capital has been supplied exclusively by the ship owner members of the P&I clubs, it makes the case that there should be more acknowledgement of the effects of over-reserving in the P&I system, especially when it results in higher than necessary premiums.

## Possible headwinds?

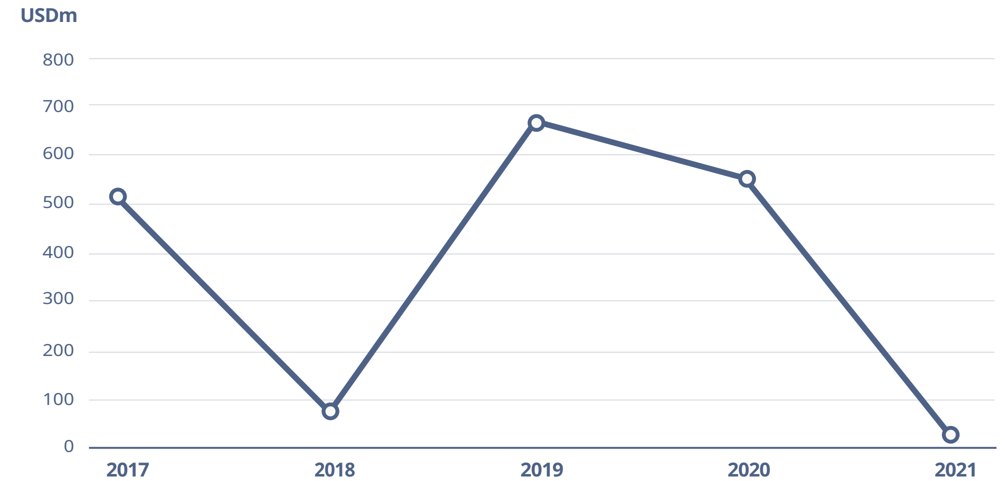
The two potential headwinds we are currently hearing most about from the P&I clubs are inflation and the challenging investment markets.

The absence of investment income significantly affected the 2021 year (see Figure 4). Regardless, our view is that investment returns should be considered in a longer-term context. Gains and losses are often not realised when the clubs mark to market, so looking at any individual year is likely to be misleading. While a difficult investment climate is unwelcome, some of the investment classes favoured by the clubs will benefit from higher interest rates. There is no reason to think the clubs will not continue to benefit over time from a modest, but valuable, income from the funds they have under investment.

The effect of inflation is more difficult to measure. While it is a concerning feature of the current economic landscape, the impact inflation will have on P&I claims may be more limited than for the general environment.

Cargo values are certainly increasing, but cargo claims are often governed by package limitation – or vessel limitation for larger claims – which do not adjust for inflation. There has been little evidence to suggest vessel payrolls are increasing significantly, something that otherwise might drive up the cost of crew personal injury claims. In all likelihood, any effect of inflation on the cost of P&I claims will only be seen over time and is not a solid justification on its own for increasing P&I premiums now.

## 04| Investment flat in 2021



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# Conclusion

The case for abandoning general increases in favour of an approach where P&I club members paying fair premiums to reflect the individual risk they present is stronger than ever.

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