BEST'S MARKET SEGMENT REPORT

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February 15, 2022

P&I Clubs in 2022 — An Even More Challenging Year

With the cost of pooled claims at a record high for the first half of the year, AM Best expects the clubs to return another combined underwriting loss in 2021/22

Principal Takeaways:

- P&I clubs will seek significant price improvements at the February 2022 renewal, in response to deteriorating claims experience
- The cost of pooled claims were at a record high for the first half of the year, surpassing the peak reached in 2020
- For 2021/22, AM Best expects P&I clubs to return a combined underwriting loss for the fifth consecutive year
- Solvency buffers have reduced but remain good for many clubs

For the third consecutive year, the majority of P&I clubs have announced general increases ahead of the February 20, 2022 protection and indemnity (P&I) renewal date for ship-owners, amid deteriorating claims experience.

The P&I segment is dominated by the 13 members of the International Group of P&I Clubs (International Group), which collectively insure approximately 90% of the world's ocean-going tonnage. In advance of the February 2022 renewal deadline, nine clubs have announced that they will apply a general increase to P&I premium rates. The other four— Britannia Steam Ship Insurance Association Holdings (Britannia P&I), Assuranceforeningen SKULD (Skuld), London Steam-Ship Owners' Mutual Insurance Association (The London P&I Club) and Gard P&I (Bermuda) (Gard)— have also announced similar actions to improve premium rates, referred to as minimum target adjustments, target increases or internal targets.

The general increases announced for the policy year 2022/23 are above the previous year, ranging between 5% and 15%, and have been attributed to:

- An increase in the cost of pool claims
- The cost of attritional COVID-19 related claims, and
- The erosion of premium levels up to 2019 to a level considered unsustainable

AM Best considers the level of general increases modest, given the underwriting loss expected for 2021/22, and expects that further rate adjustments will be needed to reach price adequacy.

As mutual insurers operating for the benefit of their members, the 13 clubs must balance the need to maintain their financial stability with the economic constraints of their membership. Certain segments of the shipping industry, such as containers and bulk carriers, have recently started to benefit from a spike in the price of transport. This is likely to ease the renewal process for clubs this year, with members having more funds to cope with rate adjustments.

Over the past few years, renewals have become increasingly informed by analysis of individual loss records and risk exposures, with deductibles used to control exposures. AM Best notes that member-specific pricing adjustments are also carried out by clubs applying general increases.

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More Pressure on Technical Results

The International Group reported an underwriting deficit of USD 519 million for the 2020/21 financial year (including premium discounts), based on the combined accounts of the 13 principal clubs of the International Group (see **Exhibit 1**). On the same basis, the combined ratio rose to 117% from 114% in the prior year (according to AM Best data) (see **Exhibit 2**). Call income increased by approximately 6%, driven by the general increases applied by the majority of the clubs during the 2020/21 renewal.

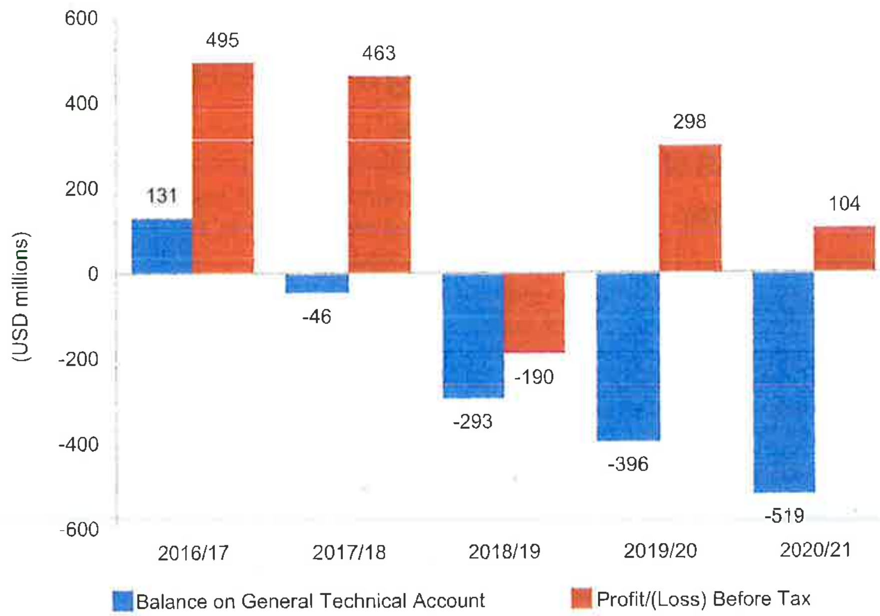
As in the previous financial year, all 13 clubs reported a technical loss. Claims incurred rose by 10% in 2020/2021, following a 7% increase in the previous year, and were above the five-year average (see **Exhibit 3**).

The clubs' expense ratio decreased in 2020/21 to 20.3%, having fallen in the previous financial year. However, even with this drop, AM Best notes that the expense ratio is higher by approximately two percentage points than that of the period prior to 2016.

The clubs compete on their service levels, with

Exhibit 1

P&I Clubs – Financial Performance of the International Group



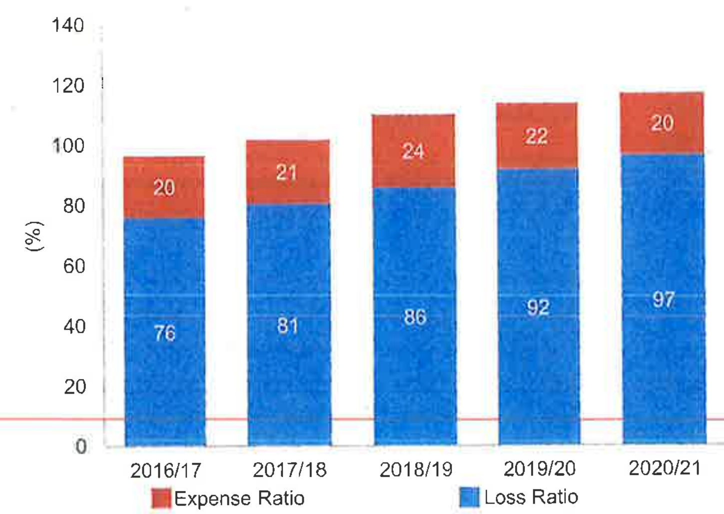
Combined accounts of the 13 principal clubs of the International Group (the whole of the International Group is not captured).

Sources: BESTLINK

Best's Financial Suite – Global, AM Best data and research

Exhibit 2

P&I Clubs – Combined Ratios of the International Group



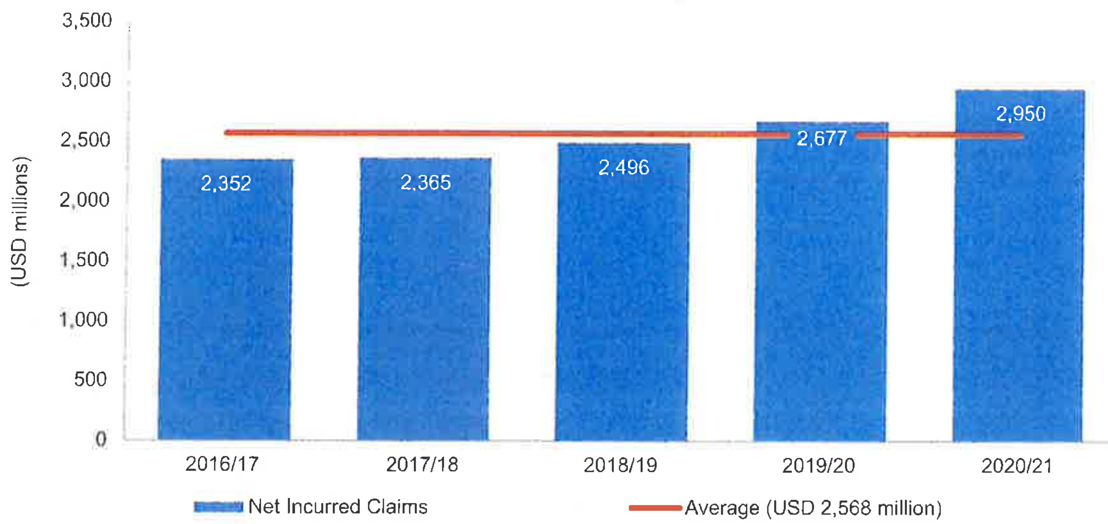
Combined accounts of the 13 principal clubs of the International Group (the whole of the International Group is not captured)

Sources: BESTLINK

Best's Financial Suite – Global, AM Best data and research

Exhibit 3

P&I Clubs – Net Incurred Claims



Combined accounts of the 13 principal clubs of the International Group (the whole of the International Group is not captured)

Sources: BESTLINK

Best's Financial Suite – Global, AM Best data and research

the demand for superior claims handling, knowledge of local markets, loss prevention advice and other services restricting the clubs' ability to reduce expenses.

Influences on Claims

A number of factors continue to influence claims trends, asserting an upward pressure on costs:

- The increasing size of vessels, which adds complexity when they suffer severe incidents.
- An upward trend in ship-owners' liability limits.
- Technological advances allowing deep-water wreck removal.

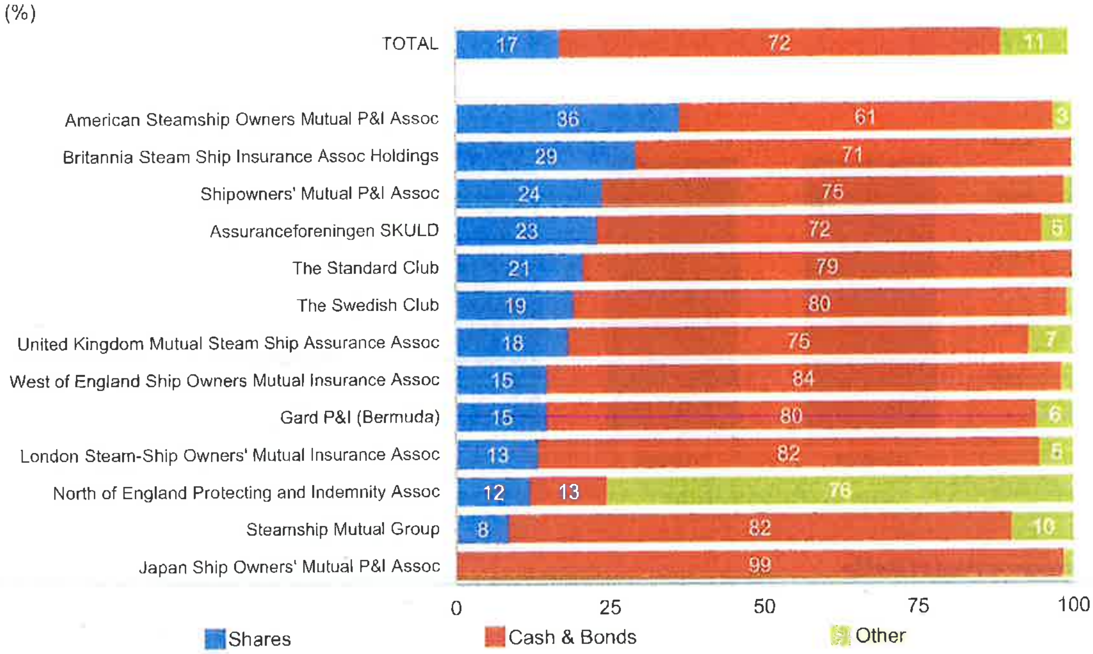
Social inflation has also been mentioned by some of the clubs as an influencing factor in pushing up claims costs.

By contrast, factors such as the fall in the age profile of vessels, technological advances in navigation, investment in loss prevention, and increases in club deductibles continue to have a positive impact on claims costs. In addition, the number of large claims seen in any one year will vary, leading to volatile loss experience.

For 2021/22, AM Best expects the clubs to return another combined underwriting loss. The cost of pooled claims was at a record high for the first half of the year, with further claims added in the second half.

AM Best notes that the COVID-19 pandemic has not been a major driver of pool losses. No COVID-19 related pool claims were recorded for the first half of the 2021/22 year, while three COVID-19 related claims for cruise vessels hit the pool in 2020. However, clubs have reported attritional passenger and crew claims related to the pandemic in both 2020 and 2021. Such attritional claims are likely to continue while travel restrictions and quarantine requirements persist.

Exhibit 4
P&I Clubs – Investment Split 2020/21
(%)



Sources: BESTLINK
Best's Financial Suite – Global, AM Best data and research

Investment Returns Probably Not Enough to Fully Offset Technical losses in 2022

AM Best notes that P&I clubs tend to have a higher appetite for investment risk than other non-life commercial insurers, with members taking a long-term approach to investment earnings. Many seem willing to tolerate year-on-year volatility. Overall, the proportion of investments allocated to equities (including mutual funds) is fairly stable, standing at approximately 17% at year-end February 2021 (see **Exhibit 4**).

Investment strategies differ significantly across the International Group. For instance, American Steamship Owners Mutual P&I Association (The American Club) has a relatively high appetite for equities whereas the investment portfolio of Japan Ship Owners' Mutual P&I Association (Japan P&I Club) consists almost entirely of cash and fixed-income securities.

Following two financial years characterised by high volatility and above average investment returns, a drop in returns is expected in 2021/22.

Investment returns for 2020/21 were above average due to the upturn in equity markets during the second half of the year, following the decline in March 2020 caused by the COVID-19 outbreak. Seven of the 13 clubs reported a profit before tax for the year and overall, the combined result was a profit before tax of USD 104 million. Combined non-technical earnings (mainly investment returns) of USD 624 million were sufficient to offset the combined technical loss of USD 519 million.

It is likely that the majority of the clubs will report positive investment results for the 2021/22 year, albeit lower than in the previous two years. These should only partly offset the expected underwriting losses.

Going forward, earnings are likely to continue to be affected by equity market volatility, with near-term returns remaining constrained by the prevailing low-interest rate environment as fixed-income securities and cash account for more than 70% of the clubs' investments.

Fixed-Premium Offerings – An Ongoing Source of Competition and Diversification

The mutual P&I market continues to face competition from commercial insurers providing fixed-premium cover. The main direct market participants are British Marine, owned by QBE, and MS Amlin, part of the MS&AD insurance group.

Over recent years, a number of managing general agencies (MGAs) have ceased their activities in this space due to the challenging market conditions. Others, like Thomas Miller Specialty, have taken advantage of the situation and expanded their presence in the fixed-premium space through acquisitions of books from ceased MGAs. In January 2022, Thomas Miller Specialty changed its capacity provider from AIG to United Kingdom Mutual Steam Ship Assurance Association (The UK P&I Club), thereby moving a large fixed premium offering from the commercial to the mutual market.

In response to the fixed-premium offerings by commercial insurers and MGAs, the majority of clubs in the International Group introduced their own fixed-premium covers, usually targeted at smaller ships. The importance of such offerings to an individual club largely depends on the ship size segment in which it operates. The fixed-premium segment is important to Shipowners' Mutual P&I Association (Shipowners), which focuses on providing cover to owners of smaller and specialist vessels. North of England Protecting and Indemnity Association (North P&I Club) uses its subsidiary, Sunderland Marine, to offer a fixed-premium P&I product.

Fixed-premium cover is an attractive alternative for small vessel owners that do not require high limits and do not want to be exposed to the possibility of supplementary calls. However, the traditional mutual P&I cover offered by the International Group remains the preferred choice for large vessels operating internationally due to the high limits available and the ability of clubs to issue "Blue Cards". These certificates provide a guarantee that ship-owners have adequate insurance in place (a condition of port entry), relieving them from additional local requirements.

Risk Diversification

Offering fixed-premium cover is one example of P&I clubs diversifying into risks that are not covered by the International Group's Pooling Agreement. A range of business models is evident within the International Group, with some clubs like Gard and The Swedish Club writing substantial hull and energy (H&E) books, and others, such as The London P&I Club, Japan P&I Club, Shipowners' and Steamship Mutual Group, taking a more cautious approach to diversification.

AM Best notes that business diversification can be beneficial to the stability of overall technical earnings. In years when the P&I account performs poorly, good results from the H&E account can compensate (and vice versa). Being able to offer a broader range of products can also enhance relationships with brokers and clients. However, expansion outside mutual P&I business has not always been successful and can put member capital at risk if growth is not accompanied by a prudent approach to underwriting.

For example, Skuld and The Standard Club set up Lloyd's syndicates in 2010 and 2015 respectively. Performance from inception was disappointing and both syndicates entered run-off in 2019. In 2020, Skuld agreed the sale of the syndicate to a run-off provider, The RiverStone Group.

Challenging Reinsurance Renewal

Overall, clubs in the International Group cede around 21% of premiums written. As part of the International Group pooling arrangement, participating clubs mutually reinsure one another by sharing claims in excess of USD 10 million. Additionally, the group buys general excess of loss (GXL) reinsurance cover up to USD 3.1 billion in the open market. By negotiating as a group, the clubs are able to achieve better terms on their reinsurance protection than would be possible on an individual basis.

In a very difficult environment, the International Group has successfully renewed its reinsurance programme for the 2022/23 policy year. Both the individual club retention and attachment point of the GXL contract remain unchanged at USD 10 million and USD 100 million, respectively. The upper limit of the GXL programme, as well as the capacity of the overspill protection, also remain unchanged.

The International Club's GXL was previously placed on a multi-year basis and so did not have to be renewed for the 2020/21 policy year. The 2022/23 policy year renewal was therefore the first renewal following the outbreak of the COVID-19 pandemic.

Reinsurers concerned about the exposure to systemic risks have sought to introduce pandemic and cyber exclusions into many reinsurance contracts since the 2020 renewals. However, wholesale exclusions were not introduced to the IG's programme at the 2022/23 renewal and the programme continues to provide free and unlimited cover for malicious cyber, COVID-19 and pandemic risks for claims up to USD 450 million excess of USD 100 million.

Above USD 550 million, these risks are covered up to USD 2.15 billion in the annual aggregate. The clubs have therefore retained a significant level of cover for such risks, while allowing reinsurers to limit their downside exposure to multiple very large losses from such sources. The clubs will pool any losses that exceed this annual aggregate limit. The fact that coverage has been largely maintained is viewed as a success for the clubs and an indication that reinsurers are now taking a nuanced approach to pandemic and cyber exclusions.

Due to the hardening market conditions and the deterioration in the group's claims track record, the cost of the reinsurance programme increased significantly at the 2022 renewal. This cost is passed to ship-owners, with the increase in rates ranging between 15% and 55%, depending on the type of vessel.

Individual clubs continue to purchase their own reinsurance protection to cover claims below their USD 10 million retention. The level of protection purchased depends on each club's risk appetite, and is influenced by the size of its capital base and its ability to absorb large losses.

Hydra – Third Quarter 2021 Emergency Cash Call

Hydra is the captive reinsurer of the International Group, based in Bermuda. The captive provides reinsurance cover for the Group's pool claims between USD 30 million and USD 100 million and for the USD 100 million aggregate deductible for claims in excess of USD 100 million.

Hydra is a segregated accounts company. Each club has its own segregated cell, which needs to be funded to hold a certain amount of regulatory capital. During the third quarter of 2021, the captive went below statutory capital requirements as a consequence of the record pool claims seen in recent years and 12 of the 13 members had to recapitalise their cells simultaneously. The total emergency cash call amounted to USD 240 million, with clubs' contributions depending on their share of the pool and on any previously held capital buffers within their cells. AM Best notes that this cash call will not have an impact on most of the club's balance sheets, as the participation in Hydra is generally treated as an investment (and not consolidated). On the other hand, the losses suffered by Hydra will affect the club's earnings and thereby also their capital positions.

Hydra's poor results are an additional setback for the clubs. Unless performance improves, further cash calls could be required in the medium term.

Capitalisation Continues at Strong Levels

The clubs entered the 2021/22 year with a record level of free reserves (see **Exhibit 5**), reflecting the overall positive operating result for 2020/21. In general, regulatory solvency ratios were strong and the majority of the clubs had prudent, albeit reduced, capital buffers (see **Exhibits 6 and 7**).

AM Best expects the clubs to report an overall decrease in free reserves during fiscal year 2021/22, with technical losses likely to be only partially offset by investment earnings (assuming the absence of large movements in equity markets in February). Risk-adjusted capitalisation is expected to deteriorate, but remain good on average. This is due to the capital buffers built up over the past 10 years, providing resilience during a challenging period.

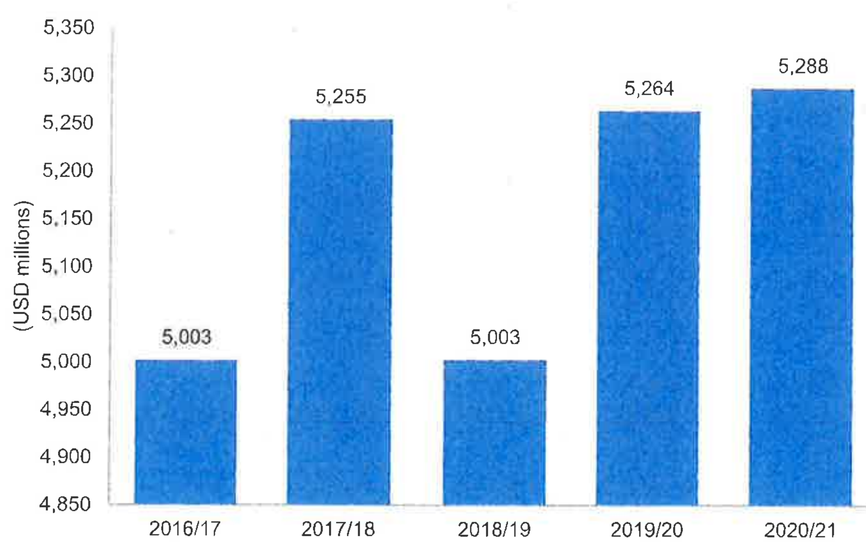
P&I clubs have improved their understanding of their risk-based capitalisation since the introduction of Solvency II, and they now have a better insight into the impact that different realistic scenarios have on their capitalisation. Most have clearly defined appetites for underwriting and investment risk.

AM Best views the clearer articulation of risk appetite positively, as well as the general improvement in governance and enterprise risk management (ERM) standards throughout the International Group.

At a group level, nine of the 13 clubs report a solvency capital requirement (SCR) ratio under Solvency II. At the end of the 2020/21 fiscal year, the clubs' SCR coverage ratios varied from 136% to 257%, with only three clubs reporting a ratio above 200%, compared to six in the previous year (see **Exhibit 7**). The average solvency ratio of the clubs fell by approximately 20 percentage points year-on-year, due to the operating losses reported by some of the clubs, which had a negative impact on own funds, combined with higher volumes of business, which increased

Exhibit 5

P&I Clubs – Free Reserves of the International Group



Combined accounts of the 13 principal clubs of the International Group (the whole of the International Group is not captured)

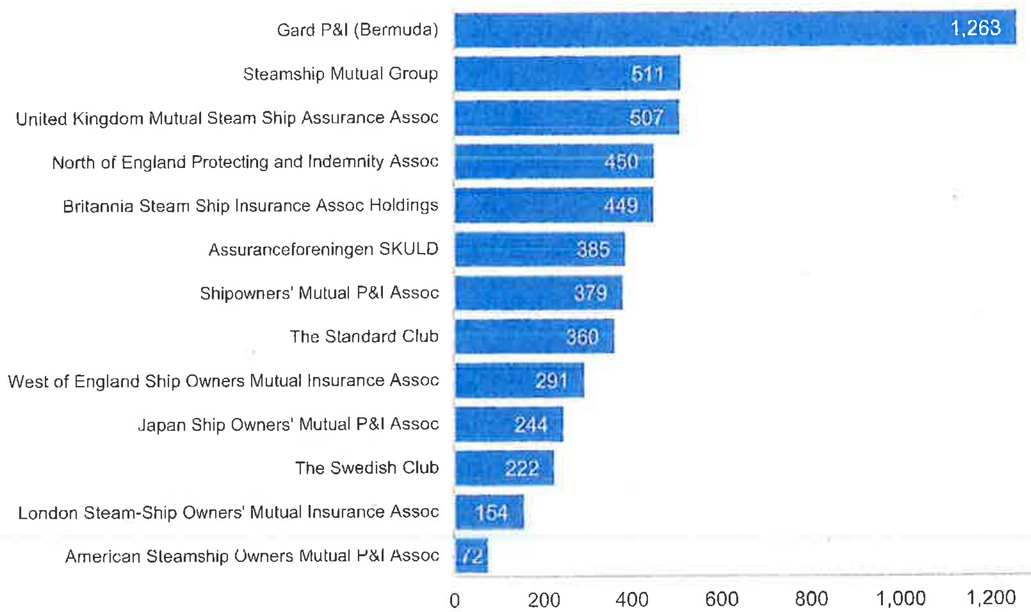
Sources: BESTLINK

Best's Financial Suite – Global, AM Best data and research

Exhibit 6

P&I Clubs – Free Reserves by Club 2020/21

(USD millions)



Sources: BESTLINK

Best's Financial Suite – Global, AM Best data and research

Exhibit 7

P&I Clubs – Solvency II Key Figures, 2020/21

Company Name	Eligible Own Funds to Meet SCR (USD millions)	SCR (USD millions)	Solvency II SCR Ratio (%)
American Steamship Owners Mutual P&I Assoc	N/A	N/A	N/A
Britannia Steam Ship Insurance Assoc Holdings	565	298	189
Gard P&I (Bermuda)	1,434	558	257
Japan Ship Owners' Mutual P&I Assoc	N/A	N/A	N/A
North of England Protecting and Indemnity Assoc	296	132	224
Shipowners' Mutual P&I Assoc	438	230	190
Assuranceforeningen SKULD	477	259	184
Steamship Mutual Group	N/A	N/A	N/A
The Swedish Club	297	129	230
London Steam-Ship Owners' Mutual Insurance Assoc	151	111	136
~~The Standard Club~~	~~N/A~~	~~N/A~~	~~N/A~~
United Kingdom Mutual Steam Ship Assurance Assoc	612	331	185
West of England Ship Owners Mutual Insurance Assoc	359	220	163

Sources: BESTLINK

Best's Financial Suite – Global, *Best's Statement File – Solvency II*, AM Best data and research the capital requirements. However, in general, coverage ratios remained strong, also helped by the capital credit given to the clubs' ability to make additional calls to members.

The ability to make such calls represents a proven source of financial flexibility for the P&I clubs and is viewed as a key strength. Supplementary calls constitute tier 2 ancillary own funds under Solvency II, subject to supervisory approval, and AM Best recognises this source of contingent capital in its analysis of clubs' balance sheet strength.

Two clubs announced additional unbudgeted calls in 2021. The London P&I Club made additional calls for the 2019, 2020 and 2021 years, while The American Club made additional calls for the 2018 and 2019 years and anticipated an additional call for 2020 to be confirmed in 2022. Previously, The American Club had also made additional calls in respect of 2016 and 2017.

The impact of levying such calls can be damaging to a club's relationship with its members, not least if a club is alone in levying a call or if a call is made when ship-owners face difficult economic conditions. Therefore, the clubs need to take into account the volatile nature of P&I business and their exposure to riskier asset classes, as well as their members' appetite for one-off capital contributions, when determining their target free reserve buffer over regulatory capital.

The accumulation of free reserves in past years led to pressure from both members and from brokers acting on behalf of those members, for clubs to reduce prices. This, combined with a challenging claims environment, and in particular an increasing frequency and severity of large claims, eroded underwriting profitability, leading to the overall technical losses reported in the last four underwriting years, and expected for 2021/2022. The general increases announced by the majority of the clubs for the February 2022 renewal should help improve underwriting results, however, AM Best expects that further general increases will be required over the next renewal cycles before the clubs return to overall technical profitability.

In AM Best's view, clubs need to take action as the buffer in the current levels of capitalisation is reducing. In addition, while there are certain expectations for increases in interest rates, these remain at historic lows, and with equity markets volatile, clubs need to keep their focus on underwriting discipline to ensure financial strength is maintained.

Cyber Risk and Maritime – New Protection Gaps

Cyber risk has been a prominent topic of discussion among the largest shipping companies in the wake of a series of cyber attacks in 2020 and 2021.

In a bid to minimise this risk, the International Maritime Organization (IMO) released maritime cyber risk management guidelines, which came into force on January 1, 2021. These require ship-owners to demonstrate they have incorporated cyber risks into their risk management systems.

The International Group's reinsurance programme includes cover for the majority of the clubs' certificated risks regarding malicious cyber, COVID-19 and pandemic risks, although an annual aggregate limit has been placed on coverage for claims in excess of USD 550 million. The Group has decided to pool the excess risk not covered by the programme, resulting in no change for members' cover (regarding poolable risk). AM Best notes that this decision exposes the clubs to the unlikely but potentially very severe risk of multiple large claims from cyber attacks.

For their non-poolable risks, some clubs have decided to restrict cyber cover as they were not able to find protection in the reinsurance market. This decision will create a protection gap, leaving ship-owners exposed towards certain risks.

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