Managing Director's Annual Review

Collectively the International Group of P&I Clubs has had another very successful year with an aggregate underwriting surplus, their first for four years, and an overall surplus of $324m, adding a further 7% to their free reserves - a new record high of $4.6bn.

The year has been marked by an improvement in their underwriting, delivering a 5.8% increase in net premium income. This compares to only a 2.8% increase in the entered gross tonnage and no increase in incurred claims. The Clubs have managed to increase their premium rates, however the current average rate of $3.2 per gt is lower than the $3.7 per gt charged in 2011. In the intervening period the entered gross tonnage of the Group grew twice as fast as the net premium income. The improved underwriting also emanated from recent benign claims years. This however was not reflected in a reduction in total incurred claims. The 2014 IG Pool policy year started well with only 15 reported claims at year end, which are estimated to cost $180m - the lowest first year total since 2008. The Clubs generally reported a lower incidence of high value claims, which in the past has been identified as the principal cause of adverse fluctuations in underwriting performances.

This collective underwriting improvement is timely as investment managers thus far, have had a difficult task in generating any meaningful level of investment return. Interest rates have remained obstinately low and in a few isolated cases even been negative. The ECB (European Central Bank) embarked on a belated bout of quantitative easing, which drove rates and the value of the Euro even lower. In America and to a lesser extent in Britain, there continues to be much speculation as to when the authorities will start increasing interest rates again. Subsequent events seem to have 'scuppered' any immediate likelihood of increases. Meanwhile President Shinzo Abe - Prime Minister of Japan continued his economic experiment with another massive session of quantitative easing, which resulted in the Yen falling by almost 20% against the Dollar.

The net result is that investments held in non US Dollar currencies have fallen in value and government bonds have generally performed poorly. The only assets that have shown any real returns were Dollar corporate bonds and equities. Consequently, Clubs holding large corporate bonds and equities did considerably better than those holding government bonds and non-Dollar currencies. Ironically those Clubs holding fewer equities , perhaps to reduce perceived risk (and thus enhance their credit and regulatory ratings) will have come off worst. The same however may not be said for 2015 !

Aside from the main operational issues, discussions still rage over the potential benefits and pitfalls of diversification, with some Clubs 'rushing headlong' into new ventures in which they have little or no experience, while others remain unconvinced. A significant potential problem may arise if too many Clubs choose to set up Lloyd's facilities, as those clubs will very likely be in direct competition with the syndicates currently underwriting the IG reinsurance contract. This will undoubtedly result in disharmony!

We believe that the Clubs should stay true to their core values and not seek perceived 'greener pastures' in the commercial market, gambling in a game they don't really understand, with money that isn't theirs, in risks that are not compatible with P&I, and the members never really knowingly signing up to the (adverse) consequences of these new ventures . In reality it is not, in our view, for the greater good of the Club and its members, but to enhance the 'managers' reward.

The Clubs however do need to modernise and to build on the long established strengths of the mutual system and discard the elements which are no longer really relevant in today's world e.g. the ability to make supplementary calls and the automatic assumption that general increases are a renewal expectation. Dudley Taylor, our Chairman, sets out his vision and justification for modernising the mutual system, without losing or damaging its core strengths!

Turning to Solvency II, the Clubs will now have their internal models to calculate their 'Solvency Capital Requirements' or at least have formal approval to use the 'Standard Formula' approach. This will hopefully conclude an enormously long and expensive initiative taking over ten years to complete. It should now only leave 'Pillar III' - which focuses on solvency and transparency requirements, which should take considerably less time to complete.

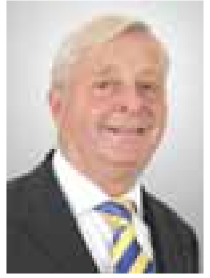
Another potential 'blot on the landscape' is IFRS 4 - the new International Financial Reporting Standard on insurance contracts, a final draft of which was scheduled for this summer, but fortunately has been delayed.

Club Managers and their Boards will doubtless have on the top of their agendas at this time, their 2016 general increase requirements. Club Managers will no doubt seek to argue that; current premium rates are comparable to those of ten years ago, the cost of claims is rising, the size of ships are increasing and Shipowners liabilities have never been greater, with new conventions regularly coming into force. The Members' and their Brokers' retort must be that the Clubs are now over-capitalised, Solvency II requirements have been addressed, the cost of claims (per gt) has fallen and the members , in many cases, continue to face challenging financial times.

Looking forward, individual Club reinsurances will continue to play a key role in all Clubs ability to mitigate the impact of large value claims, which traditionally have an undue influence on the results of any one policy year. Investment Managers will also be playing an important role in achieving any level of investment income and crucially avoiding losses. At this stage in the cycle we suspect that Club Managers would be content to report a nil investment return!

With little or no investment income likely in 2015, it can be anticipated that this issue will be adopted as an argument by those Clubs seeking general increases. We anticipate that even modest general increases will be unwelcome by members and in fact unjustified ! We can also anticipate that some Clubs will reduce their 2014 estimated total cost by reducing or returning to their Members an element of the premium debited. This will further evidence those Clubs getting their budgeting wrong by unnecessarily imposing general increases at the commencement of the policy year, only to return some of it to the members at the end of the same policy year.

The reality is that The International Group of Protection and Indemnity Clubs have never been financially stronger and this has been achieved at a time when the same cannot be said for their Members who own and fund the mutuals. Club Managers must stop 'slavishly' following the 'road map' laid down by the rating agencies and return to the basic principles of serving their membership as PandI Clubs and not adopting the approach of commercial insurance companies.



Julian South
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