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Why P&I clubs could be facing their biggest hurdle yet

There is no reason to believe the upward trend in claims will go into reverse any time soon, writes Mike Grinter

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A RICH concoction of costlier liability regimes, a more punitive legal environment, tighter financial regulations and shipping's recent good fortunes are all conspiring to create difficult times ahead for P&I clubs, according to Jerry Westmore, vice-president of broking house Marsh's P&I department.

He was speaking at a Marsh-sponsored seminar in Seoul where he considered the issues facing the P&I clubs in the run-up to the 2006-07 renewal.

As global trade has risen, particularly last year and this, driven largely by China's world factory and its demand for raw materials, the shipping industry has benefited immensely in terms of record freight rates and return on capital.

But, as is usual with such booms, the increase in traffic and its strains on manning are having an adverse effect on the claims profile of P&I clubs.

In the period 1999 to 2004, the clubs' net claims have risen from a shade under $1bn to roughly $1.6bn.

It is too early for clubs to have a clear picture of their claims profile this year, but with trade growth having continued through the year, there is no reason to believe that the upward trend in claims will go into reverse any time soon.

Over and above the increase in claims and their value as a result chiefly of a 21% increase in commodity prices in 2004 and a further surge of 16% this year, other inflationary pressures are exerting an influence.

Mr Westmore cited a report by British accountants Moore Stephens, who found that shiprepair and maintenance costs increased by more than 20% during 2004 as a result of increased steel costs and lack of space in repair yards as many shipbuilders gave up space to accommodate the rising demand for new buildings.

London continues to be the centre for the resolution of shipping claims despite the fact they are far and away the most expensive and most profitable in Europe. According to Mr Westmore, the average level of fee generated per fee earner is now $333,000 and the average profit per partner is close to $750,000.

During a period which almost coincides with the upper end of the most recent shipping cycle shipowners, and in turn their P&I clubs, are being exposed to liability regimes that demand increasing levels of compensation. In at least one example the clubs find themselves in the front line.

The Civil Liability Convention of 1992, the Supplementary Fund, Stopia and the 1996 Protocol to the 1976 Convention for the limitation of Maritime Claims have all witnessed greater or additional limits.

The Draft Supplementary Fund Protocol of 2003, with its additional layer of compensation in respect of oil pollution damage to which the 1992 CLC or the 1992 Fund Conventions apply, is split into two agreements.

The first, the Small Tanker Oil Pollution Indemnification Agreement (Stopia) replaces the present limit of liability for a tanker up to 5,000gt of $6.7m with a limit of $30m for a tanker not exceeding 29,548gt.

The second agreement pulls the clubs directly into the firing line by virtue of a provision to the memorandum of understanding with the International Group that gives the 902 Fund the right of direct action against the insuring club.

Liability funds concerned with loss of life or personal injury have seen compensation limits head skywards.

The 1996 Protocol to the 1976 Convention for the Limitation of Claims raised limits, for which Mr Westmore gave the example of ships between 30,001 and 70,000gt where limits have been raised to $900 per gt from $375 and in the tonnage band above 70,000 from $251 per gt to $600.

Owners of passengerships have faced enormous liabilities since the 2002 Protocol to the Athens Convention of 1974. At SDR400,000 (about US$580,000) per passenger, a ship with 3,500 passengers could end up with a bill of $2bn.

The above are the more obvious examples cited by Mr Westmore but are far from comprehensive.

More stringent financial regulations as they apply to the governance of the clubs are the source of an additional financial burden.

The European Solvency II requirements have established a framework for operational, market, financial and risk management and reporting across the insurance, primarily to determine an appropriate level of capital needed for the protection of policyholders.

Individual Capital Assessment and the Enhanced Capital Requirement introduced by the British Financial Services Authority anticipate the Solvency II regulations and add further to an increasing administrative burden to the clubs.

Mr Westmore cited Datamonitor's contention that the European insurance industry would spend $1.75bn next year for IT systems to ensure compliance with regulatory authorities.

The adversities to which he referred are examples of exterior threats that must be countered by having a wide-ranging risk management programme in place.

The financial burden they may represent can be countered to a greater or lesser degree by arriving at an insurance rate that takes full cognisance of the risks.

Mr Westmore's final gremlin in the machine represents a risk firmly embedded in commercial considerations.

The "churn effect", whereby the benefit of older, higher rated vessels are lost to scrapping and replaced by aggressively rated new vessels, will present a serious challenge to the clubs because it is happening on such a vast scale.

The ISL 2005 market analysis records an orderbook at an all-time high comprising 4,000 vessels and almost 216m dwt. Tankers account for 40% of the total, containerships 30% and bulkers 16%.

At the beginning of this year, orders for new containerships represented an additional 50% capacity to the existing fleet.

Mr Westmore drew a number of scenarios, all of which potentially saw the clubs outmaneuvered by their members: "Clubs with sizeable entries from major shipping lines, especially those with large dry and liquid bulk tonnage will be most affected.

"As these members renew large parts of their fleets they will expect the new tonnage to attract the lowest rates and their clubs will have to respond.

"If not, owners may split fleets, split them still further or make changes in the proportions entered to reward the more flexible clubs.

"Clubs that have smaller parts of the large fleets will have to compete aggressively to get their fair share of the new additions or risk seeing their premium and tonnage base seriously eroded.

"Clubs seeking to get involved for the first time in these evolving fleets will be faced with following terms that are aggressively rated in order to get involved or risk losing their older tonnage and not replacing it.

Clubs taking this course will downsize rapidly and, while they might publicly state that they are happy not to 'follow the market down', they will find it difficult to see their premium income reduce too fast.

"Some clubs may decide that they will not compete for the new tonnage and instead look to the smaller owners as they expand.

"The fixed markets which have traditionally been cheaper than the group clubs may find themselves under the sort of rate pressure they have grown used to leveraging."

These possibilities, whichever way you look at them, translate into a scenario where, in the face of increasing costs of claims and compliance, the basic premium charge per gt will fall as new tonnage enters the market, thereby introducing greater volatility within the retained layer of the clubs' cover.

Amid concerns that reserves remain at adequate levels without undue reliance on investment income, it is a given that the clubs will introduce general increases for the 2006-07 year.

It is the size of those increases and whether the clubs are prepared to stick to them rigidly which is in question. Since the 2001 renewal, the group has averaged published increases of 14.43%. The clubs' track record for adhering to published rises is uneven at best and led Mr Westmore to conjure a worse case scenario — new ships attaching at cheap rates results in overall premium decreasing and any general increase being applied to an ever reducing premium base.

If the churn effect leaves the net premium at a static level while claims increase by 5% and costs rise 2.5% the result could be as shown in the table (left).

The figures do not include investment income but clubs would not baulk at that as they are seeking to avoid reliance on it and the regulatory authorities would discount it.

P&I clubs may beware Greeks or any other maritime nation bearing gifts at the next renewal.

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