December 2020

International Group (IG) P&I Market Financial Commentary

Market Financial Year Results

Highlights
2019/20 financial year

- Premium reduced by 1.9%
- Routine claims relatively stable, greater volatility of larger claims. Incurred claims increased by 9.3%
- Deterioration in P&I market combined ratio, with a 2019/20 market average of 118% (however if all clubs had charged their full estimated total calls, the underlying market combined ratio would have been 115%)
- Range in investment returns announced by individual clubs, but overall very positive (market average return 7.4%)
- USD 476 million P&I market underwriting loss in 2019/20, offset by USD 689 million combined investment income, led to an overall market surplus of USD 213 million
- 3.3% increase in market free reserves, driven entirely by investment income
- Continued wide variance between best and worst performing clubs

Claims deterioration

After the slowdown in the speed of increase of market claims in 2018/19 (when incurred claims increased by only 3.6%), incurred claims accelerated materially in 2019/20, increasing by 9.3% (the largest margin since 2011/12). Paid claims increased by even greater amounts. Gross and net paid claims increased by 11.2% and 10.5% respectively.

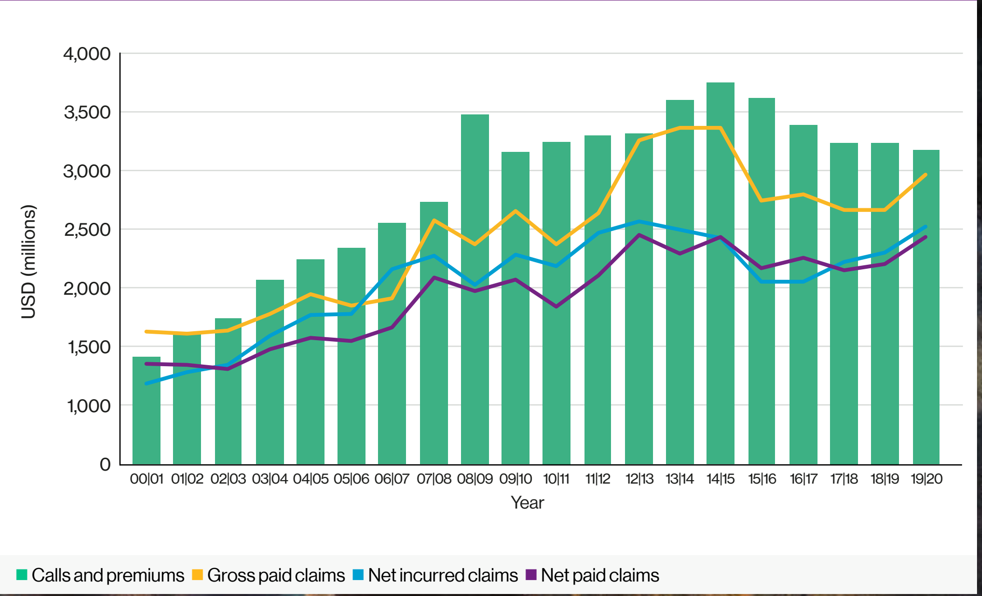
Claims volatility has been discussed in previous reviews over the last 12 years. The graph on the right demonstrates this pattern. From the beginning of this century claims inflation was relatively predictable and progressive. There has however been a marked increase in claims volatility since 2006/07. This trend is shown most starkly in the gross paid claims results but the fluctuation in net paid and net incurred claims is similarly less predictable over the most recent 13 years.

As underlying attritional claims (those below USD 500,000) have been remarkably stable across the P&I industry, the material increase in incurred claims over the last three years is another indication that the volatility in overall market P&I claims has been largely driven by very large claims.

The graph on the right displays the progression of gross and net paid claims, along with net incurred claims compared to total premium paid into the market over the last 20 years.

There has been a marked increase in claims volatility since 2006/07

Paid Premiums vs. Gross Paid Claims, Net Paid Claims and Net Incurred Claims



Underwriting loss deepens

With the continuing erosion in premium levels and double digit increases in claims, it is no surprise that the P&I market underwriting loss worsened in the 2019/20 financial year.

The overall market combined ratio in 2019/20 was 118%, deteriorating from 110% in 2018/19. The market loss on P&I underwriting in the 2019/20 financial year was USD 476 million.

This continues the pattern over the last four years of progressive deterioration in market combined ratios, as shown in the graph on the right hand side of the page.

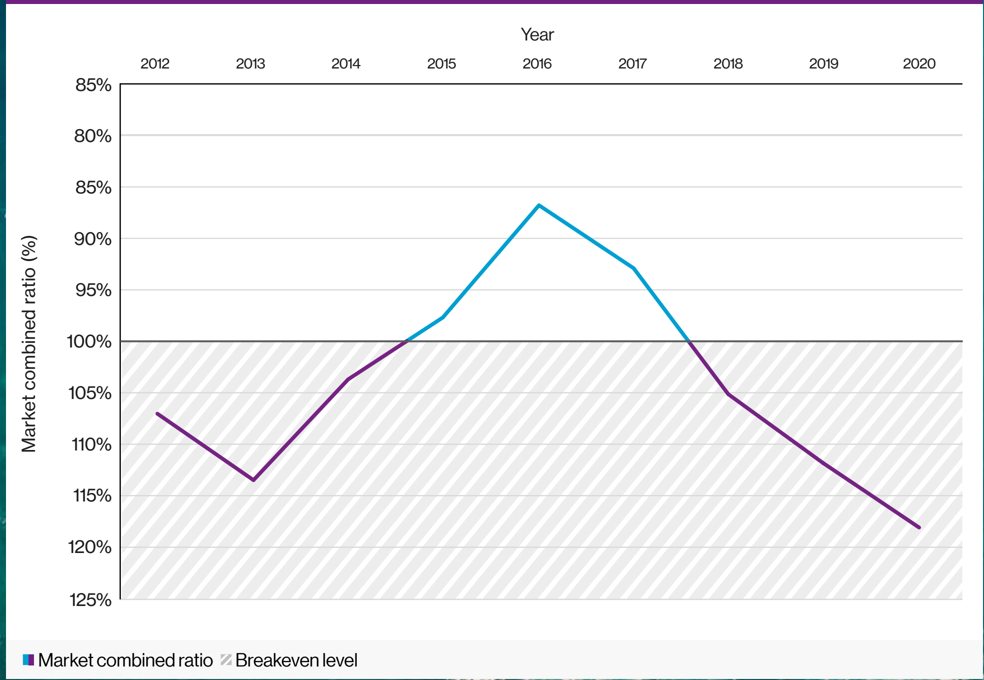
The combined ratio is essentially the net loss ratio for the club and is defined as follows:

$$\textbf{Net combined ratio} = \frac{\text{(Net incurred claims + operating expenses)}}{\text{(Premium – reinsurance costs)}}$$

Combined ratio notes

- A 100% combined ratio represents the underwriting break-even position
- Anything above 100% would represent an underwriting loss and a combined ratio less than 100% would indicate an underwriting surplus

P&I Market Combined Ratio Progression



Near record investment income contribution

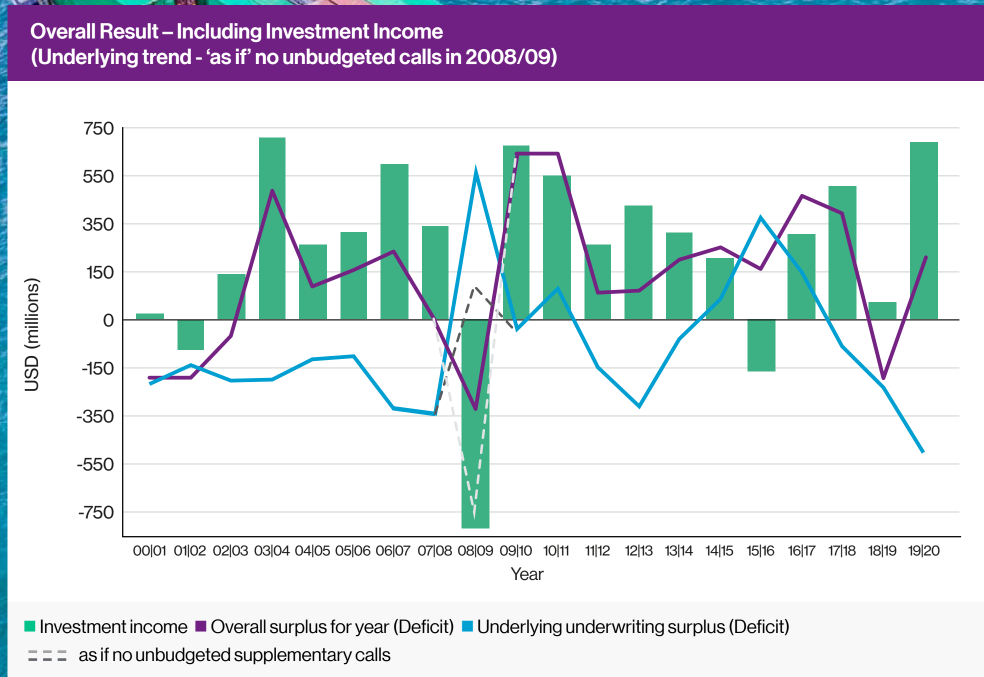
By stark contrast to the underwriting results, the contribution of investment income in the 2019/20 financial year was at near record levels. The average investment return across the P&I market in 2019/20 was 7.4%. In dollar terms, 2019/20 was the second highest contribution of investment income in the history of the (IG) market.

Despite the extremely adverse underwriting result therefore, the spectacular investment return in 2019/20 was significant enough to completely offset the substantial underwriting loss and drive an overall market surplus of USD 213 million.

The graph on the right shows the progression of underwriting, investment and overall result for the market over the last 20 years.

N.B. to reflect the underlying underwriting result, the solid lines show the results as reported, the dashed lines display how the underlying trend would have looked without the unbudgeted calls from 2008/09.

The contribution of investment income in the 2019/20 financial year was at near record levels



P&I market reserves increased, but the relative trend remain adverse

Market P&I free reserves increased by 3.3% in 2019/20, to just under USD 5.17 billion.

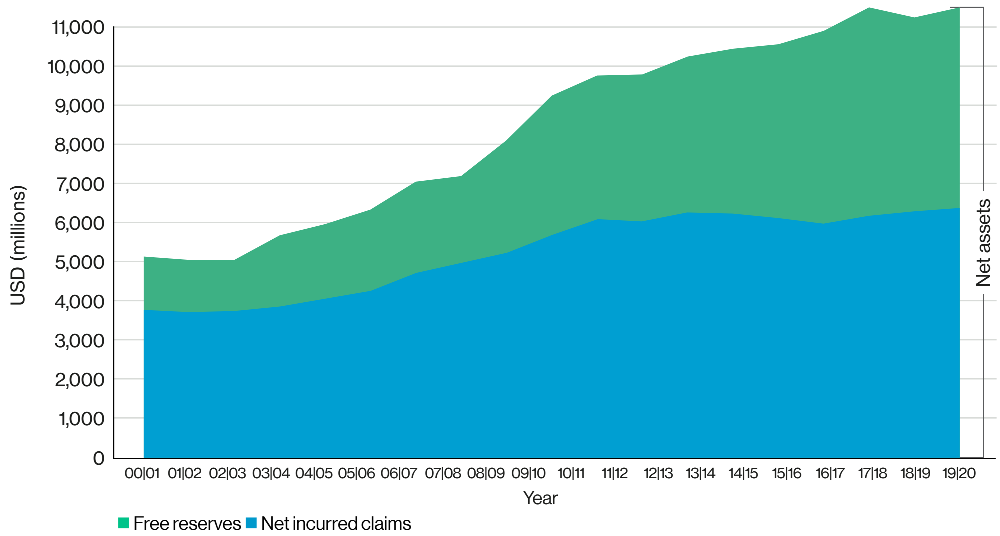
This increase did not quite offset the 7% dip in free reserves in 2018/19, but the IG market free reserve position as at 20 February 2020 still represented the second highest level, in absolute dollar terms, in the IG's history.

The combined market free reserve as at 20 February 2020 was 2.3 times larger than it was following the equity crash in 2008. This is reassuring, particularly as the closest analogy to the impact that COVID-19 has had on world trade in 2020 is the effect that the global financial crisis had on world trade in late 2008 and 2009 (both anomalies reducing world trade by just over 9%, source WTO). At the time of writing, the world is still in the grip of COVID-19, but a potential economic recovery in 2021 looks promising (WTO is projecting a 7.2% increase in world trade in 2021). In such uncertain times however, there will undoubtedly be further ups and downs along the way.

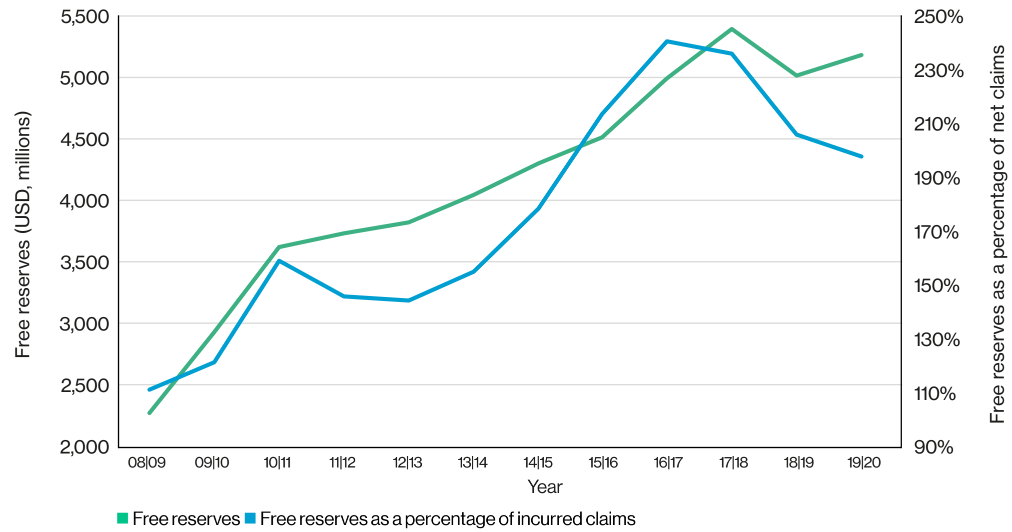
It should also be noted, that while in absolute terms, free reserves have increased materially compared to risk in the market, the relative free reserves in the IG system actually peaked in 2017. Free reserves compared to either net incurred or net paid claims, show that the ratio peaked at 20 February 2017 and has been in decline for the three subsequent years. The same comparison of free reserves to owned entered tonnage follows a very similar progression (though the peak being at 20 February 2018).

The first graph, top right displays the progression of net assets, outstanding claims and free reserves for the entire market over the last 20 years. The following graph shows the progression in free reserves (in USD, millions) compared to free reserves as a percentage of net incurred claims in order to demonstrate the divergence in relative financial strength from 2017 to date.

Development of Assets and Free Reserves



Market free reserves, compared to Free reserves as a percentage of net incurred claims



Continuing wide variation in individual club underwriting results

As we have commented in previous P&I market reviews, there is a significant variance between the best and worst performing clubs in the IG.

Combined ratios are a direct comparison of clubs' underwriting performance. The 2019/20 net combined ratios for all the clubs are set out in the graph to the right.

Only three of the 13 IG clubs reported an improvement in their financial year underwriting results, with the other 10 clubs reporting materially deteriorated underwriting figures.

The variance between the most positive and the most adverse underwriting results continued to expand in 2019/20. The difference between the best and worst combined ratio results in 2019/20 was 42%.

Combined ratio highlights

- Market average combined ratio of 118%
- Only one of the 13 clubs reported an underwriting surplus in 2019/20
- 10 out of the 13 clubs reported deteriorated underwriting results
- Over half of the market reported combined ratios of 120% or greater
- 42% variation between best and worst underwriting results in the market

Combined Ratios – 2019/20 Financial Year (Incurred claims + Expenses) / (Premium - Reinsurance)

Notes:

Gard P&I only, as reported (on ETC basis:106%). Gard Group, as reported 114% (on ETC basis 102%)

North, excluding Sunderland

Swedish, P&I only

Standard, excluding Syndicate

American Club, excluding unbudgeted calls

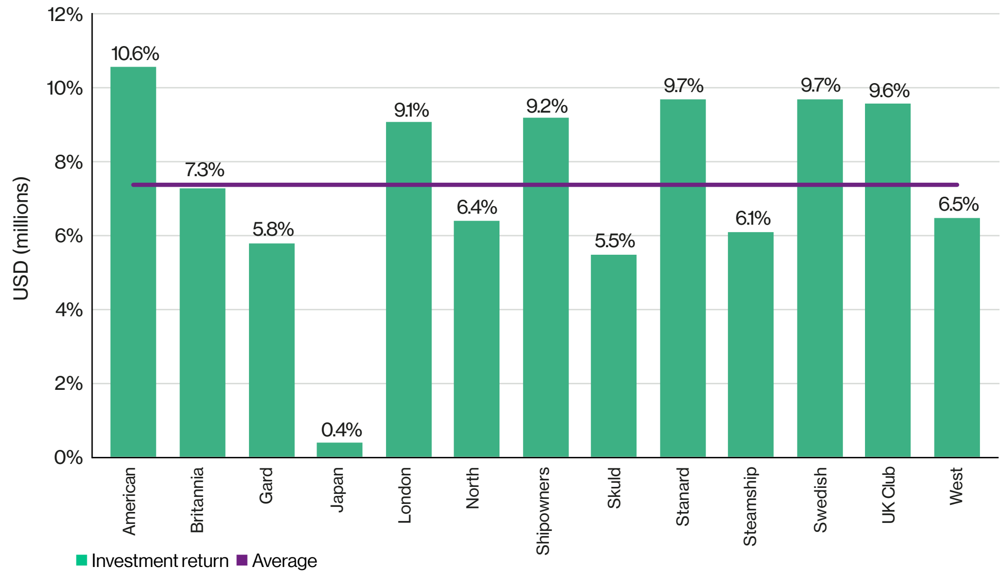
Very positive investment return offsets deteriorating underwriting losses

All clubs in the IG reported a positive investment return in 2019/20. The range of individual clubs' return was between 0.4% and 10.6%, with a remarkable 7.4% average return across the market. The graph to the right shows the percentage return on investment achieved by each club in the 2019/20 financial year.

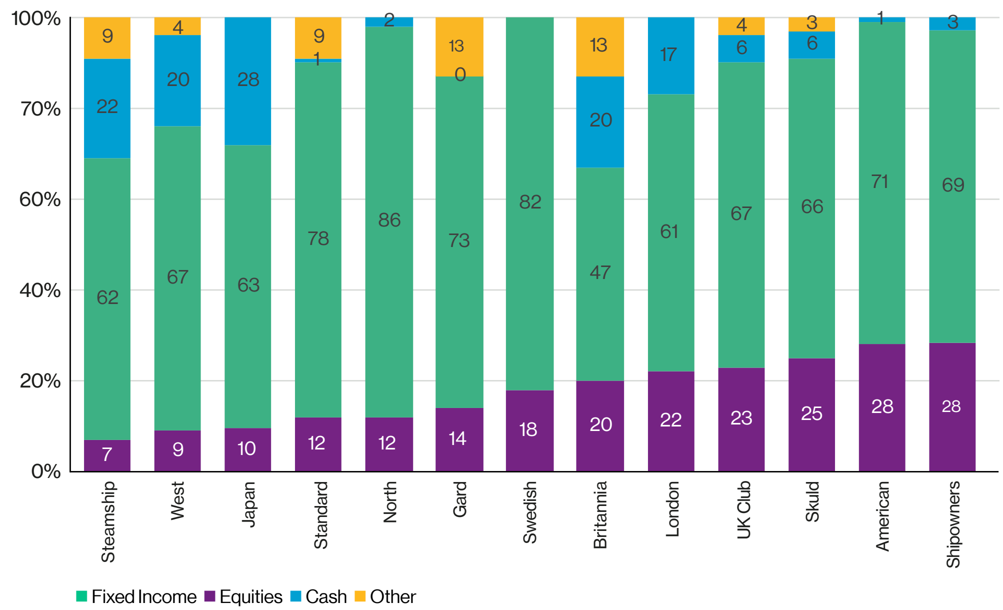
The above mentioned returns, were of course mainly recorded as at 20 February 2020, before the COVID-19 driven plunge in global equity markets in mid-March 2020. In this comparison, the Japan Club suffer from the timing of their financial year. Uniquely in the P&I market, the Japan Club's financial year ends at 31 March. The dip in world equity markets in response to the global pandemic, therefore had a predictable impact on the Japan Club's year-end figures. Fortunately, the Japan Club has never held enormous amounts of equities, but even so the dip was deep enough to almost wipe out their entire annual investment return.

The variance in allocation of assets held by each of the clubs as at 20 February 2020 is shown in the second chart to the right. The average equity holding across the IG market as at 20 February 2020 was 17.5% of total investments (increased marginally from the previous financial year). In 2007/08, before the 2008 equity market crash, the average equity holding across the market was 22.5%. After the 2008 crash, the average equity holding in 2008/09 dropped to 12.4% across the IG market and this percentage has progressively increased over the intervening years. This is a natural area of focus in this COVID-19 dominated year, when it feels that the markets could move in almost any way by 20 February 2021.

Investment Returns – 2019/20 Financial Year



Investment Allocation as at 20 February 2020 (Ordered by proportion of equities)

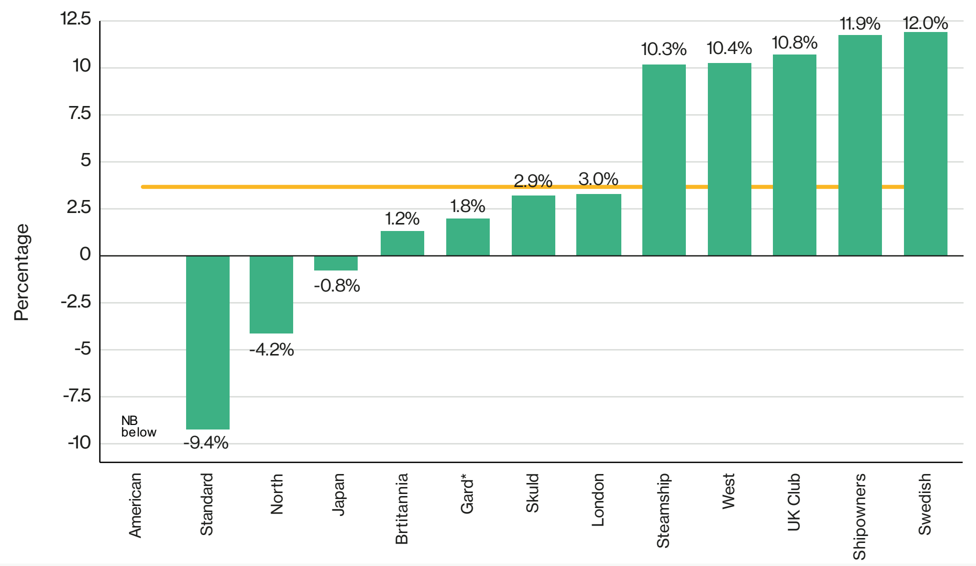


Very positive investment return offsets deteriorating underwriting losses (continued)

As mentioned earlier, across the market, investment income more than offset the large underwriting loss, resulting in a 3.3% increase in market free reserves. The final graph in this section outlines the percentage increase or decrease in each club's free reserves as at 20 February 2020. This in effect summarises the combined effect of each club's underwriting and investment results for the financial year, when compared to their own free reserves.

The market investment income more than offset the large underwriting loss, resulting in a 3.3% increase in market free reserves

Percentage Increase in Free Reserves – 2019/20 Financial Year



Percentage increase in free reserves Market average

NB American Club: as reported +19.8%; underlying result without USD 25.9m of unbudgeted calls -37.4%

Claims trends

Since 2003, Willis Towers Watson's P&I reviews have routinely highlighted trends towards greater volatility in overall claims levels.

The market has seen inflationary increases on small and medium sized claims averaging between 1% and 1.5% per year over the last 17 years. Around this relatively low-level inflationary background however, the number and size of very large claims has varied enormously. This unpredictability of very large claims, combined with increased club and IG retentions, has created enormous volatility in total claims levels in the market.

The graph the right highlights the pattern of large claims retained within the IG system. It shows the number and value of Pool claims, above each clubs' individual retentions, but below the IG excess of loss reinsurance programme, i.e. the claims Pooled (either directly, or via Hydra) rateably across all 13 IG clubs.

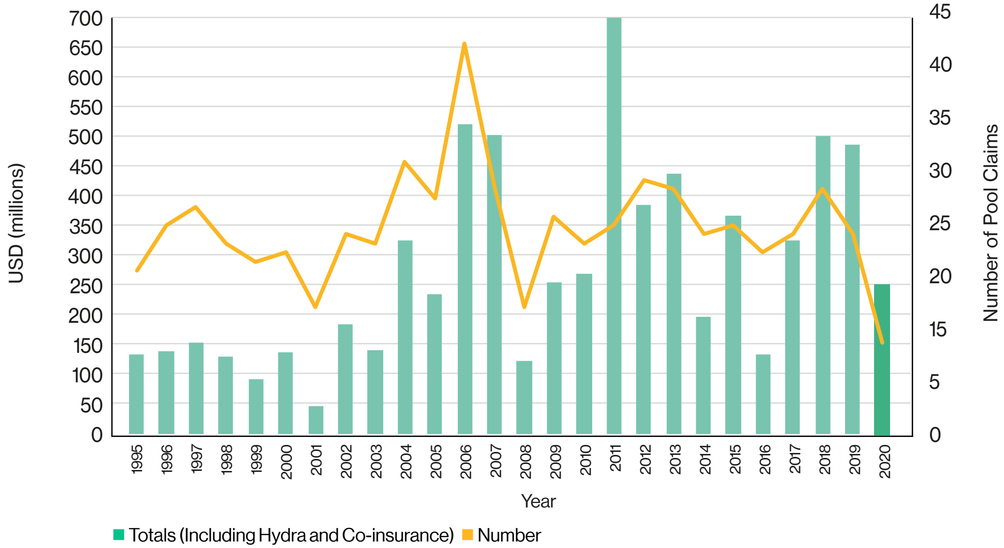
There are clear peaks of values in 2006 and 2007; again in 2011, 2012 and 2013; and again in 2018 and 2019. In these 'unlucky' years the material increases in the number of high value claims were key drivers in the overall negative underwriting results in those years. In between these periods the relative absence of a significant number of high value claims has been the primary driver in the very positive results in those years. A sharp reduction, or a lull, in total claims levels is very much a part of the overall picture of volatility, in exactly the same way as the periods experiencing steep increases (in claims levels).

As at the half year point in 2020/21 the overall Pool claims levels were higher than the (adverse) 2019/20 year at the same point. The current year is obviously very immature in its development, but the early signs are not very encouraging.

In terms of claims directly related to COVID-19, the year so far has probably been slightly better than feared when trying to project the likely losses in March/April. There have only been three major (Pool) claims directly related to COVID-19 and all three were cruise ship related outbreaks (the well-publicised DIAMOND PRINCESS, GRAND PRINCESS and RUBY PRINCESS incidents). The combined 'ground up' value of these three cases is likely to be around USD 60m. The eventual cost (human and financial) of crew being on board ships for considerably longer than originally planned, due to the logistical challenges imposed by the pandemic may take longer to manifest.

Pool and Hydra retained losses' progression

The graph below shows the USD amount (and number) of claims retained by the IG Pool and Hydra over 25 years + current (undeveloped year). Based on the structure of the Pool and Hydra as at the time of losses.



2020 year shown 'as at' 20 August 2020 (the half-year point)
Historically high for this early stage in the year's development

As at the half year point in 2020/21 the overall Pool claims levels were higher than the (adverse) 2019/20 year at the same point.

Expectations for the 2021 renewal season and deferred calls

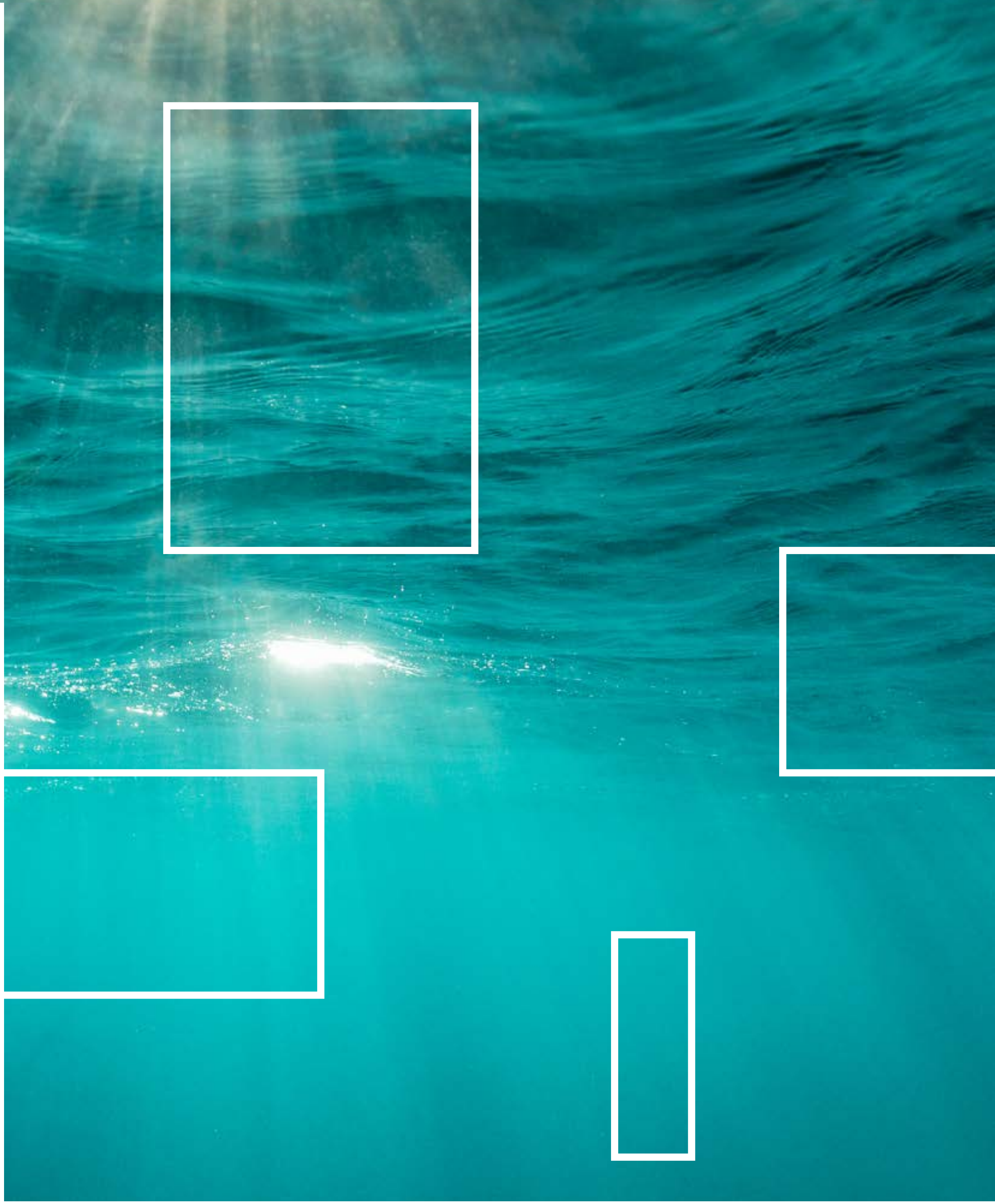
With evident underwriting losses across the market and reduced confidence that investment income will again be able to mask this operational deterioration, it comes as no surprise that 2021 renewal season will be the hardest in eight years. The decisions made by club Boards in autumn 2020 have not been whether premiums need to be increased, but rather how quickly does each club need to increase premium levels.

In a challenging year for most ship owners/operators, this is not an obvious question. Each club has the challenge to balance the need to harden underwriting resolve against how much of the clubs' capital they should use in smoothing any premium increases over a number of years. In the end, the majority of clubs have signalled with their announced general increases that they will be seeking to address the underwriting deficits over two or three years, with the likely erosion of capital in the meantime.

The range of general increases is shown on the following page. As usual the levels of the announced increases do not necessarily correlate directly with each clubs' underwriting losses. The clubs operate within a competitive market, so the announcements are a function both of need and market pressure. Consequently, no club has strayed out of the 5% to 10% increase range (despite the 42% variance in actual underwriting results in 2019/20).

Clubs are again trying to increase deductibles as part of the renewal 'package' (even if only to be used as a negotiating point combined with low announced general increases). Similarly, we again expect the approach of routinely applying deductibles to costs, fees and expenses to embed across the market.

We anticipate that there will be a smaller number of announcements regarding returning premiums (or not charging full deferred calls) and/or capital rebates, but the strongest three clubs will likely continue with this pattern. At the other end of the market, we would not discount further isolated incidents of unbudgeted calls from one or two of the financially weaker clubs in the coming years.



Expectations for the 2021 renewal season and deferred calls (continued)

We have long argued that with the increased capitalisation across the market, the maintenance of material release calls is simply not justifiable. We suspect however that the hardening in underwriting across the clubs will be matched by some of the less confident clubs also increasing release calls, in an effort to try to protect their renewable book.

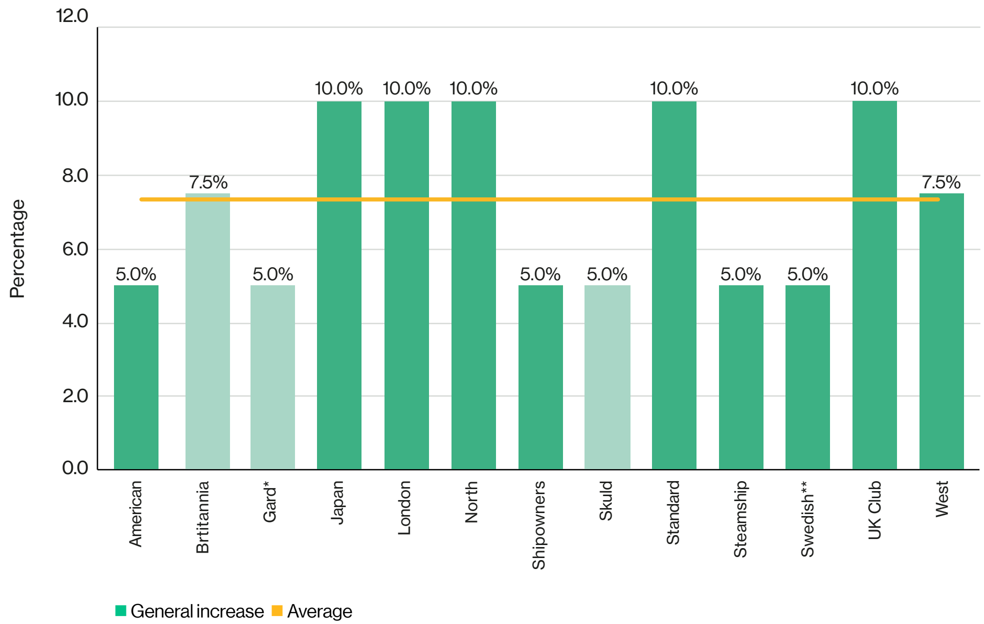
As mentioned above, the direct financial impact of P&I claims related to COVID-19 has been relatively modest, in the context of the overall IG market. The broader (non-marine) COVID-19 exposure will however have a much greater impact across the global reinsurance markets.

The impact of the pandemic on non-marine business interruption insurance policies worldwide has been extraordinary. These hundred-billion dollar plus exposures are filtering through the direct policies into the world reinsurance markets, which have hardened materially as a result, across all classes of cover.

Mercifully, the main parts of the IG excess of loss reinsurance programme are currently half-way through a two-year agreement, so this has largely insulated mutual P&I pricing from the adverse movements in the reinsurance markets in 2021. The impact will however be felt immediately across most non-poolable reinsurance covers, particularly those with higher limits. High capacity club specific reinsurance covers will undoubtedly face significant upward rating pressures, combined with reinsurers seeking to exclude COVID-19 and malicious cyber risks from anything renewing in 2020 and 2021.

While the main parts of the IG reinsurance programme will be unchanged, there are amendments to the allocation of the reinsurance premium across the various vessel categories at 20 February 2021. Specifically, the 'dry' cargo ship reinsurance category will be split, in order to separate out container vessels. This segregation will lead to a modest increase per GT for container ships, as their historic loss record into the reinsurance layer is not as good as other dry ships.

IG Market General Increases – February 2021



Note: Britannia, Gard and Skuld have not announced specific general increases, but their expected internal targets are used above.

The direct financial impact of P&I claims related to COVID-19 has been relatively modest

Expectations for the 2021 renewal season

- Average general increase +7.4%
- Capital and/or premium will be rebated by a small number of the strongest clubs
- Average release calls will increase as less confident clubs seek to protect their renewable book
- Hard reinsurance market, but the main IG programme is fixed on a two-year agreement. Minor adjustments in rates applied to different vessel types and a new class of ship (container) to be introduced to the IG reinsurance rating structure
- Major challenges for clubs' non-poolable programmes in terms of premium increases and the imposition of exclusions relating to COVID-19 and malicious cyber

International Group (IG) P&I Market Cycle

Average market general increase of +7.4%

Notes to this section

In this section a number of references are made to variances in financial performance between individual clubs. Willis Towers Watson's P&I clients have access on request to more comprehensive comparative analysis of individual clubs.

N.B. The above comments relate to the combined financial year results of the individual clubs in the International Group, excluding where possible any Hull and Machinery (H&M) and/or Energy classes of business written by P&I clubs. The only club omitted from this overall market analysis is the Swedish Club, which has not consistently separated their H&M class and it is not possible to allocate their asset base across the different constituent parts of their portfolio. As the Swedish Club represents less than 2.5% of the IG P&I market, its omission does not affect the overall analysis materially. Our aim is to consistently summarise the P&I market (only), in the same manner year-on-year.

Willis Towers Watson's P&I clients have access on request to more comprehensive comparative analysis of individual clubs.

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