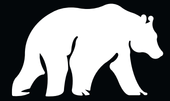

LOCHAIN PATRICK

INSURANCE BROKERS

Half Yearly Report 2021

A Fragile Equilibrium

The curse of compounding

Many owners are suffering their third consecutive year of premium increase. For owners with even the best records, the cumulative impact of what, in isolation appear reasonably modest rises, is very material with most owners on a "like for like" basis now paying in the region of 50% more for hull insurance than in 2017. For those owners unfortunate enough to have had a substandard claims experience in the same period, this compounded impact could easily be in the region of 200%+.

Bemused owners, especially those who have met their insurers, have probably recently been exposed to their underwriters assertively expressing "technical rating" and "price adequacy" as justification for the quoted terms. Certainly these are drivers for price calculation but, given the magnitude of recent increases the terms price adequacy and technical rating, are difficult pills for owners to swallow. The seldom asked questions, given the scale of the correction over the last three years, to those underwriters might be "are you now making excessive profits from marine hull?" Or, "why on earth were you prepared to write business three years ago at prevailing market prices that must have been so far below the technical prices?".

The reality probably lies somewhere between these two. In a holistic market it is not black or white. There is no right or wrong answer, just degrees of greyness. This greyness is not confined to marine business. In fact, other lines of business have had more harsh renewal terms imposed. Cargo rates, for example, have increased more than double in percentage terms than hull. E&O and D&O, downstream energy, contingency risks are all paying many multiples of increase to those that have been imposed on hull risks. Even a year ago, underwriters were writing business at uneconomical terms. It is certainly an underwriters market at the moment, and there is growing realisation within the underwriting community that this is the case. In 2021, in general, the underwriting horizon currently looks very bright.

Despite all this remediation, Quarter 1 2021 saw Lloyds post its fourth consecutive underwriting loss with a combined ratio of 110.3%, as COVID-19 losses of GBP 6.2 billion pushed the market into a GBP 900 million loss. The adverse development of prior years (including COVID-19) had more than counter balanced the far more favourable underwriting climate (described by Lloyd's CFO as being "the best for a generation"). Excluding COVID-19, the Lloyd's market turned in an underwriting profit with a 97% combined ratio. Similar results, to a greater or lesser extent, were being declared by the Company market, reflecting both the vastly improved underwriting environment but also the deleterious impact of COVID-19 and adverse development of under reserved prior year losses. These figures are good but not great, certainly considering the dramatic remedial terms imposed. This is often the case as the cycle emerges from soft market to hard market. Reserves in the soft market in many cases are now proving to be inadequate and have needed strengthening. "Payback" is the term often used as underwriters use tomorrow's premium to pay some of yesterday's losses. The more penal terms have not resulted in a usuary level of profit, but have been used to wallpaper over the historical underwriting cracks by smoothing the deficiencies of the soft cycle. This "payback" however, harbours some future problems of increased capacity. When premiums are very attractive new capacity is attracted into the market with some upscaling as well.

The real beneficiaries of this underwriting environment have undoubtedly been the newer entrants. Although they have smaller investment returns than their more established competitors, they also have fewer legacy issues with the underwriting climate giving a very favourable tail wind.

As the basic laws of supply and demand start to kick in, this increased supply of capacity, with no real increase in demand, should result in rate reductions for owners. Currently the market appears to be defying gravity. Although there has been some tapering of premium increases with some downward pressure on rates, there is little/no evidence of reductions. The underwriting community is relatively small and, with most risks still being subscription placements, even if the leader were prepared to give a reduction, the supporting capacity will not, as yet, acquiesce to the brokers demands for reduced premiums. Nobody wants the tag of being the first to give any sort of reduction. There may be movement of business in and out of competing international markets as orders are increased and decreased between those markets, which may be writing the same risk at differential terms. The mid year 2021 position is that markets are resisting reductions and still looking for increases.

The reasonably easy explanation to explain this defiance of gravity is that of "higher cost of capital".

At times, where interest rates and bond yields are low, money is attracted into the insurance market and that money is prepared to take a very modest return that is, perhaps, better than the opportunity cost of investing in other areas. That was certainly the case following the implementation of Solvency II and its impact on the insurance market. Overall returns were driven down, year on year, to a point when they became regularly negative. That cumulative impact of loss left some capital bruised and some capital badly damaged. When time was called on that unsustainable position, towards late 2017, capital providers re-evaluated their positions, deciding that the downside returns of the soft market significantly exceeded the upside prospects. Capital providers started to vote with their feet. Modest increases proposed by underwriters, in many cases, were insufficient to keep that capital. Capital providers required a greater return on their capital in the good years, over time, to cover those loss years.

This also translates through to the newer markets which are certainly availing themselves of Solvency II friendly capital, (typically in the form of Quota Share reinsurance). The reassureds would undoubtedly have had to make projections of likely profitable returns to attract reinsurers. The pressure is on these new entrants to deliver on those projections. To undercut the market could jeopardise that reinsurance quasi capital, a risk they dare not take at this stage of their development. But for how long will this last?

Let's crystal ball gaze

It is officially a hard market (as is very evident to any purchaser of insurance in any class of business). Whilst Lloyd's syndicates form a far smaller proportion of the hull market than historically has been the case, a sufficiently large amount of business is transacted through the market, for any change in risk appetite to have ramifications throughout the international markets. That change in risk appetite was imposed on hull class underwriters by the Lloyd's Franchise board, when it designated marine hull as a decile 10 line of business (which meant that it fell into the 10% worst performing lines of business). Lloyd's syndicates were required to put together radical remedial plans for profitability from the class. Not only did they have to put together radical plans, but they also had to execute those plans with each line of business being under the microscope of the Lloyd's Performance Management Department (PMD). Those that failed to implement the plans that were agreed with Lloyd's faced the ultimate sanction. A certain irony, not lost on many observers, was that the original line of business that made the Lloyd's market over 300 years earlier was the line of business that was least likely to make the remediation cut.

The early signs following the first year of rises were somewhat disappointing and ultimate results were likely to be only marginally better than breakeven. The most recent year of 2021 is too early in development to be able to accurately project forward. 2020, however, looks to be developing into a something of a bumper year for hull underwriters. To put that into context, before the eulogies are banded about too much (for the Lloyd's market at least), this would be the first truly profitable year in the last twenty.

On balance it looks like the competing pressures, subject to no other shock exogenous factors may result in a fragile equilibrium for the immediate future.

The case for future reductions

This correction brings with it storm clouds on the horizon for underwriters and, conversely, more light for shipowners, with new entrants offering broader choice. But the increased capacity is not coming from Lloyd's. Marine hull is still viewed with suspicion by the Lloyd's hierarchy. The only real increase in any capacity from the Lloyd's market, has come from organic growth to reflect rate change, rather than any foot being taken off the brake pedal, (i.e. Lloyd's remains somewhat risk averse for hull business). That is likely to change as premium increases translate into profit, and a more sustainable marketplace and marine hull emerges from the cocoon of a decile 10 class as a profitable butterfly.

International markets and company underwriters have taken advantage of the hull risk appetite (or more correctly reduced appetite) at Lloyd's. The Scandinavian market has taken increased shares on placements which, combined with organic premium increases, has certainly resulted in a greater presence on hull (and hull and P&I combined) risks. In the London market there has been some significant change but restricted to the Company market. Convex was the first sizeable start up. The North of England set up its hull operation, but that is reasonably low key. Most of the rest of the increase in capacity has come from the upscaling of existing operations, albeit most of them being relatively new operations. Fidelis, Lancashire and others were quick to take advantage of the corrective rating environment. Navium is, perhaps, a major disrupter to the market due to the scale of the operation of this new entrant focused on the marine market under the stewardship of one of the most successful marine underwriters of his generation, Clive Washbourn.

HDI Gerling will be setting up a London branch in Quarter 4, bringing additional capacity to the market.

This position is likely to be only short to medium term. The improved profitability of the account is encouraging new entrants, all of whom are looking to grow market share whilst growing profitability. Invariably these twin objectives are mutually incompatible.

The case for further increases

Is 2020 the new norm? Very difficult to tell whether this is a normalised year or not. COVID-19 played an impact, but other factors are also affecting the shipping industry. The lay up of almost the entire world fleet of cruise ships will have removed almost all the navigating perils that those vessels would have otherwise been exposed to.

Commercial vessel deployment in 2021 has seen a dramatic change as the global supply chain works to absorb the surge in trade after the first wave of the pandemic. To date it has struggled, with the increased trade demands being exacerbated by two other issues, the six day blockage of the Suez canal by the Ever Given and the six day closure of the port of Yiantan, China, as a result of COVID-19 outbreak.

It was reported in Tradewinds that at the end of June there were almost 300 vessels waiting at anchor at Yiantan. The port has a huge throughput of about 20 million TEU per annum, and so disruption there is hard to make up. Vessels have been leaving Yiantan off the schedule due to the severe congestion.

The situation has led to a shortage of empty boxes as cargoes from containers are unloaded in less congested ports. Port congestion and the resulting decline in liners' schedule performance has been a persistent story. IHS Markit recently reported that the time containerships are spending waiting for berths has more than doubled since 2019.

This already difficult position has been exacerbated by the partial closure of the World's third busiest container port at Ningbo, as a result of COVID-19. On 17th August there were 141 ships at a shared anchorage for the Shanghai and Ningbo ports. 60 more than the median number from April to August. The same day it was reported that the West Coast of America was also clogged with 37 ships awaiting berth space, the most since early February. The average wait for berth space was over 6 days.

The congestion and bottlenecks not only slowed ships' ability to reach the ports but also, in many cases, extended the time spent in port. These dislocations have resulted in even further delays. This ongoing problem looks set to blight the supply chain for some considerable time, as the container industry enters its traditional peak season of July to October, for deliveries to retailers in Europe and the US, for Christmas and Thanksgiving. Some commentators have warned that the container market will not return to normal before early 2022.

The impact on the supply chain is not just one of delay, (which by itself results in increased cost to shippers), but also basic increased freight costs. Tradewinds reported that shippers are being inundated by a plethora of surcharges that can double the base rate, (known as Freight All Kinds – or FAK). The additional cost is being added to the existing sky high base rates.

A similar situation occured in the bulker market as China's steel manufacturers and coal fired power stations returned to normality. The Baltic dry index currently sits at 200% higher than at this time last year.

As society comes out of lockdown, economies and economic pressures rebound. COVID-19 caused a sharp decline in newbuildings as orders were cancelled or delayed. The reduction in the level of newbuildings has had a knock on impact in the pre-owned hull market, where more mature vessels are commanding high freight rates. A very buoyant containership market has seen vessels that, previously, were being considered for demolition, now being traded on. Vessels going for demolition are reaching record prices. 15-20 year old Panamaxes are achieving close to the original build cost and twice what they were valued earlier in the year. This increased utilisation of older vessels may result in an increased incidence of claims. Efforts to increase shipping capacity have led lines to postpone dry-dockings and sailing ships faster. The price of steel is at/near an all time high. A routine frequency of hull claims will, therefore, likely result in a higher severity of claims, as the price of steel and spare parts increases with reduced availability in repair yards.

The newbuilding orderbook has recovered and orders are in the region of 17% of the World fleet. However, these vessels are unlikely to be delivered until 2023 or beyond. Newbuilding ordering in the first six months of 2021 was the highest in tonnage terms since 2014 (according to Clarksons Research) with order volumes in the first half surpassing those in the whole of 2020.

Notable Marine Casualties in the January to July

Box overboard

Of particular issue at the end of 2020 and the start of 2021 was the high incidence of containers lost overboard. In a World Shipping Council 2020 update it was estimated that on average 1,382 containers are lost at sea each year, based on a survey done between 2008-2019. Suddenly, seven instances of containers being lost overboard have occurred in the space of less than 3 months;

- One Aquila; 2018 built, 14,000 TEU - over 100 containers lost overboard in Pacific on 5th November
- One Apus; 2019 built, 14,000 TEU - caught in a storm on 30th November losing 1,816 boxes. Early estimates are for a cargo loss of USD 200-300 million, plus P&I plus hull damage
- Ever Liberal; 2014 built, 8,452 TEU - lost 36 40' boxes overboard plus 21 collapsing onboard on 2nd January 2021in the East China Sea
- Maersk Essen; 2010 built, 13,000 TEU - 750 boxes overboard on January 16th in the North Pacific
- MSC Zoe; 2015 built, 19,000 TEU - 342 boxes overboard in the Wadden Sea on 2nd January 2021
- MSC Aries; 2020 built, 14,000 TEU - 41 boxes overboard on 29th January 2021 in the North Pacific
- Maersk Eindhoven; lost approximately 260 boxes overboard on February 17th 2021

Other marine losses of note in the period included

- MSC Lirica; built 2003 - fire loss in Corfu whilst in lay up. It appears that the fire was contained and managed. There may be some not insignificant smoke damage to passenger accommodation and public areas, but the integrity of the vessel was maintained
- Ever Given; 20,000 TEU - containership grounding and blocking the Suez canal for six days
- Seacor Power lift boat; estimated to be valued at around the USD 130 million - capsized and sank with the sad loss of thirteen lives during severe weather eight miles off Port Fouchon
- X-Press Pearl; total loss of a three month old feeder containership off Sri Lanka following fire in the vessels' cargo. 1,486 containers among them 81 carrying dangerous goods, which included 25 tonnes of nitric acid, along with other chemicals, cosmetics and low-density polyethylene (LDPE) pellets
- Accommodation barge Papaa-305; sank off Gujarat with the tragic loss of 49 seafarers
- Crimson Polaris; ran aground and split in two on 11th August. Although not strictly in the first half year, this is a very significant loss

Seafarers, the forgotten people in the COVID-19 pandemic

Reports state that there are about 100,000 seafarers stranded at sea beyond their regular stints, some of whom have not set foot on land for nearly 9 months. The crisis is double edged. The same report states that there are about another 100,000 stuck on shore, unable to board the ships they need to earn a living on. Only 1 in 40 seafarers have been vaccinated according to the GCaptain website.

In a snapshot of the situation, in June almost 9% of merchant sailors have been stuck aboard their ships beyond their contracts' expiry, up from just over 7% in May, according to data compiled by the Global Maritime Forum.

The United Nations describes the situation as a humanitarian crisis at sea and says governments should class seafarers as essential workers. It has been expressed that as many as 25% fewer seafarers are joining vessels than pre-pandemic.

The good news

The first six months of 2021 has shown how fragile the supply chain can be, but also how important shipping is as the links for that chain. Shipping, unless there is a large loss of life or environmental issue, seldom makes the front page of the national papers. Over 60,000 merchant vessels and over 1,000,000 seafarers provide the links to that chain and keep working tirelessly to keep shipping out of the limelight. As 95% of all goods consumed at some point will have been on board a ship, society should be eternally grateful for the role that shipping plays in our everyday lives.

Prepared by:

LOCHAIN PATRICK
INSURANCE BROKERS

Number One Minster Court
Mincing Lane
London EC3R 7AA
Telephone: +44 (0)207 398 1700
email: enquiries@lpib.co.uk
www.lpib.co.uk