LOCHAIN PATRICK

INSURANCE BROKERS

MARINE

Report 2020

Experienced Guidance

INTRODUCTION

In January of 2020 the Chinese New Year celebrated the year of the Rat. In the global insurance industry 2020 has been the year of the "cat". The Rat symbolizes wealth and the beginning of a new day. The "cat" symbolizes the natural (and non-natural) catastrophes that have blighted 2020. Indeed, the recently released Swiss Re sigma estimates that for 2020 industry losses from man-made and natural disasters are as high as USD83 billion, making it the fifth costliest year for the insurance industry since 1970. A record thirty named Atlantic storms, including twelve which made landfall in the US (also a record), combined with convective storms, floods, wildfires to produce these very costly events.

2020 saw something of a perfect storm. Add to the above ingredients low level/nonexistent investment returns, social inflation, riots in the US, concerns over some under reserving in Casualty lines, not to mention the impact of Coronavirus with a possible USD100 billion loss to the insurance industry (as estimated by Lloyd's John Neal), and we end up with a heady cocktail that has resulted in capital being eroded and the rating agencies making noises over their ongoing concerns regarding capital adequacy for both insurers and reinsurers balance sheets.

We have the seemingly incongruous situation of what has been described as the "best underwriting environment for a generation" with underwriters reporting continuing losses. The hard market is the direct result of this hangover and is part of the longer term cure. Excluding the Covid-19 related losses, some of this increased incidence of loss is being attributed to climate change. If so, the prospects for more black swan events in 2021 and beyond, looks worryingly likely and increased premiums are less likely to be retained by underwriters, but will be required to pay the increased losses that may reasonably be anticipated.

These losses have mostly been outside the marine world, but all of them have, to a greater or lesser extent, impacted the marine Hull world as the increased cost of capital and management pressures to produce better positive returns are imposed upon underwriters at the coal face.

The first half year of 2020 saw a continuation of the hardening of the market that commenced in late 2018, as Underwriters held firm. Time had finally been called on many years of unsustainable underwriting in a large number of specialty lines. However, even without the impact of Covid-19, the early 2020 loss experience for underwriters was poor.

Covid-19, in less than a year since it was first identified, has fundamentally affected the lives of almost every person in every country in the world. It has struck over 87 million people and, so far, has tragically resulted in the recorded deaths of over 1,890,000 although (with some under reporting and mis-diagnosis) the figure is likely to be even higher. The human tragedy continues as countries fight to come to terms with the virus and to find the socio/economic balance that will enable the human race to survive and to prosper.

Pre-virus 2020 had seen hardening in the insurance market across all lines gaining extra momentum. The hoped for profitability turnaround, demanded by both management and shareholders, has been eroded not only by the increased cost of reinsurance, increased cost of capital, but also by the requirement for some insurers to remedy inadequate levels of reserving.

With the very positive underwriting environment, and the painful strengthening of reserves having largely been undertaken, the forecast for the second half of 2020 should have signaled a return to profitability for the beleaguered balance sheets of some insurers. However, this does not seem to have materialized largely due to the high incidence of natural catastrophe losses.

The continuing near zero, or even negative interest rates has firmly put the underwriting result into the cross hairs. Insurers cannot use the time value of money between premiums being paid in through to claims being paid out to allow the underwriting ratio to exceed 100%. Negative interest rates in fact exacerbate that position as investment returns in some case are deleterious to the overall underwriting position, resulting in even greater pressure on the pure underwriting result.

The 2019/2020 renewal season had seen underwriters faced with increased reinsurance costs in the magnitude of 25% or more. The year of the "cat" 2020, referred to in the opening paragraph, has seen increased frequency of large losses or small catastrophes (deliberate oxymoron). The greater the severity of original loss results in a larger proportion of the loss being transferred to the reinsurance market. The greater the frequency of large original loss, the larger proportion of those losses are retained by the primary market, with less being recovered from reinsurance.

The events of 2020 have resulted in frequency and some severity but without extreme severity. This has resulted in the primary markets having retained a large proportion of these cats, but having made some recovery from the reinsurance market. Whilst not too badly hurt the loss to the reinsurance market has been sufficient to be a salient reminder to reinsurers of the cost and value of their product. The cost of reinsurance consequently continues to rise into the 2020/2021 renewal season.

Reinsurance cost is a cost of capital and so, therefore, as reinsurance costs increase the cost of capital increases, putting even greater pressure on primary underwriters to make a positive underwriting return.

RESERVE STRENGTHENING REQUIREMENTS

The Prudential Risk Authority had uncovered anecdotal concern that commercial pressure from management to deliver improved results had sometimes translated into actuarial judgments being challenged disproportionately, resulting in some long tail areas of the business being inadequate. An example of what has been dubbed "loss creep" was typhoon Jebi. In one quarter of 2019 the deterioration of this loss exceeded all other losses reported in that period. The longer tail lines of business needed some reserve strengthening. There is a double impact here, as not only do the closed year claims reserves need to be funded from open year premiums, but also the actuaries' re-evaluation of current and future liabilities inevitably results in a requirement for increased premiums. An identified problem has resulted in many carriers losing the benefits from the hardening market to reserve strengthening.

For Underwriters a better outlook but with the tangible results, for reasons discussed above, yet to translate through to the bottom line, due to that perfect storm.

- Although not a loss in 2020, but worthy of note is the cost of wreck removal of the "Golden Ray". Originally advised at USD115 million this increased in late January to over USD660 million. Add the Hull loss of USD80 million and the loss of the cars estimated at USD145 million, and the loss of the "Golden Ray" loss, in 100% terms, is heading towards the USD1 billion mark.
- "Stellar Banner" Very Large Ore Carrier (VLOC) grounding. Top value of the Polaris fleet at USD91 million Hull and IV. Vessel scuttled after being declared a Constructive Total Loss offshore the coast of Brazil. This, interestingly, brings to a total of 39, the number of bulk carriers lost over the last ten years.
- Tornado in Tennessee, resulted in a USD350 million cargo loss stemming from damage to a Dell storage facility in Nashville.
- "Hoegh Xiamen" car carrier valued at USD24.5 million is almost certainly a total loss following a fire on board. Value of the second hand cars onboard is not known.
- Fire on board a nuclear submarine the "Perle" whilst undergoing maintenance in a yard in France, may exceed Euro 100 million
- Collapse of a crane that had been installed on the "Orion1" and was undergoing load testing. It is estimated the loss may exceed Euro 50 million.
- Derecho (from Spanish derecho "straight" as in direction) is a widespread, long-lived, straight-line windstorm that is associated with a fast-moving group of severe thunderstorms, known as a mesoscale convective system, and potentially rivaling hurricanic and tornadic forces. Such a storm hit Iowa and Illinois, (with peak gusts of 140 mph, equivalent to a Category 4 hurricane) in the quarter causing damage estimated at USD2.5 billion (part of an economic loss of USD5 billion, although some estimates are as high as USD10 billion).
- Californian wildfires. Moody's noted that the California insured losses already make 2020 the third highest year for insured losses in the state. Estimated at USD5 - USD8 billion by Moody's. As at 16th September 2020, 9,657 homes and commercial structures had been damaged or destroyed and more than five million acres had been burned. In addition, as at mid-September 2020, 3,865 structures had been destroyed in Oregon, Washington and other western states.
- Beirut port explosion, sadly resulting in significant loss of life, with a small cruise ship capsizing and eight other small, elderly vessels badly damaged or sunk. Ammonia nitrate explosion. Current estimate announced by Guy Carpenter is a total insured loss of approximately USD2 billion with a loss to the Hull, Cargo and Port markets of around USD250 million.
- "Wakashio" - a VLOC in ballast, ran aground at Pointe d'Esny off the coast of Mauritius in July 2020, leaking more than 1,000 tonnes of bunkers into the environmentally sensitive area. Pollution exposure was limited to a maximum of around USD66 million through convention signature. There were initial fears that the removal of the wreck could cost insurers over USD500 million. However, the expedient removal of the fore section is likely to result in a significantly smaller loss.
- "New Diamond" - a VLCC carrying two million barrels of oil caught fire. Mercifully, although the vessel (reportedly valued at USD20 million) was a constructive total loss, the cargo was saved and pollution minimal. A bullet dodged.
- "Gulf Livestock 1" - sank in the East China sea during Typhoon Maysak, with 40 missing crew.
- "MSC Gayane" USD130 million claim notified after vessel carrying 20 tonnes of cocaine detained by US authorities. The seizure, hidden inside containers, had a street value of approximately USD1.3 billion making it the largest cocaine seizure in the 230-year history of US Customs and Border protection.
- "One Apus", 2019 built 14,000 teu carrying capacity, caught in a storm on 30th November, 2020 has lost or damaged an estimated 1,816 boxes. At the time of writing she had made it to the safe port of Kobe. The discharge of the boxes is estimated to take until the end of January, 2021. This loss showed both the strength of the vessel build to withstand such cargo shift, but also the weakness of the loading and stacking of large containerships to with stand a type of loss that affects containerships in particular, being the headsea parametric rolling phenomenon. Early estimates are for a cargo loss of USD 200-300 million, plus P&I of USD 50-60 million plus Hull damage.
- It is particularly sobering for the Marine, Transport and Aviation market which, although as commented above had an improved H1, in 2019 had already racked up a 108% combined ratio at Lloyd's. In the property cat market, the nature of the catastrophic event hits most/all of the market to a greater or lesser extent. In Specialty, risk losses always fall asymmetrically across the market, but the broad incidence of loss in 2020 in the specialty lines (including those outside the marine microcosm) appears to have resulted in most of the market looking at the fourth consecutive loss year.

WHY DOES IT COST MORE TO INSURE MY SHIP?

Many Shipowners ask why is it costing more to insure their ship. The feeling is that reinsurance shouldn't affect Shipowners, nor cost of capital, as Shipowners bring only relatively small, largely non correlating risks to the table, and do not bring natural catastrophe exposure. Shipowners might say that they have pretty much the same risk today as they had the day before. Why should they have to pay for other peoples' losses when it has nothing to do with them? They have a good record, so why is there a rise being charged?

The basic doctrine of insurance is that of the "contributions of the many to pay the losses of the few". With a high incidence of natural catastrophes combined with hot running levels of risk losses in the Specialty market, we have the position where the "contributions of the many are paying the losses of the many". Clearly this is an unsustainable business model. The correction therefore has to be borne by the many. Premium increases, as a consequence, have been distributed market wide, with toughest renewal terms being borne by the most problematic lines and the poorer performing risks within those problematic lines. Underwriters have re-evaluated their risk appetite with deep dive actuarial analysis of what have been the perennial loss making lines. Some underwriters have closed these problem classes. For those underwriters prepared to try to tough it out, the value of their product has been re-evaluated with enhanced premiums required and tougher terms and conditions being imposed. As the marine market is still playing catch up, insofar as the recent rises had not covered the recent increase in losses, and with other lines having been more responsive, some of the continued impact of the hardening market has fallen upon this market. Underwriters are not prepared to carry or absorb loss making lines of business. For them, now each line of business must have a potential for profit or it will not be entertained. The greater the malaise, the stronger the medicine.

It is an open secret that marine Hull had underperformed year on year for the last 10 years or more. Indeed, marine Hull was the laughing stock of the insurance industry. Every year underwriters would bemoan their figures and quote loss making numbers, yet at the same time offer their clients a reduction in fear of otherwise losing the business.

The figures published earlier in 2020 revealed that the marine account for all Lloyd's syndicates combined produced a calendar year combined ratio for 2019 of 106.17% against 2018:115.93%, 2017:122.45% and 2016:106.22%.

But now underwriters have said "enough is enough, we cannot continue on this basis". If we lose business we are only likely to lose business which, in total, is likely to lose money.

Just as Shipowners enjoyed the benefits of underwriters having a lower cost of capital over several years, and having a much greater appetite for marine, they are bearing some of the cost of the prevailing increased cost of capital, rising insurance market losses and low/nonexistent interest rates.

INSURANCE MARKET CAPACITY (ALL CLASSES) INS AND OUTS

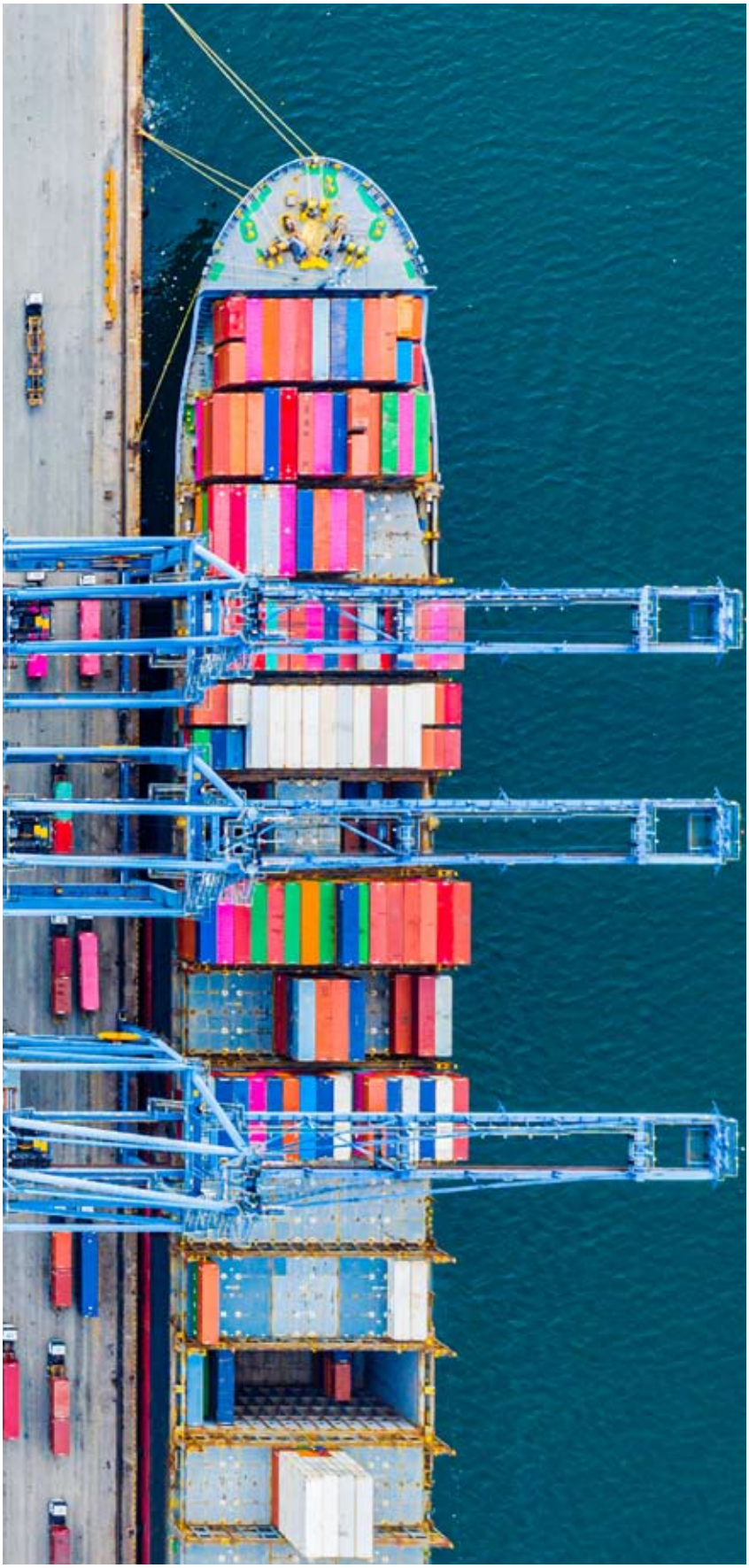
CAPACITY IN

- Brit raised USD500 million of committed capital for their "follow only" algorithmically driven syndicate
- Nephilia has been given approval to create syndicate 2358 as a "follow only" syndicate writing a portfolio of Lloyd's specialty risks backed by ILS capacity
- Argenta has submitted a business plan to Lloyds to increase capacity by 55% to £660 million
- Ark capital raised to take it to USD1 billion
- Fundraising has begun for Convex. Capital has grown from USD1.8 billion to USD3 billion post second round fund raise
- Lancashire raised £277 million
- Ren Re raised USD1.05 billion
- Beazley raised £247 million
- Hiscox raised £375 million
- Partner Re raised USD881 million
- Plus others are in the process of capital raising
- North of England has moved into Hull business

With capital raises for existing companies and new entrants, it is estimated that there will be more than USD10 billion of new capacity into the market. It appears that the Covid-19 dominated landscape is resulting in scale-ups rather than start-ups.

CAPACITY OUT

- Amlin withdrawing from multiple marine lines in Singapore. It will no longer write Energy fixed premium P&I, Hull Liability, Yacht, Bloodstock, Hull, Cargo and Specie Lines from its Singapore base. It is understood that Amlin is reducing Hull business writings for 2021 by over 30%
- K2 International has put its book of marine specialty into run off. This was one of the business lines transferred to K2 International from Pioneer underwriters
- Argenta closed down its Hull account
- Argo closed down its Hull account.
- Axa/XL has cut its Lloyd's syndicate capacity for 2021 by 17%



MARINE HULL

The International Union of Marine Insurers (IUMI) at its virtual conference in September 2020 reported that global Hull premiums had remained relatively stable, with 2019 premiums of USD6.9 billion, representing a 0.2% increase over 2018. Global premiums had stabilized but the global fleet had continued to grow. In general, the age of the world fleet was increasing. This is likely to accelerate as a result of Covid-19 as new building contracts are cancelled or deferred, but older vessels are amortised over time and ageing tonnage equals a reduced aggregate fleet value. The danger there, of course, is that partial losses of ageing tonnage are likely to increase over time, but the premium base is impaired due to premiums being a function of rate percent of values. For many years the total loss content of ships insurance premiums have been used to pay working losses, leaving the cupboard bare for when the total losses occur at the same time as normal incidence of partial loss. In the hardening market for underwriters it is ever more important, in the near future, for attritional premiums to be adequate to pay working losses. The good news is that the long term downward trend of total losses in ocean Hull had continued (reaching an all-time low) and so there can be some premium reapportionment or offset.

IUMI reported that loss ratios in Europe improved slightly in 2019 but are likely to reach at least 80% once the underwriting year is more fully developed. This, after expenses, is yet another loss.

LLOYD'S 'T' RISK CLASSIFICATION FIGURES

These figures are for the market and relate to the property damage coverage, both premiums and claims, that have been incurred by Lloyd's syndicates. Although they are impure figures they are a good indicator of the health of the Lloyd's marine market and a good barometer of the global marine market.

These figures (for the 2020 underwriting year) for the first time in many years look encouraging, albeit at a very early stage of the account development. On the basis that Lloyd's presents figures (being net premium after all brokerage and external costs and taxes and pre-reinsurance costs and pre-reinsurance recoveries, and before internal costs) breakeven is an ultimate settlement in the low 80%'s.

For 2020, at the end of Q2, the net incurred loss ratio for the class sits at 8.9%. This compares with 39.8% at the same time for 2019 and 31% for 2018 (with similar loss ratios for preceding years). The impact of the hardening market has started to manifest itself as rate increases in the latter part of the previous year slow the development of the 2019 tail. Between Q2 and Q6 the 2019 underwriting moved from an incurred loss ratio of 39.8% to 75.69%. This compares with the preceding year 2018, which moved from 31% after Q2 to 99.9% at the same corresponding period.

Before getting too excited that rate hardening is the panacea for the travails of the Hull market it should be noted that, from the same classification figures that claims incurred of £190 million at Q6 2019, this figure is just over 60% of the 2018 figure of £350 million. A very significant fall away in the claims figure. It is hard to believe that shipping has suddenly cleaned up its claims act, and so it may be inferred that this dramatic improvement may be a result of the downturn in trade, with fewer vessel miles travelled as a result of the Coronavirus pandemic.

Further analysis of these Lloyd's figures show that the Gross premiums have remained reasonably stable. With the rises being charged to almost all clients it can also be inferred, from the static premiums, that Lloyd's syndicates have de-risked and have largely kept the same, or similar, premium but with reduced exposures. Reduced exposures would, of course, result in reduced claims incidence. One consequence of Covid-19 has been that people have been travelling less and buying less. This has translated into a lower utilization of shipping, with many vessels in hot lay-up (and some in cold lay-up), and also slower steaming. A direct result of this has been the abnormally low level of claims incidence.

Covid-19 resulted in the entire cruise vessel industry being laid up for over 6 months, effectively in hibernation. The pandemic has really hit the sector hard and large operators are cutting back the size of their fleets. Carnival recently announced that it was planning to reduce the size of its fleet by thirteen ships.

Shipbuilding order books are at their lowest level for 17 years, as reported by BIMCO. Looking at the order book for commercial shipping (container ships, dry bulk, and tankers), BIMCO reported that orders have declined significantly. Dry bulk carriers were down 65%, containerships were down 40%. Crude oil tankers orders were down 4% (partially due to the existing tonnage being used for storage by traders following the collapse in the price of oil) and product tankers orders were down 12% from a year ago.

There has also been an increase in demolitions. Dry bulk carriers were up 80% over the previous year, containerships were up 25%, product tankers were up by 10%, but only two crude oil tankers were sold in 2020 for demolition. However, although orders are down, deliveries continue to outpace demolition and BIMCO reports that fleet volumes have continued to rise.

This downturn in world trade and reduced claims, combined with increased premiums, makes the 2020 year for Hull look very rosy, at least in the short term. As the Hull account has lost money for 18 of the last 19 years, one may be forgiven for allowing Hull underwriters their moment in the sun. However, there is a danger of complacency and any return to the previous norm of trading is likely to result in an uptick in claims activity. As world trade recovers, it may not be an unreasonable assertion that incurred claims are likely to rise again. It will be interesting to see the "new normal" pattern unfold.

Like Brexit, cyber matters appear to have been superseded in the battle for press coverage. Banished to sub-headings in industry reports as a result of the ongoing pandemic, the risk has not gone away. Indeed, it has been reported that cyber-attacks are up by 400%. It is a timing issue before cyber risks, cyber-attacks and cyber losses once again take pre-eminence in the insurance industry.

However, given the ongoing problems caused by Covid-19, there is a certain irony that cyber, which was universally seen as the most significant threat, has in fact turned out to be the insurance industry's saviour, enabling remote working and online underwriting of risks.

For at least the immediate period cyber is not the threat, but the solution.

COVID 19

No current report can be complete without a section on Covid-19 and this report is no exception. The impact of Covid-19 appears to be as prolonged as it is deep. The impact on the whole of the marine shipping industry is apparent in every aspect of marine trade.

It was reported at IUMI that the average weekly mileage undertaken by vessels and the average number of port calls per week had both dipped significantly as a result of the pandemic. Bulk carriers were affected less, with business down by around 12.5% but with a significant recovery since, with the cruise sector effectively shut down.

The downturn of trade has resulted in less demand for bunkers, and so the corresponding fall in bunker prices has resulted in a change of behaviour with Ultra Large Container Carriers increasingly sailing around the Cape of Good Hope, rather than transiting through Suez.

Covid-19 appears also to be having a large impact on the insurance industry, which is being presented with claims from many different areas and many unexpected and previously unforeseeable areas.

Most lines of marine business are having a Covid-19 exclusion clause inserted. The fear of systemic loss is invariably the driver for the exclusion as reinsurance purchased would have a pandemic exclusion. If not mirrored by direct underwriters this would leave those direct underwriters very exposed. Senior management are also insisting that coalface underwriters add a Covid-19 pandemic exclusion to most/all policies irrespective of whether it is a peril insured against or not, leaving the class underwriter no latitude.

THE FUTURE

LLOYD'S 2021

There has been a divergence in capacity allocations for 2021. Five syndicates will not go into 2021; Neon syndicate 2468 (which closed in very early 2020), Sompo syndicate 5151, DTW syndicate 1991, Patria Re 6125 and Starstone 1301, whilst five new entrants commence for the 2021 year. New entrants include Inigo syndicate, (the Richard Watson led purchase of Starstone), plus the follow only Brit syndicate Ki, Mosaic, Nephila follow only syndicate, and Parsyl (vaccine transport syndicate). Capacity at the new entrants of £781 million does not replace capacity from the departing syndicates of £1.05 billion.

Of the top ten syndicates by capacity two have remained static in size; Hiscox and Amlin. The Axa XL syndicate has reduced capacity by 17.2%. Beazley's flagship 2623 (the largest syndicate in the market) has increased its stamp capacity by 21.5% to pass the £2 billion threshold for the 2021 year. The Brit syndicate has increased by 19.8%. Ascot will increase by 39%, Munich Re by 14% and Aegis by 29%. The rest have increased broadly in line with the aggregate market increase of 9%.

Lloyd's has restricted stamp capacity growth to the top two quartiles of the market. The natural conclusion to be drawn is that in the continuing hardening market the bottom two quartile syndicates will be forced to further de-risk. As a sweeping generalization the Lloyd's market increase of just under 9% for 2021 is more than counterbalanced by continuing premium increases, as the overall rate increase across all lines of business appears to exceed 9%, and so for 2021 Lloyd's underwriters are likely to continue to streamline their businesses.

THE COMPANY MARKET 2021

This market is less capital constrained as there is no central body controlling the aggregate capacity. Subject to convincing investors, FCA, PRA and the rating agencies of the substance of the opportunity, a company looking to expand is free to pitch for increased capital from investors wishing to take advantage of hardening terms with no regard to the aggregate insurance capacity of the market.

Capital raising has already occurred for Convex, Fidelis, Lancashire and others. As the future looks rosier there are likely to be further raises. It appears that there is a scaling up rather than starting up (with a couple of notable exceptions) but as the hard market continues more capacity is likely to follow.

SCANDINAVIAN AND EUROPEAN MARKET 2021

The European markets have been playing catch up in 2020 after initially remaining softer. Scandinavia is now following the firmer stance taken by London. The Scandinavian market is enjoying increased income as a combination of increased rates and probably, more importantly, increased shares on target business, as competing capacity either withdraws or tightens renewal terms.

COMBINED LLOYD'S AND COMPANIES

The natural laws of supply and demand are likely to dominate the foreseeable future. The demand side of the equation is stable as the requirement for insurance coverage remains largely unchanged. On the supply side early indications are that exiting capital is now more than being matched by incoming capital. That's the good news. The bad news is that all excess of capital in is likely to be required to fulfil the requirements brought about by increased cost of capital. Hence there is likely to be an ongoing hardening. If more capital continues to enter this upward trajectory, then increases are likely to be lower than 2020. But the near and medium term future for the insurance market is likely to be dictated by incidence, or the absence of natural catastrophes into 2021 and the ongoing impact of Covid-19 to claims, but also as a result of lower utilization to premiums.

CRYSTAL BALL GAZING

Given near normal incidence of loss for 2021, the entering capacity is not likely to destabilise the hardening market, although it may assist in flattening the trajectory of increase of the cycle. The opportunistic start-ups and scale-ups have almost certainly raised capital on the back of strong promised returns, and so will not be looking to undermine the continuing hardening. The existing markets are still in recovery mode and still looking to repair damaged balance sheets. The risk appetite for both is that they are hungry but not starving. Bottom line improvement rather than top line growth has been the mantra for insurers for some while (although until recently their actions belied their words). Now it appears that their actions are now matching their words.

2020 was the year of the Rat. 2021 is the year of the Ox. In the Chinese Zodiac the Ox is very hardworking and methodical. The Zodiac goes on to say that 2021 is going to be a year when work will get rewarded and those who are lucky in terms of money this year, will be the ones that make a considerable effort.

The insurance market would consider that "lucky in terms of money" might be somewhat disingenuous given the financial pain that has been suffered, and that the efforts that have been made have been designed to replace luck with adroitness but, with that one change, the insurance market is hoping for its own Year of the Ox.

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