THE LINK

MARINE NEWSLETTER APRIL 2015

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Hull market round-up

In this article, we consider the current issues facing the hull market. In addition to three members of our marine team – Sean Woollerson, Nick Lockyer and Andreas Liasis – we invited Peter Townsend from Swiss Re and Bob Clarkson from Brit Insurance to debate the issues.

What is the current climate in the marine insurance market?

Sean: The market is really soft and seems to be softening. Where is it going to end?

Bob: In the recent past, high freight rates and therefore high asset values, increased volume of ship construction work and war risks premiums have all benefitted the market, so while the market was softening, the actual premium earned was maintaining a level. But now we have an influx of capacity and asset values have come down significantly, ship construction is down, and war is pretty benign at the moment, the market is feeling the effect.

Peter: I think the biggest issue we've got is that the Costa Concordia – a USD 2 billion hull and liability loss – did not turn the market. If that doesn't turn the market, what sort of loss does the market need in order to change?

Bob: I feel it did turn the market fractionally, arguably for 12 months. It just did not move it very far in terms of a positive rate improvement.

Peter: I think Solvency II means we are looking at a perpetual soft market. That is because the basis on which capital is allocated under Solvency II means there is a diversification credit for capital providers, so companies can use capital twice for non-correlating business. That

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FOREWORD

Welcome to our marine newsletter, which we have decided to rename The Link to compliment our new brand and value proposition 'Your Strongest Link'. We've chosen this name because at JLT Specialty's (JLT) Marine team, we see ourselves as your strongest link between you and the insurance market. We understand that managing risks to protect people and assets is critical to your business, so the team focus on delivering cost effective market-leading solutions and certainty in adverse situations.

In this issue, we talk to Peter Townsend from Swiss Re and Bob Clarkson from Brit Insurance – as well as Sean Woollerson, Nick Lockyer and Andreas Liasis from our marine team – about the current issues facing the hull market.

On page four we look at the ship recycling industry, which is facing a tough year – although we discover there are some reasons for optimism.

We also look at the growing importance of Directors' and Officers' cover for shipowners and the new product we have developed for shipping companies.

In addition, we get an update on the volatile situation in Libya because – in the absence of a strong central government – ship owners and ports & terminal operators are likely to become increasingly affected.

We meet a senior partner from our marine team – Mark Cracknell – and get an update on our inaugural graduate open evening which was a great success.

Finally we look at the hot topic of cyber risks from a P&I perspective.

We hope you enjoy the issue and we'd love to hear what you think, so please get in touch with any feedback.

Kevin Lugg
CEO of the Marine Division
JLT Specialty

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means capital providers are prepared to take a lower return on capital. If the market starts to harden we'll get an influx of even more capital, which would tend to depress rates.

Nick: But alongside that, we have had nearly two years without any dramatic losses. So while premiums have been coming down, claims certainly haven't been going up. What happens when this benign loss scenario finishes?

Peter: There are two elements to a hull price – one is the premium to cover working/attritional losses and the other is that to cover the catastrophic loss. With the lack of catastrophe losses in the last two years, underwriters are using that premium to pay working losses. If this situation is the new norm, we can survive. But if there is a return to a higher incidence of catastrophe losses then we are in trouble.

Andreas: Another big issue is cyber risks – that's a really hot topic at the moment. Anyone can actually hack into a vessel and change the chart and make the vessel think it is somewhere that it is not.

Peter: The University of Texas has already done it – a GPS spoofing test where they took control of a mega yacht under test conditions.

Will there be more consolidation in the insurer and broker sectors?

Peter: If we look at the mere fact that two of the largest Lloyd's marine syndicates have combined XL and Catlin, rather than the two smallest. I think that must indicate the way that some companies are thinking. And if insurers can reduce fixed costs through consolidation, there is likely to be more.

Nick: What about on the broking side? We have seen Willis and Miller in mergers, haven't we?

Bob: There's typically an appetite to grow every business. Obviously for those companies that are listed, it is almost a prerequisite that they don't just stand still. So how do brokers a) grow and b) maintain profitability? If they haven't made the necessary return on equity, they are going to have to make a move.

Peter: One of the capital providers' requirements is they want to see bottom line growth, but they also want to see top line growth – and they are almost mutually incompatible. If you can't get profits up you need to get costs down, which is one reason why we may see more consolidation rather than less.

What is the appetite of capital providers towards the marine market and what are their expectations?

Andreas: There seems to be a huge amount of capital around looking for a home, and a lot of it is coming into insurance.

Bob: Part of the problem is the capacity has nowhere else to go.

Peter: The business model has been replicated many times. You have a hurricane in the States, the insurance market gets hit and property CAT rates rise heavily. You then get a new entity set up, which is basically a roulette underwriter because they are writing only property cat for high returns, unencumbered by previous losses. That quickly results in overcapacity in the reinsurance market, rates fall, those new entities need to write more to expand and diversify, but the only way they can do that is by putting more capital in. So companies tend to write property CAT business to start with and then diversify – often by setting up a Lloyd's vehicle to write everything other than CAT-exposed business. We've seen it many times, for example with Validus, Ariel, Montpellier re, ACE and XL.

Sean: In terms of expectations, do capital providers generally demand a percentage return (for example 15%) on capital employed from their underwriting units?

Peter Townsend (Swiss Re), Nick Lockyer (JLT Specialty), Sean Woollerson (JLT Specialty), Bob Clarkson (Brit Insurance) and Andreas Liasis (JLT Specialty).

Bob: Yes – that's very common. Everybody has a business plan and to get that signed off by your capital providers requires a prescribed year-on-year return on equity which can be achieved across the cycle. However, it's a challenge to all businesses to make sure that the numbers are achievable. Plus Lloyd's has challenged a number of syndicates and agencies on their figures.

Sean: So you have to convince your capital providers – and then you have to convince Lloyd's that your plan is achievable.

Are there any trends in claims activity?

Peter: Our book, on an exposure basis, is far more volatile than it ever has been. We are definitely seeing fewer claims, but while frequency is down, severity is up and that's a consequence of the increasing use of bigger ships. They get goods to their destinations pretty efficiently – but when one goes wrong, you know all about it.

Bob: We have certainly seen fewer claims in the last three years. I think that is because the industry has improved – the ships are better and the equipment is better, as is cargo management.

Peter: If you look at the Lloyd's loss book from 20 or 30 years ago, there would virtually be an incident every single day, now there are likely to be large intervals between such losses – which is the reason why those ships were paying that much more premium.

Nick: Improved technology and aids to navigation has certainly reduced the number of navigational errors.

Have there been any developments in the reinsurance market that have impacted on direct underwriters?

Sean: [To Peter] We have discussed in the past that you don't buy any reinsurance – it's all retained internally, which I think is good for a company of your size.

Peter: I believe most hull books are net retained for single risk exposures. So the only time they would ever collect a reinsurance recovery is if there were an incident involving a combination of interests or a combination of hulls.

Peter: The reinsurance market is now under greater pressure than the direct market. There is an abundance of capital out there trying to find a home, so capital comes in, direct underwriters buy reinsurance, and therefore the cost of their reinsurance comes down. They can either retain the difference or move it down the food chain, which tends to be what happens, and give reductions themselves, their cost of capital is reduced because their reinsurance costs are reduced. It's the old adage of the reinsurance tail wagging the insurance dog.

Bob: Although I think that the tail is at least getting shorter on the dog, to the extent that retentions are getting higher and therefore less likely to have an impact. ■

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Ship recycling market is facing a tough year but stakeholders see some positives

2014 started strongly for the ship recycling market with plenty of activity in all sectors and by June vessel recycling rates had climbed to over USD 500 per Light Dead Weight (LDT). The traditionally strong end of the year, however, proved mostly a washout, with rates driven down to around USD 400 caused by an influx of cheap Chinese steel billets into the Indian subcontinent.

It is a depressed situation that has continued into the first quarter of 2015 with several vessel recycling sales fixed at below USD 350/LT (a drop of 30% in nine months!) per LDT, hardly surprising when scrap steel is on offer in the USD 250 - USD 275 per tonne Free On Board (FOB) range via Indian and Pakistan ports.

The world's second-largest economy is cooling and what is more, in contrast to past years, Beijing seems relaxed about the slowdown, leaving Chinese steel producers with a shrinking domestic market and consequently a surplus of product which is now finding its way to the export markets.

The Indian and Pakistan governments have both announced their intention to impose extra duty on the subsidised Chinese steel, but so far there are no confirmations when this tax will be introduced. Until such time as a penal tax is imposed recycling rates look likely to head further south and the appetite for ship recycling will decline as a result.

There is little doubt that there is pent up supply of owners wishing to scrap ships, especially from the beleaguered dry bulk sector, but many will probably opt to try to ride out the storm until markets improve, gaining any employment for their ships or in the absence of fixtures idle the ships in hot or cold lay-up until markets improve.

According to Petroula Karagianni, Dubai-based risk manager at Global Marketing Systems (GMS), the world's largest cash buyer of ships for recycling, much depends on how deep the pockets of owners are, as to whether they need to recycle ships now or can continue trading at a loss.

"It all depends on the cash flow of the owner whether they can wait for the market to improve," said Karagianni.

GMS keeps a continuous dialogue with owners from its offices around the world and will try to create a solution to the owners' needs with a specific vessel. The services include a range of products, from buying ships for recycling on simple 'as is where is' terms providing owners with prompt access to cash, to buying ships for trading, or to a cash infusion into a vessel.

Sellers also have the advantage that the contract is 'locked in' and not subject to the whims of a recyclers' yard, some of whom are notorious for walking away from a deal at the last minute. As a buyer with a proven track record and about 3,000 deals, GMS underwrites the market risk for owners. As a result, ships are almost always sold via cash buyers like GMS.

Additionally, funds from the sale of the vessel are paid in cash and not subject to the complexity of a letter of credit, a very important point for owners who are not experienced with the banking systems of India, Pakistan and Bangladesh.

Although Turkey is becoming a bigger player, India, China, Pakistan and Bangladesh remain the so-called 'big four' in ship recycling and accounted for over 90% of all ships recycled in 2014.

However, a state subsidy of USD 150 per Gross Registered Tonnes (GRT) granted to Chinese-flagged ships at the nations recycling yards has skewed the balance of activity which means that international flagged ships are virtually excluded from recycling in China – unless an owner is prepared to accept a discounted price of USD 225 per LDT!

The Chinese scrapping subsidy which lasts until the end of 2015 (there are rumours that it could be extended) has undoubtedly been a further drag on the ship recycling markets in Asia and together with the combination of cheap Chinese steel imports all seem to add up to a rather pessimistic outlook for the ship recycling industry in the near and mid-term future.

But shipping is a cyclical industry and since the 2008 global financial crash volatility has swung wildly with the supply /demand equation shifting often from quarter to quarter, instead of the pre-crisis much slower year-to-year norm.

It follows that shipping people tend to be optimists, seeing the glass half-full scenario of the prospect of a bull market in a downturn rather than an indefinite continuation of a bear market. London-headquartered Clarksons Research Services is a shipping analyst and in its blog it suggested another reason why ships will continue to be scrapped despite the existence of depressed rates.

The blog says: "In practice ships only get scrapped when investors believe they can never make a profit. The limited capital tied up in an old ship is underwritten by its scrap value, and trading in the hope something will turn up does not cost much. The problem is the repair cost. By 30 years old the bills are bigger and the future limited, so even well maintained ships bow out at the sixth special survey, while their neglected contemporaries disappear at the fourth or fifth."

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Jamie Dalzell, Shanghai-based trader at GMS believes that the market may now have bottomed out but concedes "we have said that before" and also admits that the past months have been "terrible," with GMS having taken financial hits on some deals.

GMS, says Dalzell, is a long-term player having been in the ship recycling business for over 20 years, and has consequently ridden out many previous downturns of this nature.

Founded by Dr. Anil Sharma in 1992 GMS has done much to improve the reputation and transparency of an industry that is generally regarded as 'murky'.

Working conditions have improved significantly at many Indian subcontinent yards, says Dalzell.

However, regulation, such as the adoption of the Hong Kong Convention (HKC) for the Safe and Environmentally Sound Recycling of Ships in 2009, has also contributed to a vast clean up of the industry.

CAN OWNERS DICTATE WHERE THEIR SHIPS GO TO BE RECYCLED?

"Absolutely yes," says Dalzell. "During our negotiations we recommend yards to owners that comply with our Green Ship Recycling programme, and if they wish we take them there for a visit to see at first hand the high standards."

He added that a visit to the recycling yard by a shipping line representative was becoming more common as owners take more notice of their environmental responsibilities.

The current much low cost of bunkers could extend the life of some cargo vessels that were previously regarded as uneconomic in terms of fuel economy.

On the flipside, if shipping lines dispense with slow steaming due to lower fuel prices, fewer ships will be required and therefore more vessels could be earmarked to make their final voyage to the recycling yards.

One way or another ship recycling will continue and possibly increase as the average age for recycling a ship comes down with more eco-friendly technology advanced new builds being delivered.■

JLT has developed a strong trading relationship with GMS through our ability to provide innovative insurance solutions in this demanding sector. We would like to thank GMS for their invaluable input and support in providing the interview and content for this article.

GMS Leadership

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D&O Liability for Marine

Directors' and Officers' (D&O) Liability is not always the first form of insurance to be prioritised by risk managers in the marine industry.

The focus is understandably on the more tangible risk exposures of hull, machinery and third party liabilities where the potential loss to a business is clearly defined.

The marine industry has also traditionally been run by family owned businesses, financed by private family money, and governed by century's old rules and regulations. Historically, therefore, there has not been any great scrutiny of corporate governance and management practices which is standard in other industry sectors.

We are now seeing an increase in demand and importance of D&O Liability insurance, which is mainly attributable to recent developments in the global business environment and the emphasis on corporate governance brought about from the rise in corporate collapses and scandals.

For the marine industry specifically, the need for larger and more specialist types of vessel, has led to a huge influx of new capital introduced in recent years, whether in the form of private equity or direct stock market listings. This has led to a commensurate increase in scrutiny of management practices and standards by new third party investors.

More and more senior directors' and officers' are being subpoenaed or investigated, and individual decision makers can be left without access to adequate legal protection when investors and regulators are seeking scapegoats or apportionment of blame. The traditional marine covers do not always offer such protection for individuals.

D&O FOR THE SHIPPING INDUSTRY

The Financial Lines Group in JLT Speciality handles D&O insurance requirements for companies as diverse as Fortune 500 companies with major US stock market listings to smaller private companies. In collaboration with our marine colleagues, we have developed industry specific D&O products for all participants in the marine industry (from shipping companies, to freight-forwarders and ports authorities) which provide direct legal protection for individuals, separately from any litigation against the company.

We would therefore be happy to discuss any D&O requirements, and can offer a health check review of your current policy if that is appropriate. ■

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Security Outlook – Libyan Sea Ports

MS Risk have published a report looking at the Libyan Sea Ports for JLT Specialty Marine

Libya is home to some of the largest crude and natural gas reserves in Africa. The nation has been wracked with civil war and terrorism, affecting its economy and security at maritime ports along the Mediterranean Sea.

Without a diplomatic solution, security is likely to deteriorate throughout 2015. Two competing governments and their armed forces are struggling for primacy. As fighting intensifies, air and sea ports have been targets for airstrikes. The battle for oil facilities has already impacted the Gulf of Sirte, forcing closure of several sea ports.

Amid the fighting, terrorism is thriving. Porous borders in the south have created a smuggling pathway for Al Qaeda in the Islamic Maghreb. In the north, Ansar al Sharia-Libya and ISIS in Libya are operating in Cyrenaica and Tripolitania provinces, mainly along the shoreline. In the absence of a strong central government, it is likely that merchant shipping along with ports and terminals operators will become increasingly affected in future.

JLT retain the services of MS Risk as security advisors to assist our clients and our team in keeping up to date with security issues. Sean Woollerson, Senior Partner in JLT Specialty's Marine division says "This is a particularly important resource for us as we need to be able to negotiate the best rates for our clients; having real time intelligence that is not readily available, even to the market, is a sound broking practice which enables us to deliver to our clients." ■

To request a copy of the MS Risk on Libya report please email edward_threlfall@jltgroup.com

MS | RISK

Meet Mark Cracknell

Q. What does your role involve?

I'm a senior partner in the marine team. I work largely on strategic business development, identifying people and opportunities and working with the marine executives and other stakeholders such as network offices to make the most of them.

Last but very far from least I work on a number of client relationships – making sure that clients always get what we have promised them.

Q. What is a typical day like?

I work with clients and offices all around the world, so I do quite a lot of travelling. When I'm in London, a day might involve a meeting with the commercial team and meetings with underwriters about specific client work, or regular catch-ups to nurture market relationships for the benefit of our clients.

Q. What experience do you bring to your role?

I've spent nearly 30 years in the marine insurance market, since starting as a claims executive in a P&I club (Steamship Mutual). I ran Aon's marine business unit in the UK, and before that was head of P&I at Marsh. I joined JLT Specialty 18 months ago; I was attracted by the fact that marine is a very important part of what we do and something that is ingrained in the culture of the business.

Q. Why marine?

I've always worked in marine, so I have nothing to compare it with! I often recommend it to others, though. I have met a great many interesting people all around the world, lots of whom have become friends. That's a privilege not afforded to everybody.

Q. What big or interesting placements have you worked on?

Too many to think of a single defining example. The shipping world being what it is means our clients face constant challenges when it comes to risk and insurance. Playing our part in helping with that is a huge source of satisfaction.

Q. What's happening in the marine market?

The hull market is characterised by a vast surplus of capacity, which continues to drive prices down.

In the mutual market, the cost of P&I is going up. The legal environment for ship operators is ever-harsher, plus the things P&I insures against are simply getting more expensive. For example, a removal of wreck that wasn't technically possible 20 years ago can now be accomplished. When I started in the industry, P&I costs for shipowners were probably a quarter of hull insurance costs – but now they are usually equal or more. ■

Inaugural graduate open evening

In December, we held an open evening for graduates interested in our 2015 graduate programme.

The informal event was intended to give graduates a feel for JLT Specialty and working in the City, as well as helping JLT to become an employer of choice for future graduates.

Attendees met graduates from the current scheme and members of the business, including representatives from each of the divisions and HR, as well as members of the Chartered Insurance Institute (CII).

Douglas Lee from the marine division at JLT Specialty says: "The evening was a huge success. It gave us the opportunity to sell ourselves as a business and scout for talent among the applicants. Since the event, we have received hundreds of applications and we're interested in taking on graduates that we were particularly impressed with at the event." ■

Get in touch: If you want to send us your CV or apply for the graduate scheme, please email us at graduates@jltgroup.com

Cyber Risks for P&I Clubs

There is no specific exclusion of cyber risks under normal P&I club rules. However, some traditional exclusions can apply. War risks are perhaps the best example. Rupert Banks of Charles Taylor P&I, managers of Standard P&I Club explores the issues.

P&I liabilities are excluded from club cover where they are incurred as a result of, “any hostile act by or against a belligerent power, or any act of terrorism”, since these constitute as war risks. In cases where a cyber attack can be characterised as either of these (or as another war risk), P&I cover would not respond.

Whether or not a computer virus constitutes an act of ‘terrorism’ for the purposes of the rules will largely depend on the motivation behind the act. In the context of war risks, terrorism has been broadly understood by English courts to mean an act or acts that aims to kill, maim or destroy indiscriminately for a public cause. For example, a computer virus released by an individual or group for the purposes of merely causing general disruption for the sake of it and for no public cause would be unlikely (without more) be classified as ‘terrorism’. Ultimately what for this purpose constitutes an act of terrorism is a matter for club boards to interpret according to their discretion, and their decision is final.

A hostile act by or against a belligerent power, is not defined in club rules and club boards are not afforded the same discretion in deciding what it means. However, such acts have generally been considered by English courts to arise in circumstances of ‘war’ and ‘civil war’. It is also generally understood that such acts have to be engaged in by a government or, at the very least, organised rebels who have the stated intention of overthrowing a government or depriving them of authority over part of their territory. A computer virus released by a government or organised rebels in a period of war or civil war would be subject to the exclusion of war risks under club cover. Otherwise P&I cover could respond.

Whether or not a computer virus constitutes an act of ‘terrorism’ for the purposes of the rules will largely depend on the motivation behind the act

Several members offer limited additional cover under the bio-chemical risks inclusion clause 2015 for crew injury, illness or death (including deviation, repatriation and substitute expenses and shipwreck unemployment indemnity) arising from the malicious use of computer software, code or viruses.

However, it should be noted that such losses are excluded if the ship or its cargo is used to inflict harm, or a computer, system or software programme is used to launch, guide or fire a weapon or missile. ■

For more information, please contact marinecommercialteam@jltgroup.com.

JLT Specialty Limited provides insurance broking, risk management and claims consulting services to large and international companies. Our success comes from focusing on sectors where we know we can make the greatest difference – using insight, intelligence and imagination to provide expert advice and robust – often unique – solutions. We build partner teams to work side-by-side with you, our network and the market to deliver responses which are carefully considered from all angles.

Our marine team of over 100 specialists has built its reputation over many years. The team is made up of a broad range of professionals who have all the necessary skills to help you manage your risk. You demand a stronger approach based around your business, providing cost-effective solutions, service excellence and claims certainty.

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