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MARINE P&I

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P&I CLUB RESULTS & THE END FOR THE "SUPER CLUB" MERGER

As we suffer yet another typical wet English summer, it's a good time to digest the clubs' financial results that have recently been announced and circulated by Arthur J. Gallagher.

The figures cited in this report include the 31 March 2016 results for the Japan Club which have been released however are internally inconsistent.

2015/16 P&I Club Financial Results

Collectively the IG Club overall surplus of $204 million (m) increases the total free reserve from $4.621 to $4.825 billion (b). The majority of this increase comes from 4 clubs (Gard, Steamship, West of England and North of England), with Steamship and North of England, contributing $65m and $90m respectively.

CLUB	STA-TUS	OVERALL RESULT	UNDERWRITING RESULT	INVESTMENT RESULT	OTHER NET INCOME	CLOSING FREE RESERVE
North of England	PR	$90.0m	$102.8m	$(12.8)m		$428.1m
Steamship	PR	$64.1m	$65.0m	$(1.8)m	$0.9m	$440.3m
Gard	AC	$47.6m	$96.2m	$(53.9)m	$5.3m	$1.016.0m
West of England	PR	$33.0m	$30.2m	$2.8m		$276.7m
Skuld	AC	$13.0m	$22.0m	$(9.0)m		$360.7m
Standard	AC	$9.8m	$17.7m	$(5.3)m	$(2.6) m	$390.1m
London	AC	$3.3m	$15.3m	$(11.5)m	$(0.5) m	$160.7m
Japan	PR	Split not available				$176.0m
UK	PR	$(0.8)m	$17.8m			$547.0m
American	PR	$(2.6)m	Split not available			$56.0m
Swedish	AC	$(3.1)m	$2.0m	$(2.9)m	$(2.2) m	$181.0m
Shipowners	AC	$(20.9)m	$3.2m	$(22.4)m	$(1.7) m	$279.4m
Britannia/Boudicca	AC	$(32.9)m	$(8.0)m	$(23.5)m	$(1.4) m	$512.7m
Total		**$203.8m**				**$4,824.7m**

Note: status is at time of going to print
PR = press release or similar
AC = accounts released

Certain aspects of the above analysis between underwriting/investing and other results may change as further information arises on production of final accounts. The above figures include surpluses on pension funds at North of England ($18.2m) and Gard ($16.9m) as part of the underwriting result. West of England investment income includes a revaluation surplus on their office premises. Shipowners' figures are for a period from 21/02/2015 to 1/12/2016 rather than a full year.

In April's PIC newsletter, we called for clubs to return any increase in free reserves at a time when Shipowners continue to operate in very difficult times. Skuld and Gard have already done this, to an extent, Skuld for the first time this year and Gard for many years now.

Amongst the 'high earner' group, Steamship's $64.1m surplus comes on top of a $75.0m gain in 2014/15 financial year, meaning that free reserves have increased by over 46% in 2 years. Whilst North of England did not enjoy a profitable year in 2014/15, with an overall deficit of $22.7m, its free reserves nonetheless have risen by over 37% in the last 2 years due in part to the acquisition of Sunderland Marine. West of England have also enjoyed two consecutive years of solid profits, increasing its free reserves by $60m, almost 30%, since the start of the 2014/15 year.

It is refreshing perhaps that both Steamship management and the North of England Chairman have intimated that the question of returning money will be discussed at their winter board meetings, and we feel that West of England should also consider a similar proposal. However capital adequacy is something that has to be evaluated in a broader context than simply short term profitability and so the eventual outcome of this sort of discussion is far from a certain thing.

Furthermore, now freed of the constraints of a planned merger, it is time for the UK and Britannia clubs to reconsider calling levels. There was strong speculation in the market that funds would be returned to members as part of this merger: now that it is off, will these two clubs consider returning funds anyway?

P&I CLUB COMPARITIVE INDICATORS

Q: What are the best indicators when comparing P&I club data?

We at Arthur J. Gallagher are looking at this in more detail. As one of the leading brokers, we often compare and comment on various methodologies of evaluating the financial security of the clubs and the alternative market. An important base measure has always been an evaluation of the so called free reserves, i.e. the club assets net of all claims, and other liabilities. Even this simple measure seems to be less transparent nowadays as diversification persists. The advent of Solvency II disclosures will result in a more risk based approach capital adequacy evaluation, but it remains to be seen how truly transparent and comparable this will be.

The continued release of improved old year policy balances, as claims estimates and IBNR prove to be redundant, is a serious limitation on any analysis of true trends – at least to the outsider. The impact of older year improvements on financial year combined ratios may conceal real underlying trends.

During the current period of reducing claims numbers, these releases will continue to play a big role in determining profitability, but disclosure is not always very clear. Initial claims estimates and IBNR provisions, based on historic trends developed over many years, will continue to be excessive, at least during the tenure of the current market conditions. They will continue to be used to justify general increases when established, but then when the over provisions are taken down this tends to slip under the radar.

So in practice owners and brokers negotiate renewal on current, high, claims estimates, plus 'safety value' added by the club. Two to three years later these figures settle for far less and hence additional free reserves emerge - and so the cycle continues. This may be a facet of the current trading environment, with fewer claims, but it needs to be reflected on renewal: the probable $350m to $400m underwriting profit this year is as clear evidence of this trend as one could want.

Therefore at Arthur J. Gallagher, we are now considering further ways of comparing clubs which we feel owners would have more confidence in. As part of this exercise, we will look at the so called abatement layer, which now has an overbearing impact on loss statistics and again is not fully transparent amongst members/clubs. In this respect, Britannia is the exception showing the member's full record up to US$10m being the current retention.

THE DEMISE OF THE UK/ BRITANNIA MERGER

Turning to the proposed merger between the Britannia and UK clubs, this has now been consigned to history along with several past attempts to consolidate within the market. Britannia is fast becoming "always the bridesmaid, never the bride" having been involved in 2 publicised attempted mergers this millennium. The cessation of merger talks was announced in a brief press release from both parties which simply stated that "While a number of potential synergies and benefits were recognised, no agreement could be reached on acceptable terms, and the discussions have now been terminated".

This rather bland statement is the culmination of almost 4 months hard work and negotiation since the merger talks were officially confirmed in February, and probably well over 6 months since the possibilities were first looked at by the parties involved. Given the current state of the shipping market, where every dollar is important, members deserve to know how much this has cost their clubs in professional fees, management time etc. The members deserve more than 1 sentence in explanation of what will be a substantial cost.

We can only speculate on the areas where an acceptable agreement could not be found, but it is highly likely that the capital equalisation between the parties would have been a bone of contention. Even after their 2015/16 losses, Britannia was still the stronger party in terms of headline ratios such as free reserves per ton and free reserves to premium income, so this was not to be a simple equalisation calculation. The matter of the UK club hybrid capital, Boudicca and UKPI's investment in its own management company could only have complicated the issue and left room for disagreement.

The potential differences in the clubs' reserving and IBNR policies, and differences in "hidden reserves" yet to be released as back year surpluses (see above) would also very likely been an area of disagreement.

Add this to personnel issues and other complexities involved in writing the rule book for a merger between 2 active mutuals, then it is perhaps no surprise that the matter never got as far as being put to the members to decide.

We may never know the detailed whys and wherefores of the collapse of the deal, although we hope that, in a spirit of transparency, a little more flesh is put on the bones, but in many ways the market should be better for its collapse. A smaller market would not offer the owners, and their brokers, as much choice and would unquestionably put the future of the International Group Agreement in jeopardy. Further consolidation would also probably have attracted the interest of Brussels, if that is of continuing relevance after the 23rd June decision.

This merger could have been a life changing event for the P&I industry, or, some might say, a life threatening event for the market as we know it. As a merger between two of the largest clubs, it may have forced the next tier of clubs to react by themselves merging. This would have resulted in a two tier market emerging, with three or four large clubs and a few specialist niche clubs.

Those other mergers may still take place, as other clubs may still be looking at realistic possibilities that they would not otherwise have done, but they will be voluntary instead of reactive. Will an air of calm return to the market and status quo be restored, or will those other clubs continue with the plans they may have developed in reaction? The reality of this merger may have gone away, but its impact could yet be seen elsewhere.

Amongst the broking community, there have long been strong proponents of consolidation in the market, although we have never subscribed to this view. Now these plans have come to nought, let us hope that those seeking radical change take note and appreciate that this is still a very conservative market, and, if it isn't broke, don't try to fix it.

In closing, one thought – the Press Release notes that the mergers between the clubs had terminated. No mention is made of the proposed merger between the management companies. We are assuming that this will not proceed, but arguably the economy of scale benefits relating to overhead costs could be achieved by merging the managers but not the clubs. Perhaps it was therefore that the inability to reach agreement was at Manager level and not club level?

May we take this opportunity to wish you all a relaxing and enjoyable summer and, as always, we remain at your disposal.

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