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Emerging trends in marine insurance : is there a trend towards demutualisation of mutual clubs?

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EMERGING TRENDS IN MARINE INSURANCE

Is there a trend towards demutualisation of mutual clubs?

By

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A dissertation submitted to the World Maritime University in partial fulfillment of the requirements for the award of the degree of

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MARITIME AFFAIRS
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DECLARATION

I Certify that all the material in this dissertation that is not part of my own work has been identified and that no material is included for which a degree has previously been conferred on me.

The contents of this dissertation reflect my own personal views, and are not necessarily endorsed by the University.

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ABSTRACT

Title of Dissertation: **Emerging Trends in Marine Insurance**

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This dissertation analyses the emerging trends in the marine insurance industry with specific reference to the structural changes in the mutual P&I Clubs. The marine insurance industry as a service industry is subject to pressures sometimes under estimated but they exist and they are increasing. The impact of such changes specially the changes in the general insurance industry that has influence on the mutual clubs in the marine insurance industry is examined. Recently, the mutual P&I clubs has witnessed the pressure of a review by the European Commission of International Group Agreement and competition from fixed premium providers. The mutual clubs are responding to these challenges by providing range of services including one-stop- shop service through Joint ventures or alliances with the corporate players. The development of information technology, the commoditisation of insurance services and competition by products on the basis of price rather than historical relationships are undermining the insurance relationship, which continues to be at the heart of the most marine mutual insurers. The above aspect raises the question on the survival of concept of mutuality. The concluding chapter analyses the impact of various factors which influences the demtualisation of mutual clubs such as cash flow, free reserves, access to capital, size of the insurer, management and administrative expenses, underwriting losses, rate of investment income and ratings from specialised rating agencies. Analysis of results show that the P&I clubs Skuld and Steamship mutual have strong tendency towards demutualisation, the clubs London and Japan have a weak tendency towards structural changes and the other clubs are favourably positioned towards structural changes. The recommendations emphasise the challenges and trends and the need for reorientation of mutual clubs.

KEYWORDS: Marine insurance, Demutualisation, Structural changes, P&I clubs, Fixed premium providers

TABLE OF CONTENTS

Appendices

List of Tables

LIST OF ABBREVIATIONS

AER	Average Expense Ratio
ART	Alternate risk Transfer
BMM	British Marine Mutual
CLC	Civil Liability Convention
CMI	Comite Maritime International
DGIV	Directorate General Competition(EC)
EC	European Commission
ETC	Estimated Total Calls
FD&D	Freight Demurrage and Defence
FP	Fixed Premium segment
FPP	Fixed Premium Provider
GT	Gross Tonnage
H&M	Hull and Machinery
HNS	Hazardous and Noxious Substances
HSBC	HSBC Insurance Brokers Limited
IACS	International Association of Classification Societies
IGA	International Group Agreement
ILO	International Labour Organisation
ILU	Institute of London Underwriters
IMO	International Maritime Organisation
ISM	International Safety Management Code
ITC	Institute Time Clauses
IUA	International Underwriting Association
IUMI	International Union of Marine Underwriters
LIRMA	London International Insurance and Reinsurance Organisation
LLMC	Limitation of Liability of Maritime Claims

LNG	Liquefied Natural Gas
LPG	Liquefied Petroleum Gases
LUC	London Underwriting Committee
MOU	Memorandum Of Understanding
MARPOL	Marine Pollution
OPA90	Oil Pollution Act, 1990
P&I	Protection and Indemnity
RDC	Running Down Clause
S&P	Standard and Poor’s
SOLAS	Safety of Life at Sea
STCW	Standards of Training Certification and Watch keeping
UK	United Kingdom
UNCTAD	United Nations Commission on Trade and Development
US	United States of America

CHAPTER 1

INTRODUCTION

As the marine insurance companies stand on the brink of a new millennium they are facing tougher competition than would have seemed possible a few decades ago. And the state of the marine insurance industry today is the direct result of the incredible transformation of the overall financial services industry and in particular the general insurance industry. Over the past 20 years staggering changes have taken place in the global general insurance environment. Companies in the insurance industry are currently facing a number of challenges and trends inter-alia globalisation of markets, consolidation and specialisation, increased competition from new competitors, new products and alternative distribution channels, changes in customer needs, changes in the security perception of vessel operation, reducing margins and increasing costs, increasing sophistication and complexity of information technology including e-commerce and increased risk requiring innovative risk transfer vehicles. (Geib Gerd, 2001.p.1)

1.1 Do these changes in the general insurance industry create any impact in the marine insurance industry?

Shipping being a specialised industry has so far insulated itself from the developments that have been taking place in the general insurance industry. The new entrants into the marine insurance market have taken knowledge from other industries and applied it to the marine sector. This includes knowledge on customer behaviour, distribution, brands, perception and service. The brand values of mutual clubs, which relied on shipowner's trust and reliability, which seemed to belong to the marine insurance industry for so long, are no longer enough to provide sustainable competitive advantage for the traditional players. Thus the changes that are taking place in the general insurance industry are relevant to shipping. Shipping is an international industry subject to unique environmental, political, and commercial considerations. Marine insurance as a service industry, which exists to provide the ship owner the cover that he needs has to operate on a global basis and is subject to all pressures sometimes under- estimated but they exist and they are increasing (Taylor, 2000.p.22).

The events of the past few years, the review by the European Commission (EC) of the International Group Agreement (IGA), the decision to limit the amount of cover under P&I by the mutual clubs and the incredible interest in P&I shown by commercial insurers have sparked considerable debate about the functioning of mutual clubs. In June 1999 the DGIV of the EC granted a ten-year exemption to the IGA until February 2009 subject to the condition that there should be competition among clubs who are members of the IGA and all the clubs should publish their Average Expense Ratios. With the increasing transparency and changes in the reporting standards consequent to the EC investigation, S&P developed a full rating process for the P&I clubs and many clubs voluntarily opted for interactive ratings (made with the cooperation of the insurer) which was first published in 1999. The mutual clubs went through a process of review that resulted in the merger of the Liverpool & London and Newcastle Club with North of England Club and the demutualisation of British Marine Mutual, London. The mutual clubs also started examining their weaknesses in comparison to the commercial insurers, namely the unbudgeted supplementary calls. Consequently the UK Club announced a new reinsurance arrangement with Swiss Re designed to support it's solvency position without the need for unbudgeted calls, which is the new trend evolving among other mutual clubs (Sydenham, 2000.pp.4-5).

1.2 What is the impact of the entry of fixed premium providers in P&I?

The other development that has been noticed in recent years is the increased retention of risk by the clubs both individually and collectively through the group pool system. The group clubs have repeatedly indicated their readiness to increase the pool's retention of risk should reinsurance rates rise and it is a major benefit of the pool and it's spread of risk that the clubs have this flexibility. The S&P report identified that the major issues facing the marine mutual insurance market is consolidation, diversification and demutualisation. If consolidation of mutual clubs takes place the International Group could end up with far fewer members resulting in lack of choice for the shipowners, which may drive more business to the fixed premium market. The mutual clubs are combating the threats from the fixed premium competitors by providing a range of services through joint ventures or alliances with the corporate players. This may pose a danger to the clubs since the corporate players who are entering into joint ventures may desire to have a firm hold on the mutual clubs affecting their freedom and possibly resulting in a take over.

1.3 Impact of information technology

The impact of technological development, especially information technology, on the insurance industry is phenomenal. Delivery systems for insurance products have become much more sophisticated. In contrast to the personal one to one approach of brokers with underwriters nowadays the shipowners have direct access to information on availability of insurance cover and terms and conditions of cover from all over the world and decide on the insurer who is best suited to the interest of the shipowners. The major disadvantage in such a system would be testing the reliability of the insurer but looking into the credit ratings given by the reputed credit rating agencies can solve this tricky issue. The technological development, therefore, constitutes a direct attack on the relationship insurance, which continues to be at the heart of the most marine mutual insurers. The technology therefore contributes to the commoditisation of insurance services, which in turn encourages competition by products on the basis of price rather than historical relationships. The individual shipowners who are members of the mutual club are aware of the alternatives and they may refuse to cross-subsidise other members of the mutual clubs who contribute less to the bottom line (Wilderman, 2001. pp.2-5)

1.4 Emerging force in marine insurance industry –E-commerce

Another area where competition seems set to increase is electronic payments processing and provision of insurance services over the Internet. This is a global phenomenon that will certainly affect the marine mutual industry. Non- financial firms which means the non-marine insurance providers, who control communication networks and the gateways could set themselves up as brokers directing customers to the best product. (Brinson, 2000. p.15). The loyalty of the customer would increasingly be to the broker rather than the producer of the product or the one who actually provides the insurance service. What is the immediate impact of such a development? At the very least this process will squeeze the margins of traditional insurance providers. It is also highly likely that there are non-financial firms offering such services who would be in a position to design a new product by using the information available to them through data mining technology. Whether such a product will start competing with the traditional product offered by segmented insurance service providers is important. Let us say a popular web portal can offer an integrated service of P&I, Hull, Cargo and FD&D cover from various insurers by combining the best, which meet the specific needs of the shipowners and call it new product. In such a case the brand value of the original segmented product, namely the insurer of P&I or Hull or cargo loses it's importance.

1.5 Is there any trend towards demutualisation of mutual clubs?

The world wide insurance industry was dominated by mutuals only a decade ago. Since then there has been a trend towards demutualisation, which saw many mutual insurance companies in the life insurance sector demutualising in the last decade. A report from Reuters (2000) observes that the mutual insurance companies reforming as joint stock companies may be a mistake, and the current trend to demutualise may stop, or even reverse. The report noted that some mutuals planning to convert to stock ownership, such as Metropolitan Life in the U.S., did just the reverse earlier this century, and said the trend may yet swing back to favour mutual ownership.

One of the biggest reinsurers Swiss Re also said in its latest report (Sigma report, 1999.p.34) that mutual insurers have some fundamental advantages over joint-stock competitors and should reconsider the decision of rushing to demutualise. The current trend would show up to 10 large insurers abandoning mutual status over the next three years. Among the big names slated to demutualise are the U.S.'s two largest life insurers, Prudential and Metropolitan Life, and the four largest Canadian life insurers. In the UK, life insurers NPI and Scottish Widows are in the process of demutualising after being acquired by other companies. The trend was set by Swiss Life, Norwich Union and AMP, which demutualised in 1997 and 1998. Sigma report said life insurers were demutualising to make capital access and acquisitions easier, but warned that this meant losing the mutual's cost advantage of having no customer-owner conflicts. The report observed that the mutuals, without any short-term shareholders to please have the advantage of flexible pricing and long-term investment. The demutuality is an option open to mutual clubs to expand their business and accessing capital by becoming joint stock companies. Demutusalisation requires significant changes to P&I club's corporate culture. A move to fixed premium inherently points to a shareholder's interest approach as opposed to the mutually beneficial concept. There are considerable differences between the financial structure of mutual and corporate organisations. Demutualised clubs will no longer be able to make supplementary calls to members to cover greater than expected losses so they will have to back their underwriting with appropriate capital. The demutualised corporate entity cannot rely entirely on providing P&I insurance cover since this may result in a narrow business review of concentrating on one type of business sourced from one industry. This is primarily due to the fact that shipping being a cyclical industry, a slump in the shipping industry will affect the bottom line of the insurance business. The clubs that demutualised in the last three years were British Marine Mutual (BMM) providing P&I cover, Charterers' Mutual providing cover for charterers and Transmarine providing cover for strike and disruption. The increasingly competitive nature of the P&I market might influence mutual clubs to opt for merger rather than demutualisation as in the case of two big P&I clubs Britannia and Standard, who negotiated for a merger last year, which, however, finally fell through. Mr.Todd of syndicate 329 observed that 'the rush to demutualise may be pushed to one side while merger mania sweeps through the market. Consolidation is easier than demutualisation'(Beatty,1990.p.19).

Apart from demutualisation, there are certain considerations that are driving merger and acquisition activity across the insurance industry for the purpose of capital allocation, competitive positioning and pressures for global presence. Many insurance companies are seeking mergers and acquisitions to gain benefits of scale and hoping that they benefit from lower costs, improved time to market, greater flexibility and more attractive positioning to investors. In this project I propose to analyse what these changes mean for marine insurance companies and what the industry will look like in the coming years.

The topic, *emerging trends in marine insurance industry - demutualisation of mutual clubs* was chosen because it reflects author's concern for the changes that are taking place in the general insurance industry which are likely to have influence in the marine insurance industry. The author, having a financial and maritime administration background, believes that the trends in general insurance industry need to be thoroughly analysed for the cause that may contribute to the mutual clubs. This belief, indeed influences author's decision for choosing this topic.

Many books have been written about P&I clubs but not many have been formally written about emerging trends or demutualisation of mutual clubs in the marine insurance industry. The material that influences this work is obtained through different sources such as books from the WMU library, (Stephen Hazelwood, Gaskell, Phil Anderson, Christopher Hill, Drewry Insurance report …), texts from technical seminars, conferences (Mare Forum,2000, IUMI,2000…), P&I review reports (Elysian, Marsh HSBC …), Personal e-mail enquiries to various P&I clubs, discussion with shipowners, insurance brokers and managers of insurance clubs during field visits (Greece, London, Bremen…), personal discussion with visiting Lecturers (Mr.Claes Lindh, Mr.Svensson, Dr.Harlambides…) and a variety of marine periodicals, websites and lecture notes. The topic is difficult, to the author of course because of the availability of limited research material. However, it is interesting. His passion for the subject is motivation behind this work.

CHAPTER 2

DYNAMICS OF MARINE INSURANCE

2.1 Legal regime for marine insurance

The Marine insurance was practiced as the early as twelfth century by Lombards and the members of the Hanseatic League introduced it to England. The institution for providing marine insurance in the UK started with the Lloyds coffee house in the seventeenth century. Lloyd's developed the standard marine policy called the Lloyd's S.G (Ship &Goods) in 1779 and it remained in use until 1982.The S.G form is given as the sample of form of policy in the First Schedule to the Marine Insurance Act, 1906. During 1982 a new simplified policy document evolved called MAR form keeping in view the changing needs of the industry. (Gaskell,1987,p.500).

2.2 Types of Marine Insurance

The most important types of insurance in the marine insurance market are Hull and Machinery (H&M), Protection & Indemnity (P&I), Freight, demurrage and defence (FD&D), War risk, and Strike insurance. The H&M covers the ship, the equipments on board the ship including the propulsion and auxiliary machinery, cargo handling and navigation equipments and similar items of plant. H&M also covers the ship's contribution to general average, salvage and ¾ th of the liability to the other vessel in collision. The P&I insurance cover the ship owner against the third party liabilities, which are covered under other insurance policy (Wijnost and Wergeland, 1997.p.216). FD&D insurance provides insurance for legal costs and technical support and assistance to defend or prosecute a wide range of uninsured claims and disputes. P&I clubs offer this type of insurance as an additional class of insurance. The War Risks insurance provides cover if the vessel finds itself in a war zone or other areas of hostilities since the normal H&M and P&I insurance are likely to be suspended. Strike insurance covers insurance of losses, which are consequent to strike at the ports or during the performance of a voyage. A ship owner or manager usually buys cover for financial consequences of damage to his own ship, damage to other people's property or death or injury to people. A charterer specifically a time charterer, has insurance similar to the ship owner. Cargo owners requirements are usually confined to loss or damage to cargo.

2.3 Application of various International conventions

For the shipping industry, being international in character, the operational requirements of a ship in international trade are primarily governed by various International conventions mainly the conventions of the International Maritime Organisation (IMO), International Labour Organisation (ILO), UNCTAD, Comite Maritime International (CMI) and the port state regulations where the ship is likely to trade. IMO is entrusted with the responsibility of maritime safety including prevention of pollution of the marine environment. The important conventions of IMO in this respect are SOLAS1974, MARPOL1973/78, STCW 1978/95, CLC1969/92, LLMC1976/96, FUND1971/1992, and HNS1996. These conventions impose certain minimum standards on the operation and maintenance of ships, which are important considerations for the marine insurers for the efficient management of risk (Donner, 2000). The application of ISM, which has direct implications on marine insurance, is discussed here under.

2.3.1 Impact of Implementation of ISM code

This code has come into partial operation from 1st July 1998 for certain types of ship and it is fully applicable from 1st July 2002 for all types of ships. The ISM code focuses on improving and establishing sound management standards so as to provide safeguards against accidents caused by errors on the part of the shipboard and shore management. Therefore the implementation of the ISM code has a wide range of implications on the parties who are connected with the operation of a ship, namely charterers, cargo owners, insurance companies, financiers, ship brokers, underwriters and the classification societies. The UK P&I club's recently published study of major claims has identified the causes of such major claims which include deck officer error (25%), crew error (17%), equipment failure (9%), structural failure (9%), shore error (9%), pilot error (5%), mechanical failures (5%) and engineer officer error (2%) (UK P&I Club, 2000, p.19). If we look at the above findings we can conclude that the majority of the identified errors were human errors and following the safe practices laid down under the ISM code could minimize human error. In support of this statement, the statistics on voluntary compliance show a reduction of 10% in liability insurance, 7-8% in P&I premium, 40% in lost man hours, 40% in pollution fines and the damage to container claim has fallen from $2million to $20,000 (Skuld, 1998) (Mary Bond, 1999). Proper implementation of international conventions would help in reducing the losses and would consequently reduce claims. In the competitive environment the mutual clubs are required to find ways and means of reducing their cost and any effort to minimize the loss would improve their bottom line. Mr. Frederick Kruse of the Swedish Club (The Swedish Club, 1999) in his paper presented at the P&I

conference 2000 in London, stated that he is of the view that the competitive factors in future take many forms and one of them is loss prevention. The Swedish club made an analysis of the impact of ISM and found that the hull claims record of ships subject to the ISM code's first dateline (July, 1,1998) is some 30% better than that of vessels subject to the Phase II deadline (July, 1,2002).

2.4 Economic aspects of the marine insurance

The marine insurance market is one of the largest segments in the shipping market apart from shipping finance and freight. The International Trade Reports from WTO (WTO report, 2001) have quantified the volume of world trade for the year 1999-2000 at 5.3 billion tonnes and the value of the trade for the year 1999-2000 to cost US$ 5473 billion for exports and US$5729 billion for imports. The cost of the transportation process is estimated to be 4-5% that works out to around US$250 billion and of this the cost of marine insurance is estimated to be US$8.8.Billion. The cost of marine insurance forms an important component of ship operation costs (around 5 %-10% of the cost of transportation) and therefore the extent of the insurance cover and obtaining competitive rate for obtaining such cover from various service providers is important for the ship owner (Drewry, 1998.pp.7-8). The global marine insurance market could be divided into two major markets, one in London and the other forming the rest of the world. The London marine insurance market is estimated to be around 30% of the global market due to the legacy inherited by London that many international insurance companies used to conduct their business from London.

The major players in the London insurance market could be divided into three categories, namely Lloyd's, other insurance companies and the Mutual club operators. The shares of business of different markets in 1998 are as under

Table 1 Market share of London market(1998) (Figures in US$ billion)

London market		**Rest of the world**	
Lloyd's	2.52	Japan	2.38
Other companies	1.95	USA	1.26
Mutual clubs	1.11	Other countries	6.02
		Mutual clubs	0.70
Total	5.58		10.36
Percentage	30%		70%

Source: Modified from Drewry report on Marine Insurance, 1998(p.8).

The above table clearly shows the dominance of the London market in marine insurance with other big markets in the USA and Japan.

If we look at the global figures estimated for different types of marine insurance, the details are as follows

Table 2 Market share of different types of insurance (1998)

	Type of Insurance	**Volume(US$ bn)**	**Market share**
1	Marine cargo	7.27	45%
2	Hull	4.34	27%
3	P&I	1.68	11%
4	Marine Liabilities	1.54	10%
5	Marine Offshore	1.11	7%
	Total	15.94	100%

Source: Modified from Drewry report on Marine Insurance, 1998(p.8)

The above table clearly shows that the major share of the marine insurance market is towards cargo insurance followed by hull and P&I cover.

In addition the share of major countries that are involved in the marine insurance is given below. The Table 3 shows that Japan is leading the overall marine insurance market with market share on premium of about 17% followed by UK. If we look at the sectoral analysis UK has predominant position in hull and offshore market with market share of about 18% and 57% respectively. In the case of marine liabilities market more than three fourth of the market is held by USA, UK and Norway. This clearly shows the declining role of UK and shift of concentration from UK market to Japan market.

Table 3 Proportion of premium revenue in 1997 (in percentage)

Country	**Hull**	**Cargo**	**Liability**	**Offshore**	**Total**
Japan	14.4	22.1	2.8	2.3	17.4
UK	18.1	7.9	23.1	57.6	14.9
USA	7.6	9.1	31.5	12.0	10.5
Germany	3.1	13.9	0	0	9.1
France	10.4	8.4	2.0	8.0	8.5
Italy	6.4	6.9	2.4	2.8	6.2
Norway	9.0	0.7	27.4	12.5	5.6
Netherlands	3.5	2.9	0	0	2.7
Spain	4.0	2.5	0	0	2.6
Australia	2.6	2.2	1.3	0.9	2.2

Source: IUMI Report, 1999

2.5 Main Players in the Marine Insurance market

The oldest marine insurance market, Lloyd's in London is not an insurer and individuals who operate syndicate on their own account place the insurance at Lloyd's. Only Lloyd's authorised brokers can conduct the business at Lloyd's and being Lloyd's brokers provides them the opportunity and direct access to large marine underwriting activity. The International Underwriting Association (IUA) (IUMI, 1999) explains the importance of the London insurance market in the following terms.

‘’The market includes virtually all the world's top international insurance and reinsurance companies, which conduct business worldwide from their London operations. Currently there are 108 Syndicates, about 100 insurance and reinsurance companies, 39 Marine Protection and Indemnity Clubs and 127 brokers operating in the market. London writes an estimated 25% of the world's international reinsurance, at least 30% of marine insurance and 42% of aviation. Lloyd's London is the world's second largest commercial insurer and eighth largest reinsurer ’’.

During 2001, London markets have the capacity to accept premiums worth around £11 billion, and have licenses to trade in 64 territories around the world. The market has an A+ rating from Standard & Poor's.’’

Apart from above, there are other major organizations, which operate as companies, and they are classified into 3 groups (Drewry, 1998 p.20)

1. Institute of London Underwriters (ILU) & London International Insurance and Reinsurance Market Organisation (LIRMA). ILU provides insurance and reinsurance services and LIRMA provides insurance to non-marine activities. ILU had 46 member companies writing hull and cargo liability insurance at the time of merger with LIRMA.
2. Joint Committees:

   A number of individual syndicates, which underwrite both at Lloyd’s and ILU, form these committees and they play technical, educational and advisory roles.
3. London Underwriting Committee (LUC) & International Union of Marine Underwriters (IUMI)

LUC has a relatively small part of the marine insurance market in London. IUMI acts as an association of Underwriters, who organizes annual meetings and offers a forum for a number of marine insurers to lobby their views and try to reach some consensus in the marine underwriting practice. Apart from the London markets there are other markets primarily for Hull in western Europe (Norway, Germany, Switzerland, & France) and Eastern Europe (relatively small). A significant portion of the marine insurance market is operated by the Mutual insurers who provide insurance for P&I, Hull and Transport (ISL, 2000.pp.7-15).

2.6 Cost of marine insurance on the ship operational cost

The marine insurance cost forms approximately 5-10% of the operational cost of a ship. The cost of Hull and P&I insurance vary from ship to ship depending on the reputation and experience of owner or manager, claims record, size of fleet, voyage pattern, nature of cargo, type of vessels, value of the vessel, flag, year of build, tonnage, main machinery, class, compliance with international conventions namely ISM, OPA90, CLC, HNS…etc and nationality of crew (Drewry, 1998 pp.74-76). The cargo insurers and insurers of marine liabilities also seek similar information but with special emphasis on cargo details. The indicative ship insurance cost obtained by M/S Ensign Marine Consultancy Ltd for the year 1998 is given in Table 4.

Table 4 Indicative Ship Insurance Cost (in US$)

VESSEL TYPE	DECLARED VALUE	HULL/IV	WAR RISKS	P&I	TOTAL
GeneralCargo(5000GT)	5,000,000	40,000	2,500	25,000	67,500
Reefer(9000GT)	18,000,000	92,000	9,000	40,000	141,000
Ro-Ro(15,000GT)	12,000,000	70,000	6,000	45,000	121,000

LPG/LNG(30,000GT)	50,000,000	1,75,000	20,000	50,000	245,000
Bulk (35,000GT)	15,000,000	70,000	7,500	60,000	137,500
Container(50,000GT)	80,000,000	250,000	30,000	75,000	355,000
Tanker(100,000GT)	60,000,000	150,000	22,500	90,000	262,500
Passenger(60,000GT)	200,000,000	500,000	60,000	250,000	810,000

Source: Modified from Drewry report on Marine Insurance, 1998(p.8)

The analysis of the figures shows that there is a wide variation in insurance cost depending on type of ships namely the passenger ships, tankers, LPG/LNG vessels and container vessels having higher cost for insurance in comparison to general cargo and bulk carriers. The figures in the table depend on following assumptions

1. Reputable manager and flag
2. Vessels are not singleton but part of large entity
3. Classed with IACS member
4. Less than 15 years old, well maintained and recently surveyed
5. ITC clauses include ¾ RDC with Hull and ¼ RDC with P&I
6. Increased value and disbursements about 10% of Hull value
7. Values in US$

The cost of insurance varies depending on the following factors. In the case of a 20-year-old vessel the insurance cost may go up by 20%. Similarly, if the vessel insured were singleton the cost would be up by 10%. The claims record also influences the cost of insurance varying from 5% to 60% depending on the level above break-even loss ratio.

2.7 Analysis of data of various types of claims and identifying major risk areas in the operation of ships

The UK P&I club in their report on the analysis of major claims for the period

1987 to 1997 identified the following principal risk groups by value of claims

Table 5 Principal risk groups by value of claims

Nature of claim	**Share (in terms of value)**
Cargo	26%
Personal injury crew	13%
P&I Non crew	7%
Pollution	19%
Property damage	16%
Collision	10%
Others	9%

Source: UK P&I Club (2000.p.93)

From the above it may be seen that the cargo claims constitute the largest major share of claims followed by claims for pollution damage and property damage.The above analysis also identified the factors namely deck officer error (30%), structural failure (20%), shore personnel error (15%), equipment failure (10%) and Others (25%) as the major causes of damage.The above findings clearly show that the majority of the insurance claims occur due to human error, which could be minimized by following safe practices on board ship. The implementation of ISM and STCW in true spirit will greatly help in reducing such claims, which will be beneficial to both shipowners and insurers in minimizing the cost of insurance.The above analysis by the UK P&I Club (UK P&I Club, 2000.pp.1-93) also provides the following trends in respect of insurance claims

1. The number of claims is declining but the average value per claim has been showing an increasing trend.

2. The incidence of major cargo claims is declining. However on the other hand the average value per claim is increasing.
3. Similarly the numbers of pollution incidents are declining but their average value is far higher than the general average value of a claim since the pollution claims are expensive.
4. The number of third party claims and personal injury claims also follow the above trend and their average value is showing an increasing trend. Among the personal injury claims the study reveals that the crew error injury claims are much smaller than the non-crew injury claims viz. passengers, pilots, stevedorers and other third parties.

The above findings clearly establish that in future the claims, even though fewer in number are going to be substantial in value terms, which is a major concern to the insurers. The insurers should find ways and means to avoid major claims, which have a direct impact on their profitability and the cost of insurance.

CHAPTER 3

MUTUAL INSURERS IN THE MARINE MARKET

3.1 Background of the concept of mutual insurance

The concept of mutuality for sharing the risk existed among the tribes in the early civilizations of China, India, Babylon and Egypt. The formation of societies, guilds, clubs and associations during the Greek and Roman civilizations established the concept of mutuality for sharing the risks. The concept of mutuality in marine insurance originated in UK with the formation of hull clubs in the early part of the 18th century to guard against exorbitant insurance premia charged by the monopolistic companies established by virtue of the Bubble Act of 1720 (UK). Even though the Bubble Act restricted the operation of partnerships for insuring marine risks, the mutual clubs operated as associations, which were considered to be different from the partnership. (Hazelwood, 2000 p.2). The repeal of the Bubble Act, 1720 (as amended in 1824) and the introduction of the Companies Act in 1862(UK) provided the legal framework for the operation of mutual clubs.

The mutual clubs for P&I insurance evolved in the mid 19th century on the lines of mutual hull clubs, which had been in existence since the beginning of eighteenth century. The necessity for P&I mutual clubs arose to meet the growing needs of the shipowners who needed protection against the liabilities for loss of life and personal injury under the Merchant Shipping Act, 1854 and also the risks not covered by the ordinary marine insurance. The number of collision accidents also increased in number raising the concern of the shipowners. The Lloyds statistical committee studied the reason for increase in the collision claims and they gave findings that the number of collisions at sea increased after the introduction of steamers. (Young, 1995, p.4). Traditionally the shipowner's liabilities were restricted to the value of the ship and freight and the liabilities, which were in excess of them needed cover as in the case of one fourth of the collision liabilities, which were not covered by the London under writers under the Running Down Clause (RDC).

Table 6 THE IGA CLUBS

	NAME OF THE CLUB	LOCATION	SHORT NAME
1.	American Steamship Owners Mutual P&I Association. Inc	New York	American Club
2.	Assurance Foreningen Gard	Oslo	Gard
3.	Assurance Foreningen Skuld	Oslo	Skuld
4.	The Britannia Steam Ship Insurance Association Limited	London	Britannia Club
5.	The Japan Shipowners Mutual P&I Association	Tokyo	Japan Club
6.	The London Steamship Owners Mutual Insurance Association Ltd	London	London Club
7.	*The North Of England P&I Association	New Castle	N Of E Club
8.	The Shipowners Mutual P&I Association	London	Shipowners Club
9.	The Standard Steamship Owners P&I Association Ltd	London	Standard Club
10.	The Steamship Mutual Underwriting Association (Bermuda) Ltd	London	Steamship Mutual
11	Sveriges Angfartygs Assurans Forening	Gothenburg	Swedish Club
12.	The United Kingdom Mutual Steamship Assurance Association (Bermuda) Ltd	London	UK Club
13.	The West Of England Shipowners Mutual Insurance Association (Luxembourg)	London	W Of E Club

*Merged with the New Castle P&I association & Liverpool & London club

Source: Drewry Report on Marine Insurance,1998.p.47.

The first mutual liabilities company the Shipowners' Mutual Protection Society was established in 1855. This was followed by the other associations who also started offering P&I cover to their members. The members shared the risks of claims in proportion to the tonnage of their ship. The concept of P&I expanded when the shipowners required an indemnity for loss or damage to cargo when they were made liable under the Act as in the case of 'Western Hope'. There are about 16 mutual clubs in existence out of which 13 are members of International club Group Agreement (IGA) and the rest are non-IGA members. (Drewry, 1998.p.47). The list of clubs who are members of the IGA may be seen above. The list of P&I insurers who are not members of IGA are given below

Table 7 The Non-IGA P&I Insurers

	Name	**Location**	**Fixed/ Mutual**
1	British Marine Mutual Association Limited	London	Mutual*
2.	The Charterers Mutual Assurance Association Limited	London	Mutual*
3.	Deutche Versicherungs-Und Ruckversicherungs –AG(Darag) With Gerling –Konzern AG	Rostock	Fixed
4.	Dragon Protection And Indemnity	London	Fixed
5.	HIH Marine Insurance Services	London	Fixed
6.	Lloyds And Companies (Various Markets)	London	Fixed
7.	Ocean Marine Mutual P&I Association Limited	Brussels	Mutual*
8.	Osprey Underwriting Agency	London	Fixed
9.	Southern Seas Agencies Limited	Florida	Fixed
10.	Terranova Insurance Company Limited	London	Fixed

Source: Drewry Report on Marine Insurance, 1998 p.47.

* Demutualised in 1998 & 1999 and have become fixed premium operator.

3.2 Sharing of risk in mutual Club

The arrangement of sharing the risk for members in the clubs who are members of IGA is shown in Table 8 (Anderson, 1999.pp.30-34).

1. Retention: The members of the pooling arrangement each bear their own claims up to a maximum of US$ 5 million for each claim.
2. Pooling agreement: Claims in excess of retention and up to US$30 million are shared by pooling in accordance with a percentage contribution allocated to each club which is worked out based on premium income, entered tonnage and pool recovery record.
3. Excess reinsurance contract: In order to reduce the possibility of unexpected calls on members the clubs developed a system of reinsurance and clubs used to pool their claims for reinsurance in excess of a specified figure. This arrangement helped sharing of heavy claims made against one club by other members of the other clubs who are under the reinsurance pooling arrangement. The first pooling agreement was concluded among 6 clubs based in London in 1899 called the London Group, which later became the International Group.

Table 8. Development of General excess of loss insurance limits and costs (in US$)

Year	Club retention	Pool retention	Limit	Cost per GT Tankers	Cost per GT Dry Cargo
1989	1,200.000	12,000,000	1,250,000,000	0.3165	0.1585
1990	1,600,000	12,000,000	1,250,000,000	0.4366	0.1789
1991	1,600,000	12,000,000	1,250,000,000	0.5722	0.2132
1992	2,000,000	15,000,000	1,050,000,000	1.3985	0.4062
1993	3,000,000	25,000,000	1,050,000,000	1.3873	0.3980
1994	4,000,000	30,000,000	1,180,000,000	1.4367	0.4214
1995	5,000,000	30,000,000	1,530,000,000	1.4367	0.4214
1996	5,000,000	30,000,000	1,500,000,000	1.2346	0.3061
1997	5,000,000	30,000,000	2,030,000,000	0.6786	0.2357
1998	5,000,000	30,000,000	2030,000,000	0.5479	0.1957

Source: Drewry Report on Marine Insurance, 1998.p.67

Claims in excess of US$ 30 million and up to a maximum of US$ 500 million (now raised to US$1 billion) for pollution claims and US$ 2 billion per claim for other categories are covered by this reinsurance contract. The clubs also share the reinsurance premium according to the tonnage entered in the club. The rates vary according to the type of the tonnage with the oil tankers having the highest rates per ton compared to bulk**.**

4. Overspill claims layer: The P&I clubs operated with unlimited liability till recently but in 1996 a decision was made to introduce an upper limit based on a percentage (2.5%) of the tonnage limitation figure (Article 6(1)(b) of Limitation of Liability on Maritime Claims,1976 (LLMC,1976 convention) of all the vessels entered in all the International Group clubs. In 1999 this amount is estimated at US$ 4.25 billion.

The development of general excess of loss reinsurance limits and costs may be seen in Table above**,** which shows that the club retention has increased from US$1.2 million in 1989 to US$ 5 million in 2001 and the pool retention also increased from US12 million in 1989 to US$ 30 million at present. The overall limit for reinsurance also has increased from US$1.25 billion to US$2.03.billion. The trend over the years has been one of gradual increase in the retention limit on individual clubs and the pooling limit.

3.3 Legal Status of operation of mutual clubs

Most of the P&I mutual clubs are registered under the Companies Act relevant to their jurisdiction as mutual benefit societies without share capital. (Hazelwood, 2000, p.13). The P&I associations in UK are registered under the Companies Act as registered companies limited by guarantee with no share capital. Their members are not shareholders since they do not subscribe to capital or share any profits. In the relationship between the members and their club the overriding obligation is the mutual responsibility. The members contribute to the damages suffered by other members by virtue of the obligations provided under the Articles of Association and Rules of the club, which guarantee each other's claims. This arrangement works as network of reciprocal guarantees and it explains the non-profit making nature of the clubs. The relationship between the members and their club is laid down in the Articles of Association, which provide for the governance of the club by the board of directors elected at the general body meetings and the directors are bound to conduct the business as stipulated in the Articles of Association. The Articles of Association also cover matters relating to the qualification for entry into the club, termination and withdrawal of membership, right to protection and indemnity, liability to contribute in the case winding up and to pay the calls of the club. In most clubs the directors meet at regular intervals every two or three months to decide on matters of general policy and to consider the claims that require their approval. (Hazelwood, 2000, p.14) Many of the P&I clubs in the UK have transferred their residences abroad and maintain registered offices offshore. The clubs in the UK moved to offshore destinations not only to obtain exemption from tax on investment income but also to guard against the exchange rate fluctuations of the pound sterling since the companies registered in the UK are bound to maintain their investments in sterling pounds that devalued by more than 14% against the US Dollar in 1967 (Drewry, 1998). The matter of fluctuation in currencies was important since most of the members of the mutual clubs in the UK were non-British and the clubs were required to pay a large proportion of their claims in currencies other than sterling. The offshore clubs provided a cushion against the effects of devaluation, inflation fluctuation of exchange rates and the burden of UK investment taxation (Hazelwood, 2000, p.18).

3.4 Management of P&I clubs

Nowadays the management of the P&I clubs is carried out by separate specialist legal entities either limited companies or partnerships who work for fee, based on the entered tonnage, or by charging working expenses and salaries of their employees. The management company normally carries out the day-to-day administration of the club and the claims handling service. The managers are responsible for the collection of calls, appointment of correspondents, claims handling, underwriting, investments, signing policies, payment of claims and maintenance of records and accounts. The powers of the managers are provided in the Articles of Association of the club and the managers are authorized to enter into contracts on behalf of the club. Many P&I clubs also have a network of correspondents all over the world who assist the members of the club in dealing with the claims. These correspondents act as service providers of the club on a consultancy basis and they also conduct investigations on behalf of the club for processing the claims (Hazelwood, 2000, p.23).

3.5 Basis of operation of various players in the mutual insurance

3.5.1 Insurers

The mutual market mainly consists of insurers who deal directly with the shipowners or their brokers. The underwriters calculate the size of the call based on the following factors

- Member's claims within the club's own retention
- Contribution to pool claims
- Proportion of the excess reinsurance premium
- Management expenses
- Investments

The underwriter works out the rate for the Estimated Total Call (ETC) by using the following formula:

Estimated Total Call = Basic Rate * Contributing or Entered Tonnage

The basic rate represents the rate of premium assessed by the underwriter based on the information collected by him. The club directors determine the proportion of Advance Call, which is normally payable in two or more instalments throughout the year. Apart from the above the clubs which are members of the international group make provision in their rules for catastrophic claims or overspill claims and these claims are incurred by the members of the club towards the claims of other clubs in the group under the International Group Pooling Agreement (Hazelwood, 2000).

3.5.2 Role of agents and brokers

The intermediaries such as agents and brokers play a key role in the negotiation and formation of marine insurance contracts. This practice started since the beginning of Lloyd's Coffee House, which specialized in the marine insurance market. The distinctive three-sided nature of marine insurance is that two commercial parties, insurer and insured deal with one another through the medium of a third, the broker. Brokers have always served as the intermediary between insurer and insured, even when both parties are commercial entities that would be quite capable of finding and negotiating with one another without assistance. From the very beginning, when "office-keepers" were often traders and insurers themselves, the broker has been in a uniquely independent position, with strong legal and commercial links to both sides of the insurance contract. In contrast, an insurance agent is more closely associated with one side of the insurance contract, usually the insurers. The difference between an agent and a broker was explained as follows by Lush J in Norwich Union Fire Insurance Society Ltd v Brennans (Horsham) Pty Ltd:

‘’[N]either of these is a term of precision but the broad distinction is between a person, firm or company which carries on an independent business of placing insurance upon the instructions of clients and whose basic relationship of agency is with the client, and the insurer's agent whose function is to procure persons to insure with his principal, the insurer, and whose basic relationship of agency is therefore with the insurer. In short, a broker usually acts for the insured and an agent usually acts for the insurer''. (Hazelwood, 2000,p.45)

3.5.3 Reinsurance

Reinsurance is an arrangement between insurance companies, wherein one company (the ceding company) cedes a portion of a risk (policy, premium, and losses) to the other insurance company (the assuming company or reinsurer). Therefore the risk of loss is spread and a disproportionately large loss under a single policy does not fall on one company. Reinsurers can be other insurance companies or companies specializing in reinsurance only. (Hazelwood, 2000,p.110)
There are two types of reinsurance:
1.Facultative - reinsurance of one particular risk (policy) where the reinsurer retains the right (faculty) to accept or reject each risk offered by the ceding company.
2.Treaty - reinsurance (usually written on an annual basis) of an entire class of business consisting of many policies, where the ceding company agrees to cede and the reinsurer agrees to assume all of the risks (policies) of a particular class of business.
When a ceding company places either facultative or treaty reinsurance, the reinsurance is usually placed on one of the following bases:

- Pro-rata or Quota share – reinsurance: The reinsurer shares a pro rata portion of the premium and losses of the ceding company on a fixed percentage basis; e.g. 25%, 30%, or some other percentage.

- Excess of Loss Reinsurance: The reinsurer (subject to a specified limit) pays 100% of the losses of the ceding company in excess of a certain agreed limit (e.g. $30,000,000 retention) either on a per risk basis or in excess of a certain aggregate of all losses of a particular type (e.g. $10,000,000 for windstorm losses). It includes various kinds of reinsurance: catastrophe, per risk, per occurrence, and aggregate excess of loss (Hazelwood, 2000).

In the case of P&I, the International Group of clubs arranges excess loss reinsurance in the market on behalf of the individual member clubs. The Drewry Report on Marine Insurance (Drewry, 1998.pp.67-68) states that since 1994 the excess loss reinsurance cut in at $30 million for each claim and the gradual trend has been for the P&I clubs to take a greater share of the risk at the lower end and to extend reinsurance to higher levels at the top end. The above report observed that the shipowners are critical of the reinsurance programme since over the past 20 years only three cases have shown losses to reinsurance underwriters namely Amoco Cadiz (1979) and Exxon Valdez (1989) and the reinsurance premium was as high as US$360 Million in 1994.

3.6 Marine risks covered by P&I Clubs under Club rules

There are two principal forms of insurance covered under P&I namely liability insurance, which places an obligation on the insurer to pay any damages which the assured is likely to pay as a result of occurrences which are defined in his insurance cover, and indemnity insurance, which places an obligation upon an insurer to reimburse or indemnify an assured only to the extent that the assured has incurred and discharged his liability. The insurers duty to indemnify does not arise until the assured has paid damages to the third party. It is not necessary for a member to have cover against all of the risks covered in a club’s rules and each member may negotiate which risks he wishes to have covered and whether he wishes to bear deductibles in respect of any such risk. The risks normally covered are given in the P&I rule book (Hazelwood, 2000, p.153). The information on coverage of risks would clearly show that the shipowner with full P&I cover is insured against all the liabilities from catastrophic oil spills, costly collision and staggering loss of life to feeding stowaways, compensating passengers for loss of luggage and bailing out drunken crew members from local gaols. (Hazelwood, 2000, p.153)

3.7 Current problems in the mutual insurance market

The major challenges faced by the mutual clubs could be classified as under

3.7.1 Losses

1. Underwriting losses
2. Increase in claims –increase in deficit –falling reserves
3. Increase in administrative cost

3.7.2 Relevance of concept of mutuality – survival of pooling agreement

A. Bilbrough & Co who are managers of the London P&I club (Edminston, 2001) were of the view that the group unity is important for collective financial strength and maximum financial security for about 87% of the World's merchant fleet. The International Group has real assets totalling about US$6billion to meet claims and free reserves totalling about US$2 billion. The other advantage of the group system is that the group has the largest reinsurance contract placed in the Lloyd's market that provides them the power to negotiate better rates. The system of club letters of undertaking has wide acceptance and the group clubs do not default on the payment of the claims.

3.7.3 Competition within the IGA

Consequent to the investigation by European Commission (EC) and amendment carried out by the IGA the clubs are allowed to freely quote their rates net of management cost so that the competing clubs will have to match them in full. This arrangement forces the clubs to cover their management cost out of their investment income. This will also facilitate shipowners to enter their fleets in more than one club and each of his clubs becomes a holding club and they can quote freely on any of the new purchases of the shipowner. However, the major factor which discourages the shipowner moving from one club to another is the release call charged by the clubs to release a member, which is supposed to cover the liability for future supplementary calls (Edminston, 2001).

3.7.4 Competition from fixed premium insurers

The entry of fixed premium insurers in the recent years has triggered certain changes in the P&I mutual market.

- Fall in the rates of insurance premium
- Reduction in average expense ratio of mutual clubs
- Reduction in supplementary calls
- Improvement in quality of service

However, the fixed premium insurers are small and offer no apparent advantage other than the certainty that the clients will not have to pay supplementary calls. The following fixed players have entered the market and some of them have the backing of big players.

1. HIH - an Australian insurer (Collapsed recently)
2. Dragon –formed by a manager of mutuals
3. Terra Nova – a Bermuda based insurer

4. Southern seas – backed by a American insurer
5. AXA - established big player in France
6. British Marine – Based in London

3.7.5 Changing needs of ship owners - One- stop-shop service

The one-stop-shop service means that one club or company that would cover the comprehensive insurance needs of the shipowners by providing a wide variety of insurance cover. Phil Mitchell of the United Insurance brokers is of the view that the ‘’mutual market is moving towards the concept of ‘one stop shop’’, offering multiple products to suit the customer’s insurance requirements. He pointed out some recent developments like Thomas Millers & Company Limited, the managers of the UK P&I club who have worked out a strategic alliance with Swiss Re and they have positioned themselves similar to Tindall Riley to offer a multiple product insurance service. The other mutual clubs also follow a similar approach as in the case of the Steamship Mutual, which provides cover for cargo operators, transporters, ports and harbours and tugs. The Gard Club provides administrative services for insuring all marine and energy risks. The Swedish Club already offered Hull, P&I and associated risk covers for many years. The North of England Club also runs a hull mutual service. The Standard Club is also expected to move in the same direction (Mitchell[1], 2001).

3.7.6 Investigation by regulatory authorities on the practices

The European Commission (EC) considered the procedure forbidding the International Group clubs from quoting a rate lower than that of a holding club as

[1] Personal E-mail received from Mr. Phil Mitchell, United Insurance Brokers, London

a restriction on freedom of competition and thereby violating the relevant provisions of the Treaty of Rome. The European Commission also investigated the value of the group pooling system and the need for rating under the International Group Agreement (IGA). The previous limit on cover of US$20 billion was also considered by the EC to be too high. After several rounds of negotiations the International Group (IG) Clubs had with the EC and certain amendments made to the IGA, the EC granted a ten-year exemption from European competition laws with effect from 20-2-1999. The previous exemption from the EC expired in 1995.The European Commission finally approved the IGA subject to two conditions that clubs will publish within their annual financial statements their Average Expense Ratios, being the average of their management expenses (excluding claims) as a proportion of the premium and investment income over the last five years. The other condition is that there should be free competition between clubs in terms of rating business in so far the rating relates to management costs. (Crichton , 2000)

3.8 Emerging trends in the mutual insurance

3.8.1 Mergers, Alliances and Acquisitions

Similar to the shipping industry, which in recent years has been moving towards consolidation with mergers, acquisitions and alliances, the international insurance market is also heading towards market consolidation or polarisation. The following consolidations in the international insurance industry have given some major players a chance to increase their corporate power and diversify into new fields including marine insurance. (Drewry, 1998.p.57)

1. Royal Insurance and Sun Alliance Insurance of the UK
2. AXA and UAP of France
3. Allianz and AGF of Germany/France

4. AGF and RNV of France and the Netherlands
5. ING and BBL of the Netherlands.
6. Credit Suisse and Winterthur of Switzerland.
7. General Accident and Commercial Union of UK
8. Eagle Star and Zurich Re of UK/ Switzerland.
9. Exel and MidOcean Reinsurance of Bermuda (reinsurance company)

The summary of consolidation of mutual clubs market is given below.

Table 9 Consolidation of players in Mutual marine insurance

	Name of the Club	Alliance Partner
1.	American Steamship Owners Mutual P&I Association. Inc	MOU with American Hull insurance Syndicate for mutual cooperation & Support on cover, service and capabilities
2.	Assurance Foreningen Gard	Sub contracted the management to a new company Gard Services AS for the joint marketing of hull and P&I insurance products
3.	Assurance Foreningen Skuld	Looking for alliance. Lost 2.5Million GT in 2000 renewal.
4.	The Britannia Steam Ship Insurance Association Limited	Tindall Riley the managers of this club have sold their entity to Allianz AGF MAT to offer multi product service including hull insurance.
5.	Liverpool And London Steamship P&I Association Limited	Merger arrangement with North of England to transfer 5 Million GT.
6.	The North Of England Protecting &Indemnity Association	Offer hull insurance through MSMI. Merger arrangement with Liverpool and London to acquire 5 Million GT
7.	The Standard Steamship Owners P&I Association Ltd	Agreement with Tokyo marine & Fire Insurance company to provide P&I cover to Japanese shipowners.
8.	Sveriges Angfartygs Assurans Forening	Offer both Hull and P&I cover
9.	The United Kingdom Mutual Steamship Assurance Association (Bermuda) Ltd	Reinsurance programme with Swiss Re to protect the club's free reserves to avoid the additional calls. Thomas miller the mangers of the UK club offer hull product Dex through Swiss Re

Source: Compilation of data from P&I review 2000 of HSBC, Elysian Insurance services and Marsh.

The above trend of consolidation among the insurance companies triggered a chain reaction of consolidation among broking houses. The number of Lloyd's brokers has reduced from 272 in 1983 to 206 in 2000.The Lloyd's syndicates are also consolidating either by leaving the market or by mergers. The syndicates underwriting marine business have reduced from about 146 to 46 in the last ten years. The P&I mutual clubs also started consolidating starting with the North of England and The Newcastle merger in 1998.Similar mergers of the Liverpool Club with the London Club and Skuld with the Swedish Club are predicted by some reports. The trend of consolidation of P&I clubs will result in fewer, stronger and more efficient clubs (Drewry, 1998.p.58). One of the views, which explains the necessity for consolidation of P&I clubs is that the need to disclose administrative costs and Average Expense Ratio of P&I clubs (consequent to the EC decision) might force less efficient clubs to look for mergers (Crichton, 2000). This leads us to the question of optimum size of the club where some experts are of the view that the optimum size for any P&I mutual would be around 30 million tones GT (Crichton, 2000). Mr. Phil Mitchell of the United Insurance Brokers also identified the future trend towards mergers of P&I mutual clubs as well as support of the clubs by the big players in the general insurance industry. He pointed out the following arrangements

- Allianz /AGF is buying the management of the Britannia
- Swiss Re is supporting the UK P&I club
- Munich Re has strong links with a number of other clubs

3.8.2 Can the P&I mutual insurers survive?

The views of the managers of the Britannia P&I club (Mitchell, 2001[2]) is that, volume is vital, quality is vital, pooling is vital and mutuality is vital. But they feel that the pooling arrangement with other clubs might collapse under the stress of competition, divergent business plans and pressure of all sorts. It is also thought that without the benefits of the pooling system the reinsurance is available at a cheaper rate up to US$2 billion. Therefore, the product of mutual clubs which have a pooling arrangement will be less distinguishable from that of it's competitors. The Britannia Club also feel that the backing of a big insurance group like Allianz/AGF will help them to provide 'one-stop-shopping' for it's clients by providing insurance cover for Hull& Machinery and associated risks, other transport risks, finance cover …etc. The P&I mutual clubs have survived almost unchanged for a century in almost every respect. The system has relied on stakeholder's culture, pooling of risks, cohesion and benevolent monopoly.

Mr. Roger Ingles[3] of Elysian Insurance Services (Ingles, 2001) observes that the market needs a revival of either a non-IG Club or fixed alternative otherwise it will lose it's vibrancy as the EC are so keen to see. Therefore, the competition between the clubs does exist but it is rather benign. The decay of the fixed alternative in such a quick frame will allow the clubs to restore their pricing levels to such that they may one day get closer to an underwriting profit but that may be 2-3 years away. The rebirth of competition may quash that even happening. Latest talk in the insurance sector is that the increases ranging from 10% to 20% in premium are expected next February 2002 when the majority of cover falls due for renewal. This may come as a shock to owners since they have enjoyed several years of unchanged or fractionally higher payments and in many case rebates of around 25% on ETC (Brewer, 2001.p.6). The owners appear to have little room for manoeuvre in choice of cover as external competition has dwindled. The provision of insurance at cost by the club has to be better for the owner than using a commercial underwriter who will have cost of capital and profit based motives. Reinsurance rates will continue to drive up prices unless the clubs simply self-insure a greater amount of risk.

[2] Personal E-mail received from Mr. Phil Mitchell, United Insurance Brokers, London.
[3] Personal E-Mail received from Mr. Roger Ingles, Elysian Insurance Services, London.

CHAPTER 4

ROLE OF FIXED PREMIUM INSURERS IN THE MARINE INSURANCE MARKET

4.1 Concept of Fixed premium insurance

The fixed premium insurance is a commercial insurance service provided by insurance companies established with the primary purpose of making profit. The fixed premium refers to the predetermined premium for providing the insurance cover based on a contract between an insurer and insured. In this contract the insurer retains the component of risk by charging the insured a fixed premium based on the expected value of losses. The risk is then either assumed or reinsured or hedged or securitised (or combinations of these actions) against the payment of premium. The risk premium is also required to compensate shareholders and financial investors. (Looberge, 2001). The fixed premium insurers provide the assured the certainty of cost. Since the underwriter is expected to make a profit the cost to the assured, at least in economic theory, would be higher than that for mutual insurance. Insurers who are called commercial insurers, composite insurers, fixed premium providers or non-mutual insurers, provide fixed premium insurance.

4.2 Basis of operation of fixed premium insurers

The fixed premium segment (hereafter referred to as FP) is one of the largest groups in the general insurance segment which offers life and property insurance all over the world. The fixed premium providers (hereafter referred to as FPP) are one of the four major marine markets listed below. (Nixon, 1987)

1. Stock insurance companies
2. Lloyds associations
3. Mutual clubs
4. Reciprocal or insurance exchanges

The FP segment falls under stock insurance companies, which are incorporated business organisations organised as profit making ventures and owned by shareholders. These companies are governed by the state where the company is incorporated and they are obliged to satisfy the designated requirements of capital and reserve funds. The contracts they issue are usually written for a definitely stated consideration called premium. The insured receives no dividends from the earnings of the company. The premium charged by the insurance company is a fixed sum so that the insured knows exactly what his protection will cost. The capital, surpluses and the reserves of the company help to guarantee the payment of claims made by the assured and the assured cannot be called upon to pay additional premium amounts in the event that the losses are greater than anticipated. The insurer bears the risk as an entity separate and apart from the assured. In a stock company management and control vests with the stockholders. They elect the board of directors who in turn delegate the authority to the officers of the company. A policyholder of a stock insurer is not involved with the company beyond the payment or denial of indemnity when he suffers a loss (Nixon, 1987).

4.3 Responsibility of various players in the fixed premium insurance

4.3.1 Underwriters

The insurance company that underwrites the policy provides an assessment of the FP for a particular vessel depending on various factors as in the case of mutual clubs. The rates of premia of FPP's are influenced mainly by their performance in earlier years and reinsurance market rates since their focus is on profit. FPP's work under a pressure to maximise returns before the market conditions favourable to them disappear. Most of the FPP's offer limited cover ranging from US$100 to 500 million (Crichton, 2000). The low premium offered by FPP's in comparison to mutual players may reflect low overheads and light weight infrastructure. The underwriters of the fixed premium insurance market operate through their agents who provide them the business. The shipowners or insured normally approach the insurers through their brokers who arrange the cover with the insurance company. The distinguishing feature of the operation of underwriters in the fixed premium market is that there is no direct link between the insurers and the insured and the insurer relies on the intermediary to finalise the policy. The intermediaries or the brokers play a crucial role in finalising the insurance contract.

4.3.2 Reinsurers

There is no distinction between the reinsurers in the fixed premium market and the mutual market. The reinsurers operate in both markets. The reinsurers fix the rate for the reinsurance arrangement depending on the volume of business brought in by the original insurer. The bigger the volume the better the reinsurance rates offered by the reinsurers. The FPP purchases reinsurance from the reinsurance market to cover the risks over and above the deductibles retained by the shipowner. In comparison to the mutual club, normally the

FPP's have no retention limit on the insurance policy and they have limited capacity to purchase reinsurance since they provide P&I cover up to US$500 million as against US$4.25 billion (US$2.03billion for reinsurance) provided by the mutual club. In this respect the mutual clubs have the advantage of obtaining better rates for reinsurance through the pooling system where the reinsurance requirements of all the member clubs of the IGA are taken in one lot. The ability of the clubs to underwrite liability risks at competitive rates is based heavily on their ability to buy reinsurance on equally competitive terms. Following successive reductions of twenty per cent in the rates under the International Group Agreement reinsurance contract in 1998/99 and 1999/2000, the negotiations for the 2000/2001 renewal produced a contract for two years at a fixed price. The negotiations were held against a background of lower rates and with fears that the reinsurance market might harden in the coming months. In addition to the savings in the reinsurance premium, the limit for oil pollution has been increased to $1billion from $500m. Overall, the group received a reduction in reinsurance costs of about seven per cent.

4.3.3 Agents

The fixed premium insurers operate on a worldwide scale either through their own offices or agents. The agents canvass for the business of the insurer for a fee which is based on the amount of premium generated through his / her own effort. The agents normally work for more than one insurance company (may be competitors) offering multiple products to suit the needs of the customers.

4.4 Interrelationship between the Hull market and P&I market

The fixed premium providers are focussing on the P&I market due to the fact that the profitability in the hull market has not been encouraging due to the fall in premium over the last ten years. The hull market has been suffering from a structurally soft market for almost a decade now with the rates being at the bottom due to overcapacity and fierce competition. Profits are no longer made and the businesses are concluded without proper risk assessment since they are cost driven. The hull underwriting market acts like a pure commodity market with underwriters having no technical expertise. (Barr, 2000 p.173). The underwriting losses are covered to a large extent by deductibles and reinsurance. The competitive market also encourages insurance for substandard ships. The advent of the mutual clubs assault on the hull market may be much sooner. Swedish Club already does, the Gard, the North of England and the UK clubs do to a limited degree and the Standard, the Steamship and the Britannia seem to be plotting an entry later this year. American Club has hooked up with AHIS to provide hull insurance. (Ingles, 2001)

Similarly the entry of FPP is triggered certain changes in the liability market (P&I). In the last two years we have seen a trend of mergers and demutualisation efforts on the part of mutual P&I clubs. The end of the Liverpool and London Club, the Ocean Marine Mutual being put into provisional liquidation, and British Marine Mutual changing its status from a mutual insurer to a fixed premium provider are some of the developments. The Jonathan Jones syndicate at Lloyd's, which has built up a significant portfolio of P&I business, has moved into the fixed premium P&I market. According to Nigel Russell (2000), Director of the marine division of Lloyd's broker HSBC Insurance Brokers (HSBC, 2000.pp.2-7) has said, "If commercial insurers take a significant market share from the mutual clubs, it is very likely that the clubs will have to respond by offering their members a higher level of service on other insurances." HSBC's recently released Protection and Indemnity Review notes that fixed premium competition may already be manifesting itself in the mutual market in another way as many clubs announced that they were changing their basis of calls. The reasons for these changes, says HSBC, may be twofold. Firstly, the idea of charging a supplementary call can be seen as a disadvantage in terms of the clubs' ability to compete against fixed premium facilities. Secondly, the rating agencies give the clubs little or no credit for their ability to collect supplementary calls, and indeed are very unhappy about supplementary calls in general. From a marketing point of view HSBC says that the budgeted supplementary calls are no longer popular, even though they might be good for owners' cash flow. In an increasingly competitive insurance industry, the other clubs are trying to reduce or eliminate the supplementary call from their bases of collecting premiums.

4.5 Consolidation of syndicates in the Lloyd’s market

The continuous trend of falling premium rates in the Hull and P&I markets as well as the cargo markets has an impact on the number of syndicates who operate in the Lloyd’s market either by closing down their business or merging their activity with someone else to survive in the market. The capacity trends at Lloyd’s also show a steady decline in the number of marine syndicates (Molck Ude, 2000)**.** The results below clearly show consolidation of various syndicates

Table 10 Capacity trends at Lloyd’s market

Year	**Capacity at Lloyd’s US$ millions**	**Number of syndicates**	**Total capacity**
1989	6738	134	15723
1991	6139	106	16397
1993	5615	62	13103
1995	5615	46	15199
1997	5550	42	15349
1998	5690	39	15124
1999	5840	40	14675

Source: IUMI, 2000

at Lloyd's, who are responding to overcapacity and falls in the rates in the recent years. The major drop in the number of syndicates is seen for the period 1991 to 1992 when the market turned drastically with huge losses.

4.6 Comparative analysis of fixed premium insurance providers and mutual P&I clubs

The data obtained from 13 P&I clubs and fixed premium insurers with reference to their structure, operation, cover, claims handling and services were analysed and the essential differences between the two segments are given below. (Gerits, 2000)

Table 11 Comparison of fixed premium insurance providers and mutual P&I clubs

	Mutual P&I Clubs (IGA)	**Fixed Premium Providers**
Profit	Non profit making organisation	Profit making organisation for the shareholders
Incorporation	Incorporated as mutual company under the companies act of the relevant jurisdiction	Incorporated as commercial company or stock insurance company under the relevant jurisdiction
Capital	There is no share capital	Share capital with shareholders
Entry of Members/ Shareholders	Membership open only to those who have insured their ship and entry into the club through strict process of scrutiny of the fleet and reputation of the shipowner or the management company.	Members are shareholders and the shares are freely traded in the market.
Premium	The premium is called 'calls' and is calculated for the members depending on various factors. The amounts of calls vary depending on the financial performance of the club.	The premium is predetermined depending on various factors but once it is fixed there is no more change depending on the financial performance of the insurance company
Underwriting	Benefit of good underwriting is	Benefit of good underwriting

results	passed on to the members in the form of reduced calls (premium) or returned calls (premium)	becomes profit for the shareholders and the insured has no benefit.
Control &Management	Shipowners (insurers & insured) through their elected Board of Directors	Shareholders (neither insurers nor insured unless they are share holders)
Decision on Claims	Board of Directors elected by the shipowners or insured	Shipowners have no say and officers of the company who have been delegated the responsibility, process the claims.
Coverage of claims	Omnibus clause covered	Well defined claims coverage with no omnibus provision
Limit of cover	Up to US$4.25 billion	Normally up to US$500 million
Guarantee or undertaking for claims	Normally 'letters of undertaking 'issued by the club (IGA) (widely known & accepted) in case of arrest or detention by the claimant to minimize the hardship & loss to the member	No established or proven systems except the bank guarantees which normally cause considerable delay and expense.

4.7 Major players in the fixed premium insurance market

The major players in the fixed premium segment include British Marine, AXA Corporate solutions, J.L.Jones, Darag, Dragon P&I, Osprey Underwriting Agency Limited, Terranova Insurance Company Limited and Southern Seas Agencies Inc (Andersson, 2001). The major players and the volume of business handled by them are given below (Lingard, 2001).

Table 12 Fixed Premium Insurers in the Marine Market

Name	Limit of Coverage US $ million	Target business	Number of Vessels	Entered Tonnage (million GT)	Premium income 2000(US$ million)
AXA Corporate Solutions, Paris	500	Vessels upto 30000GT	300	NA	NA
British Marine, Luxembourg	500	All types of vessels	4900	3.50	26.53
J.L.Jones & Others	500	All types of vessels	861	9.06	23.10
Darag, Rostock, Germany	100	Containers (Upto 2000 TEU) General Cargo, Ro-Ro,	826	2.01	16.00

		Bulk Carriers (upto 20000GT)			
Dragon P&I, London	500	General Cargo, Container, Reefer, Bulk Carriers and Product Tankers between 2000 to 30000 GT	NA	0.42	2.00
The Korea Shipowner's Mutual Protection &Indemnity Association, Seoul	500	South Korean Operation of all types	NA	NA	NA
Osprey Underwriting agency Limited, London	25	Small vessels including tugs, barges & dry cargo vessels	NA	NA	16.00
Raets Insurance Group- Inter Coastal Ship owners' P&I BV, Rotterdam	500	Dry Cargo & Tankers carrying non persistent cargoes up to 10,000GT (Excluding USA, Trans Atlantic or Trans Pacific Voyages)	500	NA	8.00
Southern Seas Agencies, Inc, Brighton, UK	25 & 500	All types of vessels except Tankers and Passenger vessels.	200	NA	7.25
Terra Nova Insurance Company Limited, London.	25	Domestic, Coastal and Short Sea trading vessels.	3000	NA	NA
Total			10,587	14.99	98.88

Source: Marsh P&I review, 2000(modified)

The analysis of the volume of business of FPP show that they cover about 10587 vessels with an entered tonnage of about 15 Million GT earning premium revenue of approximately US$98.88 million (for the period 1999-2000) (HSBC, 2000). In contrast the P&I mutual clubs cover about 66503 vessels with an entered tonnage of 558.81 Million GT earning premium (Call income) of 14.94 billion (for the period 1999-2000). This clearly shows that the volume of business handled by the FPP's represents only about 3% of tonnage and 0.6% of the premium revenue handled by the mutual club insurers (Appendix A & B). Does this mean that the major players in the FPP do not pose any threat to the business of mutual clubs? Does this convey that the FPP's could not make inroads into the share of the business handled by the mutual clubs? For the time being the answer to these questions is in affirmative till substantial market share is held by FPP's.

4.8 Points for consideration by the shipowner

The shipowners who are members of mutual clubs did not have any alternative till recently and they have been used to the mutual club culture for more than 100 years and it is difficult for them to get convinced to switch over to any new arrangement of insurance until they are fully convinced of their benefits and advantages. The aspects that the shipowner has to look into before taking a decision to join a mutual or FPP will be (HSBC, 2000.p.1)

1. Financial strength of the insurer including the size of the contingency reserve of the mutual club if any
2. Supplementary call record of the mutual club versus the certainty of the fixed premium as well as the level of the general increases if any
3. The breath and depth of the claims service including the network of correspondents and agents
4. Location of local offices if appropriate
5. If entered in a mutual club the aspect of compatibility with other members namely does the club have other members from the same country or region and is it familiar with the owner's type of operation
6. The size of the club and the implications that this may have on financial stability and service
7. Personal relationship with members of the insurer's staff
8. The benefits of insuring other risks with the same insurer
9. The lower limits of cover given by the commercial insurers compared to the exposure to the overspill calls with the IGA clubs.

The above issues require careful examination before a decision is made by the shipowner on the type of insurance and insurer that is best suited to his needs. The target group of the FPP's are to a large extent different from the mutual clubs. The analysis of information in Table 12 show that the FPP's are clear in their target market, which will be

1. Small size vessels which are less than 30000GT
2. Providing cover mainly to Container vessels, Dry Cargo vessels, Bulk Carriers and Coastal vessels.
3. Coverage of liability up to US$500 Million
4. Avoiding Tankers, Passenger Vessels and vessels trading on the USA/Trans Atlantic and Trans Pacific routes.

Therefore we can safely conclude that the FPP market has a definite advantage over the mutual clubs in respect of small vessels, which do not trade in high-risk areas and therefore require limited coverage of liability.

4.9 Deficiencies and weaknesses of the fixed premium market

As stated above the fixed premium segment targets only a limited portion of the ocean going vessels avoiding high-risk areas. This clearly shows that the FPP market is treading cautiously into the marine liability market and they do not have sufficient expertise or knowledge of this specialized industry to play a dominant role for the time being. Fredrik Kruse, General Manager of the Swedish Club (Kruse, 2000) is of the view that in the past the prospects for the fixed premium P&I were grossly overstated and that the realities are different.

1. There is always a niche market for fixed premium irrespective of what happens in the wider market
2. Fixed premium tends to enjoy modest growth whenever the market is weak
3. Fixed premium insurers failed to take significant tonnage from the IG clubs
4. The factors that restrict the growth of the fixed premium market

- Fixed premium providers (FPP) are commercial entities driven by the need to make profits
- FPP's offer somewhat limited cover and tend to lack sophisticated claims handling infrastructure
- FPP's have limited capacity to buy reinsurance

Therefore if the FPP's are to survive in the marine liability market they should understand the key issue of long term commitment to shipowners and quality service at competitive rates.

4.10 Major changes in the mutual club market, which are of significance to the FPP's

1. Restructuring effort taken up by the mutual clubs

The mutual clubs felt the need to restructure their activities in response to the competition from the players outside the clubs and the investigation by the EC on their alleged anticompetitive practices. The changes came in the form of

- Amendment to IGA limiting the total liability cover to US$4.25 Billion as against unlimited coverage
- To publish the administrative expense ratio of the clubs for the last five years, which will identify the efficient clubs
- Certain relaxations in the restriction on movement of tonnage from one club to another club encourage competition among the IGA clubs
- To get interactive ratings from rating agencies on their financial performance and strength

2. To be more responsive to the needs of the shipowners

Providing one stop shop solution to customers through multi- product services

- Providing efficient service by worldwide presence- opening more offices or appointing correspondents.
- To minimise the supplementary calls and reduce the percentage of actual calls to Estimated Total Calls (ETC)
- To reduce the reinsurance premium by effective negotiation with the reinsurers

3. To form alliances with major insurance companies in the commercial market to provide multi product services
4. To appoint professional management companies for the management of the affairs of the companies

4.11 Failure of Fixed premium insurers in P&I segment

There are only a few fixed premium insurers survived and they are small. They do not seem to have any apparent advantage other than the certainty that the clients will not have to pay supplementary calls. Is this an advantage to the shipowner, BMM the mutual company, which demutualised recently is working on aggressive expansion strategy. It has merged P&I of Lloyd's syndicate of Jonathan Jones and provides H&M cover for small ships (Andersson, 2001). The fixed premium insurer have not been in a position to make serious inroads into the business of Mutual clubs since entered tonnage of the mutual clubs have not declined in the past few years and in fact it has increased. If we look at the table given below the total tonnage insured by Mutual clubs rose from 471 million dwt in 1997 to 558 million dwt in 2000 (HSBC, 2000.pp.14-50). The Fixed premium insurer can emerge as real force only if

1. There is high supplementary call charged by mutual clubs
2. High premium increase by mutual clubs
3. Break up of International Group Agreement (IGA)

CHAPTER 5

5.1 Is there a trend towards demutualisation of mutual insurance companies?

In order to analyse the trends in the mutual market in the maritime industry it is pertinent to examine the trends in the general insurance industry, which is dominated by life and property insurers. Mutual insurance companies wrote an estimated 42% of the global premiums in 1997. Six of the ten largest insurance companies in the world are mutual insurance companies.

Table 13 Largest insurance companies in the world

Rank	Company	Country	Assets in US$ billions	Form of ownership
1	AXA	France	407.9	Stock
2	Nippon Life	Japan	323.3	Mutual
3	Allianz	Germany	293.7	Stock
4	Prudential Insurance Company	USA	259.5	Mutual
5	Zenkyron	Japan	245.4	Mutual
6	Dai-Ichi Mutual Life Insurance	Japan	219.6	Mutual
7	Metropolitan Life	USA	201.9	Mutual
8	American International Group	USA	194.4	Stock
9	Sumitomo Life	Japan	181.6	Mutual
10	Prudential	UK	178.9	Stock

Source: Swiss Re Economic Research & Consulting, 1999(Sigma, 1999.p.5)

This shows that the mutual insurance companies are a big force in the general insurance industry. If we look at the country wise analysis of the premiums written by the mutual insurers the mutuals command the largest share in Japan (more than 75%)followed by USA (about 35%), UK, Germany and France (averaging about 25%). The above data show that mutual insurers are dominant in Japan and USA compared to Europe. Is there a trend towards demutualisation in the general insurance industry? The analysis of the data in the last 10 years shows a different picture.

Table 14 Market share of mutual insurers in major insurance markets (in Percentage)

Country	**Property insurance**		**Life insurance**	
	1987	**1997**	**1987**	**1997**
USA	31	33	40	35
Japan	4	3	93	89
UK	14	8	46	33
Germany	19	16	31	26
France	40	37	10	5
Aggregate	24	24	57	52

Source: Swiss Re Economic Research & Consulting, 1999 (Sigma,1999.p.18)

The overall market shares of the mutual insurers remain more or less stable in the property and life segment except for some regional variations. There is a perceptible decline in the share of the mutual insurers in the UK, Germany and France compared to USA and Japan.

5.2 What are the circumstances that influence the demutualiation of mutual insurance companies?

The research report (Sigma, 1999) indicates that the mutual insurers are under pressure to go in for demutualisation due to competition and consolidation that are evidenced in the general insurance industry. Over the past few decades consumer demand for insurance services has shifted from the traditional insurance policy cover to new financial products. The mutual insurers can remain mutual as long as they stay competitive. They can convert to stock ownership companies, which provides them the benefit of the opportunity to grow with access to capital but it has risks too. The risk is that the stock ownership companies are susceptible to take over from other big players in the market.

5.3 How the mutual insurance companies respond to the competition from other players specially the stock insurance companies?

We have discussed in the earlier chapters the response of the mutual insurers to the competition by providing one-stop-shop solutions, reductions in supplementary calls, trying to offer the certainty of premium, reductions in administrative cost and looking for mergers and alliances. Some clubs have done away with the word ‘call’ and they replaced it with the word ‘premium’ like the fixed premium market. A new spirit of competition has taken root among the clubs consequent to the investigation by the EC and their conditional extension of the antitrust law exemption for the IGA. This has contributed to new competitive pressures and the obvious signs of this competition are a sudden interest in the total package, that is to say the one-stop-shop solution, merger discussions, more emphasis on financial strength and the launch of new products. (Kruse, 2000) The mutual insurers respond to the competition from the stock insurance companies by providing high quality value added service and efficient financial management resulting in control of supplementary calls. The strength of the mutual insurers is in the service. Most shipowners seek quality service and they naturally gravitate towards those clubs with good financial strength and a track record of zero supplementary calls. The clubs differ from each other in financial strength, membership profile and claims experience. The focus of the mutual clubs in the competitive environment could be (Malmros, 2000)

1. Financial certainty-Zero supplementary call
2. P&I cover up to US$4.25 billion (with no premium cost for risk transfer in the US$5-30 million band)
3. Quality of service

4. One-stop-shop service (a single service provider will cover H&M, P&I, FD&D, Loss of Hire and war risks)
5. Proactive loss prevention support
6. Fair and competitive premium

There is a pressure on the clubs to reduce the administrative costs consequent to the decision of the EC instructing the clubs to divulge their average expense ratios. One way of achieving the reduction in administrative costs could be mergers of clubs, which would minimise the overheads. The implication of competition from the commercial providers is that many small clubs may merge resulting in a number of large clubs or some of the small clubs may get demutualised (Malmros, 2000). This would lead us to the next question as to what would be the optimum size for a P&I club? The view of Peter Crichton of the North of England P&I Association is that it would be 30 million tonnes (Crichton, 2000).

5.4 What are the critical factors that would tell us whether the mutual insurer is likely to demutualise?

Research carried out on the demutualisation process in the general insurance industry focusing on the demutualisation of life insurance companies offers an interesting perspective. Even though the above study focused on the mutual life insurers, the basic concept and purpose of mutual insurers remain the same in any segment of the insurance industry. The practical implications of the conversion of the organisational structure from mutual to joint stock company is influenced by various critical factors (Carson, 1998.p.2). They are,

1. Free cash flow
2. Access to capital
3. Wealth expropriation at the time of conversion
4. Expense preference behaviour
5. Loss ratios

The relationship of the variables mentioned above to the probability of demutualisation gave the following findings (Carson, 1998.p.6).

The probability of demutualisation is

1. Positively related to the level of free cash flow
2. Positively related to the level of surplus from the members' point of view for expropriation
3. Negatively related to the level of surplus which relates to access to capital from the capital market
4. Negatively related to the size of the insurer
5. Positively related to the level of management expenses from the mutual insurer point of view
6. Positively related to the losses (Loss ratio)

Let us analyse the above factors and see how they are linked to the mutual insurance industry

5.5 Factors which influence demutualisation of mutual clubs in maritime industry

Let us now try to apply the above findings to mutual P&I clubs and identify whether they are susceptible to demutualisation or not. In the case of mutual insurers I propose to consider the following as the factors that would influence demutualisation. The relationship between these independent variables and their effect on demutualisation will be analysed qualitatively to find whether a mutual club would have a tendency to demutualise. The data utilised for this study are the financial data pertaining to the mutual clubs who are members of the IGA and the data are gathered from various published sources and compiled in a format, which would facilitate analysis. The following factors are assumed to influence demutualisation.

1. Cash flow
    - Supplementary call percentage

- Cost of premium as percentage of ETC
- Release call percentage

2. Free reserves/Surplus
    - Total free reserves per GT of entered tonnage
    - Free reserves as percentage of call income
    - Ratio of free reserves to net outstanding claims
    - Ratio of claims recoverable to gross claims outstanding
3. Access to capital
4. Size of the insurer
5. Management and administrative expenses i.e. AER
6. Losses
7. Rate of return on investment income
8. Ratings from specialised rating agency

5.5.1 Cashflow

The free cashflow is the residual that exists after the company has invested in all beneficial projects (Jensen, 1986. pp.323-339). Studies indicate that the mutual insurers have higher free cash flow compared to stock insurance companies and therefore the agency costs associated with the free cash flow is higher for the mutuals than the stock insurers. (Mayers & Smith, 1981)(Wells, 1995). The greater the level of cash flow the higher the likelihood of demutualisation in order to control the agency costs of equity. In the case of a mutual insurer also the level of free cash flow is an important factor, which determines the capacity of the insurer in prompt settlement of claims.

5.5.1.1 Supplementary call

The cash flow of a mutual insurer is directly dependent on the amount of call income and investment income. The members of a club normally contribute to the calls on the basis of an estimate arrived at by the club keeping in view their investment income, estimated claims and administrative expenses. The members in one year are responsible collectively for the claims arising in that year and they contribute to the supplementary call if deficits and free reserve requirements require excess supplementary call.

Table 15 Excess Supplementary call /overspill claims
(including the recharged cost of group excess reinsurance programme)

P&I CLUBS	**2001**
Gard	5%
Shipowners	5%
Britannia	5.50%
Standard	5.50%
UK Club	7%
London Club	9.50%
North of England	11%
Swedish Club	11%
West of England	11.25%
Steamship	13.50%
Skuld	13.50%
American Club	13.50%

Source: P&I review 2000, Elysian Insurance services

A higher supplementary call indicates either a greater deficit or a desire to increase free reserve requirements. Clubs tend to look for ways and means to reduce their supplementary call since members may not like to have unbudgeted supplementary calls. The clubs may look for Alternative Risk Transfer products (ART) to stabilise additional supplementary calls through alliances with major reinsurers as in the case of the UK Club and Steamship, which worked out alliances with Swiss Re and ERC-Frankona. Under this new arrangement the members of these clubs in a particular year of account will no longer be collectively accountable for their own claims, the deficit will be recovered under the finite amount of calls and future year members have to pay the cost through incremental reinsurance premium in the later years. Therefore the clubs that have higher supplementary calls of more than 10% namely the American, the Skuld, the steamship, the West of England, the Swedish and the

North of England clubs may tend to go in for alliances with big reinsurance companies to provide finite calls to their members through ART. Is this arrangement in tune with the concept of mutuality? The Elysian P&I review report (2000) observes that the concept of mutuality undergoes a change under the new arrangement wherein the existing members may pay a finite call and new members in the coming years may pay additional amounts of reinsurance premium consequent to deficits in the earlier years. The basic tenet of mutuality gets altered in case the members are allowed to switch clubs they may choose the best alternative to avoid an increase in the premium.

5.5.1.2 Cost of coverage as a percentage of ETC

Table16 Cost of cover as Percentage of Estimated Total Call (ETC) (25 year average since 1976) in percentage.

Name of the club	ETC
Britannia	79.9
The Shipowners	87.3
Japan	91.7
Gard	95.2
The UK	101
Steamship Mutual	102.2
American	106.2
Skuld	108.6
The North of England	109.4
The Standard	109.8
The West of England	117
The Swedish	117.8
The London	124.6

Source: P&I review 2000, Elysian Insurance services

Similarly many clubs are charging larger premia higher than ETC .The cost of coverage as a percentage of ETC for 25 years since 1976 in Table 16 shows greater control on calls exercised by Britannia (80%), Shipowners (87%), Japan (92%) and Gard (95%) in comparison to the London (125%), Swedish (125%) and West of England (117%) clubs. The clubs that have higher cost of coverage tend to look for ways to minimise the cost through the ART mechanism by establishing alliances with big insurance companies or demutualise to work out permanent arrangements with big players in the insurance market who offer ART.

5.5.1.3 Release calls

Table 17 Release calls of Clubs (2000)

Name of the club	Release calls
Japan	5%
The Shipowners Club	5%
The UK Club	5%
The Standard Club	15%
Steamship Mutual	15%
The London Club	20%
American Club	25%
Britannia Club	25%
Gard	25%
The North of England	25%
The Swedish Club	25%
The West of England	25%
Skuld	30%

Source: P&I review 2000, Elysian Insurance services

If we look at the release calls percentage in Table 17, the clubs that have higher release calls display their vulnerability since they expect claims in excess of the budgeted calls. The clubs want to protect it's recovery of claim from departing members through release calls which shows that clubs are expecting to charge their members additional calls as reflected in the release call. However, such release calls lose their relevance if the clubs go in for ART since ART eliminates the prospect of excess calls to existing members and only future members will feel the impact. Most of the clubs have higher release calls of more than 15% and even 30% as in the case Skuld.

The clubs that show a nominal release call of 5% are the Japan Club, Shipowners Club and UK Club. The higher release calls also indicate either the expected additional future claims or a fear of losing their existing members. The clubs that have higher release calls may tend to look for programme for reducing their future claims through ART or look for alliances or mergers with other clubs in order to maintain their market share. The clubs that have higher release calls are also susceptible to takeover and they may demutualise to provide finite cover.

5.5.2 Free reserves

The demutualisation involves a transfer of wealth to the stakeholders of mutual insurers. The amount of expropriation of wealth is directly related to the free cash flow and reserves. The higher the relative levels of cash flow and reserves are, the more likely it is that they would motivate the demutulisation since the members of mutual insurers gain more by expropriation. In the mutual insurance industry the relative levels of free reserves, after taking into account the outstanding claims and other liabilities, would represent the net assets of the mutual club, which are potentially available for expropriation if the mutual club is demutualised. If we look at the case of demutualisation of a leading marine mutual company BMM in 1999, BMM had as membership 1700 shipowners with 6500 ships at the time of demutualisation. BMM had reserves to the tune of US$41 million and annual income of US$69 million and it distributed around US$ 30 million to its members. This worked out to a sum of approximately US$4600 per ship for each member (Beatty, 1999). The members of a mutual with large reserves and surpluses would be motivated by larger personal gains if they were to demutualise. The free reserves consist of assets extending beyond the specific provisions made for claims. Free reserves are held in trust by clubs for members and represent the members' protection in depth. Free reserves protect members against any fluctuation in club results. The clubs that have strong reserves could be regarded as clubs with good financial strength, i.e. the Shipowners Club, London Club and Standard Club. Therefore the free reserves could form the basis for ascertaining the strength of the clubs by working out ratios in relation to entered tonnage of the club, call income, outstanding losses and net outstanding claims.

5.5.2.1. Free reserves per owners GT entered in the clubs

The ratio of free reserves to entered tonnage may be considered as a yardstick to assess and compare the financial strength of the clubs. This ratio is similar to the member's equity per Gross tonne of ship (GT) in the club on a break up basis with no provision for winding down costs.

Table 18 Total free reserves per owners' GT entered in the clubs (in US $)

Name of the club	**2000**	**1999**	**1998**	**1997**	**Percentage increase in 2001 to 1997**
American	4.23	5.61	6.62	5.02	-16
Britannia	1.85	2.18	2.68	2.92	-37
Gard	4.55	4.89	5.07	4.14	+10
Japan	1.05	1.04	1.00	0.97	+8
The London	5.89	5.34	5.02	3.82	+54
The North of England	3.38	4.01	3.14	2.71	+24
The Shipowners	11.21	10.91	9.87	8.02	+40
Skuld	2.46	2.65	2.67	2.98	-17
The Standard	5.71	5.90	7.06	8.14	-29
Steamship Mutual	2.34	2.35	2.32	1.84	+27
The Swedish	NA	NA	NA	NA	NA*
The UK	4.17	4.75	4.11	3.91	+7
The West of England	4.34	4.35	3.80	2.40	+81

*Swedish does not publish break up figures for hull and P&I insurance.

Source: P&I review 2000, Elysian Insurance services.

From the above it may be seen that the clubs which have higher reserves per GT, namely the Ship owners Club, the London Club and the Standard Club as well as the clubs which are showing consistent increases in the free reserves namely the West of England Club, the London Club and the Ship Owners Club are expected to have good financial strength and by virtue of the high proportion of free reserves and consistent increase in their reserves, they demonstrate more propensity to demutualise than the other clubs.

5.5.2.2. Free reserves as a percentage of call income

The Table 19 provides information on the strength of the clubs with reference to their call income. A high percentage of reserves to call income indicate the strong reserve position of the clubs, which are not directly dependent on an increase in the call income. However, a rising percentage could be due to either increased free reserves or falling premium or a combination of both. This ratio is similar to the conventional premium / surplus ratio. The clubs that have a relatively higher ratio are the London Club, the Standard Club, the Gard Club and the UK Club demonstrate that they have strong reserves and, therefore, they are more susceptible to demutualisation in comparison to other clubs. The reserve to call income of the Britannia Club has fallen by 13.1 % showing the erosion of its reserves.

Table 19 Free reserves as a percentage of call income

Name of the club	**2000**	**1999**	**1998**	**1997**	**% Increase in 2001 to 1997**
American Club	97.77	102.33	83.41	70.55	38.5
Britannia Club	91.41	99.69	110.40	105.22	-13.1
Gard	175.56	184.23	176.74	130.39	34.6
Japan	43.84	36.33	36.15	32.82	33.5
The London Club	230.11	210.35	155.25	94.00	144.7
The North of England	115.03	96.98	74.01	59.61	93.0
The Shipowners Club	119.07	107.83	86.32	67.60	76.1
Skuld	73.27	67.88	70.39	54.33	34.9
The Standard Club	209.03	223.66	230.97	209.83	0
Steamship Mutual	55.60	46.95	44.32	31.37	77.2
The Swedish Club	146.30	142.05	105.15	77.68	84.8
The UK Club	160.45	158.82	133.22	104.69	53.2
The West of England	126.70	119.83	94.07	55.42	128.6

Source: P&I review 2000, Elysian Insurance services

5.5.2.3 Ratio of free reserves to net outstanding claims

Table 20 Ratio of free reserves to net outstanding claims

Name of the club	2000	1999	1998	% Increase in 2001 to 1998
American Club	43.93	51.46	45.52	- 0.04
Britannia Club	26.09	29.86	50.82	-48.66
Gard	55.66	63.84	70.30	-49.27
Japan	34.85	34.35	33.30	04.65
The London Club	48.31	43.93	42.01	15.00
The North of E	36.07	31.22	35.82	06.97
Skuld	32.49	79.57	36.50	-10.98
Shipowners	87.15	67.63	71.61	21.70
The Standard Club	65.11	64.99	74.51	-12.61
Steamship Mutual	20.99	19.97	20.27	03.55
The Swedish Club	77.88	77.16	78.30	- 05.36
The UK Club	47.98	52.04	43.16	11.16
The West of England	39.25	39.21	34.29	14.46

Source: P&I review 2000, Elysian Insurance services

This ratio shows the tolerance within the club for adverse claims development. How much reserve is available to meet adverse claims as a percentage of the net exposure in the balance sheet? How far can the free reserves be utilised to meet additional claims? This scenario may not arise since the clubs would normally go in for supplementary calls or ATR or other reinsurance arrangements. The clubs that show the highest ratios of more than 50% i.e. the Shipowners Club, the Swedish Club, the Standard Club and the Gard Club have adequate reserves since a large proportion of their reserves could be utilized for meeting outstanding losses and in contrast, the clubs that have weak and inadequate reserves are Britannia, Steamship and Skuld. The clubs that have higher ratios may have propensity to demutualise since the members would be motivated by large personal gains consequent to demutualisation.

5.5.2.4 Ratio of claims recoverable to gross claims outstanding

The ratio of claims recoverable to gross claims outstanding indicates the reinsurance leverage of the club i.e. How much of the club's gross claims liability is dependent

Table 21 Ratio of claims recoverable to gross claims outstanding

Name of the club	2000	1999	1998	% Increase in 2001 to 1998
American Club	17.75	12.18	15.47	14.73
Britannia Club	20.42	11.10	09.68	110.95
Gard	13.75	15.76	13.32	03.22
Japan	05.35	08.39	20.76	-74.22
The London Club	14.59	15.42	13.23	10.27
The North of E	28.04	26.02	25.96	08.01
Skuld	27.72	26.40	24.99	10.92
The Shipowners Club	37.94	38.24	27.88	36.08
The Standard Club	16.47	17.62	21.07	-21.83
Steamship Mutual	27.03	23.06	23.11	16.96
The Swedish Club	31.87	24.68	28.37	12.34
The UK Club	10.06	13.93	15.00	-32.93
The West of England	16.56	16.85	18.42	-10.10

Source: P&I review 2000, Elysian Insurance services

upon the strength of reinsurance arrangements and how much relies on it's own balance sheet. The clubs that show a higher ratio of 25% or more i.e. the Shipowners, the Swedish, the North of England, the Skuld and the Steamship Mutual clubs have weak leverage or weak reinsurance arrangements compared to the clubs such as the Japan, the UK and the Gard clubs that have lower ratios. Similarly the clubs that have a higher increase of ratios since 1998 namely the Britannia Club and the Shipowners' Club show the declining leverage on reinsurance arrangements in comparison to the Japan and UK clubs who have improved their ratios since 1998.The clubs that have higher ratios which means weak reinsurance are likely to be more vulnerable to structural changes to improve their leverage than other clubs.

5.5.3. Access to Capital

The mutual insurer may convert to joint stock Company for the purpose of gaining access to capital markets which would be required to fund projects. If the mutual insurer has a high free cash flow and has no profitable project to spend it on then it would suggest that it would not go in for demutualisation to fund projects. (Wells,1995). The lower the relative levels of surplus the higher the probability of demutualisation to gain access to capital markets. In the case of marine insurance mutuals the demutualisation of BMM appears to have been prompted by their desire to increase their capital and expand their activities since they were a well-run club with no call crisis and good tonnage at the time of demutualisation. Richard Leslie, the General Manager of BMM mentioned that the demutualisation of BMM would increase the market share and offer more products to the shipowners apart from enhancing the solvency of the company. In this deal, the newly formed stock company British Marine Holdings received additional capital to the tune of US$35 million from an investment company Capital Z Financial Services Fund II L.P. This investment company is a US$1.85 billion global private equity fund focused on the insurance, financial services and health care services industries (Beatty, 1999). Therefore, the demutualisation of a well-run mutual club could also be prompted by their desire to access capital and increase their market share. The clubs that have the lowest reserves namely the Japan , the Britannia the Steamship Mutual and the Skuld clubs have higher propensity to demutualise in order to access capital and finance their expansion plans.

5.5.4 Size of the insurer

The steps in the demutualisation process include obtaining approval for conversion from a majority of the directors, insurance regulatory authorities and the majority (normally two thirds) of voting members. (Garber, 1986) (Hemmings, 1995). In addition, other approvals are required under the relevant legislation from the tax authorities and labour departments. The larger the mutual insurer the more cumbersome

Table 22 Size of the club (based on entered tonnage (Million GT)

Club	2000	Market Share %
The UK Club	90.3	15.98
Gard	89.8	15.89
Britannia Club	79.0	13.98
Steamship Mutual	64.1	11.35
Japan	48.0	08.50
The Standard Club	42.0	07.44
Skuld	39.6	07.00
The West of England	37.0	06.55
The London Club	25.8	04.57
The North of England	21.3	03.77
The Swedish Club	13.7	02.42
The Shipowners Club	08.2	01.45
American Club	06.2	01.10
Total	565	100

Source: P&I review 2000, Elysian Insurance services

the process of demutualisation, and, therefore, the larger mutuals are less likely to undergo a demutualisation process. The above aspect is relevant to mutual marine insurers if the membership is quite large and the pattern of distribution of members country wise shows that the members of a particular club are spread out all over the world. However, this aspect may not be decisive since some mutual clubs are more regionally oriented with membership concentrated from particular regions and relatively few owner members hold a voting majority in the club. In any case, the above aspect is one of the important factors for consideration at the time of demutualisation. The larger clubs who have more than 10% market share such as the UK, the Gard, the Britannia and the Steamship Mutual clubs may look for opportunities to merger with small clubs such as the American Club or the Swedish Club in order to increase their market share. The much talked about merger of the Standard and the Britannia did not materialise last year but such mergers are expected in future.

5.5.5 Management and administrative expenses

Table 23 Average Expense Ratio (5Years on 2000)

Name of the Club	5 year AER
Japan	5.68
The London Club	5.8
Britannia Club	7.31
Gard	7.4
The North of England	7.7
The Standard Club	7.9
The UK Club	8.12
The Swedish Club	8.26
American Club	8.4
The West of England	8.52
Steamship Mutual	8.7
Skuld	9
The Shipowners Club	16

Source: Elysian Insurance Services

There were some studies conducted in 1980's which indicate that the mutual organisations have higher administrative and management expenses than stock companies (Frech, 1980, O'Hara, 1981). The above research is old and the managers may have learnt from them or changed behaviour but managers of mutual organizations cannot share the benefits of the ownership, such as stock options or bonuses linked to the profit which gives rise to expenses preference behaviour in the form of consumption of more perquisites and agency costs. (Verbruggae & Goldstein, 1981). Until recently the mutual marine insurers who are members of the IGA were not obliged to disclose their administrative expenses and When the issue of exemption from competition legislation came up for approval before the European Commission, the Commission found this to be anti competitive and instructed the members of the IGA to disclose their 5 year Average Expense Ratio (AER). The result of this exercise was that many clubs with higher administrative cost were forced to find ways and means of cutting the cost including mergers and alliances.

The clubs can compete effectively within the IGA as long as they have a better AER. Therefore, the average expense ratio of a mutual club is one of the indicators for demutualisation.

The publication of AER was as a result of the negotiation with the EC when it agreed to the new exemption in 1999.The following factors may distort AER (Elysian P&I review, 2000)

1. Size of the vessel
2. High level of deductible agreed by owners and consequent low premium
3. Clubs with more regional offices may offer better service to their members with more expense
4. Clubs with good record able to reduce it’s calls to it’s members can produce the same AER as a club with a poor record and which has a high premium level.

In general, higher AER ratios as in the case of the shipowners, the Skuld, the Steamship Mutual, the West of England and the UK clubs (above 8%) indicate that the clubs are incurring higher administrative costs, which might drain their reserves or may result in enhanced call premium, are susceptible to merger or takeover in order to bring down their administrative cost.

5.5.6 Losses

The mutual insurer may have higher losses due to various reasons including poor underwriting or under pricing its services. Sustained high loss ratios would reduce the reserves, which will affect the growth prospects and solvency of a mutual insurance company. This may also trigger the need to go in for additional capital but access to capital could be possible only through demutualisation. Therefore, a higher loss ratio is associated with a higher probability of demutualisation. Most of the clubs have underwriting losses for the past five years due to a fall in rates of premium and increase in claims. The clubs faced competition from fixed premium providers as well as hull insurers who entered the P&I market to cover up the losses in Hull market. In the year 2000 only two clubs generated an underwriting profit, i.e. the Standard and the Steamship clubs. The remaining clubs continue to sustain losses, many for at least the fifth consecutive year. The clubs that have high underwriting losses have limited options to minimize losses except going in for increases in calls or utilising the reserves or cutting costs. In a competitive market it will be difficult to increase the calls and, therefore, the clubs, which have been sustaining losses for the past 5 years, may tend to merge or form alliances or demutualise in order to survive in the market.

Table 24 Underwriting result of IGA (in US$ ´000)

Name of the club	1999-2000 (12 months)	1998-99 (12 months)	1997-98 (12 months)	1996-97 (36 months)
American Club	-9707	-4923	-4011	-13
Britannia Club	-21396	-29492	-11602	421
Gard	-2124	7579	15462	31352
Japan	NA	NA	NA	NA
The London Club	-21600	-29900	-30900	NA
The North of England	-10520	-5572	-6156	-5277
The Shipowners Club	-4468	-3622	NA	2200
Skuld	-13500	-3400	4100	360
The Standard Club	5281	1742	6477	1023
Steamship Mutual	691	25112	23755	14590
The Swedish Club	NA	NA	NA	NA
The UK Club	-109225	-81631	-88735	-86770
The West of England	-5673	476	534	1786

Source: P&I review 2000, Elysian Insurance services

5.5.7 Investment Income

The investment income forms an important component of income of mutual clubs and the determination of estimated call income depends on the amount of investment income the club is expected to earn in a particular year. The investments of clubs are spread in fixed assets, equities and other investments. Nowadays most of the clubs engage professional investment advisors for investments and some clubs

Table 25 Percentage of investment Income for the period 1999-2000

Name of the Club	Percentage of investment income
The North of England	0.52
Japan	1.64
The West of England	3.18
Britannia Club	4.66
American Club	5.60
Skuld	5.68
The Standard Club	5.99
The London Club	6.30
The Swedish Club	6.52
The UK Club	6.84
Gard	7.10
Steamship Mutual	9.05
The Shipowners Club	9.50

Source: P&I review 2000, Elysian Insurance services

achieved high returns from large holdings of equities wherein the risk is higher. The clubs that have large reserves have large amounts of capital to invest such as the Britannia Club, which over the years established a very substantial balance and achieved considerable investment returns. The clubs that have a higher proportion of investment income as a percentage of total funds, such as the Shipowners, the Steamship Mutual and the Gard clubs, were able to minimise their call income requirement from members and they have an advantage over the clubs, which have a lower percentage, such as North of England and Japan. The clubs that have a lower proportion of investment income of less than 4% namely the North of England, the Japan and the West of England clubs may have propensity to demutualise or undergo other forms structural changes such as mergers or alliances in order to increase their investment income which would improve their bottomline.

5.5.8 Ratings given by specialized rating agency

Table 26 Ratings from Standard & Poor's

Name of the club	**96-97**	**97-98**	**98-99**	**99-00**
American Club	BBB	BBB	BBB	BBB+*
Britannia Club	A	A	A	A
Gard	A	A	A	A
Japan	BB	BB	BB	BB
The London Club	BBB	A	A	A
The North of England	BBB	BBB	BBB	A-*
The Shipowners Club	A	A	A	A
Skuld	BBB	BBB	BBB	BB
The Standard Club	A	A	AA-	AA-*
Steamship Mutual	BBB	BBB	BBB	BBB
The Swedish Club	BBB	BBB	BBB	BBB
The UK Club	A	A	A	AA-*
The West of England	BBB	BBB	BBB	BBB

*These clubs have obtained interactive ratings from S&P

Source: Modified data from Marsh P&I review, 2000 and HSBC P&I review, 2000

The ratings given by rating agencies reflect the financial strength of the clubs. The ratings also give an indication as to whether the clubs will be in a position to survive the competition within the IGA as well as from commercial insurers. The ratings also provide information to shipowners as an aid to decide on the reliability of the insurer and the mutual clubs that have higher ratings are in a better position to increase their market share than the ones with poor ratings. Therefore, the clubs that have poor ratings are susceptible to takeover or merger with other clubs who have better ratings. Furthermore, the clubs with better ratings may tend to demutualise in order to increase their market share and diversify their business into non-P&I and even non-marine insurance business. The Standard and Poor ratings predicted the vulnerability of the Ocean Marine Club, which became insolvent as well as the New castle, the Liverpool and London clubs, which were taken over. The clubs that have marginal ratings of BB or lower, i.e. the Skuld and the Japan clubs may look for alliances or mergers if their ratings are further downgraded in future.

5.6 Summary of analysis and result

In summary the relationship of various factors, which determine the changes in the structure and operation of the club is given below. The general term ‘structural change’ is used since the club may choose to go in for any of the structural changes like mergers, alliances or demutualisation in order to survive and stabilize their business activity. To arrive at conclusions as to which clubs are likely to undergo structural change, certain assumptions on the benchmarking of figures were applied. These assumptions were based on discussion with certain insurance clubs and information gathered from various P&I review reports For example, only supplementary calls of above 12% were considered to influence structural changes and the rest of the clubs were not considered for that factor.

1. Cashflow

- The higher the supplementary calls the stronger the tendency towards structural changes. The supplementary calls of above 12% are considered to influence the structural changes.
- The higher the cost of premium as percentage of ETC the greater is the chance of structural changes. The percentage of cost of premium on ETC of above 110 is considered to influence structural changes.
- The lesser the release calls the weaker the inclination towards structural changes. The release calls of above 25% are considered to influence the structural changes

2. Free reserves

- The higher the free reserves the stronger the tendency towards structural changes
- Reserves per GT of more than US$4 are expected to influence structural changes

- Free reserves as a percentage of call income of more than 150% are expected to influence structural changes.
- A ratio of free reserves to net outstanding claims of more than 50 is considered to influence structural changes.
- A ratio of claims recoverable to gross claims of more than 25 is considered to influence structural changes.

3. Access to capital
    - A need to access capital arises when the club has low reserves. The lower the reserves of a mutual club the higher the chances of demutualisation to bring in financial stability and expand their business
4. Size of the club
    - An entered tonnage of more than 50 million GT (say about 10 % of total tonnage of P&I clubs) is considered to influence structural changes in the club.
5. Management and administrative expenses
    - An Average Expense Ratio (AER) of 8% or more is considered to influence structural changes in the club.
6. Underwriting losses
    - Even though higher underwriting losses may trigger the clubs to go in for structural changes, there is no significant trend was observed in the data relating to the underwriting losses of various clubs since many clubs were incurring losses for more than 5 years.
7. Rate of return on investment
    - A rate of return on investments of 4% or less is considered to influence structural changes in the club.

8. Rating given by specialised rating agencies.

   - A lower rating of BB or below given by the specialized rating agency Standard & Poor is considered to influence structural changes in the club.

Based on the above parameters the clubs that were short-listed are given below. The clubs that had the greatest number of factors are considered to be strong candidates for structural changes. The clubs are grouped based on the number of points obtained by them. A Summary of the analysis is given in Appendix:A.

Group 1: very strong tendency towards structural change - Clubs that had total points in the range of 9-12

Group 2: strong tendency towards structural change - Clubs that had total points in the range of 5 - 8

Group 3: Clubs that have a weak tendency towards structural change - Clubs that had total points in the range of 1-4.

Based on the analysis presented in the above table the clubs are grouped as under

Group 1 - None

Group 2 - Skuld, Gard, Steamship, Swedish and West of England

Group 3 – American, Britannia, Japan, London, North of England, Ship Owner, Standard and UK

From the above it may be inferred that the Skuld, the Japan, the Gard, the Swedish, the Steamship mutual and the West of England have a strong tendency towards structural change, which may be merger, alliance or demutualisation. The clubs that showed the weak tendency towards structural change are the American, the Britannia, the London, the Japan, the North of England, the Shipowner, the Standard and The UK clubs. Even though all the clubs are grouped into two categories if we look at the critical factors and deviation from cut off limit, the clubs Skuld and Steamship have strong tendency to demutualise than other clubs in Group 2. Similarly in Group 3, the clubs Japan and London have weak tendency towards demutusalisation. In respect of other clubs they are favourably positioned to undergo structural changes in the coming years. One interesting observation is that out of the thirteen clubs five clubs have shown a strong tendency in varying degrees, which explains changes that are happening in the mutual marine industry. The present dominance of the mutual clubs will continue for some time and their survival is enhanced by the consolidation effort that has been taking place among the mutual clubs. This might result in the emergence of certain super clubs who are efficient and strong and they may decide to demutualise if the circumstances warrant that they need to grow big and access funds from the capital market. Similarly the emergence of some FPP's as big players in the P&I segment is not ruled out notwithstanding the fact that this segment is dominated by the mutual clubs.

CHAPTER 6

CONCLUSIONS AND RECOMMENDATIONS

6.1 Challenges faced by marine mutuals

There are an ever-increasing number of changes happening in the general insurance industry, which poses challenges to the marine insurance industry. The mutual marine industry which controls about 80% of P&I insurance stood united when they faced the challenge from the European Commission (EC) investigating their anti competitive practices. The approval given by the EC to the International Group Agreement (IGA) for another ten years up to 2009 was a big relief to all mutual insurers. However, one should not forget that the approval was given with a rider that there should be fair competition among the clubs who form part of the IGA and transparency in their operation. Whether such competition among IGA members will pose a challenge to the survival of the IGA is a big question? The benefits, which clubs used to derive from being members of the IGA are diminishing or becoming insignificant, especially with the emergence of Alternative Risk Transfer (ART) products. The other aspect, which poses a challenge to the IGA is the emergence of a trend of consolidation among mutual clubs, i.e. mergers, acquisitions, alliances and demutualisation. Such a trend witnessed in the last few years, has contributed to the demise of two clubs, the New castle Club and the Liverpool & London Club, which merged with the North of England Club. Similar mergers are not ruled out in future and this may result in the development of a few big clubs, which would compete with each other and control a major share of the marine insurance market. What is going to be the role of the IGA in such a scenario? It may be insignificant since the big clubs would be in a position to bargain for better reinsurance premia and provide higher limits of cover than those currently available to the IGA.

6.2 Changes in the marine insurance industry

The mutual insurance industry has faced competition from fixed premium insurers, which triggered certain important changes in the mutual marine industry, inter alia (Mitchell, 2001)

- Decline in the rates of insurance premia
- Reduction in management and administrative expenses i.e. Average Expense Ratio (AER)
- Reduction in supplementary calls
- Improvement in quality of service of mutual clubs
- Provision of one- stop-shop services to meet the changing needs of shipowners
- Demutualisation of some mutual clubs
- Alliances and mergers of some mutual clubs with big players in the insurance sector.

6.3 Why Fixed premium providers failed in their effort?

The above changes were swiftly adopted by the mutual marine industry meet the new competition from the fixed premium providers. The fact of the matter is that the Fixed Premium providers (FPP) could not make inroads into the mutual marine industry and are now confined to small ship segment with limited amount of cover up to US$ 500 million in contrast to US$ 4.25 billion offered by IGA clubs. Perhaps the blessing in disguise is the changes that the FPP's have brought in to the mutual industry.

The failure of FPP's could be attributed to the following reasons

1. Timing of their entry into market, i.e. when the insurance business cycle is at it's downward cycle
2. Quick and united response from mutual insurers in making structural changes to counter the advantage of FPP
    - Consolidation among mutual clubs
    - Introduction of certainty of premium – fixed calls in contrast to unbudgeted calls
    - No supplementary calls
    - Adoption of ART products to provide finite calls
    - Cut in insurance premium and reduction in reinsurance cost

In retrospect the failure of FPP is only a temporary phenomenon and a second assault when the insurance market cycle in it's upward trend is not ruled out. They may be successful in their second attempt if mutual clubs are slack in keeping pace with the changes that are taking place in the commercial insurance market.

6.4 Is the concept of mutuality relevant in marine insurance today?

The system of mutuality relied on stakeholders' culture, pooling of risk, cohesion and benevolent monopoly. Nowadays, the needs of shipowners are changing very fast due to the sophistication of delivery systems for insurance products. In contrast to the personal one to one approach of brokers with underwriters shipowners nowadays have direct access to information on availability of insurance coverage and terms and conditions from all over the world and decide on the insurer who is best suited to the interest of the particular shipowner. The technological development, therefore, constitutes a direct attack on the relationship of insurance, which continues to be at the heart of most marine mutual insurers. The cohesion and benevolent monopoly also suffer due to competition. The individual shipowners who are aware of the alternatives may refuse to cross-subsidise other members of the mutual clubs who contribute less to the bottom line. Therefore, the long-term survival of the mutual concept is unlikely unless the mutual insurers come out with some innovative mechanism to meet the changing needs of the shipowners in a technologically highly sophisticated environment.

6.5 Is demutualisation a viable option to mutual clubs?

Studies seem to point towards demutualisation as one of the most important options. The worldwide insurance industry was dominated by mutuals a decade back. Since then there has been a trend towards their demutualisation, which saw many mutual insurance companies in the life insurance sector demutualising. Even though Swiss Re in it's latest report (Sigma, 1999) observed that mutual insurers have some fundamental advantages over the joint stock companies and should reconsider the decision of rushing to demutualise, the trend towards demutualisation is clear. The fundamental advantage that a mutual insurer has is the cost advantage of having no customer – owner conflict and flexible pricing. However for the time being it appears that the advantages of demutualisation outweigh the disadvantages. This was clearly evident when one of the mutual marine insurance providers BMM demutualised in 1999 in order to access additional capital and expand their activities.

6.6 What does demutualisation mean for the mutual marine insurance industry and what are the critical factors that influence demutualisation?

There are no such studies carried out in the mutual marine industry. However the studies carried out in the general insurance industry identified, free cash flow, access to capital, wealth expropriation at the time of conversion, expense preference behaviour and loss ratio as critical factors that influence demutualisation. Applying the results of the above study in combination with P&I research reports published by Elysian Insurance Services (2000), Marsh (2000) and HSBC (2000), eight critical factors namely free cash flow, the free reserves, the access to capital, the size of the insurer, the management and administrative expenses i.e. AER, underwriting losses, the rate of return on investment income and the ratings given by S&P were taken up for study to examine their influence on demutualisation of mutual clubs. To examine the Cash flow, the Supplementary call percentage, Cost of premium as percentage of ETC and Release call percentage were considered. To analyse the Free reserves/Surplus, the total free reserves per GT of entered tonnage, the free reserves as percentage of call income, the ratio of free reserves to net outstanding claims and the ratio of claims recoverable to gross claims outstanding were examined.

The analysis data relating to the 13 P&I clubs who are members of the IGA revealed that

- Skuld and Steamship mutual has strong tendency towards structural change, which may be merger or alliance or demutualisation.

- London and Japan club showed weak tendency towards structural change
- Out of 13 clubs 5 clubs have shown strong tendency in different degrees.
- Other clubs are favourably positioned to undergo structural changes in the coming years.

6.7 Recommendations

1. Mutual clubs should reorient themselves to meet the following challenges and trends

    - Globalisation markets
    - Consolidation and Specialisation
    - Increased competition
        - New competitors
        - New products
        - Alternative distribution channels
    - Changes in customer needs
    - Changes in the security perception of vessel operation
    - Reducing margins and increasing costs
    - Increasing sophistication and complexity of information technology including e-commerce
    - Increased risk requiring innovative risk transfer vehicles.
2. Mutual clubs should not shy away from changing basic structure if the circumstances especially the changing needs of shipowners so warrant.

3. The mutual marine insurance industry should be alive to changes in the general insurance industry and apply knowledge taken from other industries to marine

sector. This includes mainly customer behaviour, distribution, perception and service.

4. The mutual marine industry should keep their option open to the following six key imperatives facing any financial service organisation.
    - Mergers and Acquisitions
    - Risk management (ability to identify, manage and allocate risk exposure on global basis)
    - Time to market new products and services
    - Customer management
    - Corporate repositioning and branding
    - Non interest expense reduction by shared services, outsourcing and competitive positioning
5. Mutual clubs should keep in view that their brand values which relied on shipowners trust and trust are no longer enough to provide sustainable competitive advantage to them.
6. Mutual clubs should be aware of the implications of technological development especially the developments in information technology, evolving roles of state including deregulation and implementation of anticompetitive and anti trust laws.
7. Mutual clubs should realise that the development of information technology has broken the information barrier between the shipowner and underwriter. This in turn has contributed to the commoditisation of insurance services that encourages competition by products on the basis of price rather than historical relationships.
8. Mutual clubs should be aware of threats from non-marine insurance providers who control communication networks and the gateways could set themselves up as brokers directing customers to the best product. In such a scenario the loyalty of customer would increasingly be to the broker rather than the producer of the product or the one who actually provides the insurance service.

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Appendix A

Volume of Business of P&I Mutual Clubs

(in terms of number of vessels)

Name of the Club	1995	1996	1997	1998	1999	2000
American Club	900	960	915	912	1037	NA
Britannia Club	3139	3268	3426	3396	3489	3736
Gard	4984	4878	4666	4596	4418	4257
Japan	9620	9480	9074	8563	7948	7387
The London Club	920	941	955	956	952	931
The North of England	1151	1311	1382	1491	1775	1648
The Shipowners Club	21120	22260	23756	24593	21827	23500
Skuld	4912	5136	5500	5577	5521	5133
The Standard Club	2154	2245	2234	2303	2400	2550
Steamship Mutual	3398	3898	4373	4684	4815	4974
The Swedish Club	447	463	495	540	610	722
The UK Club	5000	5450	5000	5000	5350	5665
The West of England	6900	6700	6800	6750	6900	6000
Total	64645	66990	68576	69361	67042	66503

Source :P&I Review of 2000,HSBC Insurance Brokers Limited, Marine Division.

Appendix B

Volume of Business of P&I Mutual

(In terms of Entered Tonnage in Million GT)

Name of the Club	1995	1996	1997	1998	1999	2000
American Club	4.1	4.8	6.1	6.8	8.8	6.2
Britannia Club	59	63	69	69.1	73.5	79
Gard	74.5	79.3	84.1	86.3	89.3	89.8
Japan	43.3	46.3	46.5	47.2	47.9	48
The London Club	23.8	26.6	25.7	25.16	24.83	25.81
The North of England	11.2	14	16.5	19	22.1	21.3
The Shipowners Club	5.6	6.2	6.6	6.9	7.4	8.2
Skuld	27.2	28.9	32.6	38.1	40.5	39.6
The Standard Club	29.5	30.9	33.5	38.1	41	42
Steamship Mutual	61.1	63.1	68.5	67.8	63	64.1
The Swedish Club	8.6	8.9	9.8	10.4	10.9	13.7
The UK Club	91	91	91	91	91	90.3
The West of England	32.4	35.7	38	38.3	38.7	37

Source: P&I Review of 2000,HSBC Insurance Brokers Limited, Marine Division.

Appendix C

Analysis of factors that influence structural changes in mutual clubs.

Name of the club	Suppl. call above 12%	ETC above 110%	Release calls above 25%	Free Reserves per GT above US$4 per GT	FR to call income above 150%	R1 above 50	R2 above 25	Access to Capital	Market share above 10%	AER above 8%	Investment income less 4%	Rating of BB or below S&P	Total points
American	X		X	X						X			4
Britannia			X					X	X				3
Gard			X	X	X	X			X				5
Japan								X			X	X	3
London		X		X	X								3
North of E			X				X				X		3
Skuld	X		X				X	X		X		X	6
Shipowners				X		X	X			X			4
Standard				X	X	X							3
Steamship	X						X	X	X	X			5
Swedish		X	X			X	X			X			5
UK Club				X	X				X	X			4
West of E		X	X	X						X	X		5

Appendices

Appendix A   Volume of Business of P&I Mutual Clubs

(in terms of number of vessels)

Appendix B   Volume of Business of P&I Mutual Clubs

(In terms of Entered Tonnage in Million GT)

Appendix C   Analysis of factors that influence structural changes in mutual clubs.