

In addition to the claims cost, there must be provision for reinsurance premiums, the cost of administration of the P&I club and the level of solvency margin the club is required to maintain to meet regulatory requirements. These are considered later.

Allowance will be made for the fact that the claims payments may be spread over a number of years and that the income from premiums may earn investment income for the P&I club over that same period.

Incurred but not reported (IBNR)

A factor is used to take account of the possible future increase in the total of claims for each particular policy year that has passed but is still open. This is known as the incurred but not reported (IBNR) factor.

Two main considerations influence this factor:

- incidents that will lead to claims which have already occurred but have not yet been reported to a P&I club, or even the shipowner
- the possibility that liabilities in respect of known claims may exceed the original estimates made (IBNER – incurred but not enough reported).

General and individual increases

When setting the level of premiums, after taking account of all the factors previously mentioned, the club's managers may decide to ask the directors of the club to authorise a general increase to apply to the entire membership at the policy renewal, regardless of an individual member's claims record.

The concept of mutuality under which a P&I club operates means that it is necessary for each member to make a contribution based on the level of projected claims, including other members' claims, and the level of general costs.

The managers will also consider each member's claims record on an individual basis. A claim against a shipowner may take many years to come to a conclusion. The P&I club must therefore account separately for the amounts actually paid and the amounts for which outstanding provision has been made. The club will usually try to take a long-term view so that members are not unduly penalised over claims that they and the club may still be vigorously defending.

TYPES OF PREMIUM

When the required level of funding has been established, each member will be advised how much to budget for the coming year. Many P&I clubs have replaced the traditional method of collecting calls with a simplified method.

Traditional calls

Traditionally the required level of premium for each member was known as the 'estimated total call' (ETC). As the P&I club would not be required to pay all claims during the immediate 12 month period, known as the policy year, it did not require payment of the entire ETC at once. However, as the club might have difficulty in collecting the balance of the call from a member in two or three years' time, most P&I clubs required a large proportion of the ETC to be paid during the policy year. This first part of the payment was generally known as the 'advance call'.

The managers of a P&I club would then review the policy year after it ended. Depending on the outcome of this review the club would charge all or part of the balance of the ETC. This further charge was known as the ‘supplementary call’. The term ‘supplementary’ was misleading, inferring an unexpected premium, when it was in fact only a deferred payment of the originally estimated premium.

Premium descriptions

To avoid the confusion inherent in the traditional system, particularly in the use of ‘supplementary’ calls, some P&I clubs have changed to a simplified method of collecting premiums that still provides members with flexibility in their cash flows.

Before considering the different types of premium, it may be useful to explain some of the jargon used in P&I insurance.

Definitions of premium and call

Premium – an amount that can be quantified prior to a vessel being entered with a P&I club.

Call – an amount that cannot be quantified, but which the member may become liable to pay.

For example, the current terminology, described below, is typical of that used by many P&I clubs.

Club terminology

Mutual premium – the expected annual premium for an entered ship expressed as a rate per unit gross tonnage (GT).

Fixed premium – the pre-set premium for a ship usually entered by voyage or time charterer rather than by its owner.

Release premium – a payment made for a vessel leaving the P&I club that relieves the member of any future liability for premium relating to that vessel.

Additional call – an extra unforeseen funding requirement where premium raised for any one policy year is not adequate to meet the funding requirements mentioned above.

Overspill call – an extra unforeseen requirement, specifically to fund an overspill claim.

Each of these is examined in turn.

Mutual premium

The mutual premium is the expected annual premium for an entered ship based on the general claims experience of the club and the individual claims record of the member. To assist a member’s cash flow, the premium is usually paid in instalments.

Example of premium payments

The mutual premium is collected in four instalments.

If the premium is US\$40,000: $US\$40,000 / 4 = US\$10,000$.

The four instalments would be due in April, June, September and December during the policy year that starts in February.

Release premium

When a member sells a ship, or for any reason leaves a P&I club, the managers of the club may raise an additional surcharge. When the member pays this surcharge, they are relieved of the liability for any future additional calls due in respect of the vessels leaving the club, except for overspill calls (see below). The total amount of the unpaid mutual premium, plus the amount of the surcharge if any, is known as the ‘release premium’ or ‘release call’. The directors set the surcharge for each open policy year.

A member may be given the option to give the P&I club a bank guarantee instead of paying a release premium. The guarantee would be worded in such a way that any future calls due, in respect of years for which the member’s vessel was entered, would be included and drawn upon when required.

Additional call

If the amount necessary to fund any given policy year is more than the originally forecast mutual premium, the extra amount required from members is known as an additional call. The member expects to pay the instalments of the mutual premium, but an additional call is unexpected and invariably comes as an unwelcome surprise.

Overspill call

An overspill call will occur very rarely and is only made when an overspill claim occurs, as described in Chapter 4. If the relevant policy year has been closed, a P&I club’s rules provide for any overspill call that occurs for that year to be made on the oldest open policy year at that time. This has never yet happened in practice.

Laid-up ships

Rule 15

A vessel is said to be laid-up when trading has been suspended and it is placed out of commission for a period of time. It may be moored alongside a berth, at anchor or secured to a buoy.

There are a number of reasons why a shipowner may wish to lay-up a vessel, but it is very often influenced by the economic trading conditions. If the demand or charter rates are such that the vessel is operating at a loss, then it may be in the owner’s interest to reduce operating costs and vessel wear and tear by taking the vessel out of service.

A shipowner may be entitled to a refund of its P&I premium in the form of laid-up returns. These returns are subject to specific requirements, in particular that vessels should be laid up in a safe port location approved by the P&I club’s managers. In addition, the managers must be advised in advance of any vessel preparing to leave a period of lay-up as the vessel may be required to undergo a survey. P&I club circulars give up-to-date information relating to the requirements to qualify for such returns.

The decision on where and how to lay-up a vessel must be properly considered and approval sought from the flag state, classification society and insurers. It is essential that the vessel is maintained in a safe and secure condition and that the environment remains protected.

There are principally two categories of lay-up: hot and cold. Hot lay-up would be suitable for a vessel out of service for a relatively short period of time. Machinery will be kept operational and flag state and classification society requirements must be complied with. Manning levels would normally be reduced to below those prescribed in the

minimum safe manning document. A vessel with manning levels at or above statutory minimum manning requirements would be considered as 'idling' rather than laid-up.

If a vessel is to remain out of service for a longer period of time, then cold lay-up may be considered suitable. In cold lay-up, all systems are shut down with the exception of emergency power or use of a temporary generator set. Manning levels will be in line with emergency requirements to deal with fire, flooding, mooring and security risks.

POLICY YEAR

Although the policy year may have come to an end it will still be kept technically 'open' for some time after the end of the calendar year to which cover is related. This allows a P&I club to take account of the fact it may take several years for claims to reach a final outcome and for the final figures to become known.

The policy year will remain 'open' until such time as the P&I club's managers and directors feel satisfied that all claims that occurred during the actual policy year have been quantified. It is undesirable to leave policy years 'open' indefinitely and the customary procedure is for the managers to make annual assessments of the progress of the claims in each of the recent policy years. They will then make recommendations to the directors of the club as to whether any particular policy year should be closed or left open for another assessment twelve months later. Normal practice is to close a policy year two years after the end of the actual policy year, although on rare occasions it may not be closed until three years after the end of the policy year. Only then will the members know exactly how much their P&I cover has cost for that particular policy year.

When the time comes to make a decision on closing a policy year, the managers and the directors may decide to accommodate any claims in excess of the original estimates by an additional call, or they may decide to transfer funds from reserves. It may be that there is still too much uncertainty over the outcome that the directors decide it would be unreasonable to cover this by an additional call. The policy year may then be closed and provision made within the reserves to cover any outstanding claims. Even then, the club still has the ability to transfer these old claims out of the closed year and into the oldest of the current open years and to include these claims when calculating an additional call to make on members in that policy year.

There are a number of factors influencing the decision to close a policy year, including the following.

- The initial claims results may be better than expected, with fewer incidents leading to claims.
- Investment income from the P&I club's assets may be higher than anticipated, so claims can be accommodated out of the club's reserves.
- Any further claims may be fully covered by, and therefore recoverable from, reinsurance.
- The directors may feel that any uncertainties, such as claims incurred but not yet reported, can be accommodated out of the club's reserves.

LOSS RATIO

The loss ratio measures the underwriting performance. It is the financial level of claims (both paid and outstanding) as a percentage of premiums paid over the same period.

Individual member loss ratio

The ultimate aim of the underwriters and the club as a whole is to achieve an acceptable loss ratio for each member. The loss ratio may be calculated using claims amounts (net of deductible) and premiums (net of brokerage fees), or by using figures net of reinsurance and net of abatement – where premiums are deducted for reinsurance and abatement contributions and claims amounts include any recoveries from the reinsurer.

An example of a simple loss ratio calculation is shown below:

$$\text{Loss ratio} = \frac{\text{Level of claims}}{\text{Premium}} \times 100\%$$

Example of loss ratio

If a member's claims for a particular period amounted to US\$300,000 and the premium received was US\$600,000 then:

$$\text{Loss ratio} = \frac{\text{Level of claims}}{\text{Premium}} = \frac{\text{US\$300,000}}{\text{US\$600,000}} \times 100\% = 50\%$$

It is difficult to say precisely what an acceptable loss ratio is. For each member it will be dependent on a number of factors including the type and trade of the vessel, the size of the fleet and the cost of reinsurance.

Each member must also contribute to the running of the P&I club. Typically, somewhere in the region of 10–20% of a member's premium is allocated as its share of club's operating and administration costs. Each P&I club must disclose its operating costs by means of an average expense ratio (AER), which expresses these costs as a percentage of the premiums received.

A member's loss ratio must be viewed over a period of several years and of course a contribution must be made towards other members' claims.

Combined loss ratio

The combined loss ratio of an insurer is a measure of the overall underwriting performance. As it is a universal measure, it also allows for a comparison of the individual clubs.

The combined loss ratio is the sum of all claims (net of reinsurance recoveries) and club operating costs, as a percentage of all received premiums (net of reinsurance contributions).

ABATEMENT

The abatement of claims is a process by which the relatively small number of high value claims – which are volatile in nature – are spread across the whole of the membership in accordance with mutual principles.

REINSURANCE

The unpredictable nature of claims, and the very high value claims that might occasionally occur, could lead to enormous variations in the premium level required from one year to the next. This would make accurate forecasting by the management of a P&I club, and therefore budgeting by the member, virtually impossible.

The solution lies in reinsurance, a method of risk transfer whereby an insurance company or P&I club passes on all or part of the risk to another insurance provider. Reinsurance is vitally important to a P&I club and allows it to offer stability to its members and provide security for claims up to the catastrophic level.

The various levels of reinsurance of a typical mutual P&I club in the International Group are examined in the following sections. It should be noted that the retention and attachment levels are revised on a yearly basis.

Pooling agreement

Despite the need for reinsurance, it is desirable to minimise the use of the commercial market and extend the principle of the P&I club's own mutuality between members to its reinsurance arrangements.

Claims can be for almost any amount, but the highest frequency of claim will be found at the lower financial levels. Therefore, the concept of mutuality will work best at these lower levels. In order to achieve this, and at the same time achieve the best possible spread of risk, all of the P&I clubs in the International Group participate in a mutual pooling agreement.

Each club will meet the first US\$10 million of each and every claim of theirs (2018 figure). This amount is known as the in-club retention. Any claim that exceeds US\$10 million is then shared by the pool up to US\$100 million.

The first US\$35 million layer in excess of the US\$10 million retention is known as the lower pool. The first US\$20 million of this lower pool is shared between the clubs in the International Group and the remaining US\$15 million is reinsured through a reinsurance captive owned by the pooling clubs known as Hydra. Each club's contribution to the lower pool is based on the club's own entered tonnage, mutual premium and its record in the pool, known as the 'one thirds' formula.

The next US\$35 million layer in excess of the lower pool is known as the upper pool. This upper pool is split 7.5% to the claiming club and the remaining 92.5% is reinsured by Hydra. Contributions to the upper pool are calculated differently to the lower pool and are based on the club's entered tonnage as assessed by reference to the reinsurance premium rating applicable to ship type. This is known as the 'weighted tonnage premium'.

The next US\$20 million layer is also reinsured by Hydra. This layer was introduced in 2017 to smooth out some anomalies in the attachment point of the upper layers that involve private placements.

Hydra is a cellular captive insurance and segregated accounts company incorporated under the laws of Bermuda, in which each P&I club in the International Group is an account owner. The International Group also uses Hydra to co-insure a share of the first general excess market reinsurance layer of US\$500 million above US\$100 million (see next section).

Group excess-of-loss reinsurance

The number of claims above the US\$100 million limit of the pooling agreement is relatively few. However, uncertainty over the size and number of such claims makes it an unattractive proposition to insure them within the International Group. Excess-of-loss reinsurance is therefore obtained from the commercial market for claims over US\$100 million up to US\$2,100 million per occurrence.