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“The role of P&I Clubs in raising shipping standards”

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Introduction

1. Most of the world's blue water tonnage is insured for third party liabilities by the mutual P&I Clubs in the International Group. Can their measures to influence and manage the risks they underwrite assist in raising standards? Or does the safety net that they provide help to support and subsidise those who observe low standards in operating ships? This paper addresses these questions against the background of the report to the OECD Maritime Transport Committee on insurance and substandard shipping, and the related submissions of the International Group to the International Oil Pollution Compensation (IOPC) Fund 1992.

2. The report commissioned by the Maritime Transport Committee of OECD, dated June 2004, is published at <http://www.oecd.org/dataoecd/58/15/32144381.pdf>, entitled “The Removal of Insurance from Substandard Shipping”.

3. The International Group comprises 13 P&I Clubs (based in the UK, Bermuda, Norway, Japan, Luxembourg, Sweden and the USA) who insure the third party liabilities of more than 90% of the world's blue water fleet and more than 95% of the world's tanker fleet.

4. With the IG Clubs having such a huge market share, variations in the quality of the world's blue water fleets must accordingly be reflected to an extent in variations in the quality of tonnage entered in the Clubs.

5. The Clubs are non-profit making, mutual associations, controlled not by shareholders seeking profit, but by the assureds – the shipowners. They are vehicles by which shipowners collectively share their risks, and where shipowners are therefore both insurers and assureds. The Clubs accordingly have a close interest in maintaining the quality of their membership.

Price as an incentive to shipping standards

6. A ship with a poor loss record will attract increases in the premium charged to its owner, designed to keep the record roughly in balance over the long term. However,

- losses may be mutualised within individual Clubs in excess of an abatement layer (typically \$2 million per accident);
- losses are shared with other Clubs through the International Group Pooling Agreement in excess of \$6 million per accident;
- and losses falling on the Pool are reinsured in excess of \$50 million per accident.

Major losses are therefore never fully paid for by the individual owner through the loss record, but are shared above \$2 million with other members of the same Club, and above \$6 million with members of all other Clubs.

7. Clubs compete strongly for market share, partly by reference to financial factors, and partly by the quality of their general services, especially by services relating to claims handling, and services relating to the prevention of claims.

8. Their competition in respect of price is constrained by the International Group Agreement (IGA) which, for one year following a switch of Clubs, requires the new Club to charge the same premium rating for a ship as the old Club, unless it can be shown that the old Club's rate is unreasonably high. Financial factors are nevertheless key elements in the competition between Clubs, with a narrow path to be trod between on the one hand restricting general premium increases to competitive levels, while on the other hand building up sufficient financial strength to withstand an unexpectedly bad claims year or unexpectedly poor investment returns.

9. Increasingly, the competitive management of Club finances must respond to additional constraints imposed by the expectations of regulators and rating agencies, especially expectations that risks can be identified and protected against with sufficient capital.

10. If a Club can help a member to reduce his insurance claims, the consequence is that less insurance premium will be required from that member. If this is repeated across a Club's membership, the Club will generally benefit from a reduced claims bill, an improved underwriting result, and a reduced risk of having to charge supplementary premiums. A Club in this position should attract more members. It is accordingly in the financial interest of Clubs to encourage their members generally to manage their risks and to prevent losses.

11. It is, of course, also in the interests of each Club member individually to lower his insurance premium rating – and the only painless way to do this is to incur fewer claims. However, not all members are successful in this, and some may not even try if the cost of loss avoidance is perceived to be greater than the cost of recovering losses through P&I insurance.

Use of premium rating as a disincentive to sub-standard shipping

12. The Clubs can influence one side of this equation through a combination of responsible underwriting, and the constraints of the International Group Agreement. In an ideal world, this role of the Clubs could be used to address the issue of substandard tonnage by discriminating financially against the substandard ship for the extra risk it is assumed to bring, ensuring that this is reflected in higher premiums paid by its

operators. Conversely, insurance costs might be eased for those who could demonstrate that their methods of operation were less risky.

13. Describing the idea of financial discrimination against the substandard ship is straightforward. However, the idea makes use of two assumptions that are controversial. First, it is assumed that there is a clearly understood meaning for “sub-standard”, such that ships of this kind can be identified. Second, it is assumed that that ships of this kind cause more damage.

14. In their report of January 2001 for the OECD Maritime Transport Committee, entitled “The Cost to Users of Substandard Shipping”, SSY Consultancy & Research Ltd defined a substandard ship as: *“A vessel that, through its physical condition, its operation or the activities of its crew fails to meet basic standards of seaworthiness and thereby poses a threat to life and/or the environment”*.

In the 2000 edition of ‘Procedures for Port State Control’, IMO defines a substandard ship as: *“A ship whose hull, machinery, equipment, or operational safety is substantially below the standards required by the relevant convention or whose crew is not in conformance with the safe manning document”*.

15. There is no evidence that it is true, as a statistical statement, that ships of this kind cause more damage, albeit it is obvious that in particular cases serious casualties have been attributable to the substandard condition of a ship.

16. A ship can therefore be in a condition that falls within these definitions, in possession of ‘valid’ flag state and classification certificates, and yet have no P&I claims record to speak of, perhaps because it sails predominantly in local trades, calmer waters, carrying cheaper commodities, etc. And it may have no adverse port state control record, if it trades at ports where PSC enforcement is not vigorous.

17. Insofar as such a ship is so identified as a source of additional risk, this will indeed have a bearing in the Club system on whether the ship can be accepted and if so at what premium rating.

18. A pre-condition to the existence of financial differentials for substandard tonnage is that there should be underwriting discipline. Such discipline exists to a reasonable degree within Clubs and also applies (through the IGA) when the Clubs in the International Group compete for each other's business. But it is harder to find in the market generally, for reasons previously indicated. This means that although the Clubs can make life uncomfortable for the substandard operator, he will probably find other insurance somewhere outside the Club system. That is not so much a criticism of the commercial market as a plain truth about different aspects of the profit and not-for-profit systems.

19. By the term 'discipline in underwriting', I mean that the insurer must have a concept of a fair and reasonable rate for a risk, and a policy of not accepting business for which he cannot get agreement to a proper rate. The Clubs do generally have such policies,

because they have a duty to deal equitably as between Members. The risks that each individual Member brings to the Club therefore cannot be considered on a purely commercial basis, but must be underwritten by applying the same principles as are applied to each other Member. Not only does this mean that a Club will try to arrive at a reasonable rate for a risk, but also that it may deem there to be no reasonable rate at all for some owners, whose standards are considered to be incompatible with those of other Members. It is therefore not at all unusual for a Club underwriter to reject more than he accepts of the tonnage shown to him over the policy year.

Effect of International Group Agreement on shipping standards

20. Discipline in underwriting also extends to transfers from one Club to another in the Group. As noted elsewhere, IGA does not allow the relationship between an owner's claims record and the rating of his insurance premium (or calls) to be ignored purely for reasons of competition between insurers. This therefore strengthens the ability of each individual Club to maintain discipline in underwriting, knowing that the shipowner cannot avoid the consequences of a bad claims record merely by hopping from one Club to another. That is not a restraint which applies when a ship moves from a Club to a commercial, profit underwriter.

21. The premium rate will reflect the Club underwriter's judgement of the future risk, which in turn will be strongly influenced by the past insurance claims record. If the increased risk accompanying a badly maintained or operated ship has been crystallised in the form of a claim, then this will affect the premium rating. However, to the extent that a substandard ship trades without claims, without PSC detentions, there will be nothing to raise suspicions about the risk it presents. Conversely, a poor claims record may sometimes reflect not a substandard ship, but simply a run of bad luck for a first class operator.

The Clubs therefore need a number of other methods to aid identification of potentially substandard ships, and to help the underwriter in judging whether, and if so at what rate, to underwrite the risk.

Identification of substandard ships

22. The right to enter a Club and the right to coverage has always been conditional on ships being properly classed. However, additional Club surveys were introduced, from about 1990, partly because of concerns about the reliability of class surveys, and partly because the quality of operation of insured ships, although central to the interests of P&I underwriters, was not of direct interest to class societies and was not assessed by them.

23. All the International Group Clubs commission condition surveys on some ships prior to acceptance, normally on ships over a certain age. They may also do the same for ships already within the Club where:

- (a) a ship changes classification societies, usually from an IACS to a non-IACS society;
- (b) information from PSC indicates that the ship is below the acceptable standards of the Club;
- (c) the ship has a deteriorating claims record or a if a claim demonstrates a lapse in shipboard maintenance, or
- (d) a ship inspection visit indicates that the ship is not maintaining the standards acceptable to the Club.

24. In addition some Clubs also undertake an annual programme of ship visits and inspections, with the aim of raising awareness to practices onboard that could lead to claims or affect safety. Although they have some elements in common, these are not identical to class surveys or port state control inspections but they will involve the assessment of safety standards, service and maintenance, cargo-worthiness, operational performance, manning, pollution control and management systems.

Practical improvements in standards enforced by Clubs

25. A ship with serious problems may be refused entry, while in less serious cases cover may be suspended until whatever repairs are required have been made. Some Clubs will decline to renew the entry of a ship if it is in breach of repair requirements when the new policy year begins. In serious cases, persistent survey problems may result in an entire fleet being declined renewal.

26. The fact that substandard ships are still around does not mean that existing measures to get rid of them are ineffective. An analysis of major liabilities caused by failures in the structure or equipment of ships over the period 1987 to 2002, from the largest of the Clubs, showed a clear and consistent year-on-year decline in numbers (although not values) of such incidents.

Club Surveys – scope.

27. While all Clubs make use of condition surveys to assess the quality of certain ships entered or to be entered, there has been no uniform practice in relation to the scope of such surveys, or their triggers.

28. A minimum scope of information to be included in any condition survey undertaken by an International Group Club was accordingly drawn up with input from all Clubs. A 'sample' condition survey report form was also drawn up, to illustrate the requirements of the scope. These documents have been agreed by the Clubs and will ensure for the first time that the scope of their condition surveys is at least as extensive as that in the scope document.

29. A further recent change agreed by the Clubs is that the survey department of each Club should report any vessel which causes concern not merely to the underwriting department but also to the central management of that Club. It is necessary to

introduce this measure generally because there is no precise correlation between claims and condition. The issue of vessel quality should therefore be given its own focus of attention, independently of any consequences manifested in claims, by being reported as a matter of routine to the Club's central management.

Club Surveys – Triggers.

30. Although Clubs have long undertaken condition surveys on a systematic basis, differing standards have been employed; for instance, some Clubs would survey 10 year old ships on entry, whereas others might only survey 15 year old ships, or only tankers. Clubs have now implemented a new (minimum) requirement that condition surveys be undertaken upon the application for entry of any sea-going ship aged 12 years or more.

31. With regard to ships already entered, Clubs have agreed as minimum requirements that their condition survey programs will include any vessel that appears on the EC blacklist and will include any sea going tanker, ten years old or more, which has carried heavy fuel oil as cargo during the preceding year. In order to implement the latter proposal, owners are being required by their Clubs, at the beginning of the policy year, to declare the names of ships of more that have carried Heavy Fuel Oil as cargo during the previous year. That vessel will then be subject to survey.

Condition Surveys – Exchange of Information.

32. The OECD report notes that a great deal of information is collected about the condition of ships but surmises that the main barriers to transparency are legal. The report suggested that it would be a significant step if the Clubs were to set up a database where each Club would be obliged to lodge survey and inspection reports.

33. Legal opinions were obtained on whether Clubs are entitled, or obliged, to pass on information about action taken by Clubs on the basis of condition surveys or inspections to other members of the Pool. The opinions vary under different legal systems, but it is considered possible without legal obstacle merely to record on a central database the identities of ships on which a condition survey has been carried out, so that underwriters will be aware if a prospective entry has been surveyed by another Club.

34. The Group has established a central database as described, and is requiring that underwriters should consult the database before quoting and should obtain from the prospective member and Club concerned a copy of any relevant report. On the basis of advice currently available, this is unobjectionable from a legal point of view, but from a commercial point of view Clubs will continue to seek consent from their members to the sharing of such information.

Penalties if Sub-Standard Vessels knowingly underwritten.

35. At present a Club may decline or withdraw cover on the basis of an adverse survey report only to find that the vessel has been accepted by another Club and furthermore face the possibility of having to share in a claim brought to the Pool from that vessel.

36. New provisions are being drafted that would allow a Club in extreme circumstances, where it feels that a ship is so unfit that the risk it presents should not be shared by the Pool in the normal way, to nominate the ship for designation by a panel of experts as a vessel to which a double Pool retention should apply i.e. a Club in which the vessel was entered would be responsible for the first \$12 million instead of the first \$6 million of every claim.

37. The implementation of this proposal is subject to the Group receiving satisfactory legal advice that the procedures could not be regarded as an 'abuse of dominant position' within the meaning of the competition law provisions of the Treaty of Rome. For this purpose, a scoring system has been developed with a view to permitting an objective judgment to be reached on the basis of the factors outlined in the survey report.

Loss prevention programmes

38. The Clubs also contribute to improving standards in shipping by extensive loss prevention and education programmes.

39. Addressing the human factor in claims, many new loss prevention initiatives were developed by the Clubs through the 1990s. All Clubs now produce loss prevention materials, in the form of circulars, newsletters, posters, books, videos, seminars, conferences, and even distance learning. Not all of it is instructional material - one Club has sponsored a service to provide electronic delivery of local news based on crew nationality - improvements in the quality of life on board might just translate into improvements in their performance.

40. Some Clubs have joint-ventured with other institutions with maritime expertise, to allow more ambitious projects, and this has improved the links between them and bodies such as the International Chamber of Shipping, BIMCO, Intertanko, and the Nautical Institute. The range of subjects addressed is wide, and a growing number of Clubs now distribute information via internet websites. In some cases this allows advice on best practice relating to safety issues not only to be seen by an intended audience of Members, but also to be developed by contributions from others with relevant expertise or experience.

41. There is increased transparency and an increasing ability to provide information which is, for want of a better word, very 'fresh'. Some of this activity will be used by shipowners to enhance already first rate services, but some of it will help the less well resourced owner to improve, to move a notch or two further towards the quality end of the spectrum and away from the substandard.

Club Rules and shipping standards

42. Although the Clubs compete with each other for business, as noted above they share their larger risks under the terms of the Pooling Agreement. Therefore all Clubs in the International Group have a strong self-interest in ensuring that ships in other Clubs in the Group are of an acceptable standard, and have adopted common measures as part of their rules to achieve this aim. These include the following.

43. All Group Clubs' Rules deny rights of recovery for claims arising from failure of vessels to comply with statutory requirements of Flag States, or for claims arising on vessels that are not classed by an approved Classification Society.

44. All Group Clubs' Rules make it a condition of insurance that the insured must:

- (a) promptly report to Class any matters in respect of which Class might make recommendations;
- (b) comply in timely fashion with Class rules and requirements
- (c) authorize Class to disclose information about the ship requested by the Club, and
- (d) advise the Club if the Class Society is changed, identifying any recommendations or requirements that are outstanding at the date of the change.

45. IG Clubs also have an agreed policy not to insure, either newly or by way of renewal, any ship that does not hold a valid Safety Management Certificate required under the ISM Code, or the certificates required by the International Ship and Port Facility Security (ISPS) Code.

International Group Clubs are able to apply these common standards by virtue of the homogeneity that the Pooling Agreement provides.

Conclusion

46. Despite the stringent measures that form part of each Club's policy conditions, accidents continue to occur.

47. Statistics demonstrate that human error is the principal cause of claims and that such errors cause expensive losses in well-managed fleets as well as in fleets of a lesser quality. While the substandard physical condition of ships has declined as a source of P&I claims, some such ships still remain.

Clubs cannot and should not duplicate the work of classification societies, Flag States, or Port State control authorities. However, the IG Clubs contribute to the raising of shipping standards by risk assessment measures (including surveys) that allow them to

vet the physical and operational qualities of tonnage newly applying for entry, and to monitor entered tonnage identified as being at particular risk; they address human error by loss prevention and education programmes; and by assistance given to members to identify and manage their risks.

Clubs are motivated to do this not only for marketing reasons, but by the desire to reduce their claims bills, to improve their underwriting results, and to thereby provide a more attractive product. Insofar as there remains some substandard tonnage within the IG system its risks are spread in the same way as are the risks of good quality tonnage. However, there is no statistical evidence to suggest that the 'substandard' ships can be identified as a class of vessels whose risks are subsidized by premiums of better quality ships.