International Group reinsurance cost allocation - explanation of objectives and guiding principles

1. Background

Through the unique International Group claims pooling arrangements, the member clubs of the International Group have the ability to mutually retain more risk, and to reduce their individual and collective dependence on the commercial reinsurance markets. That being said, the very high limits, and broad range of cover, offered by the Group clubs, necessitate the annual placement of what is one of the largest global marine reinsurance contracts.

Through the Group's collective reinsurance purchasing arrangements, shipowners controlling some 90% of the world's commercial fleet benefit from the presentation of a uniquely homogeneous block of business, on standard terms, to the global reinsurance markets. This results in optimal reinsurance pricing and a significant reduction in frictional costs, including administration and brokerage, compared to any less collective or individual club reinsurance purchasing arrangements. Currently, the IG purchases USD 2 billion of reinsurance capacity for non-pollution P&I risks and USD 1 billion for pollution risks on behalf of its 13 member Clubs, and a further USD 1 billion to protect Club members against an overspill claim.

The IG has been an uninterrupted buyer of reinsurance capacity since 1951, and the mutually beneficial partnering between the IG and the reinsurance market allows a long-term view in rectifying claims and premium imbalances, which is of benefit to all parties.

2. Reinsurance cost allocation - key factors and considerations

It is recognized that it is important that the Group ensures fairness in reinsurance cost allocation between different risks covered under the reinsurance programme.

Due to the low frequency, high severity nature of claims against the reinsurance programme, the loss record for different vessel categories is volatile. In order to achieve a smoothing of reinsurance costs, loss record discrepancies between categories are accommodated in the short term, with the objective of moving towards balance in the long term.

The principal factor in reinsurance cost allocation is the historical loss versus premium record, applied to a limited number of vessel categories. Perceived changes in exposure for specific vessel categories is also taken into account over time to ensure that the cost allocation remains equitable in response to a changing risk environment. Inevitably, the incidence of claims within any particular category or categories will skew the claims versus premium record, and the adjustment over time approach, with imbalances being

tolerated in the short term, helps to dampen volatility. The vessel category records are however continually monitored, and if a category or categories do not self-correct over the medium to longer term, the reinsurance subcommittee can take the necessary corrective measures to bring the category or categories back towards equilibrium.

Several alternative methods for allocating reinsurance costs have been considered by the IG in the past, including more exposure based measures, and more detailed vessel categories.

Rating by exposure may be necessary where there is no adequate historical claims record, but to the extent that record information is available, this is a more accurate and less speculative basis for rating risk and, as such, it is the preferred approach. That being said, given the very small number of claims each year which engage the Group reinsurance programme, the available historical dataset is necessarily limited and can be very significantly impacted by a single claim event, as most recently demonstrated by the Costa Concordia.

The possibility of increasing the number of vessel type categories is kept under continuing, but intentionally cautious, review. The greater the number of vessel type categories, the greater the potential volatility for each type category. Using a limited number of vessel type categories helps in maintaining low volatility, as compared with a more granular approach which would apply the loss record to a wider range of vessel types, with the consequent risk of significantly increased volatility following an incident involving a more specific vessel type. It also compounds the impact of generic, as opposed to intrinsic, vessel type risks. Oil pollution or wreck removal liabilities for example are generic to all vessel types rather than intrinsic to the specific vessel type, but by increasing the number of vessel type categories (and thereby decreasing the numbers of vessels within each category), the impact of such generic liabilities will be increased with a consequent increase in volatility for the affected category.

Creating historical records for more detailed allocation mechanisms would be challenging, inasmuch as vessel categories have changed over time, and the necessary data relating to individual ships and their premium payments have not been captured.

Going forward, a significant increase in allocation granularity would also introduce challenges in the form of declarations and their verification, and other administrative procedures. It is also likely that reinsurance cost per category would be significantly more volatile, as diversification benefits within broad allocation categories would be lost, leading to more extreme post incident adjustments than currently is required.