Resilience in uncertain times

2011 will be remembered for a number of issues that are political, economic or related to natural events. Among the most significant are the Arab spring, uncertainty regarding the solvency of some EMU member countries, uncertainty regarding budgets in the US and a number of natural catastrophes such as earthquakes in Japan and New Zealand and flooding in Australia and Thailand.

Norwegian Hull Club has fared well in this year of uncertainty and volatility. The results from insurance activities have remained strong, reflecting a diverse portfolio and a conscious underwriting discipline. The claims picture is somewhat more mixed than in 2010, but underwriting results remain above long term expectations.

Investment markets were challenging in 2011. In general, there was a flight to safety, but what was considered safe changed during the year. It became evident that government bonds are not safe investments irrespective of issuer, and following this the safety of a number of banks were questioned. The return on the investment portfolio was slightly negative.

Norwegian Hull Club was not severely affected by the major natural catastrophes in 2011. With one noticeable exemption, the accounts are not affected by single, large claims either.

While claims figures are satisfactory in 2011, there is still inherent risk and volatility in the marine insurance business and the Club is therefore focusing on maintaining adequate financial strength and flexibility.

The result before change in equalisation provisions and tax was USD 25,0 million. At the end of 2011, the Club’s free reserves were USD 214.2 million. Norwegian Hull Club has a strong capitalization based on generally applied risk measures.

PRODUCTS AND STRATEGY

Norwegian Hull Club is a marine insurer, with Hull & Machinery related insurances as its main products. The majority of the Club’s premium income comes from international clients. The registered office is in Bergen.

Norwegian Hull Club’s business strategy is to provide integrated claims leader services and offer a diversified product mix stemming from its historical Hull & Machinery base. In the chosen market segments, the Club seeks to be a significant provider of insurance capacity and expertise, and to have a sustainable business model. Additionally, the Club emphasizes the provision of supplementary services, mainly related to loss prevention activities. This combination of products and services is a complex business model compared to many competitors, and also costly relative to providing simply a transfer of insurance risk. The Board believes, however, that the product and service mix offers attractive value to clients.

It is a part of the Club’s strategy to maintain a strong capital position.

MARKET ENVIRONMENT

As a marine insurer, Norwegian Hull Club is ultimately dependent on the development on shipping and offshore energy markets. While freight volumes in most segments of traditional shipping increased in 2011, fleet increases from delivery of newbuildings put downward pressure on freight rates. Freight markets were, therefore, in general not satisfactory.

In the offshore energy sector, the activity level is high and market sentiment clearly positive. High energy prices and shortage of new oil discoveries has lead to high exploration and field development activity. In turn, charter rates and market values remain at high levels.

The effect on business volume, measured as insured values, of lower ship values and freight rates in segments of traditional shipping such as tankers and bulk carriers have been counteracted by an increase in the number of vessels and increased values for units in certain segments such as offshore energy and large gas carriers. Total business volume has therefore increased in 2011.

As regards macroeconomic issues, 2011 was a year of many events and much turmoil. Of particular importance to the marine insurance market environment was the recognition that government bonds issued by many countries, in particular in southern Europe, are not risk
free. Besides the implications for borrowing cost and funding possibilities for the countries in question, many banks and insurance companies have had to revalue their holdings of government bonds or sell their holdings at a loss, in either case with a weaker capital position as a result. A number of insurance companies have been downgraded by the ratings agencies, and their clients are focusing more on the creditworthiness of insurers. This is likely to provide opportunities to those insurers that are not affected by financial distress. Some clients are already clearly looking at the composition of their panel of underwriters.

Besides the impact from financial markets, the insurance industry has been affected by a number of natural catastrophes. Earthquakes and flooding have hit the industry hard, with insured claims reaching an all-time high. This has an impact on insurance companies’ allocation of capital, and could have consequences for underwriting capacity in marine insurance going forward. Additionally, these large claims serve to keep the cost of reinsurance up, as reinsurance companies seek to preserve their capital and recoup some of what has been lost.

Financial markets have once again been challenging. While focus at the start of the year was on the risk for an increase in government rates, these rates have actually fallen considerably for countries that are not in the group of southern European countries facing severe budget issues. The price of risk, credit spreads, have increased, partly offsetting the effect of lower government rates and making corporate bonds more attractive relative to government bonds. As regards equities, most markets had negative returns in 2011 with the noticeable exception of USA, which was marginally positive. In light of the difficult market conditions, the Board of Directors is satisfied with investment results in 2011.

So far in 2012, sentiment in financial markets has changed to the positive and the development has generally been a reversal of major trends in 2011, with reduced credit spreads on bonds and equity markets moving higher.

OPERATIONS

While marine insurance has not been significantly affected directly by the natural catastrophes, a lot of attention has been on the risk of piracy, in particular in the waters off the coast of Somalia. Providing information on issues related to piracy is an integral part of the Club’s service concept, and there has been a lot of activity in this area in 2011.

REINSURANCE

A number of reinsurers have been downgraded in 2011. Norwegian Hull Club maintains a reinsurance programme with a panel of reinsurers, including the financially strongest globally. There was no significant change to the quality of the Club’s panel of reinsurers.

CLAIMS

The low claims cost experienced in 2010 continued in 2011, although loss ratios are somewhat higher both before and after reinsurance. Claims frequency on the Hull & Machinery portfolio has been very stable over the last three years, at a level significantly below the preceding three years. The loss ratio was still satisfactory and below long term expectations. On the Loss of hire portfolio, both claims frequency and claims ratio are up compared to the previous year but in line with the average over the last eight years.

A noticeable development is that clients are more frequently asking for part payments of claims and clients are in general more active in settling claims quickly. This is probably a reflection of reduced liquidity due to difficult shipping markets. When prudent and within guidelines adopted internally, the Club endeavours to meet clients’ request for early settlement of claims. This has caused that the actual settlements and payments of claims are at all-time high in 2011.

A part of the good claims results in 2011 stems from reductions in claims provisions made on known claims in previous years. While such reductions have been significant in the last two years, it is too early to tell whether this is just a random variation or whether the statistical models used calculate claims provisions that are above actual claims cost.

While aggregate claims figures are satisfactory, the Club was still involved in a major claim in 2011. This relates to an accommodation platform that had water ingress, capsized and sank in the Gulf of Mexico. The Club’s share of the gross claim is one of the largest in the history of Norwegian Hull Club, and the settlement was the largest single claims payment ever made.
INVESTMENTS
Investment markets were strongly influenced by macroeconomic events. Economic data and market sentiment was positive during the first two quarters, but turned negative in the third quarter as markets focused on distressed economies in southern Europe and political wrangling over the federal budget in Washington. Throughout the year, there was a risk on - risk off mode, with strong correlation between all securities in an asset class and little discrimination between individual issuers. For equities, correlation was at a 20 year high.

Norwegian Hull Club pursues a value based investment philosophy. This philosophy will in general not do particularly well in times of high market correlation. Over time, however, such a philosophy offers good risk – reward.

Norwegian Hull Club’s investment portfolio was positioned with little exposure to government bonds and interest rates, and more risk being taken on credit spreads on corporate bonds, as corporations in general are financially sound. In aggregate, this positioning was a drag on returns in 2011. Portfolio return was minus 0.4 % in local currency and minus 1.5 % in USD.

SOLVENCY II
Implementation of the Solvency II directive for insurance companies in Europe is in the process of being postponed. It is expected that the directive will take effect from 1 January 2013, but that capital requirements and possibly some other requirements will only take effect later.

Norwegian Hull Club is well capitalized compared to expected capital requirements under Solvency II, including the stress test adopted by the Financial Supervisory Authority of Norway as a forerunner to Solvency II. The Club is in the process of adopting internal processes, systems, organisation and transparency to the Solvency II requirements.

OTHER ACTIVITIES
A core part of Norwegian Hull Club’s strategy is to offer a service in addition to the mere transfer of an insurable risk. The Club has a range of such services, drawing on the extensive internal experience gained from handling actual emergencies and claims. By transferring such experience to clients, the objective is to reduce the likelihood that new accidents happen and reduce the consequences of those accidents that still happen.

MARINE BENEFITS AS
Marine Benefits AS provides health insurance for seafaring personnel.

MARINE INSURANCE PRODUCTION/IT SYSTEM
Insurance Technology Solutions AS develops and operates software systems for the marine insurance industry. At the end of 2011, the company had fifteen marine insurers, brokers and a shipping company as clients.

ENTERPRISE RISK MANAGEMENT
Risk management has become an integral part of financial institutions’ organisational structure and operations. Solvency II will provide a common public framework for insurance operations also in this respect. In addition, owners, policy holders and other stakeholders have an interest in risk being managed in the best possible way.

Maintaining and updating risk management structures, processes and systems is a continuous process. At Norwegian Hull Club, use of statistical data and actuarial tools is combined with sound judgement in the management of risks. Events over the last few years show that there will always be events that are not fully or properly captioned in models. Therefore, adequate capital must be maintained to allow for unforeseen events and developments.

The Board of Directors has established maximum risk levels and capital targets for Norwegian Hull Club. On the operational level, an Enterprise Risk Management Committee is established to monitor risk and propose changes to management and the Board of Directors.

The Club is exposed to the following main risks:

STRATEGIC RISK
Strategic risk relates to external and internal factors such as developments in the market and in the area of products, required personnel skills and reputation risk.

INSURANCE RISK
Insurance risks are the risks that the premium charged is not sufficient to cover claims being incurred and that provisions for claims already incurred are not sufficient to cover the ultimate cost.

FINANCIAL RISK
Financial risks refer to investment, credit and liquidity risks.

OPERATIONAL RISK
Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events.

INTERNAL CONTROL
There is an established internal control structure, tasked with doing periodic reviews of internal procedures and
operations. A system for reporting deviations from established procedures is a part of this structure.

The internal control function is also handling assignment of the internal audit function to an independent auditor. The internal auditor reports to the Board of Directors.

CORPORATE GOVERNANCE

Norwegian Hull Club is subject to supervision by the Financial Supervisory Authority of Norway. In addition, the Club’s governing bodies have adopted separate internal regulations regarding corporate governance issues. Composition and main tasks of the governing bodies are:

GENERAL MEETING

Members of the Club, clients that write Hull & Machinery business on a mutual basis, vote at the general meeting.

COMMITTEE

The Committee elects the Board of Directors, recommends annual accounts to the General Meeting and supervises the Board of Directors and management. The members of the Committee are elected from the members, i.e. the owners, of the Club.

SUPERVISORY COMMITTEE

The Supervisory Committee is tasked with more detailed supervision of the Board of Directors and management, and reports to the Committee. The Chairman of the Supervisory Committee shall be independent of the Club.

BOARD OF DIRECTORS

The Board of Directors is responsible for setting out the strategy, including risk tolerance, and generally overseeing the daily management of the Club. Up to two members of the Board of Directors can be independent; the others are elected from members of the Club. The Board of Directors has audit and compensations sub-committees. The Chairman of the Audit Committee is independent of the Club.

ELECTION COMMITTEE

The Election Committee makes recommendations on candidates for the various governing bodies. The Election Committee consists of the Chairman of the Committee, the last retired Chairman of the Board of Directors and three members elected by the General Meeting.

According to the instructions for the Election Committee, the Chairman of the Committee, members of the Supervisory Committee and members of the Board of Directors shall in general not be re-elected after ten years of service.

ACCOUNTS

In accordance with section 3-3 of the Norwegian Accounting Act, the annual accounts are prepared under the assumption that the enterprise is a viable going concern.

The Board of Directors and management focus on the operating result, defined as the result generated before provisions for equalization reserves and taxation but after financial items. The operating result will normally be equal to the change in free capital (equity plus equalization reserves).

RESULTS (figures for 2010 in brackets)

The operating result for Norwegian Hull Club was USD 25.0 million (USD 49.8 million). The reduction in result is due to lower results from both underwriting operations and financial items.

Gross loss ratio was 67% (56%), corresponding to a gross insurance result of USD 63.4 million. The loss ratio for own account was 72% (65%). This corresponds to an insurance result for own account of USD 43.7 million. The technical result from insurance, after operating expenses but before financial items and provision for equalisation reserves, was USD 28.8 million (USD 36.3 million).

The profit before income tax was 0 (USD 11.4 million).

PREMIUM INCOME AND Claims

Gross premium written was USD 197.1 million (USD 189.6 million). Premium earned for own account was USD 156.7 million (USD 126.3 million). The increase in premium income is due to a general increase in business volume.

Gross claims incurred were USD 129.5 millions (USD 97.4 million), and claims for own account amounted to USD 113.0 million (USD 81.8 million).

FINANCIAL ITEMS

Financial income were negative by USD 2.3 million (plus USD 14.6 million), which includes USD 6.0 million in unrealised losses on securities, and USD 2.6 million in foreign exchange losses. Administration expenses related to financial assets were USD 1.6 million (USD 1.0 million).

The main reason for the increase in administration expenses is increase in discretionary asset management fees and increase in allocated personnel expenses.

OPERATING EXPENSES

Personnel, marketing and other operating expenses amounted to USD 24.3 million (USD 18.7 million). The main reasons for the increase are increase in number of employees, generally higher operating activity including marketing, and a one-off charge relating to pension expenses.
APPROPRIATION OF RESULT
Profit before income tax was 0. After tax, the total comprehensive income for the year was minus USD 0.6 million, which the Board of Directors proposes be covered from Other equity.

BALANCE SHEET
As per 31 December 2011, equity was USD 27.5 million (USD 28.0 million). In addition to equity, the USD 186.8 million provision for risk equalisation is a general reserve that supports the various business risks.

CASH FLOW
The cash flow generated by operating activities was minus USD 7.2 million, while cash flow generated by investment activities in fixed assets was negative by USD 3.5 million. The change in cash balance during the year was negative by USD 10.6 million.

FINANCIAL ISSUES
CURRENCY
Norwegian Hull Club’s insurance operations are transacted predominantly in USD. The accounts are therefore booked in USD to minimise the effect of currency exchange fluctuations. The currency split of assets is managed with due consideration taken to the currency split of the Club’s liabilities.

RATING
On 27 May 2011, Standard & Poor’s confirmed its long-term counterparty credit and insurer financial strength rating for Norwegian Hull Club at “A minus”. The outlook was rated as “stable”.

ORGANISATION AND ENVIRONMENT
At the end of 2011, Norwegian Hull Club had 104 employees. Sick leave including long-term absence equalled 2.7% of total working hours. Unplanned personnel turnover was 1% (1 employee).

The gender ratio between employees at the end of 2011 was 38% female to 62% male. Over time, it is an objective to achieve a higher degree of gender diversity at all levels.

The Club aims to be a workplace where no discrimination occurs, in compliance with the Discrimination and Accessibility Act.

There were no accidents involving either the Club’s employees or property during the year. The working environment is considered to be good.

Day-to-day operations do not contaminate the external environment. However, the Club does insure vessels that may contribute to environmental pollution.

MEMBERS
No member represents more than 7% of the votes at the General Meeting. The ten largest members represent 32.7% of the votes.

FUTURE PROSPECTS
In the 2010 report, the Board of Directors stated that the most extraordinary feature of 2010 was the low claims cost. Claims costs were again below long term expectations in 2011. It is too early to tell whether this is just an arbitrary variation or a sign of a more permanent reduction in claims costs.

Many segments within the shipping industry are faced with weak earnings and falling ship values. While this by itself will have a negative effect on the prospective business volume for Norwegian Hull Club, this is expected to be outweighed by fleet growth through delivery of newbuildings.

Besides weak shipping markets, uncertainty in financial markets with banks focusing on shrinking their balance sheets and requiring stricter conditions on loans means financing is less available for the shipping industry. This could also have an effect on the prospects for Norwegian Hull Club’s products and services, as clients must focus more on the operational risks. Management of operational risks is a focus area for Norwegian Hull Club’s added services, and this development may therefore provide opportunities for obtaining new business.

Marine insurance is sometimes referred to as a conservative industry with little change in products and operations. While recognizing that changing products and processes in this market is a cumbersome and long-lasting exercise, Norwegian Hull Club has deliberately focused on innovation regarding services provided in addition to mere risk transfer. These services have been extensively broadened. In parallel, and in order to build a sustainable and forward-looking organisation and operations, the Club has invested considerably in human resources. Combined with a strong financial position in times of uncertainty regarding counterparties, the Board of Directors believes that this provides a solid platform for future development of the Club.