

DIRECTORATE FOR SCIENCE, TECHNOLOGY AND INDUSTRY

**MARITIME TRANSPORT COMMITTEE**

**REPORT ON**

**THE REMOVAL OF INSURANCE FROM SUBSTANDARD SHIPPING**

**June 2004**

## **Summary**

This study principally addresses the issue, originally identified in the MTC Policy Statement on Substandard Shipping., of whether the marine insurance industry could make a useful impact on efforts to reduce the incidence of substandard shipping.

The report was considered by the OECD's Maritime Transport Committee at its meeting of 24/25 May 2004. The Committee will draw on the findings and conclusions of the report as appropriate in considering its future activities on substandard shipping.

The Committee noted the report and agreed to declassify it so that it can be made available to all interested parties.

This report was prepared by Mr Terence Coghlin, acting as a consultant to the Maritime Transport Committee. Mr Coghlin was a former Chairman of the International Group of P&I Clubs.

## **THE REMOVAL OF INSURANCE FROM SUBSTANDARD SHIPPING**

### **A Report to the Maritime Transport Committee of the OECD**

#### **THE ORIGINS OF THIS REPORT**

The Maritime Transport Committee of the Organisation for Economic Co-operation and Development has for some years been concerned about the impact of substandard shipping on safety, on the loss of lives at sea and on the marine environment. It has therefore given political support to the International Maritime Organization in its efforts to obtain full compliance with international rules and standards. The MTC works towards the elimination of substandard shipping and promotes quality shipping, which it sees as a collective responsibility that requires effort not only from governments and international organisations, but also from all players in the maritime industries.

In early January 2001 the Maritime Transport Committee received from SSY Consultancy & Research Ltd a paper entitled “The Cost to Users of Substandard Shipping”. This paper looked at a number of maritime industries in the context of the campaign against substandard shipping. Marine insurance was one of these. This prompted the MTC to commission this report. The first two paragraphs of its terms of reference, drawing on the paper’s comments, read as follows:

*The marine insurance industry provides a crucial financial safety net for commercial enterprises. However, at the same time it also provides a very effective cover for substandard ships by allowing their risk to be spread over many players in the industry, and ultimately to consumers.*

*The consultant’s task is to establish whether, without prejudice to victims, it would be feasible to remove the cover available to substandard ships, while still maintaining the necessary risk spreading coverage for the rest of the industry. The analysis should cover both P&I Clubs and marine insurers.*

The terms of reference then set out a number of specifics which the MTC wished to have covered in the report. The first was “A description of the operation of the marine insurance market, differentiating as necessary between P&I clubs and marine insurers”. From the context it is clear that the relevant insurers are those who contract with shipowners, primarily the insurers of their ships, their hull and machinery underwriters, as well as their liability underwriters, primarily the mutual P&I clubs.

It is convenient to begin this paper with this description of the marine insurance market. Several pages are dedicated to painting a picture of hull insurance and several to doing the same for the P&I clubs. This is justified by the reason why the MTC put this description at the top of their list of specifics, namely that without some understanding of these insurers and the different way each operates, it is easy to misjudge the contribution that each can be expected to make to the campaign against substandard shipping. The market itself is content to be described in this detail. There was a time when its practitioners preferred to cloak themselves in mystery; but they appreciate that in today’s world the interests of the market are better protected by transparency.

After this description of the market, this report deals, albeit in a different order, with each of the several topics noted by the MTC, along with others that seem relevant to the basic task set by them.

In preparation for this report, the author met and talked with numerous individuals who work in the insurance market as underwriters, club managers or brokers, or who are in some other way directly concerned with hull and P&I insurance. He consulted shipowners and various bodies representing both the shipping and the marine insurance industry. The author acknowledges the generous support and openness that he encountered during this process. But although it was thus compiled, as the MTC wished, in active co-operation with the marine insurance industry, the author takes full and sole responsibility for what is said in this report.

## TABLE OF CONTENTS

|    |  |    |
|----|--|----|
| 1. | OVERVIEW .....   | 9  |
| 2. | RESPONSIBILITY FOR ENFORCING MARITIME SAFETY RULES ..... | 11 |
|    | Flag states.....   | 11 |
|    | Marine insurers.....                                     | 12 |
| 3. | HULL INSURANCE .....                                     | 13 |
|    | Risks covered .....                                      | 13 |
|    | Risks excluded .....                                     | 14 |
|    | Subscription.....  | 14 |
|    | Agreed values.....                                       | 14 |
|    | Brokers .....  | 15 |
|    | The main markets .....                                   | 15 |
|    | Lloyd's .....  | 15 |
|    | The IUA .....  | 15 |
|    | Mutual hull clubs.....                                   | 15 |
|    | Claims .....   | 16 |
|    | The need for profits.....                                | 16 |
| 4. | P&I INSURANCE .....                                      | 17 |
|    | The mutual call system.....                              | 17 |
|    | Structure .....  | 18 |
|    | Risks covered .....                                      | 18 |
|    | Risks excluded .....                                     | 18 |
|    | Full cover .....   | 19 |
|    | Market share.....  | 19 |
|    | Alternative facilities .....                             | 19 |
|    | Size of claims .....                                     | 19 |
|    | Pooling and reinsurance .....                            | 19 |
|    | Types of claim.....                                      | 20 |
|    | Brokers .....  | 21 |
|    | Relationship with assureds.....                          | 21 |
| 5. | SUBSTANDARD SHIPPING .....                               | 22 |
|    | Human error .....  | 22 |
|    | Ships and operators .....                                | 22 |
|    | Attitudes .....  | 23 |
|    | Minimal compliance.....                                  | 23 |
|    | The relevance of age .....                               | 24 |
| 6. | IDENTIFYING THE SUBSTANDARD OPERATOR.....                | 26 |
|    | Indicators of quality .....                              | 26 |
|    | Management audits .....                                  | 26 |
|    | Multiple inspections of ships.....                       | 26 |
|    | Surveys by class .....                                   | 27 |
|    | Port state control inspections.....                      | 27 |

|  |    |
|--|----|
| Inspections by charterers .....                        | 28 |
| Club surveys and inspections .....                     | 28 |
| Potential convergence .....                            | 29 |
| 7. BARRIERS TO THE FLOW OF INFORMATION.....            | 30 |
| Legal barriers .....                                   | 30 |
| Advice on sharing.....                                 | 30 |
| Electronic access .....                                | 31 |
| Personal contacts.....                                 | 31 |
| 8. ENCOURAGING HIGHER STANDARDS WITHIN THE GROUP ..... | 32 |
| Varying standards.....                                 | 32 |
| Substandard members .....                              | 32 |
| Declining to pool.....                                 | 32 |
| Close examination of claims .....                      | 33 |
| Agreed grounds for refusal to contribute .....         | 33 |
| Advance notice of non-contribution.....                | 33 |
| Reduced contribution .....                             | 34 |
| Competition law .....                                  | 34 |
| 9. REMOVING BARRIERS TO GREATER COOPERATION.....       | 35 |
| Choice between state priorities .....                  | 35 |
| New competition law structure .....                    | 35 |
| 10. CLASS .....  | 36 |
| Loss of confidence .....                               | 36 |
| Restoring confidence.....                              | 36 |
| Calling the tune .....                                 | 37 |
| 11. RECOGNITION OF HIGHER STANDARDS .....              | 38 |
| Encouraging quality .....                              | 38 |
| No claims bonus .....                                  | 38 |
| Quality differentials.....                             | 38 |
| Returning to classification.....                       | 39 |
| 12. DECIDING TO COVER .....                            | 40 |
| Reasons for caution .....                              | 40 |
| Indicators of quality .....                            | 41 |
| Condition surveys.....                                 | 41 |
| Systematic evaluation.....                             | 41 |
| Reasons for acceptance .....                           | 42 |
| Information from prior insurers.....                   | 42 |
| Membership quality incentive for managers .....        | 42 |
| 13. THE CORRELATION BETWEEN QUALITY AND CLAIMS .....   | 43 |
| Accidents to good ships.....                           | 43 |
| Strict liability.....                                  | 43 |
| Actors beyond control .....                            | 43 |
| The incidence of claims.....                           | 44 |
| 14. WHETHER GOOD FLEETS SUBSIDISE THE BAD .....        | 45 |

|  |    |
|--|----|
| Searching the claims record .....                    | 45 |
| The importance of the larger claims .....            | 45 |
| Relative cost of clubs .....                         | 45 |
| 15.    SETTING A RATE.....                           | 47 |
| Differing levels of acceptable quality .....         | 47 |
| The starting rate.....                               | 47 |
| The subsequent importance of claims record .....     | 48 |
| The gradualness of change .....                      | 48 |
| The effect of a fall in quality .....                | 49 |
| Rating by other indicators of quality and risk ..... | 49 |
| The effect of increases in rates .....               | 50 |
| 16.    INCREASING EXPOSURE WITHIN THE GROUP .....    | 51 |
| Raising the Group pool retention .....               | 51 |
| Targeting the pool claim .....                       | 51 |
| Possible effects of change .....                     | 52 |
| Higher deductibles for members .....                 | 52 |
| 17.    QUALITY OF OPERATORS ALREADY INSURED .....    | 53 |
| Monitoring existing assureds .....                   | 53 |
| Management audits .....                              | 53 |
| Notice of termination .....                          | 53 |
| The member quality executive .....                   | 54 |
| Restrains on movements between clubs.....            | 54 |
| 18.    LOSS OF COVER .....                           | 55 |
| Deciding not to continue cover .....                 | 55 |
| Automatic loss of cover.....                         | 55 |
| Automatic suspension of cover .....                  | 55 |
| Loss of cover for a claim.....                       | 55 |
| Warranties .....                                     | 56 |
| 19.    INNOCENT VICTIMS OF CASUALTIES .....          | 57 |
| International conventions .....                      | 57 |
| Oil pollution .....                                  | 57 |
| Bunkers .....  | 58 |
| OPA 90.....  | 58 |
| HNS.....   | 59 |
| Cargo .....  | 59 |
| Passengers .....                                     | 59 |
| Seafarers.....                                       | 60 |
| 20.    COMPULSORY INSURANCE .....                    | 61 |
| Direct action .....                                  | 61 |
| Compulsion without direct action .....               | 62 |
| 21.    CERTIFICATION .....                           | 63 |
| IMO Guidelines.....                                  | 63 |
| Certificate on board.....                            | 63 |
| Contents of the certificate .....                    | 63 |

|                                       |    |
|---------------------------------------|----|
| Suitability of insurers .....         | 64 |
| 22. WHAT INSURERS CAN CONTRIBUTE..... | 65 |
| Hull insurers .....                   | 65 |
| Cargo insurers .....                  | 65 |
| P&I insurers .....                    | 66 |

## 1. OVERVIEW

- 1.1 The responsibility for the enforcement of maritime safety rules lies squarely upon the flag states and the classification societies to which they delegate. They must not be allowed to avoid their duty to police the safety of the world's merchant fleet.
- 1.2 But marine insurers are willing to play their part, alongside others, in support of the campaign to eradicate substandard shipping.
- 1.3 Hull insurers must seek to make profits for their capital providers and, although individual underwriters are keen to avoid substandard shipping, the market as a whole is currently too competitive to make a significant contribution to the campaign.
- 1.4 By contrast, the P&I clubs are co-operative creatures of their shipowner assureds and thus responsive to their interest in keeping substandard operators out of their clubs.
- 1.5 The focus of the campaign is as much the substandard operator as his substandard ship.
- 1.6 Today's substandard operator is less likely to be running a flagrant 'rust-bucket' than trying to get away with 'minimal compliance'; having no quality standards of his own, he aims to do only just enough to reach thresholds set by others – with potentially disastrous consequences when inevitably he falls short.
- 1.7 The ageing process in ships is important, but presents different financial consequences for a P&I club and a hull insurer.
- 1.8 Ships are subject to numerous inspections as well as class surveys (some of which could perhaps be consolidated) and more could be done to make the results available to help insurers spot the substandard.
- 1.9 Steps could be taken within the claim pooling arrangements of the International Group to encourage greater discrimination by its participating clubs.
- 1.10 Many insurers have in recent years become more diligent and discriminating in their selection of assureds. But all insurers would be helped and encouraged in doing so if national and regional laws and regulations were modified as necessary to remove any barriers to the above steps and to a freer flow of information, to and between insurers, about the quality of ships and their operators.
- 1.11 It is important to re-build the confidence of insurers in the classification societies.
- 1.12 Ways should be found to publicly recognise and if possible reward ship operators who uphold high standards; in support of which class might consider reverting to classification to differential standards.
- 1.13 The substandard operator who is not recognised as such and thus obtains and maintains hull and liability insurance for his ship or ships, generally receives the benefit of effective cover at affordable cost.
- 1.14 Upon first being insured he tends to be given an 'average' rate, which varies thereafter very largely in response to his individual claim record rather than in response to other indicators of quality and risk. So for as long as his record remains unexceptionable, his rate may not be significantly higher

than that of a good shipowner in a similar trade; it will also tend to respond less sharply to an onset of claims than might be expected.

- 1.15 One reason for a club underwriter's reluctance to move rates in accordance with quality and risk indicators other than individual claim record, is the generally weak correlation between the quality of ship operation and the incidence of maritime liability claims – especially the larger claims which, taken together, have most impact on the overall cost of liability insurance.
- 1.16 Underwriters may become better equipped in future to move rates in accordance with a combination of quality and risk indicators, of which the individual claim record would be only one.
- 1.17 Although it may seem obvious that good shipowners in a club must be paying more because of the claims of the bad, and so 'subsidising' the substandard, it is difficult if not impossible to prove that this is really so.
- 1.18 It is as important for insurers to monitor the on-going quality of current assureds as to check the quality of potential new assureds.
- 1.19 An insurer who becomes concerned about the quality of a current assured is more likely to withdraw his cover than to raise his rate.
- 1.20 In any event, the premiums that a substandard shipowner pays to his hull and P&I insurers are unlikely to form such a large part of his operating costs that any foreseeable increase in those premiums will force him out of business.
- 1.21 If the substandard shipowner causes a serious accident, the insurers may be entitled to refuse his claim for the resulting damage. But by then it is too late. He needs to be identified earlier and either be denied cover or have it withdrawn before a serious accident occurs.
- 1.22 There is a variety of ways in which P&I clubs could be encouraged to do more to avoid substandard operators. The only consequent dangers to the innocent victims of maritime casualties would be if either (a) the substandard operators who were no longer accepted by the clubs were able to trade without liability insurance or (b) weaker or less discriminating insurers were to be allowed to insure them.
- 1.23 These dangers could be removed – and a serious blow struck against substandard shipowners – if IMO were to require every ship to carry a certificate showing liability insurance from an approved insurer, as outlined by the IMO Guidelines, and if there were effective machinery to ensure that approval would be given only to insurers who were strong and discriminating.

## 2. RESPONSIBILITY FOR ENFORCING MARITIME SAFETY RULES

- 2.1 It should be said at the outset of this report that the marine insurers are not and cannot become the policemen of the international maritime community, enforcing the rules on safety that have been laid down by the international conventions developed through the International Maritime Organization.

### Flag states

- 2.2 That role belongs to flag states and it will continue to be their responsibility.
- 2.3 Unfortunately, many flag states have to a greater or lesser extent failed so far to discharge the responsibilities of this role. Moreover, where parts of the role have been sub-contracted by them to certain classification societies, the results have often been equally unsatisfactory.
- 2.4 “In an ideal world Flag States, whose flags are worn by the world’s shipping, would lay down, and enforce upon their own shipowners, standards of design, maintenance and operation which would ensure a very high standard of safety at sea. Coastal States, along whose coasts shipping passes, and Port States, at whose ports or anchorages shipping calls, would have no cause to concern themselves with the maintenance of such standards. The present system of Flag State Control falls well short of this ideal...Regrettably it is beyond argument that not all Flag states live up to their responsibilities”.
- 2.5 These words were written by Lord Donaldson in his Report entitled “Safer Ships, Cleaner Seas”, following the spill of crude oil and bunkers from the grounded tanker “Braer”. He wrote them in 1994. Little has changed in the intervening ten years.
- 2.6 In his Overview to his Report Lord Donaldson said: “Primary responsibility for the safety and operations of ships lies with the States whose flags they fly and with the classification societies which they sometimes employ. If these responsibilities were effectively discharged by all States and classification societies, the problem of maritime pollution would be substantially reduced. Unfortunately they are not..... Ideally Flag States which failed to live up to their internationally agreed obligations would face severe sanctions, including withdrawal of recognition of their authority.”
- 2.7 The Flag State Performance Table recently published by the Round Table of shipping industry organisations illustrates the extent of the on-going scandal – with numerous flag states not even bothering themselves to ratify the fundamental IMO safety conventions.
- 2.8 There can be no satisfactory and enduring solution to the policing of maritime safety standards until all flag states properly discharge their responsibilities. Hence the call in the MTC’s 2002 Policy Statement for the flag states to take effective action to identify and deal with substandard ships.
- 2.9 Efforts now under way to rectify this central problem are to be applauded. They include the IACS initiative to assist flag states to raise their performance. But the key has to be within the IMO. It is to be hoped that its Voluntary Audit Scheme for flag states will gain support and lead eventually to a mandatory scheme of the same sort. Then flag states which still refuse to behave responsibly may finally suffer the overdue sanction of, in Lord Donaldson’s words, “withdrawal of recognition of their authority”.

2.10 But meanwhile other authorities, most notably port states in regional groupings throughout the world, are doing their best to reduce the central void left by the defaulting flag states.

### **Marine insurers**

2.11 Maritime industries, including marine insurers, can be expected to lend a hand.

2.12 Put in its simplest terms, hull insurers do not want to support substandard shipping. Still less do P&I clubs, whose shipowning members are disadvantaged by the activities of substandard operators in their markets as well as in their clubs. Marine insurers cannot take on the role of maritime policemen, which is not theirs and for which they are not designed or equipped, but they are willing to give support to the campaign to squeeze out substandard shipping in ways which are appropriate to their proper roles and abilities.

2.13 The surest way to obtain effective and sustained support for the campaign is to look for and then concentrate on practical steps which are aligned with the interests of those who are to take them. This report seeks to identify some such steps which could be taken by the marine insurance industry.

### 3. HULL INSURANCE

- 3.1 The owners of ocean-going ships usually buy insurance against loss of or damage to their ships from insurance companies worldwide and/or from syndicates at Lloyd's. They then obtain insurance against their liability for damage which their ships may do to others, including third parties, from mutual insurance associations called P&I clubs.

#### **Risks covered**

- 3.2 The basic aim of commercial hull insurers is to make profits by selling to shipowners cover against risks to their property, namely the hulls of their ships and the machinery within them.
- 3.3 Traditionally they did not cover loss or damage to insured ships by whatsoever risk it might be caused, but instead enumerated in their insurance policies certain particular risks against which they did and did not provide cover.
- 3.4 The language in which these risks are still described in most English and American policy wordings reflects the antiquity of this form of insurance and requires some explanation. Thus, of those risks which are covered, "fire" and "explosion" are clear enough, but it may need to be explained that the most important of these, "perils of the seas", embraces heavy weather, stranding, and collisions with other ships or objects at sea, but not "the ordinary action of the winds and waves".
- 3.5 The three risks mentioned above are the most significant of those for which the insurers are 'strictly' liable. There is a second group, added in more recent times, for which by contrast the insurers are not liable where the loss has resulted from want of due diligence by the assured or his manager. This second group of risks was traditionally gathered into the so-called 'Inchmaree', or 'negligence' clause. It included: "bursting of boilers breakage of shafts or any latent defect in the machinery or hull", "negligence of Master Officers Crew or Pilots" and "barratry [deliberate wrongful act to the prejudice of the shipowner] of Master Officers or Crew". The modern wordings make clear that it is only loss of or damage to the property insured that is covered, and thus (unless expressly agreed to the contrary) the insurers do not pay for the replacement or repair of "the boiler which bursts or the shaft which breaks" or of "correcting the latent defect".
- 3.6 Marine insurance markets outside London have developed their own policy wordings. The Norwegian, German and American policy forms are in widespread use, outside as well as within their countries of origin. The former two are "all risks" policies. All risks wordings remove from the shipowner the burden of proving that his particular loss was caused by a specified risk enumerated in the policy. The London market has in recent times brought its traditional wordings up to date. Its International Hull Clauses of 1995 have been further refined, most recently in 2003. But these Clauses still follow the "named risks" approach described above.
- 3.7 There are differences between these various policy wordings that go beyond this difference in the burden of proof between named risks and all risks. Moreover, these wordings may be further amended by individual insurers within the different markets. But these differences are not considered sufficiently substantial to merit examination in this report.
- 3.8 Although the hull policy is primarily intended to cover the shipowner's property risk, namely loss of or damage to his ship, traditionally it may also cover one important liability, namely the shipowner's

liability arising out of a collision involving his ship. The curious exclusion in London wordings of one-fourth of this liability was probably required by hull insurers to encourage the assured shipowner to ensure careful navigation of his ship and thus discourage over-reliance on the existence of insurance cover for this risk. If this was the original intention, it was undermined in the second half of the nineteenth century when an early risk accepted by the then emerging P&I clubs was the uninsured one-fourth.

- 3.9 Today it is possible to retain this traditional three-fourths/one-fourth split, but it is also possible to insure the whole collision risk with a P&I club or the whole risk with a hull insurer. Where the risk is with the hull insurer, in whole or in part, there will be stated in the policy a financial limit on his exposure. The risk in excess of that limit is usually covered by the P&I club – as will be liabilities expressly excluded by the hull policy such as pollution, loss of life and removal of wreck. Some hull policies, especially in Scandinavia and Germany, include liability for damage caused by the insured ship to objects such as docks, which otherwise will be covered by the shipowner's P&I club.
- 3.10 The hull policy also covers the insured ship's proportion of salvage and general average, as well as incidentals such as expenses incurred by the shipowner to avert or minimise losses recoverable under the policy.

### **Risks excluded**

- 3.11 War, strikes, terrorism and similar risks are almost always excluded from the hull policy and insured separately by commercial or mutual war risks insurers. The exclusion is not only of losses caused by war itself, but also of so-called peacetime war risks from derelict mines and weapons. It stretches to "capture, seizure, arrest, restraint or detainment", "strikers" and acts of "any terrorist" or "person acting from a political motive".

### **Subscription**

- 3.12 It is very unusual for a single hull insurer to cover a ship or a fleet for one hundred percent of its risk. Normally a hull policy will be underwritten by a number of different insurers, each bearing only a percentage of the total risk. This principle of subscription is of great antiquity and ensures that any serious casualty is spread across a number of insurers (and often across more than one market). Terms will be agreed with a "leading" underwriter and the other insurers will "follow" them for their agreed percentage. With a policy "led" in London, the leader might typically take a line of up to 15%, with the rest of the risk spread among up to around ten other insurers. In the Norwegian market the leader would usually take a larger line, perhaps 30%. In earlier times, mutual hull clubs would often take a 100% line, and a facility was recently launched in London with the same preference. But that practice has generally declined over time. The problem is that it leads to an over-concentration of risk, which has been thought to outweigh the advantage of more focused selection of risk. It is often the case that the hull insurance of a ship or fleet will be spread among insurers in two or more national markets.

### **Agreed values**

- 3.13 Hull policies usually contain an agreed value for the ship, which pre-sets the amount that the assured will receive should the ship become a total loss under the policy. An additional layer of total loss cover may, however, be purchased by means of an increased value policy. This layer is restricted, in some markets to an additional 25% of the basic insured value, but to an additional 50% in one of them. Insured values are adjusted from time to time as actual values change in response to age and to fluctuations in the freight market. But they may be kept artificially high to meet the requirement of a bank that the insurance should continue to cover the amount of a loan secured on the ship.

Deductibles on potential claim recoveries are usually agreed, which may affect the size of the premium charged.

### **Brokers**

3.14 Almost invariably, hull insurance is arranged through a broker, who represents the shipowner in negotiations with the leading underwriter and finds a sufficient number of following insurers to complete the policy. Even where a broker does not arrange the insurance, as may be the case more often in the case of hull mutuals, there is often a broker giving advice to the shipowner from off-stage.

### **The main markets**

3.15 Although its share has diminished over the last ten years, London remains the largest centre for the hull insurance of ocean-going ships. It has nearly 25% percent of the world market, producing in the order of USD 600 million of premium per year. The other leading centres are Japan, France, the USA, Norway and Germany.

### **Lloyd's**

3.16 Of London's total, Lloyd's accounts for about three-quarters.

3.17 Lloyd's is not an insurer, but rather a marketplace within which insurance and reinsurance can be arranged. Investors are gathered into syndicates, each of which employs an underwriter to decide on behalf of all its investors which risks to accept, on what terms and for what percentage. A number of Lloyd's syndicates are active in ocean-going hull insurance. Few are hull insurance specialists. Indeed, not many are marine specialists; many write a variety of risks with only a proportion of marine, of which hull may be a small part. Their capital comes from the investors, who used to be wealthy private individuals with unlimited liability but who, now that unlimited liability has almost been phased out, are today mostly corporate entities.

### **The IUA**

3.18 Alongside Lloyd's in London there operates a separate market made up of commercial insurers under the auspices of the International Underwriting Association. The IUA hull account is approximately one-third the size of Lloyd's. There are also other facilities in the London market which belong neither to the IUA nor to Lloyd's.

3.19 IUA members and others take percentage lines on hull policies led by Lloyd's underwriters and vice versa. Lloyd's and the IUA provide the members of the Joint Hull Committee, which meets monthly to support and develop the activities of the London hull insurance market. The Committee acts as a focal point for hull insurance issues and represents the whole London market on technical, legal, promotional and educational issues affecting hull insurance.

### **Mutual hull clubs**

3.20 Some hull insurance is underwritten by mutual clubs, notably the Norwegian Hull Club, which has over 30% of the Norwegian market, the Swedish Club, which insures P&I liabilities as well as hull risks, and Marine Shipping Mutual Insurance, which is associated with the North of England P&I Club. These mutuals are owned by the shipowners they insure and consequently share some of the characteristics of the P&I clubs, discussed below.

## **Claims**

- 3.21 In a typical year, the main cause of total losses will be weather, closely followed by grounding and fire. Most partial loss claims will be in respect of machinery damage.

## **The need for profits**

- 3.22 The corporate entities who put capital into the hull market are, of course, free to deploy that capital elsewhere and will do so if their underwriter fails to provide them with an acceptable return. Typically they will, in current circumstances, be looking for a return on capital in the region of 15 to 20% per annum. In recent years, although there has been some increase in rates, hull insurance has generally failed to produce any profit at all. This naturally encourages capital providers to look to other areas of marine or non-marine business.
- 3.23 The pressure on each Lloyd's syndicate to produce regular profits has recently been further increased by Lloyd's itself. Through its new Franchise Board it has laid down Performance Guidelines for syndicates which require them to produce plans for a gross underwriting profit on each line of business in every year. This requirement will militate against the acceptability of the multi-year "cycles" in hull rates and consequent profitability which in the past have been a feature of the market; in future quicker corrective action will be required of syndicate underwriters if profitability is seen to slump.
- 3.24 For a number of years most hull business has produced losses for the insurers, albeit that there has been modest strengthening of rates at the last two renewals. Spokesmen for the market have repeatedly emphasised the necessity to raise rates in order to re-establish profitability and thereby avoid a diversion of capital away from hull insurance.
- 3.25 William Beveridge, a Lloyd's underwriter and the current chairman of the Joint Hull Committee, said in 2003: "The failure of the market to impose percentage increases for hull and machinery business that will allow a return to profitability must ultimately impact on the willingness of capital providers to keep their money in the marine account. At present there is too much capital in the marine market, but we have to question how much longer it will be there if investors do not get the returns they are entitled to expect. Retaining the confidence of investors is fundamental to the survival of a viable hull insurance market, and the viability of the market is in turn dependant on a return to realistic rating levels." John Baxter, CFO of Swiss Re Property & Casualty Business Group, a major provider of capital to the marine insurance market, said in a presentation to IUMI's Seville meeting in September 2003: "My company will certainly manage the cycle and withdraw capital if we cannot reach our targets for any segment of the business". But for the time being there remains an excessive amount of capital in the market. This stokes up the warmth of competition between hull insurers and prevents rates rising to a more healthy and sustainable level.
- 3.26 The objective of the commercial hull insurance market continues to be to make profits for the operators of and capital providers to that market. It strives for good relations with shipowners, but that is because they are its clients. It is not a part of the shipping industry, but seeks to make profits from providing that industry with a valuable service.

## 4. P&I INSURANCE

- 4.1 In sharp contrast to commercial hull insurers, the P&I clubs are an integral part of the shipping industry. They are mutual insurance associations, owned by the shipowners who are their insured members, and they exist solely to provide these shipowners with liability cover and attendant services. They have been described as shipowners' co-operatives for liability insurance.

### **The mutual call system**

- 4.2 As their right to call on the assets of their shipowner members removes the need for external capital, the clubs have no need to produce profits and can charge only what is necessary to cover their claims costs and administrative expenses. Accordingly, it is traditional for each club to charge its members up front only part of the premium that each is expected to pay (the "advance call"), leaving part unpaid until well after the year has finished (the "supplementary call"). At this later stage a decision is taken, in the light of the general trend of the year's claims, as to whether the supplementary call needs to be charged in full or whether a lesser amount will be sufficient. In respect of an exceptionally good year there may even be a return of moneys previously called but not needed to deal with claims. The rate payable by each member of a club differs according to the risk he is judged to bring to the club, but the percentage of the rate that is payable in advance is the same for all, as is the percentage subsequently payable by way of supplementary call (or returned to members by the club).
- 4.3 Occasionally a club will find that it needs a larger than predicted supplementary call, but the obvious unpopularity of such an event has caused most clubs to build up reserves out of better years and to take other steps to avoid this danger. Some clubs have recently signalled their strong determination to avoid larger than predicted supplementary calls by a change in terminology; they now announce at the start of the year a "mutual premium" for each member, being his total expected requirement for the coming year, which is payable in instalments; if part of the final instalment is not needed in the light of the development of the club's total claims picture, it is referred to as "the mutual discount". So this so-called "mutual premium" system still involves rates that are adjustable in response to the overall results of the whole club, which continues to emphasise the not-for-profit nature of the clubs and distinguishes them from commercial insurers who charge a fixed premium.
- 4.4 For the sake of completeness, it should be added that the clubs use fixed premiums for most of their charterers' liability business. They also use them for cover against specific liabilities that are not thought to be sufficiently mutual, such as the drilling risks of a rig. Some clubs offer fixed premium facilities for small and coastal vessels. Occasionally they will also do so for a particular ocean-going ship or shipowner. In these cases the premium is not subject to subsequent adjustment, whatever may happen to the claims on the club. The fixed premium will be set at a level intended to produce a profit. If this profit materialises, it will be used to reduce the cost of insurance for the mutual members. Fixed premium policies have much lower limits than those enjoyed by mutual members. Some clubs have very little fixed premium business. Others have quite a lot. On average, fixed premium business is around a quarter of the whole. In all these cases, the balance of the club's business will be mutual.

## **Structure**

- 4.5 Although most of the clubs are managed on a day-to-day basis by professional firms, ultimate control is with the shipowner members in general meeting and with the board (in some clubs called the committee) of directors which those members elect, mainly from among their own number. The club's managers can be changed either by this board or by all the members in general meeting. Their remuneration is fixed by the board. There is a growing trend among the clubs towards having one or two representatives of the professional managers sitting also as directors on the club's board, which is partly in response to pressure from regulatory authorities for more insurance expertise at this level. But the shipowners continue comfortably to outnumber all others on the club boards.
- 4.6 Each club accepts shipowners from around the world, although some concentrate mainly on a particular area of the world. Most take all types of ship, although some avoid, for example, passenger ships and others specialise more in, as examples, tankers or in bulk carriage generally. One has traditionally served the smaller ships which most clubs would prefer to avoid.
- 4.7 Typically a P&I club board meets four times each year, receives reports from its managers on all aspects of the club's activities and decides all issues of significance. Between these meetings it is usual for the chairman of the board, with or without a sub-committee, to maintain continuous contact with the managers. Changes to the insurance cover provided by the club are proposed by the board of directors and voted on by the shipowner members in general meeting. Consequently the clubs and their cover are highly responsive to the needs and objectives of the shipowners – who individually are their assureds and collectively are their owners and their capital providers.

## **Risks covered**

- 4.8 The clubs cover the liabilities to which their members are exposed as owners and/or operators of ships. These include liability for loss of or damage to cargo; for death or injury to crew, stevedores and passengers; for collisions with other ships or with docks and other structures to the extent that these are not covered or not fully covered under the hull policy; for wreck removal; and for pollution by oil and by other substances. Some fines are covered, but so far as oil pollution fines are concerned, only where the discharge or escape was accidental; fines for deliberate breaches of MARPOL are excluded.
- 4.9 This cover is provided on an indemnity basis; that is to say that the club reimburses the shipowner assured for what he has paid out to the person or body claiming against him. But clubs may choose to pay directly to the claimant where the sum involved is too large for the shipowner to be able to pay it himself. A club will also pay direct where it has given a guarantee that it will do so, either in advance under a direct action regime such as the CLC (see below) or as part of the handling of a particular claim. Clubs also pay direct in cases of personal injury or loss of life.
- 4.10 Although many shipowners take the full cover that their club offers, it is open to each shipowner to select those risks for which he wants cover and exclude others. For example, if his crew risks are covered under a national social security scheme he may therefore not need to buy crew cover from the club. Similarly, he may elect to cover the whole of his collision risk with his hull underwriter. He may also reduce the cost of his club insurance by negotiating deductibles on some or all of the risks that he does insure with it.

## **Risks excluded**

- 4.11 As with hull insurance, P&I war and terrorism risks are excluded and may be insured elsewhere. But the clubs do provide some special high-level cover against liabilities arising from war risks, which cover is designed to sit above the upper financial limits of these externally-purchased policies. They

have also put together a facility to fill, up to USD 20 million per ship per event, the gap created in respect of crew and legal costs claims by the commercial market's recent exclusion of claims arising from biological, chemical or electromagnetic attack.

### **Full cover**

- 4.12 By contrast with hull insurance practice, which as described above normally involves a number of insurers each carrying only a percentage of the exposure of each ship, a P&I club will usually insure one hundred percent of the risk. A shipowner will often place some of his ships with one club and others with another club, but it is unusual these days for a ship to have a percentage of its cover with one club and a percentage with another.

### **Market share**

- 4.13 About 82% by number but nearly 90% by tonnage of the world's ocean-going fleet are entered with one of the 13 clubs from around the world which are members of the International Group of P&I Clubs. These clubs are based in the UK, Norway, Japan, Bermuda, Luxembourg, Sweden and the USA. For the purposes of the market share calculations above, ships of under 2 000 gross tons are excluded. If this figure of 2 000 gross tons is increased, thus excluding from the calculation more of the smaller ships, the Group's percentage of the world fleet rises further. Its percentage of tankers over 2 000 tons is significantly higher than for other types of ship, perhaps as large as 97% of the world fleet.
- 4.14 The premium income for all the 13 clubs in the International Group in the current year is expected to approach USD 2 billion.

### **Alternative facilities**

- 4.15 P&I cover can also be bought, for a fixed premium, from commercial insurers. Some small facilities specialise in this business, one being within Lloyd's. Generally this option is attractive only to smaller dry-cargo ships, coastal traders, tug and barge combinations, fishing fleets and others who can manage with far lower limits on cover than those provided by the International Group. It is not usual for ocean-going ships, and particularly tankers, to take this option.

### **Size of claims**

- 4.16 A very significant difference between hull and P&I insurance lies in the size of their largest claims. Individual P&I claims, even from a small ship, can be enormous. As shown below, the clubs consider it appropriate to offer liability cover for up to about USD 4.5 billion for a single incident. By contrast, hull insurance claims are inevitably limited by reference to the insured value of the relevant ship. A huge modern passenger ship may be valued at USD 800 million and the latest generation of container ships are worth nearly USD 100 million, but these are much higher than new building prices for most other types of ship. Moreover, values decline steadily if erratically over time and, subject to the demands of mortgage banks, this decline will be reflected in the insured values periodically agreed in the hull policies.

### **Pooling and reinsurance**

- 4.17 It is to enable them to generate the capacity to provide cover to a level commensurate with these massive liability claim exposures, that the major clubs join together in the International Group of P&I Clubs. The Group allows clubs to share ("pool") part of the larger claims that are made upon

them. The club that is insuring the ship that brings a large claim bears the first USD 5 million of that claim itself, but the excess over USD 5 million is pooled with the other clubs in the Group.

- 4.18 The Group also buys from the commercial insurance market, on behalf of all the Group clubs, a reinsurance programme that covers any single claim in excess of USD 50 million. Between USD 50 million and USD 550 million the Group reinsures 75% of the risk and retains and pools 25% of it (protecting part of that 25% retention by a special reinsurance). Beyond USD 550 million per claim, 100% is reinsured, up to just over USD 2 billion (save for oil pollution claims, for which reinsurance stops at USD 1 billion).
- 4.19 Beyond USD 2 billion the Group clubs would continue to pool any such claim, but without collective reinsurance, up to the effective limit on the clubs' cover of around USD 4.5 billion per ship per incident. This limit is achieved indirectly, by limiting the amount that each shipowner member can be required to contribute to his club to fund a claim in excess of the USD 2 billion ceiling on the Group's reinsurance programme.
- 4.20 This amalgam of pooling and collective reinsurance allows each participating club to provide this exceptionally high level of cover. The reinsurance programme, the largest individual single placement in the market, will in 2004 cost the Group clubs around USD 200 million.
- 4.21 P&I cover offered by commercial underwriters is subject to much lower limits.
- 4.22 Clubs in the Group are free to buy for themselves reinsurance from the commercial reinsurance market to cover all or part of their exposure up to the USD 5 million per claim beyond which large claims can be pooled. Many do so, typically buying cover for USD 3 million excess of USD 2 million, but with some reinsuring from an even lower start point. Others buy aggregate stop-loss reinsurance. Some clubs buy reinsurance to cover their share of any overspill beyond the USD 2 billion at which the Group's own reinsurance programme stops and pooling continues without collective reinsurance.
- 4.23 It is convenient to note here that a club which over the years brings more than its fair share of claims to be pooled with the other Group clubs in the layer between USD 5 million and USD 20 million is penalised by having to pay a higher percentage than its size alone would justify of all claims upon this layer, including its own. Moreover, a club bringing a claim to be pooled that exceeds this USD 20 million has its own normal percentage share increased by 20%, up to the point at which the claim reaches USD 30 million. Between USD 30 million and USD 50 million, at which point the collective commercial reinsurance programme cuts in, clubs share claims in the same proportions in which they share the cost of that reinsurance programme, which cost is allocated in accordance with each club's tonnage of various categories of ship; 'clean' tankers, 'dirty' tankers and passenger ships bear higher reinsurance premiums than other types.
- 4.24 In an average year, about eighteen claims on Group clubs can be expected to exceed USD 5 million and therefore be pooled. Typically, one or two of these will hit the collective reinsurance programme by exceeding USD 50 million. No single claim has yet consumed the whole of the USD 2 billion reinsurance programme. But the Texas City disaster in 1947 would clearly have done so had it occurred today and the clubs envisage that a claim of this size could indeed arise again. This is why they maintain sharing arrangements for such an "overspill" and a special mechanism that has the effect of limiting their cover to about USD 4.5 billion.

### **Types of claim**

- 4.25 In a typical year, the cost of P&I claims that each exceed USD 100 000 might be very roughly in the following proportions: liability to cargo 25%, death and injury claims 25%, pollution 20%, damage to property 15%, and collision liability 10%.

## **Brokers**

- 4.26 Although in the past many shipowners entered their ships directly with a club or clubs and some still do, it is today normal for a broker to be involved. Even if not making the contract, he may well be advising the shipowner from the wings. That broker may also arrange the shipowner's hull insurance or he may be involved only with his P&I club entry while another broker deals with the hull insurance.

## **Relationship with assureds**

- 4.27 But the shipowner's relationship with his P&I club remains different in kind from his relationship with his hull underwriter (save, of course, where his hull insurer is itself a mutual).
- 4.28 This is partly because he recognises that he is part owner of his club, whereas he is financially at arm's length from his hull underwriter – although this feeling will be more real for those shipowners who are or have been directors on the club's board than for others.
- 4.29 It is partly too because when liability claims arise, the club will usually assume the role of defender of its shipowner member against the liability claimant, whereas with hull insurance it is the shipowner himself who is the immediate claimant and looking to the underwriter for payment. In addition, most P&I clubs have sister Defence clubs, usually run by the same management firm as the P&I club itself, which help shipowner members with disputes over uninsured items such as demurrage and which enhance the already close working relationships between member and club.
- 4.30 The shipowner will be aware of which other shipowners are members of his P&I club, whereas he may well be less conscious of which other shipowners are insured by his hull underwriter.
- 4.31 He will also be aware of his club speaking for him and his fellow shipowners on issues such as proposed national or international maritime laws and regulations affecting liability insurance.
- 4.32 For these and other reasons there is a personal relationship between a shipowner and his club which does not exist to the same extent in his relationship with other insurers.

## 5. SUBSTANDARD SHIPPING

- 5.1 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.”*

- 5.2 This definition correctly draws attention not only to the physical condition of the ship, but also to the activities of her crew and to how she is operated.

### Human error

- 5.3 Historically, those who were interested in the causes of shipping casualties, including insurers, concentrated most of their attention on the physical attributes and condition of the ships in question. Thus the classification societies have concerned themselves almost exclusively with engineering aspects of the ship, gauging physical strength from the building yard and periodically thereafter throughout the working life of the ship.
- 5.4 More recently it has come to be appreciated that far more liabilities are incurred by ships because of human error on board or ashore than because of failures in the physical structure or machinery of the relevant ship. This is so despite the fact that two of the most notorious recent oil spills were from ships which broke up and sank.
- 5.5 Studies such as the UK P&I Club’s Analysis of Major Claims, first published in 1991, showed how few liability claims resulted from structural failure and how many resulted instead from human error. The focus of those concerned with loss prevention – international legislators, underwriters and shipowners themselves – shifted to standards of selection and training for seagoing officers and crew (see the Convention on Standards of Training, Certification and Watchkeeping) and to the total modus operandi of the shipowner (see the ISM Code), including the crucial relationships between those in overall operational charge from ashore and those working for them on board.
- 5.6 It is true that the hull insurer remains more concerned than does the P&I insurer about the physical condition of the hull and machinery of the ship, as this is what he is insuring. The P&I insurer is interested in physical failure and malfunction only in so far as they may cause a liability to others, which they seldom do.

### Ships and operators

- 5.7 We are probably now able to appreciate the problem of shipping standards in the round. The standards of the top management of the shipowning company will come to be reflected in the competence of its superintendents, officers and crews and also in the level to which its ships are maintained. This is true at the top end of the quality spectrum, where the whole apparatus of legislation and inspection is hardly needed. Unfortunately it is also true at the bottom end, where that apparatus is too often trying unsuccessfully to cure a fundamental problem by attacking its symptoms. What we can now see is that the real issue is not so much substandard ships as ship operators with substandard attitudes.

- 5.8 Against this background it is healthy that today's hull underwriters are much more likely than their predecessors to be making a conscious effort to get to know and understand the motivation of the senior executives of the fleets they are or may be insuring; similarly that P&I club underwriters make careful enquiries of members as to the standards of those seeking entry to their clubs from their localities.
- 5.9 That is not to say that the physical seaworthiness of the ship is unimportant, or that inspection systems to check on it are not valuable. But it is important to appreciate that these are not sufficient. The real goal is the identification of the substandard shipowner/ship operator. He may, of course, be revealed through the exposure of symptoms – for example a bad record with port state control – but this merely underlines that the whole issue must be seen and, so far as is possible, tackled in the round.

### **Attitudes**

- 5.10 It has already been suggested that the focus should be at least as much on the substandard operator as upon the substandard ship.
- 5.11 The general tightening of legislative and regulatory standards towards the end of the last century improved the quality of the ocean-going fleet. There are still some ships in deplorable physical condition, but it has become very difficult for the operator of an out-and-out 'rust bucket' to continue to trade in all but a few (shrinking) areas of the world. The danger today is becoming more subtle and is not so immediately apparent. It is as much to do with defective methods of operation and lack of effective systems as with ships that are falling apart. And the substandard operator may be clever at assuming, like a chameleon, the superficial colourings of a responsible shipowner.
- 5.12 In seeking to identify today's substandard operator, we will note his failure to set adequate standards of his own for the operation of his ship or ships. This may manifest itself in the failure of his organisation, officers, crew and ship(s) to meet minimum standards set by international regulations and by class. But more frequent than flagrant transgressions of those standards, we can expect to find attempts to do just enough to comply with them but not more. Corners will be cut and appropriate expense avoided, but still with the hope of being able – by one means or another – just to scrape by.
- 5.13 To some extent this attitude has been born out of frequent cycles of cost-cutting in a fiercely competitive industry, upon which increasing financial burdens have been loaded while its earnings have for lengthy periods been inadequate to support proper investment in men, machines and maintenance. But that history does not make it acceptable today.
- 5.14 Insurance cover will be looked upon, not as a 'safety net' in case something unexpectedly goes wrong within a sound system for operation and maintenance, but rather as a partial substitute for the expenditure needed to create and maintain such a system. But the substandard operator probably does not think that he will be the unlucky one whose ship suffers the major casualty. He may well worry less about insurers withdrawing cover or imposing large increases in premium than he does about being detained by port state or other inspectors. The consequent loss of earnings during detention is a serious financial threat to him.

### **Minimal compliance**

- 5.15 It might be asked in this context whether there is anything that can be done to weaken the perception that a shipowner has achieved "quality" merely by continuously doing just enough – and no more – to satisfy class and other inspectors. Top quality operators set and judge their own performance by their own standards. Substandard operators, by contrast, take as their goal the mandatory minimum requirements set for them by others and try to do just enough to comply with

them. They adopt a culture of minimal compliance. By setting their sights so low they are bound to fail. But, at least until the substandard operator is found out – as sooner or later he is likely to be by undershooting and causing a casualty – both he and the top quality operator will equally be shown to the insurer as ‘compliant’. Some comments on the recognition of higher standards appear in Chapter 11.

- 5.16 It may be relevant to note that, for an activity that has such capacity to harm others, shipowning still has low barriers to entry. No qualifications or licences are required and no performance bond has to be put up. If the necessary money can be raised – which is less of a problem than it should be, as some shipping bankers seem to lack discrimination – a person with little experience, knowledge or suitability can set himself up with a young ship and a good-looking office. This is an issue that goes well beyond the remit of this report – although it obviously makes much more difficult the job of the insurer who wishes to avoid substandard operators – but perhaps it deserves consideration elsewhere.

### **The relevance of age**

- 5.17 The strength of the correlation of the age of ships with the risk that they bring to their insurers is a complex subject.
- 5.18 Once a new ship is past the initial shake-down period – during which a number of casualties inevitably occur – she should have say ten years or so before she starts to show any signs of age. But at some point thereafter (which will be affected by the standards to which she was built and was subsequently maintained) structural and mechanical fatigue, which is cumulative, will gradually become more evident.
- 5.19 There is no doubt that a good operator with access to sufficient funds can cope satisfactorily with advancing age in his fleet. Better from an insurer’s point of view an ageing ship under good operational control than a young ship under poor operational control.
- 5.20 But the statistics show that as ships move beyond say their twelfth year they become more prone to claims, both from physical failure or malfunction and also from human error. More care and money has to be expended upon them, particularly around the time of third special survey. It is, of course, about this time that its falling resale value may bring a ship within the budget of lower quality operators. The problem may thus change from ageing as such to unacceptable operational standards – at just the age when those standards are becoming especially critical. Certainly a fifteen-year-old ship in the wrong hands is an unattractive proposition for any insurer. The European Commission reported to its Parliament in the aftermath of the Erika oil pollution disaster in December 1999 that 60 of the 77 oil tankers lost at sea between 1992 and 1999 were more than 20 years old. Most P&I clubs will not accept a ship of over 10 years of age without a condition survey.
- 5.21 P&I club statistics show the propensity to produce the larger liability claims rising to a peak in the 12 to 15 year age-band and then gradually falling away, particularly after about the 20th year. On the hull insurance side, actual total losses and serious partial losses seem to peak somewhat later. The 15 to 19 age-band is noticeably worse than the younger bands, but the worst results are for the 20 to 24 age-band. This discrepancy underlines that the drivers of maritime liability claims differ somewhat from the drivers of hull and machinery claims. To take an extreme case, the fact that a ship sinks inevitably causes a claim on the hull policy but may not produce any liability claim at all.
- 5.22 To the extent that ships do become ‘riskier’ with age, there is a potentially offsetting factor in hull insurance in that their market values also decline as they get older. To the extent that that a ship’s insured value is reduced in consequence, the amount that the hull insurer must pay out if the ship becomes an actual or a constructive total loss is correspondingly reduced. It is true that, on the

other hand, the frequency and likely size of claims for damage to machinery may well increase with the ship's age. But such claims can be excluded by the introduction of FPA terms (which remove from the cover the machinery damage claims) or their effect on the insurer can be mitigated by special deductibles and/or the requirement of targeted special inspections. So usually the hull insurer's overall exposure to an ageing ship will progressively decline.

- 5.23 The P&I insurer does not enjoy this compensating factor against increasing risk as the ship gets older. The capacity of the ship to incur liabilities remains more or less constant as the likelihood of an accident increases. This may be offset to some extent if an ageing dry cargo ship is eventually entrusted with carrying less valuable cargoes between less sensitive ports and along less valued shorelines. But by no means does this always happen. Moreover, as recent well-publicised disasters remind us, the less valuable cargo in an ageing tanker may have a higher propensity to pollute if it escapes than would have been the case with the more valuable cargoes that she may have carried when younger.

## 6. IDENTIFYING THE SUBSTANDARD OPERATOR

6.1 What information is available to help the insurer identify the substandard operator?

### Indicators of quality

- 6.2 Although we are seeking the substandard operator rather than the substandard ship, it may be that it is mainly by identifying the substandard ship that the insurer will be alerted to the nature of its operator – or at least prompted to ask the further questions that will reveal it.
- 6.3 The underwriter who is offered a ship or ships from a fleet that is new to him will look at the claims record of the fleet with its previous insurer(s). But this may not enable him to distinguish good operations from bad. It would help if he were given access to information on previous ‘near misses’ as well as to actual claims. But it is just the substandard operator who is least likely to collect information on such incidents, let alone share that information with insurers.
- 6.4 The underwriter is also entitled to be told by the potential assured, direct or through his broker, other factors known to the assured that may affect his decision (or, more precisely, that of an ordinarily prudent underwriter) as to whether to accept the risk or the premium that he would charge for it. Potentially this is a significant issue here, because a substandard operator may well have been involved in previous events or be involved in current activities that, if communicated to the underwriter, might alert him to trouble. The difficulty is that the law as to exactly what the potential assured must disclose is complex and, perhaps surprisingly, is still being developed by the courts; see for example *Brotherton v. Aseguradora Colseguros* [2003] 2 All E.R. (Comm.) 298, a recent decision of the English Court of Appeal on whether allegations of previous criminal conduct must be disclosed even if they are false.
- 6.5 It may be that both hull and P&I underwriters would be well advised to rely less on this general duty of disclosure and instead to make more use of “proposal” or “application” forms in which they could set out each category of information which they require to receive before agreeing to give insurance. Such forms offer the insurer the opportunity to find out about the operator himself, not merely about his ship or ships.

### Management audits

- 6.6 Some clubs specify in their rules that the club may instigate management audits of selected applicant shipowners and existing members (see para. 17.4). Some hull underwriters employ survey firms to carry out risk assessments which involve inspection of the operator’s onshore management as well as of his ship.

### Multiple inspections of ships

- 6.7 The insurer will also be able to make use of Equasis and other web-based information about inspections to which the ships in the fleet have been subject. It is well known that ships are now inspected frequently – by classification societies, by P&I clubs, by charterers (particularly in tanker and chemical trades) and by port state control authorities.

- 6.8 Although inspectors from these different organisations come to the ship with slightly different agendas, there is a good deal of overlap. This is inefficient and it is a source of considerable irritation to ships' officers who may have to deal with a succession of inspectors, going over much common ground, during today's short and busy time in port. It may also take the attention of the officers from matters of more immediate importance. It is only a matter of time before a serious accident arises which would have been avoided had the ship's senior officers not been distracted in this way.
- 6.9 This remains a problem despite the concerted efforts towards finding ways to reduce the multiplicity of inspections that were made in early 2000 by industry bodies under the auspices of the IMO. It may be time for a similar gathering to review progress in the intervening years and what further steps might now be appropriate. Not much can or should be done to abbreviate or reduce class and statutory surveys, but there must be opportunities for doing both in the case of the many commercial inspections that now take place. It would be generally beneficial were the reports of inspectors made readily available to other organisations, which could then dispense with, truncate or make less frequent their own inspections. There might even be room for the amalgamation of some inspection programmes with class and statutory work, a possibility mentioned at para. 6.22.
- 6.10 Meanwhile, it would help the insurer seeking clues to the quality of assureds or potential assured, were he to have ready access to the results of such inspections as do take place. In this area of transparency there has been progress in recent years, albeit that there is more yet to be done.
- 6.11 The current situation with regard to the availability of these surveys is as follows.

### **Surveys by class**

- 6.12 Classification society surveyors inspect in detail the structure of ships at fixed intervals and after casualties, to ensure compliance with their own rules and, under contract, on behalf of flag states. Insurers have potential access to the results of class inspections of the ships which they are currently insuring. Traditionally they obtained this by means of provisions in their policies which oblige the shipowner to instruct his classification society to supply the insurer direct with the information he needs. Increasingly the necessary information is becoming available electronically.
- 6.13 Information on the class status of individual ships is now visible on the Equasis web site, described below.

### **Port state control inspections**

- 6.14 Port state control inspectors inspect ships calling at their ports, either at random or in a targeted way, to satisfy themselves as to the condition of the ship and its compliance with international conventions affecting safety, including the ISM Code. But in relation to the physical structures of the ship, these inspections are no substitute for a full survey by class. They are relatively quick and superficial and, for example, cannot cover spaces on a ship that are not gas free. Ports cooperate in regional groupings in accordance with "memorandums of understanding" (MOUs) which provide for sharing of the results of inspections within the grouping. The results of their inspections are usually made available on open web sites to anyone, including of course an underwriter, who wishes to access it. There is room for improvement in the manner and timeliness in which some groupings make the information available, but in general the transparency of the systems is good.
- 6.15 Moreover, the information from the Paris and Tokyo groupings plus the United States Coast Guard is drawn together and made publicly available on the single Equasis web site. The information on this website can be searched not only by ship but also by fleet manager/operator, which helps the insurer evaluate the quality of the operator and not just the individual ship. There have been instances of corruption among individual inspectors, resulting not only in ships being given

clearance when deficient but also in ships being found deficient when they were not. But this problem is recognised by those in charge of the system as being intolerable and it is being addressed. There is also inconsistency of quality between different MOUs, but it is expected that the standards of these groupings will gradually converge.

### **Inspections by charterers**

- 6.16 The major oil companies inspect tankers which they may wish to take on charter. This is part, but only a part, of their vetting processes, which also cover analysis of class information and visits to onshore management. The inspection process is coordinated by the Oil Companies International Marine Forum and the resulting reports are made available, through its SIRE system, to the other participating oil companies, thus reducing the number of inspections to which a ship may be subject. The inspections take about eight hours, usually during loading or discharging operations, and concentrate on manning, operational and safety/pollution management rather than on structural aspects. There are around 11,000 inspections each year, covering around 5,000 tankers or about 65% of the world's internationally trading tankers. The consequent reports are factual and non-judgmental. It is left to each participating oil company to draw its own conclusions from the reports and to decide for itself which ships it wishes to charter. The reports are also made available to government agencies such as the port state control groupings. But no one else has access to the results of these inspections.
- 6.17 There is for chemical tankers a parallel inspection system organised by the Chemical Distribution Institute. During 2003, a total of 1,263 ships were inspected. At present only participating chemical companies can access the results, plus port state control officers whose maritime authorities have signed a confidentiality agreement. But the CDI has decided very recently to give electronic access to their reports in future to others with a legitimate interest in the operation and technical condition of such ships, in particular the P&I clubs.

### **Club surveys and inspections**

- 6.18 The clubs in the International Group are already conducting a variety of surveys and inspections of ships. These help to identify ships which should not be accepted for membership. Clubs also use surveys and inspections to ensure that existing assureds continue to uphold suitable standards.
- 6.19 P&I clubs and hull insurers commission "condition surveys" of some ships prior to acceptance, particularly where older ships are concerned. Clubs will require a pre-acceptance condition survey, by a firm nominated by them, on ships over a certain age: this is normally ten years but may be more or less for specified types of ship. They do the same after concerns have arisen about the ship's condition because of a deteriorating record, the circumstances of a casualty or a poor port state control record or a blacklisting. A check is kept on port state control reports for this purpose. Ships coming out of lay-up are also surveyed. Clubs receive notification from IACS of transfers of class and this may also trigger a requirement for a condition survey if the shipowner appears to be moving down to a less demanding society.
- 6.20 Some P&I clubs also carry out regular but random "ship visits" or "ship inspections" aimed at taking a snapshot of the general management of the ship. These inspections, in some cases carried out by ex-masters rather than engineers, are aimed particularly at the 'human dimensions' aboard and in relation to the onshore management, rather than at the ship's structural condition. It is explained that, "The Club Inspectors assess not only the general condition of the vessel, but also the intangible 'quality of operation'". The inspector will, during a visit of about four hours, look at cargoworthiness, manning, maintenance, safety standards, operational performance, and pollution control.

- 6.21 There has recently been convergence between condition surveys on the one hand and ship visits or ship inspections on the other. The human dimension issues that dominate the latter have increasingly been included in the instructions to surveyors carrying out the former. Moreover, the International Group is currently looking at the differing survey practices of its clubs with a view to establishing an agreed minimum agenda for such combined surveys and a common approach to factors that should lead to a particular ship or fleet being singled out for close attention. One trigger for such targeting might be the carriage of heavy fuel oil, particularly in older ships – a key component of two particularly damaging spills in recent years.

### **Potential convergence**

- 6.22 Bearing in mind the continuing overlap between surveys that is discussed above, the P&I clubs may think it timely to discuss with IACS the possibility of classification societies widening the scope of their surveys beyond the physical aspects of the ship to include the human dimension. This was put to individual societies at the time when some clubs were considering the setting up of their own ship inspection programmes. It was rejected then. But since that time, classification societies have become more familiar with the human dimension through auditing systems under the ISM Code and in accordance with management quality assurance programmes. It may be time to revisit this possibility. If the societies were willing to widen their scope in this way, they could be engaged to undertake the combined club surveys mentioned above. Surveys could be amalgamated, reducing overlap and the multiplicity of different inspections mentioned above. Participating classification societies would need to take on staff to deal with the additional work. Directly employed and contracted club inspectors and surveyors could initially work alongside class surveyors in the combined work and then be offered the opportunity to qualify as class surveyors. Other commercial parties might follow this example.
- 6.23 At present, club inspections and surveys are not made available, either to other clubs or to others such as port state control groupings. Nor is information made available about action taken by clubs on the basis of such surveys or inspections.

## **7. BARRIERS TO THE FLOW OF INFORMATION**

- 7.1 It is evident that a good deal of information is being gathered about the condition of ships and how they are being managed, maintained and operated, but by no means all of this can be accessed by an underwriter who wishes to avoid insuring substandard ships.
- 7.2 There are some technical steps that can be taken to improve this situation. Just for example, the information flow into the excellent Equasis system from the Tokyo MOU can and should be speeded up.
- 7.3 But the main barriers to transparency are legal.

### **Legal barriers**

- 7.4 Surveys that are within the Equasis system and which would impart significant positive and negative information to underwriters about the condition and maintenance of ships they are insuring or being invited to insure are being withheld from them. Among the factors that have so far discouraged commercial organisations such as oil and chemical companies and P&I clubs from making the results of their inspections more generally available is their fear of competition laws and of legal suits that may be brought by shipowners and ship operators whose ships have been criticised by their inspectors.
- 7.5 In a recent interview in a trade magazine, a spokesman said that OCIMF “had to go to great lengths within European and US authorities just to gain acceptance for oil companies to share reports between each other about tankers”. They had been advised that they could not publish the reports beyond the oil companies participating in the SIRE process and port state control groupings “because it may put the substandard ship operator out of business”. It is, of course, because this is what it may do that it is desirable in the public interest that such publication should take place.

### **Advice on sharing**

- 7.6 The P&I clubs in the International Group are currently taking advice as to whether they may share each other’s inspection results without offending competition or other laws.
- 7.7 They are also asking whether a P&I club has the right, or even the duty, to advise another club that it has inspected a ship of a current or prospective member who is applying to insure that ship with that other club and, in addition, to provide the result of that inspection.
- 7.8 It needs to be established whether a shipowner can be required to disclose the existence of another club’s inspection in the proposal form of a club to which he is applying for cover. If this can be required and if the other club can/must supply the result of the inspection it would make it more difficult for a substandard shipowner who has been identified as such and is being declined further cover by one club to find another willing to insure him.
- 7.9 It would also help if an International Group club that is throwing out, suspending or declining to insure such an operator had the right, or even better the duty, to advise the other Group clubs, provided of course that it could do so safely from the legal point of view.

### **Electronic access**

- 7.10 Clubs should be encouraged and assisted to do exactly these things. It would be a significant step towards the exclusion of substandard ships and operators were the Group clubs able to set up a database into which they would each be obliged, under their pooling agreement, to place such surveys and inspection reports. Information as to action taken in response to such surveys and inspections could also be included (although this would go beyond the SIRE model). Each club could be obliged to refer to this database before accepting entry of any ship or fleet.
- 7.11 To have such surveys and information available (whether or not the database included surveys from SIRE and CDI) would give underwriters the opportunity to make a more informed decision as to whether or not to give insurance to a particular ship or fleet. They would obviously have a better chance of spotting the substandard operator.
- 7.12 Individual clubs would have the information available, but like oil companies under the SIRE system, each one would be entirely free to decide what to do with it. The oil company is free to decide whether to charter the ship and the club would be free to decide whether or not to insure it.
- 7.13 Looking further forward, management audits of the sort mentioned at para. 17.4 could also be placed on the database, further improving the vision of underwriters.

### **Personal contacts**

- 7.14 In the identification of substandard operators, data is important, but so are face-to-face exchanges of information. So hull and P&I underwriters should be encouraged by their managers to meet together from time to time to discuss their work and their clients, perhaps along with other maritime specialists such as classification and port state control executives. Contacts at trade association functions are useful, but no substitute for meetings on a smaller scale in a working environment.
- 7.15 Partly for the same reason, exchanges of personnel for training periods of a month or so should also be arranged.

## **8. ENCOURAGING HIGHER STANDARDS WITHIN THE GROUP**

- 8.1 Because the P&I clubs are reinsuring each other (and from a low start point) under the pooling arrangements of the International Group, a large claim from a substandard ship operator that one of the clubs has insured will fall upon all of them. Some clubs may have to pay a larger share of the claim than the insuring club itself.

### **Varying standards**

- 8.2 This might be entirely acceptable if all clubs continuously adhered to the same member quality standards and showed equal care in the way they used the information available to them in order to uphold those standards.
- 8.3 But, as in any such grouping, there are bound at any one time to be some who are more and some who are less selective and/or less careful than the norm.

### **Substandard members**

- 8.4 The Group clubs are almost certainly insuring, unintentionally, a number of substandard operators. As has been discussed earlier, such operators are not necessarily easy to spot, particularly before they cause a large claim and come under the spotlight in consequence. But no club manager can assert with confidence that there are none within his own club, and most managers point to some that are insured by other clubs – relying in some cases on what they know of those operators from having insured them in the past. Port state control detentions point in the same direction. As the Group insures around 90% of ocean-going tonnage and as much as 97% of ocean-going tanker tonnage, it would be very surprising if all the ship operators in its component clubs were good. By contrast, tankers offered for inspection within OCIMF's SIRE system represent only about 65% of the international ocean-going tanker fleet (albeit that there are good reasons for saying that by no means all of the remaining 35% are substandard).
- 8.5 Assuming that the majority of clubs want to adhere to a standard of care that would make it very difficult indeed for the substandard operator to gain or to maintain membership of their clubs, how can they best encourage any others to raise their own entry and maintenance standards to an acceptable level?

### **Declining to pool**

- 8.6 It is, of course, open to such clubs to decline to continue the pooling and collective insurance arrangements with the other club or clubs with lower standards. But this is very much an action of last resort. The Group brings enormous benefits to the shipowners who insure with its constituent clubs (and to those who suffer from serious accidents at sea) and clubs are rightly cautious about taking any action that might undermine its solidarity. It is in the interests of all, not least the innocent victims of major casualties, that less potentially disruptive solutions should be examined first.
- 8.7 Such solutions are available. Some are more rigorous than others. Some are already under consideration. Indeed, it has been apparent during the preparation of this report that, in this and in other areas touching on substandard shipping, there is serious thinking under way, both within

individual clubs and within the committees of the International Group. Progress has been made and more can confidently be predicted.

- 8.8 It is hoped that those club directors and managers who have already turned their minds to this problem will not find the paragraphs which follow to be intrusive. They have been written in the hope that they may make a useful contribution to the debate.

### **Close examination of claims**

- 8.9 The least onerous solution would be for clubs who were unhappy with another club for insuring or continuing to insure an operator whom they considered to be substandard, simply to let that club know that if any claim came to the pool from that operator then they would examine it with the greatest care before agreeing to make their own contributions to it.
- 8.10 Although this might cause the insuring club to think again and/or to put pressure in turn upon the substandard operator to improve, its impact would be reduced by the difficulty of proving enough to justify a subsequent refusal to contribute. Assuming that the relevant ship was flag state, class and ISM compliant – which are express requirements of the pooling contract between the clubs – the objecting club would have to show that the insuring club was nevertheless in breach of an implied duty of care towards the other participating clubs in having accepted that ship. That this would be difficult is not surprising, as the intention of the Group clubs has always been that claims brought to the pool should be paid rather than questioned. After all, today's contributing club may be tomorrow's seeker after contributions. But the very issues under consideration in this paper are causing clubs to be more questioning when asked to contribute to a claim that has arisen from a ship whose operator they believe (albeit aided sometimes by hindsight) that they themselves would not have been willing to insure.

### **Agreed grounds for refusal to contribute**

- 8.11 It would be possible to give more teeth to those inclined to be more questioning by writing into the pooling agreement wider specific grounds upon which clubs could decline to contribute to particular claims brought to the pool by other clubs. The essence would be that the originating ship or its operator was substandard. That is much easier to say than to draft. Whatever words were eventually chosen would invite disputes and this alone might make the idea unacceptable to the Group clubs. But if they nevertheless decided to introduce such a provision then it could contain its own mechanism designed to resolve disputes as quickly and easily as the delicate subject matter would allow.
- 8.12 A slightly weaker variant would be to base a refusal to contribute not on the originating ship or operator being substandard, but on proof that the insuring club was or should have been aware of the substandardness. The insuring club could then defeat a refusal to contribute by proving that it carried out appropriate quality checks and acted prudently upon their results in agreeing or maintaining cover.
- 8.13 Detailed quality-checking procedures could, of course, be agreed in advance by the Group clubs. An audit to prove that these procedures had been followed in the case of a ship bringing a claim could be made a pre-requisite of pooling.

### **Advance notice of non-contribution**

- 8.14 A somewhat more rigorous solution would be as follows. If a club considered that a particular ship or operator was substandard, it would be allowed to declare in advance of any pool claims arising that it would not contribute to pool claims that did eventually arise from that ship or operator. To

avoid abuse of this procedure, the reasonableness of such a general declaration in advance could be made open to review by a panel of experts. Such panels already exist within the Group system for other somewhat similar purposes. If the panel found the declaration to be unreasonable, it would be ineffective. If on the other hand it found it to be reasonable, then other clubs would no doubt add their own declarations and the insuring club, faced with disintegrating reinsurance protection, would find it necessary to reconsider its own decision.

### **Reduced contribution**

- 8.15 If this were thought too draconian, despite the filter of objective reasonableness that would be provided by the panel (and despite any restrictions agreed as to the timing of the declarations), it could be modified to a declaration that the objecting club would contribute but only beyond say twice the ordinary start point for pooling. Currently this would mean that the claiming club would not be able to recover the objecting club's slice of the claim between USD 5 million and USD 10 million. (The same modification could be applied to the refusal to contribute to a claim, discussed above)
- 8.16 For the sake of completeness only, it should be noted that the ultimate way to eliminate differences of member standards between the clubs would be to centralise the decision to exclude a ship or operator from the Group as being substandard. But, even leaving aside the obvious legal problems, it may be assumed that this would not be acceptable to the shipowners who make up the clubs. Bad enough to be rejected by the club of your choice, but worse to be rejected by a Group committee.

### **Competition law**

- 8.17 The further the Group decides it wishes to go along any of the paths set out above in search of higher and/or more consistent membership standards, the more significant will be consideration of competition law and regulation.
- 8.18 If the advice that the Group receives is restrictive in such areas, then consideration should be given at supranational level to providing new protection to the clubs and other insurers in respect of competition and other laws.

## **9. REMOVING BARRIERS TO GREATER COOPERATION**

- 9.1 It may be appropriate at an early stage to hold discussions with national and regional governments and their competition authorities to discover whether and on what terms the former would support and the latter would approve more cooperation between the clubs. This applies to greater transparency of surveys and inspections, as well as to measures designed to tighten standards within the Group. It also applies to the increase in personal contacts between hull and P&I underwriters advocated above. Whether support will be forthcoming from the governments along with approval from the authorities may well determine what progress if any can be made by insurers towards the common goal.
- 9.2 It may emerge that there is no objection to whatever forms of increased cooperation are favoured by the International Group. If, on the other hand, legal barriers are discovered, then not only must these be removed, but specific protection must be given.

### **Choice between state priorities**

- 9.3 Cynics will say that this will never happen. But why not? If national and regional governments are serious, as they are certainly believed to be, about the campaign against substandard shipping, then it behoves them to take a holistic approach and do what is necessary to protect those to whom they are looking for assistance.
- 9.4 If there were a clash between this campaign and the other laudable public policy goal of free competition, then governments would have to make a choice. But in reality there may be no such clash here. The possible steps that are described above neither include nor incline towards any co-operation or collusion on rating. Nor is there any intention to abuse a dominant position. All that is advocated is progress towards (a) more transparency and exchange of information about operators and their ships in the interest of increasing the ability of underwriters to identify substandard shipping, and (b) greater consistency in the member quality standards of the Group. Both would be to the benefit of the public which substandard shipping endangers. Moreover, any exception required to remove the barrier to this progress could be narrowly defined. It could be a piece of surgical drafting that would clearly avoid any damage to freedom of competition.

### **New competition law structure**

- 9.5 So far as concerns EU competition law, a new regime comes into effect on 1st May. This involves a degree of decentralisation from Brussels to national competition authorities and courts. But the Commission will still have the power to make declaratory decisions in appropriate special cases that raise an issue of principle. If the political will is there, no doubt this could be done should it prove necessary in this case.

## 10. CLASS

10.1 The traditional role of the classification societies was to inspect ships' structure and machinery during building and periodically throughout the working life of the ship. This gave hull and P&I insurers confidence in the physical seaworthiness and mechanical efficiency of the ships they insured. In more recent years the societies have also contracted with many flag states to conduct statutory surveys on their behalf.

### **Loss of confidence**

10.2 Towards the end of the last century the classification societies came under increasing criticism. This was in part for being slow to react to the realisation that in the fight against avoidable maritime casualties, insufficient attention was being paid to the human as opposed to engineering aspects of safety. But it was also for seeming shortcomings in carrying out their traditional role in respect of physical standards. Too often, after casualties that involved structural failure or mechanical malfunction, the ship was found to be with a respected society and up to date with its requirements.

10.3 In the early 1990's some hull insurers showed their lack of confidence in the system by requiring ships to be given Structural Condition Surveys by the Salvage Association. Most clubs began to commission their own condition surveys in particular situations and some established ship visit or ship inspection programmes by specially retained inspectors.

### **Restoring confidence**

10.4 The ten biggest societies now belong to the International Association of Classification Societies. IACS is working hard to raise standards and achieve greater consistency among its members. It has, among other things, introduced a Quality System Certification program, which provides a mandatory audit of the internal quality systems of its ten societies. Each society is required by the European Maritime Safety Agency to evidence compliance with this scheme, failing which their recognition within Europe will be suspended or withdrawn. These efforts have been supplemented by a noticeable tightening of standards within the leading societies.

10.5 One of the assets of the class system is its worldwide reach, each society having a network of surveyors, often exclusive to one society, covering major ports everywhere. The other side of this coin has been the difficulty they have sometimes experienced in ensuring consistent standards of competence and honesty among such a numerous and far-flung workforce. There are said to be as many as 6,000 surveyors working around the world for IACS societies. The problem of the occasional 'bad apple' in this system is magnified by the inevitability that the substandard operator will seek him out and elect to have crucial surveys of his ships carried out at his port. In the context of this paper, the system is not significantly stronger than its weakest or least trustworthy link. However, the leading societies are fully aware of this problem and have in recent years been taking steps to enforce consistency.

10.6 Confidence in the leading societies is now being slowly rebuilt among hull insurers. Their routine use of the Salvage Association as a substitute has ceased. Some of the societies are themselves taking new and pro-active steps in the campaign against substandard shipping – to take just one example, the flying squads of surveyors put together by DNV. The P&I clubs continue to arrange their own ad

hoc surveys and ship visits, but this is at least in part in recognition of their need for special focus on the human dimension. The critical focus today is more on those societies which are regarded as less competent and in some cases less trustworthy. Some insurers now regard membership of IACS as the touchstone of acceptable quality, albeit that others are not happy with all of the societies within that organisation. Some hull underwriters consider oil major inspections to be a better guide to the risk that the ship presents to them. This illustrates that there is still some way to go before a proper level of confidence is re-established between marine insurers and the classification societies. The 'distance' between them that is still noticeable represents a serious fault line within the maritime sector. The sooner this can be corrected the better for shipping quality.

### **Calling the tune**

- 10.7 It is said in some quarters that it would be better were the various societies not to be competing for the business of those whose assets they are inspecting. Such considerations go beyond the scope of this report. But it should at least be asked whether it might be better if the ship inspection work that they currently debit to shipowners were paid for by insurers instead. There are, no doubt, arguments against such a change, but it would help to remove any lingering suspicion that the societies, or some of them, are not always fully dedicated to unvaryingly objective standards and/or capable of supplying surveyors of the necessary competence and integrity. This is not to make any point about current abuses, but simply to recognise that in the long run it is, as a general principle, important to have the appropriate person 'paying the piper'. Such a change might also tie in well with any move that might in future be made to transfer more club inspection work to the classification societies, mentioned above at para. 6.22.
- 10.8 Meanwhile, the steps that IACS and its leading component societies have made in recent years to restore faith in the system as it stands are welcome. These include procedures to make it harder for shipowners who are justifiably being given a hard time by one society to move easily to another which they hope will be more accommodating. They also include a now very public programme to help flag states raise their own performance – an interesting reversal of what might have been seen as natural roles, but important to the societies in that their association with deplorable flag states has hindered their own efforts to restore trust in the class system.
- 10.9 Finally, it might be healthy for the societies to discriminate more. This thought is developed in the chapter which follows.

## 11. RECOGNITION OF HIGHER STANDARDS

- 11.1 In the long run, recognising and rewarding the excellent may contribute as much to shipping standards as identifying and punishing the deficient.
- 11.2 In its Policy Statement on Substandard Shipping in 2002 the Maritime Transport Committee of the OECD recognised that “Incentive and reward programs can be effective tools to help combat substandard shipping”. It therefore strongly endorsed the acceleration and expansion of efforts in that direction.

### Encouraging quality

- 11.3 If this more discriminatory attitude were to become more general in shipping, it might eventually have a beneficial effect across the board. Meanwhile, it might give some encouragement to those operators who know their own standards are superior but who do not feel they are rewarded for them, particularly in the chartering market. It would also prevent us from seeming, by focusing so much on whether ‘greyer’ elements in the world fleet are or are not just clearing the minimum quality threshold, to condone the attitude of the ‘minimal complier’, described in para. 5.15.
- 11.4 The United States Coast Guard’s Qualship 21 and the Green Award systems are welcome moves in this direction.
- 11.5 However, both hull insurers and P&I clubs should consider whether they can do more to recognise and, if possible, reward excellent quality among those they insure.

### No claims bonus

- 11.6 Of course, the P&I clubs, like hull underwriters, do reward a good claims record by reducing a member’s rate on renewal. Their rating systems are admirable in that they respond annually to the evolving record of the individual shipowner. They take the concept of the motor insurer’s ‘no claims bonus’ and raise it to a more sophisticated level, as Lord Donaldson pointed out in paragraph 18.2 of his 1994 Report. But rates are private to the individual concerned and are in any event difficult to interpret on their own. Could the clubs do more, preferably in a more public way?

### Quality differentials

- 11.7 Some clubs already offer a ‘benchmarking’ service to individual shipowner members, giving those who ask for it a comparison of their own fleet’s performance in aspects of the club’s ship inspection programme with the performance across the whole club. Schemes such as this could be adapted to underpin an excellence award.
- 11.8 If it is thought too arbitrary for a P&I club to make a public declaration of quality merely on the basis of performance in ordinary club inspections, perhaps this could be done after good performance in more demanding inspections specially arranged for those shipowners who volunteer to submit their ships to them.

11.9 It is worth noting that we are already seeing the development of web-based systems which absorb all the public information about a ship and then, according to pre-set formulae which evaluate each clue as to quality, assign to it a relative 'star' rating.

### **Returning to classification**

11.10 The possibility of more demanding optional inspections might be of interest to the classification societies. They could return to their historic roots and revive the concept of ships being assigned to differing classes of quality. We are told that in the early days the hull of each ship would be placed into one of five categories according to the society's evaluation of its condition (A,E,I,O,andU) and its masts and rigging into three such categories (Good, Middling and Bad). Later this concept of classification lost support, seemingly because it had been made to rely too heavily on the age of the ship. Eventually, class become in effect a simple pass or fail system. This is its essence today, subject only to various special notations indicating compliance with some additional criteria. Perhaps the societies could examine whether to resume offering to shipowners, if not a whole series of levels, at least one clearly defined higher level of quality.

## 12. DECIDING TO COVER

- 12.1 The earlier discussion in chapters 6 through 9 about steps that might be taken to improve the underwriter's ability to identify the substandard operator, leads us to a consideration of the whole process by which a hull or P&I underwriter decides whether or not to give cover.
- 12.2 An insurer, whether of hull or P&I, divides the underwriting process into two distinct parts. The first part is risk selection, the decision whether or not to insure the particular ship or fleet. The second arises only if there is a favourable decision in the first; this is on what terms and at what premium to provide cover. This chapter deals only with the first part, leaving the second part to chapter 15 below.
- 12.3 The insurer will have no difficulty in deciding to provide cover if he is offered a ship from a fleet whose ships he already insures and in whose standards of maintenance and operation he has confidence born of experience.
- 12.4 When he is offered a ship from a fleet of which he does not have such experience, the insurer will be more circumspect.

### Reasons for caution

- 12.5 He will want to avoid giving insurance to a substandard operator.
- 12.6 This will be partly to minimise what he will regard as unnecessary claims within his own retention. But he will also have an eye to larger claims which affect his reinsurances. In P&I club terms, these reinsurances will be (a) any reinsurance he has below the USD 5 million per claim at which the Group pool cuts in and then (b) the pool itself. Any claim will affect his record with his own reinsurers and then with the pool, increasing his costs in future years. There is also the danger that if the condition of the ship or operator concerned is discovered to be seriously deficient, recoveries from reinsurers and even from the pool may prove difficult. Of course, the shared expectation of the Group clubs is that claims made on the pool will be paid. But the pooling contract between them excludes claims from ships that are not compliant with the basic requirements of flag state, class and ISM code. Equally significantly, clubs are today looking more critically at the facts underlying the claims brought by other clubs to be pooled. Were the Group's pooling requirements tightened in any of the ways suggested in chapter 8 above, even more care might be taken by clubs in their risk selection.
- 12.7 There is likely to be another concern about providing cover for a substandard operator, a concern which might be described as cosmetic, but powerful nevertheless. A P&I club underwriter will have in mind, before he decides to give cover, whether the fleet will enhance or diminish the standing of the club in the eyes of other shipowners. News of fleets moving from one club to another is published in the shipping press and is read with interest by shipowners, who are sensitive to the quality of those with whom they are combining within their own clubs. All clubs also publish lists of the ships entered with them for each club year. The P&I underwriter will be well aware of the adverse effect on the reputation of his club if it insures a ship that then causes a major liability incident and is exposed as substandard. Prudent members of the club will resent having to share indirectly in the resulting cost of what they will see as an exposure that their club should have avoided.

- 12.8 Some hull underwriters are also concerned about what shipowners think about the others he insures. They are embarrassed to be found to be insuring a substandard ship that suffers a well-published casualty. But in both cases the feeling is somewhat less strong than it is for a P&I underwriter (save, of course, in the case of a mutual hull club), not least because a P&I club will almost certainly be the sole (liability) insurer for the ship in question whereas the hull insurer will be one among several.

### **Indicators of quality**

- 12.9 The P&I club or hull underwriter will examine the claims history of the fleet, including estimates of the likely eventual cost of pending claims. He will ask for evidence of ISM Code compliance by the operator and the ship. He will see whether the ship is with a classification society in which he has confidence; some demand an IACS society and others feel uncomfortable even with some societies within IACS. He will look for other clues as to quality, such as the flag of the ship (some flags being unacceptable and others sending adverse signals as to quality), its usual charterers, the source of officers and crew, the identity of the producing broker, the identity of the ISM auditor, and whether there have been frequent changes of owner, of manager, of classification society or of P&I club. In some offices it is required practice to have a check made by a specialist firm into the credit rating of the proposed shipowner.
- 12.10 A P&I club underwriter will almost certainly have both a claims correspondent office and shipowner members in the country in which the fleet is based or operated and he will make enquiries of both about the local reputation of the fleet and its operator. A hull underwriter may have and make use of similar contacts. He will in any event be influenced by the type of ownership (corporate, private or investment partnership), the source and adequacy of financial backing, and the soundness of any plans to expand the fleet. He will note with which P&I club the ship is entered and may even call the club to obtain further information. A prospective following hull underwriter may well be influenced by the identity of the leading underwriter.
- 12.11 In addition, both hull and P&I underwriters now have access to information about the fleet's record with port state control through websites, notably Equasis, about which comments have already been made. It seems that all underwriters now make use of this opportunity.

### **Condition surveys**

- 12.12 If still concerned about the physical condition of the ship, the underwriter may require a condition survey by a surveyor of his choice before accepting the risk. Sometimes this will involve an inspection not only of the ship but also of people and systems within the operator's office. Most P&I clubs automatically commission a condition survey of any ship over 10 years of age. In the case of hull insurance, it would be the prospective leading underwriter who would impose this requirement.

### **Systematic evaluation**

- 12.13 The various quality indicators mentioned above have come to be relied upon by marine insurers in a pragmatic and eclectic manner. But, as insurers have increasingly adopted quality management programmes, it is becoming normal for the indicators to be a part of carefully documented processes that individual underwriters are required invariably to follow. Moreover more is now being done to evaluate scientifically the relative importance of the various quality indicators and to build up computer-based models that will provide the underwriter with a composite and objective quality reading for ships and their operators. This will increasingly provide underwriters with a powerful risk-selection tool. But it should still leave room for the individual underwriter to

superimpose his own judgment – that for example flag is a much less useful indicator than the classification society that the shipowner has chosen to work with.

### **Reasons for acceptance**

- 12.14 Once assured as a result of such enquiries that the ship being offered is in satisfactory condition and can be expected to be maintained and operated satisfactorily, the prospective hull underwriter will be willing to accept a percentage of the risk. He will then move on to consider terms and premium that he calculates should generate an acceptable profit. He will want to deploy the capital made available to him, to maintain his market and market share and, of course, to generate premium income, not only in the hope of profit but also of investment income in the period between receipt of the premium and the payment of claims.
- 12.15 The P&I club underwriter, once satisfied as to condition, maintenance and operation, will also want the ship but for slightly different reasons. He wants it and others in order to maintain or to increase the size of his club. The more ships in a club the larger its capital, this being its access to the assets of each of its shipowner members. The greater also will be its 'spread'. This generates greater predictability of future cost to its members. He (and his club's directors) will also, naturally, want to be part of a business that is growing rather than contracting or standing still.

### **Information from prior insurers**

- 12.16 A P&I underwriter will not be alerted by the club that previously insured a ship or fleet to the fact that this ship or fleet left it under a cloud. Nor will he have access to the results of any inspections or surveys that may have been required by that previous club. The same is true *mutatis mutandis* for the hull underwriter. This raises issues that have been addressed in chapters 7 and 9 above.

### **Membership quality incentive for managers**

- 12.17 Directors of clubs may wish to consider including in the remuneration arrangements for the managers of their clubs, a meaningful financial incentive for avoiding substandard ships and a corresponding disincentive for failing to do so.

### **13. THE CORRELATION BETWEEN QUALITY AND CLAIMS**

- 13.1 The likelihood of ships operated by substandard operators being involved in a casualty that causes a hull or a P&I claim should obviously be greater than for similar ships properly maintained and operated.
- 13.2 But unfortunately it is also true that well-operated, well-maintained ships suffer casualties and bring claims – sometimes very big claims.

#### **Accidents to good ships**

- 13.3 This is partly because of sheer bad luck. Those of us on the shore side of shipping sometimes forget how hostile, powerful and unpredictable an environment the sea can be. It will from time to time overwhelm even ships that are modern, well maintained and competently manned. Moreover, most substantial claims arise from human error and mistakes will be made even by properly trained people operating within good systems. Even well maintained machinery will sometimes malfunction. Such mistakes and misfortunes may cause damage to the hull or machinery of the ship. They may also lead to liabilities.

#### **Strict liability**

- 13.4 Although some consequent claims by third parties may be defeated where it can be shown that there has been no negligence, there is a strong tendency at sea as well as on land towards finding, after a casualty has occurred, that someone was at fault. Moreover many maritime liabilities are now, by local, state or supranational law, “strict”. That is to say, they are not dependent on the claimant proving negligence on the part of the person deemed to be responsible, who is often the shipowner or someone for whose acts or omissions he will be held liable. Such laws are not concerned with fault or blame but rather with identifying the guarantor of a particular activity and with providing anyone who suffers from that activity an efficient route to the guarantor’s insurer.

#### **Actors beyond control**

- 13.5 This is particularly important in the case of shipping, where safety is periodically in the hands of people whose involvement is compulsory, but who are neither selected nor controlled by the owner of the endangered ship. The classic examples are pilots. By the very nature of their business, they can cause major losses. They can put the ship aground or cause it to strike an expensive berth. Moreover, so far as liabilities to others are concerned, the shipowner is usually held responsible for the consequences of pilots’ errors. A recourse action against them by hull or P&I insurer will normally yield nothing. P&I club statistics show that pilot error causes as many large claims as mechanical failure. Hull experience also shows pilot error as a major cause of significant claims.
- 13.6 From the point of view of the shipowner’s insurer, a claim upon his policy consumes exactly the same number of dollars whether its cause was an excusable and unfortunate lapse or malfunction, or was a blameworthy manifestation of a substandard operation at the bottom end of the quality spectrum.

- 13.7 Nevertheless, as luck cuts both ways, the incidence of claims that the insurer receives from the fleet of a substandard operator may be unexceptional over many years.

### **The incidence of claims**

- 13.8 It may be that substandard ship operators produce more small to medium sized claims than operators of better standard. Opinions differ as to whether this is true and if so to what extent. Factual comparisons are almost impossible when, ex hypothesi, many of those who make up one of the groups to be compared cannot be identified. Even if they could be, this is an area in which it is difficult to be sure that one is comparing like with like: passenger ships produce far more claims than tankers, but this tells us nothing about the relative quality of such ships or their operators, and two well-operated sister ships may have very different claim patterns if they are in different trades. As already discussed, an examination of the circumstances of individual claims may produce clues to the quality of the ship operator concerned, but generalised assertions may, in this difficult area, be less useful. The difficulty of basing such an assertion on a study of the earlier claims of an operator after he has been revealed to be substandard is touched on at para. 14.2 below.
- 13.9 But even assuming that, as common sense and experience in other fields would suggest, there is some correlation between quality of ship operator and small to medium sized claims, this correlation become weaker as the size of claim increases. By the time we are looking at claims of over USD 2 million or so, it is generally agreed among those in the marine insurance industry that the claims seem to come more or less at random from operators of all quality standards.
- 13.10 That does not, of course, make the large claims emanating from the ships of substandard operators acceptable to those who must pay them or share ultimately in their results. Shipowners accept that they must all share, through the spreading mechanisms of hull and P&I insurance, the claims that arise from properly operated ships. But they rightly object to doing so in the case of claims from the ships of substandard operators, which they regard as avoidable by the insurers. The linkage is more direct and more obvious in the case of P&I clubs, but the shipowner also feels that his hull premiums could be lower if avoidable claims had not fallen on his underwriter.

## **14. WHETHER GOOD FLEETS SUBSIDISE THE BAD**

- 14.1 It follows from the comments made above about the weak correlation between quality of ship operator and hull and liability claims, that it is difficult to prove that better operators are having to pay significantly more for their insurance because of claims from substandard operators.

### **Searching the claims record**

- 14.2 In this context it might be thought useful, after an operator has been revealed as substandard, to go back over his claims record for previous years and see whether over time he has burdened the premium rates of others. But this is not likely to be helpful. If he has avoided large claims, ordinary movements in his rating will have coped satisfactorily with his claims. If he has been revealed to be substandard through the examination of the circumstances of a large claim, that claim will have overwhelmed the premiums paid by him to the insurer. So he on his own will have burdened the other assureds. But the same is true of a good owner in the aftermath of a large claim. What matters is not the results of one substandard assured or indeed of several, such as all those revealed in recent years by the circumstances of their large claims, but the results of substandard shipowners as a class. As many of that class remain unknown, no meaningful calculations can be carried out, particularly as it must be assumed that part of the reason why many of the class remain unknown is that they are obscured by still satisfactory claim records.

### **The importance of the larger claims**

- 14.3 Two interacting factors reduce the likelihood that there is significant subsidy of substandard shipowners by those of higher quality. First, as noted above, the correlation between quality and claims seems to become weaker as the size of claim increases. Second, in measuring the overall claim costs of a P&I club, the larger claims taken together cost much more than the smaller claims taken together – despite the far greater number of the latter. The U.K. Club's 1997 Analysis of Major Claims, covering ten years' experience in a large diversified club, showed that claims of over USD 100,000 were less than 2% by number but nearly 72% by value of the total claims. So the claims most relevant to the question of whether good is subsidising bad are generally acknowledged to fall more or less randomly on both.

### **Relative cost of clubs**

- 14.4 A different approach to the subsidy question would be to compare the cost of different P&I clubs to their own members. It is generally accepted that some clubs are more discriminating than others as to the quality of the shipowners they accept. It might therefore be useful to try to establish whether they are in consequence able to charge lower rates to their members.
- 14.5 Certainly one can divide a club's total income by the tonnage it insures and thus produce its average rate per ton.
- 14.6 But to draw valid conclusions from a comparison of this average rate with the average rate of a less discriminating club is very difficult if not impossible because of variances that have nothing to do with quality.

- 14.7 This is partly because of the inevitable effect of differences between the types of ship in each club and the differing policies on non-quality issues that the clubs pursue. A club with a high percentage of tankers will look cheap because tanker rates are relatively low per ton, while a club with a large book of passenger ships will look expensive. In fact the rate for the average tanker or the average passenger ship may be the same in both clubs. Trading areas may also distort the figures. To have a large number of ships trading to the United States will inevitably push up a club's average cost per ton. Differing terms of cover may also distort. A club that habitually gives full collision cover will look more expensive than if it normally gave only one-fourth. Conversely a club whose members generally take higher deductibles will seem cheaper. Finally, a club that is making exceptionally prudent reserves for developing claims will, to that extent and for the time that it is doing so, seem more expensive than it really is.
- 14.8 The uncertain outcome of this approach to the search for subsidy is underpinned by the experience of shipowners who split their ships between two clubs, confirmed by the brokers who advise them. They find that the differences in cost between the ships they have put into one club and the ships that they have put into the other club, are driven almost entirely by the differing claims records of those two groups of their own ships. Perceived differences in the general cost of the two clubs are relatively insignificant. It may be added that were this not so, there would at each annual renewal be more pronounced movements of fleets of acceptable standard towards the clubs with lower general costs; the total annual movement is in fact of only a few percent and it lacks any such clear pattern.
- 14.9 This suggests that any differences in cost between more and less discriminating clubs are not very significant. That in turn does not lend support to the proposition that the insurance costs of substandard operators are being subsidised by the other shipowners.

## 15. SETTING A RATE

- 15.1 By the fact that the insurer is setting a rate, we know that the ship or fleet has passed his enquiries as to its acceptability in terms of quality (see chapter 12 above).
- 15.2 If the ship or fleet fails that test of acceptable quality it is unlikely that a P&I club or a hull underwriter will be persuaded to reconsider it on the basis of an enhanced rate. They emphasise the strict separation of the two distinct stages of (a) risk selection and (b) the rating of acceptable risk. If the ship or its operator is recognised as substandard, the underwriter will take the position that no rate is going to make the risk acceptable.

### Differing levels of acceptable quality

- 15.3 On the other hand it does not follow that all ships and operators of acceptable quality are of equal quality. Some will clearly be of good quality. But just above the club or hull underwriter's quality threshold will be found ships and operators who are shading from white into grey.
- 15.4 Nor does it follow that a hull insurer will necessarily be happiest providing cover for those fleets recognised in the market as being the best in quality terms. Competition to insure these fleets may drive down their rates to levels that offer no prospect of profit. Especially if they own new ships of very high value, the risk/reward ratio may be unattractive. Better perhaps to aim a little lower, where quality is still acceptable but rates are fuller and values less alarming. Indeed, a reasonable spread of older ships from less sought-after operators may offer a better prospect of making a profit. As noted at para. 5.22 above, the hull insurer will be at risk on each such ship for a percentage only of a reducing value. Moreover, there are tools available that enable him to lessen even that risk, including terms that eliminate the machinery damage claims which become more of a problem with age, and special reinsurance to cushion the risk of a total loss claim. A carefully selected portfolio of such ships has its attractions to the hull underwriter (albeit that it looks far less attractive to a liability insurer, for reasons already discussed).

### The starting rate

- 15.5 The underwriter of a P&I club in the International Group of P&I Clubs may be obliged, when accepting a fleet or a ship transferring from another Group club, to adopt for its first year with his club the rate (excluding administrative costs) considered appropriate by that other club (unless that rate is held to be unreasonably high by an appeal panel).
- 15.6 This is in accordance with the International Group Agreement, designed to support the Group's pooling of claims and collective purchase of reinsurance by moderating rating competition between the Group clubs, and currently sanctioned by the EU's competition directorate. The Agreement also requires clubs, when rating tankers, to make adequate provision for all elements of cost. It does not apply if the accepting club already insures ships from the relevant fleet.
- 15.7 But if and when the club's underwriter is free to fix his own rate he will take into account a number of factors, including the type, trades, age, and flag of the ship or ships in a fleet. Drawing on his experience of fleets with similar characteristics that he insures he will produce a typical rate which he will then adjust up or down to take account of the claims record of the particular ship or fleet.

- 15.8 Two things should be noted about this process. First, a factor such as the nationality of the ship's crew may suggest good quality, but may actually increase the rate if the experience of the underwriter is that generous levels of compensation to crew from that country mean that he will be faced with crew claims at a high level. Second, at least before any prior claims record for the particular ship or fleet is added to the mix, the underwriter is, by leaning heavily on experience of ships with comparable characteristics, extrapolating what is essentially an 'average' rate. A brand new fleet without any claims record would receive such an average rate, modified only by any surcharge that the underwriter built in for inexperience.

### **The subsequent importance of claims record**

- 15.9 The rate that the fleet will pay in subsequent years will very largely depend on its own developing claims record with the new insurer. For after a time most ships and fleets in a P&I club are said to be 'making their own rate' as the club underwriter's initial rate becomes modified and re-modified by annual adjustments up or down in response to better or worse than expected claims figures for that ship or fleet.
- 15.10 In view of the often weak correlation between the quality of an operator and the incidence of liability claims (see chapter 13 above), a ship managed by an established operator of high quality may not enjoy a rate that is much different from that of a similar ship under poorer management. This is unhelpful to the search for ways of encouraging better quality operators. But it is difficult to criticise club underwriters for their belief that individual claims records, while admittedly an imperfect indicator of future risk, are a better indicator of it than any others available to them. They are understandably reluctant to cast themselves off from this secure mooring.
- 15.11 Club underwriters have not believed that they have or could gain enough information about the relative quality standards of each shipowner member to create an accurate scale of relative standards and use this as the basis for differential rating. Moreover, such grading of shipowner members may have been seen as somewhat contrary to the collective atmosphere of a mutual club. It could also invite numerous appeals from the club managers to the club board on issues that are partly subjective. Nor have club managers thought that the result, purely in terms of the prediction of the relative likelihood of claims upon the club's funds, would be an improvement. This brings us back to the often weak correlation between quality and claims that has already been mentioned. The possibility of developments in this area is discussed in paras. 15.20 to 15.24 below.

### **The gradualness of change**

- 15.12 Because of this reluctance to allow perceived differences in operational quality to increase or decrease the rate that a shipowner's claims record has created for him, P&I rates tend to be 'flatter' than might be expected. There are differences between rates for similar ships in similar trades and these are sometimes quite noticeable. But they depend almost entirely upon different claims records and very little upon any other factor.
- 15.13 Moreover, even when a very large claim comes along, its effect on the operator's rate will often be less marked than might be assumed.
- 15.14 This is partly because P&I underwriters are trained (and instructed) to be gradualist in their attempts to establish the right rate for a fleet. They are encouraged to look upon shipowner members as long-term assureds and to move their rates in moderate steps over several years rather than make violent adjustments at any one annual renewal. The objective is to move in response to the rising or falling trends in the record, but gradually, smoothing the peaks and troughs.
- 15.15 A more technical reason is that the P&I clubs, like hull underwriters in this respect, give full weight in the claims record for an individual shipowner only to the part of any large claim that is below the

point at which the claim moves from the routine to the exceptional. This point varies from club to club, but USD 2 million would be typical. The reasoning behind this cut-off or 'abatement' is that in the experience of the clubs the incidence of the largest claims tends to be random, by contrast to the flow of routine claims, which may better reflect the risk that a particular shipowner brings to his club. (Of course, if a shipowner brings a series of large claims to his club, the justification for their 'abatement' will drop away and the club will take account of the claims in full).

- 15.16 As the part of any claim that exceeds (typically) USD 2 million is ignored in the record of the individual shipowner, the rates of all shipowners have to include an appropriate allowance towards (a) claims across the club between USD 2 million and the start point of the Group's pool, currently USD 5 million, (b) the cost of that club's contribution to the pool and (c) the cost of the collective reinsurance programme. That allowance varies by club, in that clubs that have claimed less from the pool than their size would justify pay less into it and vice versa. It also varies by type of ship, in that tankers carrying dirty oil and passenger ships pay more per ton towards the collective reinsurance than tankers carrying clean oil, and all pay more per ton than dry cargo ships. The part of the rate that is left after this allowance has been taken off is what is judged sufficient to pay the claims that are anticipated from the shipowner in question for the coming year. For a tanker carrying dirty oil, this may be as little as 30% of his rate, although for most dry cargo ships it is likely to be nearer 60%.

### **The effect of a fall in quality**

- 15.17 P&I underwriters are advised by their colleagues in the loss prevention/ship inspection department if a ship performs badly in a club or port state control survey/inspection. Similarly they are told by their colleagues who handle claims if worrying information emerges from the investigation of the circumstances that led to a claim. But such information is unlikely to be translated into an increase in rate. What will happen is that the shipowner will be looked at more closely and, if judged substandard, will be thrown out then or at the next renewal. No rate increase offsets the revelation that the ship or fleet is substandard.
- 15.18 So the general picture is one of a flattish slope above the basic threshold rather than of a steep gradient. If the ship or fleet can remain above the threshold of total exclusion, its rate is not likely to be dramatically different from that of ships or fleets in much better quality operators.
- 15.19 Hull underwriters also give great weight to claims record, but their rates for comparable ships and fleets vary more sharply than is generally the case with P&I rates. Whereas in the aftermath of a serious claim a P&I underwriter will look to increase the shipowner's rate at the next annual renewal by enough to allow 'recovery' by the club of the loss ('abated' beyond say USD 2 million if appropriate) over say eight years, the hull underwriter will be looking to 'recovery' (albeit also subject to some 'abatement' of a very large claim) over a much shorter period, perhaps two or three years. But again, clues as to quality that fail to trigger a decision not to renew cover are unlikely to lead to a loading of rates beyond the dictates of the claims record (although an appreciation by the underwriter that a particular class of ships presents greater risk than he had previously thought may result in an increase in his rate for all such ships). Here again there may be room for change.

### **Rating by other indicators of quality and risk**

- 15.20 Insurers may wish to examine ways in which their assessments of rates for individual ships and fleets, upon first entry but more particularly at subsequent renewals, could move towards less reliance upon individual claims record and towards more reliance upon (other) indicators of quality and of risk.

- 15.21 In “Safer Ships, Cleaner Seas”, Lord Donaldson’s Enquiry noted, in paragraph 18.11, the sheer luck involved in whether a ‘near miss’ becomes a ‘hit’ and continued, “A vessel’s or owner’s claims record is thus only one of the factors to be taken into account in assessing the risk. We welcome the fact that hull underwriters are now taking a closer and more direct interest in both the structural and operational quality of shipping they insure. We believe that it is in the interests of insurers as well as those who want to eliminate substandard shipping that premiums are more closely related to quality and actual risk”.
- 15.22 The chances of progress in this direction are better today than when Lord Donaldson wrote these words. Indeed, some clubs are already developing underwriting models which give more weight to these quality and risk indicators other than record. This reflects in part the increasing availability of relevant information and the power of modern electronics to sift it and to draw meaningful conclusions from it. It has been noted above that there are web-based vetting systems now being developed that will produce quality gradings from such information. These gradings could eventually be used to help set appropriate rates for ship operators of differing quality as well as for the more immediate purpose of making the risk selection decision as to whether to give insurance at all.
- 15.23 The main difficulty in extending this process within the clubs will be to convince shipowners to accept a wider range of factors in the rating of their fleets. Also, when acting as directors of their clubs, they will have to be supportive, in formal or informal discussion with disgruntled members, of the rating decisions of their managers based on factors other than individual claims record.
- 15.24 One result of this change of emphasis should be greater discrimination and thus larger differences between the rates of operators of different quality, despite their using ships of the same type in similar trades. From the standpoint of this report, this is also a desirable result, although, for the reasons that follow, this is very unlikely in itself to be an adequate deterrent to the substandard operator.

### **The effect of increases in rates**

- 15.25 Even if P&I and hull insurers became more willing to load rates in response to quality clues, it is unlikely that this would have a significant impact on substandard operators. If an operator is identified as substandard he will not be offered renewal upon expiry of his policy by either set of underwriters. If he keeps just above the threshold of expulsion, the additional rate penalty he might suffer is still unlikely to be sufficient either to force him to improve his standards or to drive him out of business.
- 15.26 A combination of hull and P&I insurance costs might for a typical 10 000 dwt dry cargo ship amount to 8% of its daily operating costs and for a 40 000 dwt ‘clean’ tanker 9.5%. In each case, the total would be split about evenly between hull and P&I. Looking across all types of ship, the total averages out at around 10%. But even if these costs were, in response to the underwriters’ reaction to adverse quality clues, to double, this would not transform the financial calculations of any but the most marginal operator. The effects of a rise in interest rates on the cost of his loans is likely to be more serious than changes in the insurance elements in his daily operating costs.

## **16. INCREASING EXPOSURE WITHIN THE GROUP**

- 16.1 Although good progress is already being made within many clubs towards more discrimination in risk selection, this process could usefully be encouraged were clubs and their underwriters to be more exposed to the larger claims generated by the ships and fleets that they accept for insurance.
- 16.2 It is accepted that, for reasons already discussed at length, many large claims will continue to arise from the ships of good quality operators. But more discrimination would reduce the incidence of those large claims from substandard operations which are regarded by most club members as unacceptable and avoidable. The current situation, in which claims are poolable above USD 5 million and many clubs reinsure even their exposure up to this modest start point, reduces unacceptably the penalty for a club that lacks discrimination in risk selection. As explained earlier, there are mechanisms to penalise clubs for bringing more than their fair share of claims to the pool, but these work in arrears and only gradually.

### **Raising the Group pool retention**

- 16.3 The simplest way of improving this situation would be for pooling to be made dependent on this USD 5 million deductible not being reinsured. It would not be reasonable to introduce this rule at one step, but it could be brought in progressively over say three or four years.
- 16.4 An alternative would be to raise the deductible of USD 5 to say USD 10 million, but to allow it to be reinsured. The deductible has stood at USD 5million since 1995. Again, the change could be made over say three years. Clubs would still be able to reinsure the increasing deductible, but to the extent that they chose to do so their costs would rise, especially if the results for the reinsurers were adverse.
- 16.5 These two methods could, of course, be combined. The deductible could be raised more slowly while a warranty of no reinsurance was applied to a lower figure moving upwards in parallel. After say four years there might be a warranty of no reinsurance covering, for example, the first USD 4 million of an USD 8 million deductible.

### **Targeting the pool claim**

- 16.6 A different approach, which again could be used on its own or in combination with others including those mentioned above, would be to target the bad claim. If a claim on the Group's pool could be shown to emanate from a substandard ship, then clubs would not be obliged to contribute to it – either at all or, more acceptably, up to say twice the current pool deductible. This concept has been discussed under another heading in chapter 8 above. So have its disadvantages. The obvious problem with this approach lies in the subjective element in the decision as to whether the particular ship is substandard. If the sanction is sufficiently serious to affect club behaviour, then the club whose claim on the pool is under question will fight hard. The issue is likely to lead to litigation, which is bad for the cohesion of the Group.

### **Possible effects of change**

- 16.7 One objection that those opposed to changes of the sort proposed above will raise is that they may eventually force small clubs to merge, either with other small clubs or with larger ones. That may be true. If so, it would be sad to see some distinguished names disappearing. But it has to be said that with 13 clubs in the Group, there is still room, despite the absorption in recent times of four Group clubs by others, for further mergers without damaging loss of choice for shipowners.
- 16.8 It may be argued that were it not for the supportive environment of the Group, the present number would already have been considerably reduced. From the point of view of those working for higher standards in ships and fleets, a reduction in the present number of clubs would if anything make it easier to co-ordinate the necessary steps. Even in the extreme case of the number of clubs being halved, the average club would not be too big; it would still be insuring only about 75 million tons of shipping.

### **Higher deductibles for members**

- 16.9 This section of this report has addressed the use of deductibles to encourage higher standards of risk selection within clubs. It is on the agenda of some clubs to consider whether higher deductibles might have a beneficial effect upon their own shipowner members. A suggested alternative is that the shipowner should bear a share, say 10%, of each claim up to a fixed ceiling. No doubt deductibles and such quota shares are useful in keeping the shipowner and his staff focused on loss prevention. Many owners actively welcome that encouragement, coupled with the reduction in premium – and of overall liability expenditure – that should result. But for deductibles or quota shares to be effective in the campaign against substandard operators they would need to be uncomfortably large and also ‘warranted uninsured’. This may be unfair to good shipowners with small fleets and relatively restricted means, while still not deterring the really substandard operator, who may not worry much about how he will finance claims which he hopes to avoid – until, of course, it is too late. So, although the concept merits further study, it may be found that these weapons are somewhat unwieldy and of limited effect for this particular objective.

## **17. QUALITY OF OPERATORS ALREADY INSURED**

- 17.1 There is a willingness among hull insurers, within individual clubs and within the committees of the International Group, to improve the monitoring of quality standards of fleets they already insure. Progress is being made. In this regard, this report comments on a developing scene.
- 17.2 There is, however, still room for best practice to become universal.

### **Monitoring existing assureds**

- 17.3 In their current work towards a standardisation of survey practice, the Group should insist on all its clubs inspecting at reasonable intervals ships already insured by them. These intervals should be shortened after a ship's fifteenth birthday. It would be sensible for these club inspections to come between rather than at the same time as the periodic special surveys by class.

### **Management audits**

- 17.4 Management audits, as used by several clubs and as described in West of England's Class 1 Part 2 Rule 20 C, should also become a periodic feature of the inspection programme of every club.
- 17.5 This Rule reads in part: "The Managers may as a condition of acceptance, continuation or renewal of entry in the Association....require a prospective Member or, as the case may be, a Member to undergo a safety or other appraisal by the Managers (or such other person as the Managers may designate) of the management systems and/or operational practices employed by the prospective Member or Member ashore or on board any vessel to be entered by him or, as the case may be, any insured vessel".
- 17.6 The Rule gives power to the club's managers, in the light of the results of the appraisal, to terminate membership, vary the terms of entry or impose special conditions including a suspension of cover until the Member has complied with any resulting recommendations.
- 17.7 This concept of the management audit, like the specific requirement of another club that its members must comply with certain "minimum operating standards", predate the ISM Code. Those who pioneered these changes deserve credit. But even now that this Code has come into full effect, such provisions remain relevant. Other clubs should consider whether they might usefully adopt some parts of them.

### **Notice of termination**

- 17.8 In the case of some P&I clubs, the decision to give notice to a member that he will not be renewed is in the hands of the board of directors rather than in those of the club's managers, although the directors will usually be prompted to so decide by information put before them by the club's managers. In the case of others, the managers take the decision.
- 17.9 Typically such a recommendation will follow the emergence during the investigation of the circumstances of a member's claim that his standards are declining. It may also follow one or more unsatisfactory ship inspections and/or condition surveys and/or inspections by port state control. As laid down in the procedure manual of one club's quality control documentation, the club will be

treating these failures as indicating “lack of commitment to quality”. Other signs of this will be noted, including a weakening financial position and more subjective ones such as “deteriorating reputation”.

- 17.10 Such reports may emanate from various points within the club’s management, but, in accordance with documented procedures, they will be channelled to the person or group responsible for the quality of the club’s membership.

### **The member quality executive**

- 17.11 The standing and authority within the management office of the executive responsible for member quality varies from club to club. In some clubs this will be the senior underwriter. In others the person filling this role will be one of the other senior executives in the management. This no doubt helps to keep quality at the top of the management agenda. In some clubs there is a membership quality team, typically made up of those in charge of underwriting, credit control, ship inspection and surveys, and the handling of claims. It is the chairman of this team who makes the team’s presentation to the club’s board of directors that leads to their decision as to whether particular members should not be renewed. If clubs are to become more discriminating and refuse insurance to more fleets, the senior underwriter will inevitably come under considerable pressure. He may therefore appreciate the support alongside him of a senior colleague or of a team with specific responsibility for member quality.

### **Restraints on movements between clubs**

- 17.12 Steps should be taken to make it more difficult for a ship or fleet that is being refused renewal by one Group club on quality grounds to move to another Group club.
- 17.13 More transparency in relation to surveys and inspections would help: see chapter 7 above.
- 17.14 But, in addition, national and regional governments and their competition authorities should be asked whether they will respectively support and approve the introduction of tougher provisions to this end. Some possibilities have been discussed in chapter 9 above.

## 18. LOSS OF COVER

- 18.1 Cover can be removed from the substandard operator and, even if cover is maintained, the insurer may refuse to pay a particular claim if it is caused by serious default of such an operator.

### **Deciding not to continue cover**

- 18.2 The insurer who becomes convinced that an existing assured is substandard can and normally will decline to renew.
- 18.3 Hull insurance policies generally run for a year, although sometimes a multi-year policy may be agreed. P&I club policies run for a year, although they will usually renew automatically if neither the club nor the member gives notice ahead of the end of the year. But in neither case is the insurer obliged to renew once the fixed period expires and in many cases notice to terminate can be given at any time.
- 18.4 A large club may give such notice in this way to two or three fleets each year. The ease with which such a rejected assured can find a new hull underwriter or a new club has already been commented upon.
- 18.5 The assured may also lose his cover during the period of the insurance contract, either temporarily or for good, by the operation of terms in the insurance policy.

### **Automatic loss of cover**

- 18.6 Thus, his cover may terminate because he fails by the due date to pay the agreed premium to his hull insurer or his club.
- 18.7 The London 2003 hull clauses provide that cover will terminate (at once or, if at sea, upon arrival at the next port) if there is a failure to maintain class or a failure to comply in time with class requirements affecting seaworthiness or to have in place valid ISM documentation. Cover is also to terminate (at once or, if at sea laden with cargo, upon arrival at final discharge port) upon any change of ownership or of management or of flag, upon bareboat charter or requisition or upon sailing without prior agreement on a voyage for break-up. Hull insurers will not be liable for claims arising while the ship is navigating outside the geographical limits set out in the policy.

### **Automatic suspension of cover**

- 18.8 P&I club cover will be suspended (subject only to a discretionary power in the club's directors to decide otherwise) while class is not maintained or while the assured/member is failing to comply with class or flag state statutory requirements or those in relation to the ISM Code (or from July 2004 the ISPS Code). Cover also terminates automatically upon a change in the manager of the ship.

### **Loss of cover for a claim**

- 18.9 Cover may be removed in respect of a particular claim under either a hull policy or P&I club rules.

18.10 This will be the case where, under a policy subject to the English Marine Insurance Act 1906 (which codified previous case law), the cause of the casualty is that the ship has been sent to sea in an unseaworthy state of which the assured knew (or would have known had he not ‘turned a blind eye’ to the facts). It will also be the case where the loss arises from the “wilful misconduct” of the assured. Other national laws have similar provisions and these apply to all hull and P&I club policies. The London 2003 hull clauses remove cover for claims attributable to non-compliance with flag state requirements and class reporting requirements.

### **Warranties**

18.11 It may be noted that London hull policies traditionally included so-called “warranties”. These were in effect promises by the assured which, if broken, terminated his cover from the moment of breach and even for claims which had no connection with the breach and even for such claims which arose after the breach had been remedied. In recent years the English courts have been critical of the harsh and arbitrary effect of such warranties. Consequently the modern tendency is for hull policies to include in their place promises which spell out the consequences of breach, make those consequences more appropriate to the breach and re-establish full cover after the breach is remedied. For many expressly prohibited activities (such as, for example, ship to ship transfer of cargo at sea) cover is suspended but only until that activity is concluded.

## 19. INNOCENT VICTIMS OF CASUALTIES

- 19.1 It will be seen from the previous chapter that, in addition to hull or P&I cover being declined from the outset (see chapter 12 above) or from renewal (chapters 17 and 18 above), it may be terminated or suspended during the currency of the policy or it may be removed from claims arising from a particular casualty.
- 19.2 While the triggers for such general or particular loss of cover encourage good standards of operation by the ship operator, an actual lack of cover obviously presents a danger to the innocent victims of a casualty caused by his ship.
- 19.3 The innocent victims are much more likely to be distressed by the loss of the ship operator's P&I cover than by the loss of his hull cover, because it is the former that deals with almost all of the ship operator's liabilities to those victims.
- 19.4 The loss of hull insurance cover is likely to be important to third parties only in so far as it may leave the ship operator without the ability to pay for liabilities that were insured under his hull rather than his P&I policy. As we have seen, these may include all or part of liability for collision with another ship and/or liability for contact damage to wharves and other structures. But the seriousness of this situation is reduced by the fact that from any such cover as is given by the hull policy there is likely to be a specific exclusion of any claims for pollution or for loss of life and personal injury. These will be picked up by the P&I policy. It should, however, be noted, for the sake of completeness, that it was pointed out by Lord Donaldson's Enquiry that, in a serious casualty situation, a potential salvor might be discouraged were he to discover that there was no hull insurer who would be obliged to pay any eventual salvage award.
- 19.5 In years gone by, the innocent victims of a casualty caused by a ship which had lost its P&I cover – either permanently, temporarily or in respect of claims arising from that particular casualty – could find themselves without redress if the owner of the ship had no assets that were available to them.

### **International conventions**

- 19.6 But during the last thirty-five years, a series of international conventions has been developed, under the auspices of the IMO, to protect such victims. These conventions have been designed not only to provide uniform levels of compensation, but also to make sure that it is adequate in amount and that it will be delivered promptly and effectively. They aim to protect most categories of those who are likely to be adversely affected by serious accidents involving ships.
- 19.7 Some of these conventions have been brought into effect and are operative throughout almost the whole world. Some are fully operative but are about to be up-dated, particularly as to the amount of compensation that they offer. Others have yet to gain the adherence of a sufficient number of states to come into effect, but most of these are expected to do so within a few years from now.

### **Oil pollution**

- 19.8 The area in which international legislators have been most active is that of pollution, originally in the aftermath of the oil spill from the grounded Torrey Canyon in 1967.

- 19.9 Those who suffer damage from the escape or discharge of persistent oil from a tanker have rights against her registered owner under the Civil Liability for Oil Pollution Damage Convention 1969 and its 1992 Protocol. Persistent oil includes crude, fuel oil, heavy diesel oil and lubricating oil.
- 19.10 Liability under the Convention is 'strict'. This means that the shipowner will be liable unless he can bring himself within a very narrow list of defences, by proving that the accident was caused by war or irresistible natural phenomenon or the deliberate act of a third party or the negligence of an authority responsible for navigational aids. Should the liability claims from the casualty exceed in aggregate the ceiling that the Convention and its Protocol place upon the liability of the shipowner, the claimants can look directly to an International Fund for additional amounts of compensation. A third tier of compensation is being added by the 2003 Protocol on the Establishment of a Supplementary Fund for Oil Pollution Damage. This will become effective later in 2004. It will bring the total amount available to the pollution victims to about USD 1 billion.
- 19.11 Discussions recently began under the auspices of the International Fund (IOPCF) as to whether the oil pollution conventions require further revision. The debate is ongoing. Among other issues now in play is whether the shipowner should make a larger contribution to oil spills in order to encourage him to adopt higher standards. This question is beyond the proper scope of this report, which deliberately avoids intruding upon it. But as the debate embraces the discouragement of substandard shipping, it has inevitably raised a number of the issues that are touched on in this report.
- 19.12 Insurance by the shipowner against the liabilities imposed upon him by the Convention is compulsory. Tankers which carry more than 2,000 tons of persistent oil as cargo must carry a certificate issued by their flag state (or if that state is not party to the Convention, by a state that is a party) as proof that such insurance is in place. The state issuing the certificate will have received prior confirmation of coverage from the ship's P&I insurer.
- 19.13 The Convention also provides that these liabilities may be enforced directly against the P&I insurer of the shipowner. This is so during the life of the flag state's certificate, even where the insurer has withdrawn cover from the shipowner. The only defences available to the shipowner's insurers are those provided within the Convention itself, namely the shipowner's own defences and, in addition, "wilful misconduct" of the shipowner.
- 19.14 Should the shipowner be able to rely on one of his defences or should his insurer be able to escape liability by proving "wilful misconduct" of the shipowner, the International Fund 'drops down' to cover the consequent gap in the compensation payable to the victims.

## **Bunkers**

- 19.15 Similar rights are to be given to the victims of a spill from a ship's own bunkers, whether she is a tanker or a dry cargo ship. The 2001 Convention on Civil Liability for Bunker Oil Pollution Damage is expected to come into effect during 2007. Limits on the shipowner's liability will be at the new high level provided in the 1996 Protocol to the Convention on Limitation of Liability for Maritime Claims 1976, which Protocol will take effect in May 2004. The Bunker Convention will likewise give direct action against the shipowner's liability insurer. As with the CLC, liability will be strict and insurance will be compulsory.

## **OPA 90**

- 19.16 Victims of oil pollution incidents within the waters of the United States receive compensation in accordance with that country's draconian equivalent of CLC, the Oil Pollution Act of 1990 (OPA 90), and its corresponding Fund. The strength of this legislation reflects the degree of Congressional anger in response to the **Exxon Valdez** spill in Alaska. It is noteworthy that the P&I

clubs refused to provide the certificates that would have exposed them to direct action under this legislation. This was because they judged that exposure to be so great as to endanger their ability to continue to provide cover to shipowners for their other liabilities around the world. The final straw was that the Federal legislation, having introduced exceptionally high limits on shipowner liability, released individual States to bring in their own oil pollution laws without any upper limits at all. To fill the role that Congress had designed for the clubs, new financial vehicles had to be specially created which proved expensive, adding unnecessarily to the cost of moving cargoes into and out of the United States. The tankers trading there continue to receive from their clubs the same amount of pollution cover as when trading elsewhere, namely USD 1 billion.

## HNS

- 19.17 To revert to the rest of the world, victims of maritime accidents involving the carriage of “hazardous and noxious substances” are to have protection from the 1996 HNS Convention. A large number of dangerous and unpleasant substances are covered, whether shipped in bulk or in packages, and “damage” is widely defined. A gap left by the CLC, fire and explosion in persistent oil cargo, is filled. Liability is strict, insurance against it will be compulsory and direct action is provided for against the insurer. Again, an International Fund will be available to provide additional compensation above the Convention’s limits on the exposure of the shipowner and his liability insurer, and if necessary to fill any gap in recovery from the shipowner or his liability insurer. Although the EU states are working towards ratification by June 2006, it is not yet clear whether there will by then be enough ratifications to bring the Convention into effect, or whether there will be some further delay beyond that date.

## Cargo

- 19.18 The owners of cargo on board a ship may also be victims of a substandard shipowner. Their cargo may be damaged or lost and claims which they might otherwise have recovered from the shipowner may go unpaid if the loss of insurance cover leaves the shipowner in financial difficulty. There are international conventions which define the circumstances in and the extent to which the shipowner will be liable, but these do not make insurance compulsory, still less provide for direct action against insurers. So the shipowner may choose not to insure against liability to cargo; and if he does insure, the insurer may deploy his policy defences, including the usual provision in liability policies that the insurer’s only obligation is to indemnify the assured in respect of claims which the assured has paid in the first instance (see **The Fanti and The Padre Island**).
- 19.19 But the owner of lost or damaged cargo is in a totally different situation from that of the victims of say an oil spill. He is voluntarily in a commercial relationship with the shipowner, with whom he has a contract. Moreover he will almost always be able to recover his loss from the insurance policy which he will have taken out in respect of his cargo. The recourse action against the shipowner becomes a matter between his cargo underwriter and the liability underwriter of the shipowner. There is no need for the IMO to create international legislation to aid the cargo owner.

## Passengers

- 19.20 On the other hand, passengers have been given the protection of a convention in respect of death and injury as well as in respect of baggage claims. The 2002 Protocol to the Athens Convention relating to the Carriage of Passengers and their Luggage by Sea greatly increased the exposure of shipowners to such claims. Insurance in respect of these claims has been made compulsory. A right of direct action against the liability insurer is added. It should, however, be noted with reference to the discussion that follows about further extension of this concept, that it is not clear as at April 2004 whether the P&I clubs will be able to provide direct access in respect of all liability

under this Protocol. The issue is still under consideration. It is possible that direct action will be available for only part of the shipowner's full exposure.

### **Seafarers**

- 19.21 By contrast, there is no equivalent international convention giving officers and crew the benefits of compulsory insurance or of direct action rights against their shipowner's liability insurer. A particular difficulty here is that some shipowners exclude liabilities to their officers and crew from their P&I club cover, because these seamen are protected under a national social insurance scheme. There exists, however, a joint IMO/ILO Ad Hoc Expert Working Group on Liability and Compensation regarding Claims for Death, Personal Injury and Abandonment of Seafarers. This body has developed guidelines on the provision of financial security in cases of abandonment of seafarers and on shipowners' responsibilities in respect of contractual claims for personal injury to or death of seafarers, which guidelines were adopted by the IMO Assembly in November 2001.
- 19.22 Assuming that seafarers are adequately dealt with, it seems that the conventions in force and due to come into force over the next few years provide generously for most categories of third parties who are likely to suffer from serious shipping casualties. Levels of compensation are sufficient and liability insurance to cover them must be in place in advance.
- 19.23 Tankers subject to the CLC cannot trade today without the necessary certificate confirming that they have liability insurance in place. If they were to try to do so, they would be picked up by the first port or terminal at which they called. The many more ships subject to the other conventions mentioned above will also be unable to trade for long without the equivalent certificate, as and when each convention comes into effect.

## 20. COMPULSORY INSURANCE

- 20.1 Despite the existence of these targeted conventions, a strong case can be made out for making it compulsory for shipowners to carry insurance against all significant third party liabilities. It is, perhaps, surprising that such a provision was not introduced into international maritime law many years ago, just as it was within national laws so far as concerned other activities with an obvious potential to cause damage to others, such as driving a motor vehicle.
- 20.2 The new conventions do not make this unnecessary. First, it will be some time before they are all brought into effect. Second, some victims of maritime casualties will remain outside their scope. Of these, some can be expected to look after themselves, as in the case of cargo, mentioned above. But others cannot; for example, individuals other than passengers who are killed or injured while on or near a ship but in circumstances outside the scope of the HNS convention, or the owners of property struck by the ship. Unless local laws come to their aid, which will often not be the case, these victims are likely to be prejudiced if the shipowner does not have liability insurance.

### **Direct action**

- 20.3 But compulsory liability insurance does not necessarily have to bring with it direct action rights against the liability insurer. Compulsory insurance and direct action are distinct concepts and it is perfectly possible to have the former without the latter. It is, for example, normal for employers to be obliged to insure against their liabilities, but without direct action being required. As shown above, certain international conventions have introduced direct action for selected maritime liabilities. But there is no reason why this must apply to others. Moreover, it has been noted above that direct action rights may not be available up to the full extent of the shipowner's exposure under the new Protocol to the Athens Convention. The limits of this device may be in sight.
- 20.4 Indeed, any extension of direct action rights for maritime liabilities poses problems. The P&I clubs themselves argue strongly that its imposition is practical only as part of an international convention establishing a general legal regime either for a specified risk or for all liabilities.
- 20.5 The classic example of a practical system is that established for oil pollution claims under the Civil Liability Convention, described above. The Convention lays down an easily recognisable class of ship, establishes clear rules on liability, limits and the channelling of claims, is very widely accepted internationally as the exclusive law on this subject and dovetails precisely with the International Fund's top-up system. The P&I clubs provide state parties with certificates confirming cover and the states then provide certificates to the ships, which can then be demanded by, for example, flag state control authorities.
- 20.6 The clubs say that if it were decided to establish direct action in respect of any additional liabilities (or indeed all of them), then there would need first to be an international convention of equal clarity and acceptance. They warn, however, that the expansion of this concept from tankers carrying at least 2000 tons of persistent oil in bulk (and moving between large facilities owned by a small number of companies) to dry cargo and passenger ships is a quantum leap in terms of the bureaucracy that would be needed, because of the huge number of ships and loading ports involved.
- 20.7 In a paper (LEG 76/3) submitted on this subject to the 76th session of the IMO Legal Committee in August 1997, the International Group said: "There is the real possibility of creating a large,

expensive and cumbersome bureaucracy to deal with a minimal problem, which is likely to persist even after the bureaucracy is in place”.

### **Compulsion without direct action**

- 20.8 The alternative is to make liability insurance against all significant maritime risks compulsory, but to make no additional provisions for direct action against the insurer. This may be the wisest course.
- 20.9 In “Safer Ships, Cleaner Seas”, Lord Donaldson’s Enquiry concluded, at paragraph 18.36, that possession of “at least adequate P&I cover” was “essential”. In paragraph 18.37, the Enquiry preferred international rather than national or regional action to make liability insurance compulsory, perhaps as part of the revision of the 1976 Convention on Limitation of Liability for Maritime Claims that was then (1994) under discussion. In the event this was not made part of that revision, but compulsory liability provisions were included in the specific conventions that followed and are described above, albeit with the more contentious add-on of rights of direct action against the insurer. Compulsory insurance for all ships is a policy objective of the MTC of the OECD.

## 21. CERTIFICATION

21.1 Most ocean-going ships already carry a certificate from their P&I insurer confirming cover.

### **IMO Guidelines**

21.2 This accords with an existing IMO Resolution from November 1999, which formally adopted Guidelines on Shipowners' Responsibilities in Respect of Maritime Claims. This Resolution refers to the duty on shipowners "to take proper steps to ensure that legitimate claims are met, in particular by taking out effective insurance cover" and the fear that, if they do not, "eligible claimants may not obtain prompt and adequate compensation". It therefore adopts the Guidelines, which refer to "indemnity insurance of the type currently provided by members of the International Group of P&I Clubs" and provide, inter alia, that: "Shipowners should ensure that their ships have on board a certificate issued by the insurer".

### **Certificate on board**

21.3 A useful next step, building on these IMO Guidelines, would be to make it compulsory to have liability insurance and to require this to be evidenced by a certificate on board each ship.

21.4 At the end of the last century, an attempt to move in this direction was made within the IMO Legal Committee. That attempt was in the end unsuccessful. Perhaps that failure was not surprising. The concept is sound, but it does present problems of detail.

### **Contents of the certificate**

21.5 It is necessary to stipulate the liabilities against which insurance will be required. This is not easy. As mentioned above, there are some liabilities against which the P&I clubs provide cover which some shipowners do not need to insure, as where their crew risks are taken care of by a national social security scheme.

21.6 There may also have to be provision for more than one insurer to be mentioned on one certificate, as where collision or contact damage liabilities are covered under a shipowner's hull policy.

21.7 It is also desirable to stipulate the limit up to which liabilities (or, alternatively, each enumerated liability) must be covered. Presumably the limit (or limits) would be high. The IMO Resolution from November 1999 stipulates that cover be up to the limits in the latest amendment to the Convention on Limitation of Liability for Maritime Claims 1976. The limits under the 1996 Protocol to this Convention are very substantial. So, although "other financial security" would be an acceptable alternative to liability insurance, as under CLC and similar conventions, it would be unlikely that a shipowner would be able to use say a standing bank guarantee as an alternative to insurance.

21.8 Provisions are also necessary regarding the acceptability of insurers (as to which there are further comments below) and as to the expiry and revocation of certificates.

21.9 But if the political will is strong, details such as these can be overcome. The time may well be ripe for the Legal Committee to try again.

21.10 Once agreement had been achieved, the necessary provisions could be made effective quite quickly, perhaps by means of a brief addition to the SOLAS Convention.

- 21.11 The certificate of liability insurance would then be on the list of those documents that ships have to produce to port state control inspectors.
- 21.12 From the point of view of innocent victims, we have seen that the scope of the described conventions is good. It will be further improved by the proposed general mandatory requirement to carry insurance against all maritime liabilities.
- 21.13 Moreover, to address the other concern in the brief given by the OECD to the author of this report, there is no reason to expect that any of the suggestions made earlier in it for bearing down on substandard operators would have any adverse effect on the benefits that shipowners of satisfactory quality currently receive from the hull and P&I insurers. There is no cause for concern, provided only that legislators do not pile upon the P&I clubs burdens which are beyond their ability to bear.
- 21.14 Such overload could happen at international level. But the best example so far of maritime legislation that aimed to impose unacceptable burdens on the clubs and caused them to pull back was OPA 90. It is said that this legislation has achieved its purpose in that since it took effect the number of oil pollution incidents in United States waters has fallen. This is not the place to discuss that claim. But what is relevant to this study is that there is a point beyond which even such strong insurers as the International Group clubs cannot be expected to go, particularly where the relevant legislation is not international but confers special benefit on victims in only one country or region of the world.

#### **Suitability of insurers**

- 21.15 The residual risk to the innocent victims would be that weak or otherwise inadequate insurers might be accepted for the certification process. The issue of the selection of insurers was one that the IMO Legal Committee found too difficult at the end of the last century. It is difficult but should not be insoluble.
- 21.16 If, as is to be hoped, the existing P&I clubs become somewhat more selective in the ships they are willing to insure, there will be operators of low quality looking for cover outside the International Group. For a time at least this demand will be met by the expansion of less discriminating facilities and by the creation of new facilities of the same type, some mutual and some fixed premium.
- 21.17 Whether these facilities will be accepted as providers of insurance under the existing conventions will be up to state governments. If governments are serious about supporting the raising of shipping standards they will not grant their approval lightly. But it has to be said that the performance of flag states in their direct responsibility for safety standards is not very encouraging on this score. There is provision under the certification process laid down within CLC for a state to “request consultation with” the certifying state “should it believe that the insurer or guarantor named in the certificate is not financially capable of meeting the obligations imposed by this Convention”. This is, however, too weak a provision to be relied on to deal with a state that decided to accept an inadequate insurer for the purposes of the proposed mandatory liability insurance provisions.
- 21.18 The best answer could be for the IMO to appoint a small, expert, international committee to approve liability insurers for this purpose. It should be charged to select only those insurers who are financially strong but are also discriminating as to which shipowners they will insure. The first could be judged by the criteria used by the leading rating agencies and the latter by the sort of procedural audit that this report has proposed at para. 8.13 for the International Group pool.
- 21.19 Again, whether governments prove willing to cede their individual rights to such an expert body will be a test of the importance they attach to the elimination of substandard shipping. This proposal gives them an opportunity to strike a heavy blow in that campaign. It is to be hoped that they will take that opportunity.

## 22. WHAT INSURERS CAN CONTRIBUTE

### Hull insurers

- 22.1 Many hull underwriters are, as indicated above, taking care to avoid substandard operators. But in the essentially ‘soft’ insurance market that continues to prevail, most operators of whatever quality will find hull insurance. They may have to look for underwriters outside the main insurance centres. They may have to agree to less than ideal terms. They may have to accept that if and when a claim arises it may not be easy to collect under the policy. But they will obtain cover – and thus satisfy the need that often drives them to do so, namely the requirement of their lending banks that a hull policy be in place.
- 22.2 Indeed, for so long as the hull market remains so diffuse, so flush with capital and thus so competitive, the substandard operators are likely to continue to be able not only to find hull insurance for their ships, but to do so at prices which cause them little pain.
- 22.3 Consequently the further contribution that the hull market can make to the campaign to squeeze out substandard shipping will be limited – at least unless and until large amounts of capital have been withdrawn from the market.

### Cargo insurers

- 22.4 Now a word about cargo insurance, despite this being beyond the scope of the brief for this paper.
- 22.5 Lord Donaldson’s Enquiry, at paragraph 18.16 of “Safer Ships, Cleaner Seas”, said: “The extent to which cargo underwriters can influence the behaviour of the shipping industry must be limited by the very nature of cargo insurance”.
- 22.6 It is the owner of the cargo who takes out this cover to protect his interest in the goods. So there is no contact between the insurer and the shipowner.
- 22.7 Moreover, the cargo owner normally buys a single ‘open’ policy to cover all the cargoes he may own during the year. The premium is usually paid in advance, based on an estimate of throughput, and may or may not be subject to adjustment at the end of the year.
- 22.8 The standard clauses prevent the insurer from using the unseaworthiness of a ship carrying the insured cargoes as a defence to a claim under the policy, unless the loss or damage arises out of the unseaworthiness and the assured or his servants were privy to the unseaworthiness. But sometimes the insurer under such a policy will try to exert some quality control by including a clause requiring the carrying ships to be classed by an IACS society and not to be above a specified age.
- 22.9 This is the purpose of the Institute Classification Clause. Its scope may be extended by the addition of requirements that the ships are to be ISM compliant and/or are not to be flying certain flags. Monthly schedules in arrears may be required, showing the ships actually used to carry covered cargoes. These may give rise to additional premiums being charged in respect of the use of excluded ships.
- 22.10 But the practicalities of trade make such a clause difficult to operate, and may involve a good deal of expensive administration. The cargo owner will not always have control over the arrangements

for transport of the goods. Even where he might be thought to have control, this may be illusory, as where the goods are consigned to the next available ship and/or are consolidated with others for on-carriage.

- 22.11 So the insurers, in what is an internationally diffuse and very competitive market, are sometimes persuaded to omit the Institute Classification Clause or to soften its impact by agreeing that cover will extend to cargo on excluded ships even without additional premium being charged. The Clause is particularly unlikely to be included in policies for the largest companies, who often buy cover from the market only for exposures above the limits of their substantial captives.
- 22.12 In these circumstances it is hard to disagree with the comment quoted above from Lord Donaldson's Enquiry. This section of the insurance market is unlikely to be able to make any very significant contribution to the campaign against substandard shipping.

### **P&I insurers**

- 22.13 The fact that the P&I clubs are part of the shipping industry, owned and controlled by their shipowner members, makes it likely that they can contribute more to the campaign against substandard shipping than commercial underwriters.
- 22.14 This report has noted a number of steps that the P&I clubs are taking to this end and has suggested ways in which they can be encouraged and helped to take more. It has also proposed a system to prevent those operators who are no longer accepted by the clubs either dispensing with liability insurance altogether or moving to weaker or less discriminating insurers and continuing to trade to the disadvantage of shipowners of good quality.