



Renaissance Risk

Changing the odds in your favour

Future certainty – managing the risk

Shipbuilding – the industry

It is a well-known fact that, despite recent expansion in the industry, shipyards worldwide are “full until 2011”. Even more remarkable is that the scrapping rate of the fleet remains very low. The scarcity of vessels available for scrapping continues despite high prices, in the region of US\$400 per lightweight tonne. Both of these phenomena are driven by earnings which, whilst perhaps not at their peak, remain very strong. The growth rate of the world fleet has never been higher on a sustained basis.

Whenever demand outstrips supply, costs go up. Ship prices are up 50% on average compared to a few years ago. In 2006, tonnage prices for new tankers reached an all-time high, at \$650 per DWT. Yet, such is the allure of the high earnings potential, that there was an “I want it now” premium to be paid, with secondhand prices at \$850 per DWT. And, despite the credit crunch, these high prices are set to continue – or, at least, that is the wish of the shipyards.

New building techniques, modular construction in particular, allied with investment in the infrastructure of established Yards has helped meet the increased demand. But many of the major Shipyards are finding it increasingly difficult to grow organically with limited physical room for expansion.

This strong sale and purchase market is underpinned by a stable repair market, and whilst raw material and labour prices vary around the world, shipowners utilising the most competitive yards still “enjoy” relatively consistent pricing. However, some major Yards that have traditionally housed state-of-the-art repair facilities have shown a tendency to reduce their repair capabilities to focus on shipbuilding activities.

Shipyards are building or have orders for in 2008 around one-third of the current world fleet, almost 500 million Dwt is either on order or currently under construction, and, in order to cut production time, builders have ramped up production. As an example, LNGs can now be produced in less than 15 months; only a few years ago build periods of around three years were not uncommon.

With around one-third of the global Dwt on order at the beginning of 2008, South Korea retains its prominent position. China has developed quickly, and has a greater percentage of construction by number of vessels. Japan is in third position by both measures. On a global basis, 12% of the Dwt is taken by gas tankers, emphasising the continued growth in this market sector.

Over the past few years, the shipbuilding industry has evolved into distinct sectors, each of which has characteristics determining their insurance requirements.

The sector dominated by European based shipbuilding groups specialises in the construction of cruise vessels, passenger ferries and luxury yachts. The growth in this sector is significant because the ever increasing size and sophistication of the largest vessels now requires insurance capacity in excess of US\$1 billion.

The cargo vessel sector is dominated by Asian shipbuilders, in particular by Korean yards which have shown enormous capability in adapting. Every available coastal site in Korea is being considered for the construction of new facilities. China and Vietnam are also looking to increase their capabilities.

The Asian shipbuilders have also quickly adapted to the ever growing requirements of the energy sector with the construction of new, and conversion of existing marine units into production and storage platforms.

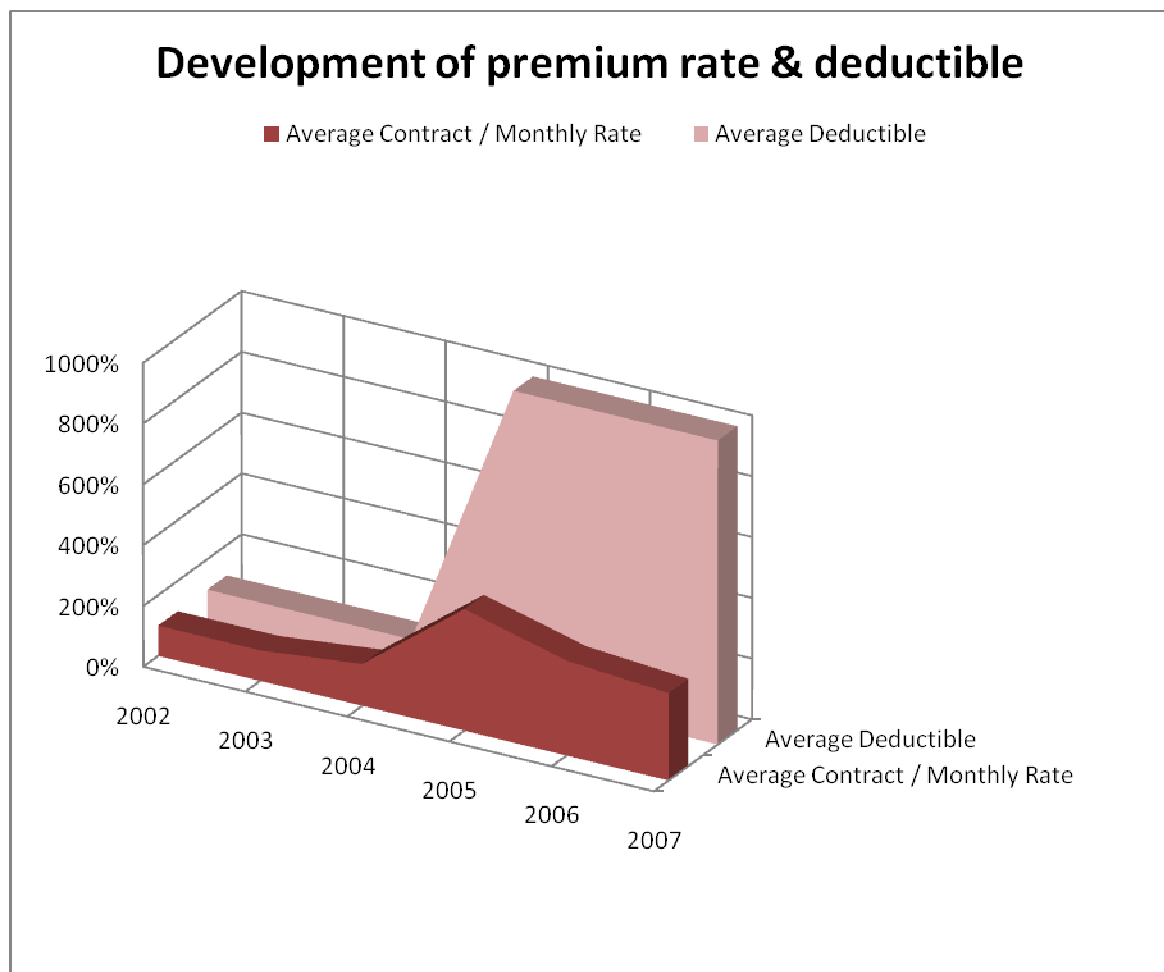
Of course, such a strong demand for shipping, and the building of ever larger, costlier vessels, creates new risk issues, including concentration and aggregation of risk. Manpower shortages are more likely; competent manpower shortages are almost inevitable, but that is for another article. Ports and routes are becoming log-jammed; new routes and better logistics are required. Perhaps it is fortunate, in a loose sense of the word, that the Northwest Passage appears to be opening up sooner than climate change models had predicted.

Shipbuilding – the insurance market

There has been much discussion surrounding a few significant losses in this sector, from 2002 to 2004, which exceeded the widely accepted global premium. The reaction of underwriters, to redress this by increasing premium levels, is perhaps understandable, but this strained relationships with a reducing number of buyers who found it frustrating that their insurance costs should be so directly linked to the losses of a few of their competitors.

The insurance market was therefore presented with a challenge: being increasingly called upon to provide solutions for complex construction projects with ever-increasing limits, but without the ability to spread the risk and premium volume.

After 2004, the market changed in nature. There was contraction of the existing participants, which was tempered by some new entrants, such as Norwegian Hull Club and Fortis, who were able to benefit from the enhanced risk management procedures imposed and premium levels enjoyed. The last two years have produced relatively benign loss ratios, which have resulted in a slight weakening of rates (see figure: Development of premium rate & deductible).



Vessel values up to around US\$25m can often be placed entirely within local markets. But once global capacity is required then terms are provided by only a relatively small group of class leading Underwriters. However, Korean and other Asian markets will now participate in Builders Risk policies outside their own country of domicile, providing additional capacity, and increasing marketing options.

Some of the lead underwriters in Builders Risk have attempted to dictate terms by leveraging the 'capacity risks', such as the latest generation of cruise vessels. However, as the larger shipbuilding groups continue to develop their own insurance strategies and flex their purchasing power, this is unlikely to succeed.

Limits required for insurance purposes are therefore generally well within the capacity of the existing insurance market. However, the sheer volume of vessels being produced creates 'aggregation of risk' issues. This was exemplified in

September 2003 when typhoon Maemi, the worst typhoon to hit South Korea in more than a decade, caused damage to a number of LNG vessels under construction.

Core insurance for the Shipyards will always be physical damage coverage. Underwriters generally prefer to insure a Shipyard for all vessels being constructed or starting construction during an annual period. Declarations are then made in respect of each vessel at pre-arranged rates thereby capturing all of that particular Shipyard's business and avoiding any adverse selection.

Some Asian Shipyards and particularly those in Korea approach Builders Risk differently. Some Yards only buy Builders Risks post launch or float-out, often with other insurers taking the risk in the Non-Marine markets while the risk is on-land. South Korean rates can be up to half those charged elsewhere principally due to their size and commensurate purchasing power. Once all of these factors are put together the rates are far more competitive than those for single project rates.

Delay in delivery is an exposure that has caused significant losses over the years, and can be linked to anything from delay caused by an insured peril to delay caused by faulty workmanship. The number of Underwriters willing to consider delay in delivery cover is a subset of the Builders Risk market, and therefore is relatively small. Such coverage is therefore generally only available to shipyards with a proven track record, and is expensive.

Post delivery, a twelve month Guarantee is often provided by the Shipyard to the Owner. Underwriters are still willing to provide coverage for such matters although, as for delay in delivery cover, premiums can make the purchase of insurance somewhat uneconomical.

Future uncertainty

I have consistently said "risk" should be re-branded as "future uncertainty". Viewed like this, the management of "future uncertainty" is as much about creating opportunities for profit as protecting against loss.

Now, I don't want it thought that I am changing tack but, in my humble opinion, Shipbuilding, Shipconversion and Repair are, at the moment, mostly about protecting the downside.

The omens are against continued good fortune. Take, as an example:

The Global Economy

Following strong growth through the third quarter of 2007, the global expansion has slowed in response to the continuing financial turbulence. Although there are pockets of expansion, the January 2008 IMF projections for global growth in 2008 have been revised down to 4.1 percent from 4.9 percent in 2007; a markdown of 0.3 percentage points from the time of the October 2007 World Economic Outlook, and the risks to this less than rosy outlook remain modestly tilted to the downside.

If the 'modest downside' does occur, and coincides with the large fleet of ships emerging from the shipyards of the world, supply will very quickly overtake demand.

The Credit Crunch

Sub-prime mortgage meltdown in the US and other forms of risky credit has caused massive liquidity problems. The shipping sector is not immune to the fallout. If the paralysis in the financial markets infects the real economy, because banks start to rein in credit to companies, entrepreneurs and individual borrowers, then economic growth could fall more sharply still, undermining public confidence.

Again, oversupply is a possible issue but, just as importantly, finance for new vessels may be harder to come by at reasonable rates. There may be a need to underpin the financial model on which the finance is based through charterers' liability insurance and residual value insurance.

Is it a true market?

As the cost of individual vessels increases, and the cumulative value of vessels under construction increases, it may become more difficult for insurance to be obtained on a true 'market basis'. To obtain capacity, more participants will be required. Others may be restricted by the volume of premium that they are allowed to write.

When most of the markets are required to complete the required capacity, then it is obvious that the level of competition falls, and pricing can drift upwards. Less obvious is that some of the participants on the programme may not have the desired security, which might lead to issues should a claim occur.

Restoring some certainty

There are some risk management solutions that Shipowners should consider before placing a contract to construct their new vessel. Price and reputation of the yard are obvious factors, as is the promised delivery time. But consider also the following points:

First point – ensure that you are using the ‘A team’ from whichever shipbuilder you engage. Although standards may be met, there is a significant difference between just meeting a standard and exceeding the standard. The best team in a small shipyard might be a better bet than the ‘B’ or ‘C’ team in a large yard. If the shipyard has been expanding rapidly, ask the Yard questions such as:

- Where are all your skilled personnel coming from?
- What experience do they have?
- Are your quality and project management skills stretched?
- What are your logistics for materials supply?

Second point - leverage your portfolio. If you have slots booked in for new vessels, or vessels under construction at a yard, is it possible to use that relationship with the yard as leverage to get preferential treatment should one of your existing fleet require repairs?

Third point – cushion the downside. The worst time to be told that your vessel has been delayed by six months due to ‘an incident’ is in the last few weeks before delivery. Have a fallback plan which ensures that you can at least recover some of the anticipated profit that you would have enjoyed had the vessel been delivered on time. Alternatively, try and avoid the event completely; for example, if you are having a vessel built in Asia, is it possible to have the construction timed such that the vessel is not vulnerable during the typhoon season?

Fourth point – explore your finance options. Use risk management to enhance your credit rating. Financiers may soon want to see residual value insurance and charterers’ liability insurance in place to protect the investment. Consider also utilising your risk management activity in dialogue with financiers to enhance the credit rating of the project, thereby reducing the loan rate.

Eventually, of course, the shipping industry will see overcapacity and a reduction in transport prices. Scrapping will increase, and the prices of vessels old and new will fall. That is a risk; but it is one that you can be prepared for.