

Marine Market Report

2022 in review



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Looking back at 2022

If 2021 was all about supply chain issues, then 2022 is synonymous with the war in Ukraine and global inflation. However, it could be argued that the war in Ukraine and global inflation are inextricably linked.

24th February 2022 will undoubtedly be noted by history as the day that Russian tanks entered Ukraine sovereign territory and irrevocably changed the global socio-political landscape. The events in Ukraine have been reported extensively across the globe and require no repetition here, other than to wish for a resolution to the conflict.

Demand-pull and cost-push inflation

Demand-pull inflation occurs when economic growth is too fast for aggregate supply to keep pace. Cost-push inflation occurs when the aggregate demand remains the same, but there is a decline in aggregate supply due to external factors. Both of these inevitably result in an increase in prices. The current global inflation is the outcome, initially, of that demand-pull increase as the global economy recovered from Covid-19 and the attendant supply chain issues. Unusually, the demand-pull was replaced almost overnight in early 2022 by the cost-push of supply constraints, brought about by the sudden and previously unforeseen supply chain issues from the war in Ukraine.

2021 saw an increase of 3.2% in global trade, as reported by UNCTAD. This reversed the 3.8% decline in 2020. The demand-pull inflation warning signs were already manifesting themselves in early 2021, with the six-day blockage of the Suez Canal and subsequent inability of the supply chain to cope with the global rebound from the pandemic.

The switch from demand-pull to cost-push inflation occurred following the Russian invasion of Ukraine. Global demand for many items fell immediately, but not quickly enough to prevent supply constraints from fanning the inflation flames. Ukraine and the Russian federation were major exporters of food, providing around 30% of the world's wheat and barley, 20% of its maize and over 50% of its sunflower oil. Together with Belarus, the Russian Federation exported around 20% of the world's fertilizers, was a leading exporter of natural gas and the second-largest exporter of oil. The sanctions introduced following the invasion of Ukraine have affected consumer economies hugely, perhaps even more than the producing nations.

All of these issues have resulted in ongoing dislocation for maritime trade.

From inflation to recession

By the fourth quarter of 2022, projected global economic growth had been revised downward, resulting in many economies moving from inflation to recession. UNCTAD estimated that higher grain prices and dry bulk freight rates in early 2022 contributed to a 1.2% increase in consumer food prices.

The shipping industry ultimately requires economic movements that are more evolutionary than revolutionary. The costing, ordering and delivery of new tonnage requires careful

assessment of the likely future state of the economy over the lifespan of such investments. Sudden and unforeseeable shifts in that assessment results in investment aversion. Alongside that, the industry also faces uncertainty and concern about the unwinding supply chain impacts and regulation changes, including decarbonising of emissions.



Regulatory changes

Three IMO environmental regulation changes came into force on 1st January 2023. These include:

- 1. The Energy Efficiency Existing Ship Index (EEXI)**
– a framework for determining the energy efficiency of vessels over 400 GT. Ship operators will have to assess their ships' energy consumption and CO₂ emissions against specific energy efficiency requirements. To ensure compliance, shipowners may need to reduce their vessels' emissions. This is a one-time certification.
- 2. The annual operational Carbon Intensity Indicator (CII)**
– applies to ships of 5,000 GT and above, and indicates a vessel's performance and efficiency based on annual fuel consumption, using a rating from A to E. The CII will be assessed annually from 2023 and will become increasingly stringent towards 2030. For ships that achieve a D rating for three consecutive years, or an E rating in a single year, shipowners need to develop a corrective action plan.
- 3. The enhanced Ship Energy Efficiency Management Plan (SEEMP)**
– the mechanism for improving CII ratings. It envisages targets and planning, and the new technologies and practices for optimising ship performance, along with procedures for self-evaluation, verification, and company audits.

Shipping is also affected by other national and regional environmental policies. The EU, for example, in 2021 presented a 'Fit-for-55' package, which charts the path towards 2050 to decarbonise across various sectors, including shipping, and includes changes to the EU Emissions Trading Scheme (ETS). In shipping, the package covers bunkering infrastructure in ports with related tax incentives and aims to promote alternative fuels, therefore establishing fuel standards and lifecycle GHG footprint requirements. Companies would have to buy carbon credits for all voyages starting or ending in the EU and when at berth in EU ports, purchase would be required for whichever flag they fly, or wherever the owner of that ship resides. Ships that do not comply could be detained or denied entry to ports. This is likely to increase the cost of voyages involving EU ports.



Shipbuilding volumes remain low

The abovementioned and other regulatory changes, alongside material uncertainties from the Ukraine war have all resulted in shipbuilding volumes remaining low. The global fleet grew by less than 3% in 2021 – the second lowest rate since 2005.

With reduced levels of new building, the logical conclusion to be drawn is that of an aging world fleet. The 2022 Review of Maritime Transport report by UNCTAD records that by number, the average age of ships is 21.9 years (up from around 20 years in 2018). In terms of gross tonnes, ship deliveries in 2021 increased by only 5.2%. Nevertheless, shipbuilding volumes remain below the 2014–2017 levels.

Congestion at ports

The supply chain disruption and chronic congestion facing world ports has been widely reported. Between September and December 2021, this congestion was estimated by Drewry to have removed around 16% of global container ship sailing capacity due to vessel delays, dwell time in ports and delays in awaiting suitable berths. Congestion was exceptionally high in Chinese export hubs such as Shanghai, Qingdao and Tianjin, mainly due to China's zero-Covid-19 policy. Congestion was also reportedly high in the United States, especially around the ports of Los Angeles and Long Beach – both major gateways for West Coast trade.

Arguably as a result of the dislocation of 2021, container operators experienced increased demand in 2022. From late 2020, spot container freight rates started to rise spectacularly, reaching new highs at the end of 2021. This was reflected in the Shanghai containerised freight index (SCFI), which tracks rates on the major trade routes from Shanghai. In December 2019, the SCFI stood at 898 points, but by December 2020 hit 2,455 and in December 2021 had reached 5,000. In the first two months of 2022, container freight rates continued to increase, but from March, for reasons mentioned above, they started to fall. By September, that index had fallen back to just over 2,000.

State of shipping markets

The dry bulk market continues to be affected by the war in Ukraine and the Covid-19 pandemic, especially in China, which accounts for around 35% of global dry bulk cargo demand. Currently, demand is lower. Similarly to container shipping, vessel supply and operating costs will be affected by energy and sustainability factors, including the IMO regulations.

The tanker market saw more vessels being delivered in 2021 than scrapped, particularly for larger crude carriers, resulting in a steep fall in freight rates. Between 2020 and 2021, average annual daily tanker earnings fell steeply, but recovered towards

the end of the year alongside the increased demand for crude oil. Earnings remained low into early 2022, but in February, the war in Ukraine led to major spikes on some routes. Economic restrictions and other measures have cut crude oil flows from the Russian Federation to Europe, to be replaced by oil from the United States and the Middle East. This has reduced the demand for very large crude carriers (VLCCs) but increased the demand for the smaller Aframax and Suezmax tankers. At the same time, the Russian Federation has increased crude oil exports from the Black Sea and Baltic Sea ports to Asia, replacing oil from the United States, Latin America and the Middle East. This too has reduced demand for VLCCs and increased the use of smaller vessels.

Freight rates may continue to stay buoyant, partly due to a recovery in oil demand and the reshuffling of global oil flows, but also due to a tightening of supply, with slow growth of vessel supply and the removal of old tankers following the introduction of the IMO's EEXI and CII regulations.

The shipping boom is more behind us than ahead of us. Early indicators of this include:

- Increase in vessel recycling
- Removal of dwell time penalties

It could be argued that the increase in the number of containerships being recycled is likely due to older ships receiving their special surveys. The current level of freight rate is insufficient to attract the investment required to upgrade these vessels to meet the EEXI and the CII requirements.

Descartes Systems Group reported the slowdown in consumer demand as overall US imports fell by 19.4% in November 2022. Dwell time penalties are gone as throughput times for containers being onward shipped by road and rail returned to pre-pandemic levels. In the same month, for the Port of Oakland, imports decreased 17.4% year-on-year. Full exports were down by 12.3%, but the empty container exports increased by 75.6% year-on-year. It is irresponsible to justify a trend on a single month's figures, but November was down on October and long-term indicators predict a decline in demand for goods.

The Port of New York and New Jersey ranked as the busiest in the US for the fourth month in a row in November 2022. It was reported by GCaptain that the port handled 723,069 TEU in November, down 4.8% on 2021 figures, but up 20.6% compared to the pre-pandemic level of November 2019. The fruits of the dredging and other infrastructure projects on East Coast ports, in addition to the new locks of the Panama Canal and labour disputes on the West Coast, look to have resulted in a sea change in world to US trade.

The insurance market

The buoyant shipping market enabled owners to pay the increased premiums for both Hull and P&I that the insurance market so badly needed to rectify years of under-pricing. Over 22 quarters of price increases have finally brought the Hull market into some degree of profitability.

With the freight markets now on a downward trend, owners will be looking for savings in all areas of their business, including insurance premiums. Will the insurance market buckle and agree reductions, or will it stand firm? It's too soon to say however, we still stand by our belief that a fragile equilibrium had been reached.

Losses

The Hull market experienced a not abnormal incidence of losses during 2022, both large and attritional. Deductibles featured infrequently in remedial action as focus remained predominantly on premiums. With little action on deductibles, there is still a high level of small partial losses, it's just that there is a much larger pot of premium to pay those losses. The trend for large losses is still downwards, which perhaps indicates improved maintenance levels, in turn reflecting the buoyant freight market and desire for owners to keep their vessels operating.

Hull off the Lloyd's naughty step

It has previously been reported that new capacity has entered the London market. This capacity has largely been company market rather than Lloyd's. The Hull market is now officially off the naughty step as far as Lloyd's is concerned, although it is still under scrutiny. The green shoots of new hull capacity are evident in some of Lloyd's syndicates business plans, as is an increase in capacity for those syndicates already with a hull account focus. Overall, Lloyd's has provisionally forecast a 14.3% top line growth for all lines of business, which equates to an increase in written premium from GBP48.9 billion in 2022 to GBP56 billion for 2023.

An increase in hull capacity without an increase in hull insurance demand should equal a softening market, shouldn't it?

A main contributing factor to these circumstances is 'cost of capital'. This is the return that capital providers require to continue to support the insurance market, rather than transfer to other industry sectors. Capacity in the Direct Hull market is reasonably abundant, but only at the current market level of profitability. That capacity will surely dissipate if the insurance market softens significantly. It should also be remembered that hull business is but a small fraction of overall insurance business.



Other lines of insurance

Whilst the Hull market has performed well recently, other specialty lines have experienced difficulty. The Aviation and Aviation War markets have both been hit with potentially huge losses as a result of the Ukraine war and the confiscation of leased aircraft by Russia. At last count, there were 388 foreign leased aircraft with values totalling USD14.7 billion in Russia, up to USD25 billion in some circumstances. Leasing companies are now submitting claims for being irreparably deprived of their assets. One such company, AerCap, is pursuing insurers for USD3.5 billion alone. Similar circumstances are mirrored in the Political Violence market, where claims are many, including for example, a EUR210 million loss stemming from New Energy's Zaporizhia Wind Park policy in Ukraine, to name but one.

In the Property & Casualty market, Hurricane Ian of 2022 created a huge loss 'drift'. As the claims continue to develop and increase, current estimations by PCS industry loss aggregator are at USD50 billion.

The Property market has been advised of an estimated USD1 billion loss as a result of flood damage and business interruption recoveries to a Toyota plant in South Africa. The French hailstorms earlier in 2022 saw loss drift reach EUR8 billion. Early estimates for winter Storm Elliott are expected to be in the region of USD5.4 billion.

It is also important to note the significance of Downstream energy losses. For example, it has been estimated that the 2022 Freeport LNG refinery explosion in Texas may produce a claim of over USD1 billion. If correct, losses in the class will significantly exceed premium levels. In addition to this, an explosion at an Oklahoma gas plant owned by Oneok is likely to cost insurers USD1.3 billion.

Swiss Re has estimated natural catastrophe losses of USD115 billion for 2022, exceeding the previous 10-year average by 40%.

Many of these losses have been passed on to the reinsurance market. Far less than previously expected, due to increased retentions before excess of loss coverages kick in, but enough to significantly impact both the reinsurance excess of loss and the direct markets. We would be wise to not overlook the impact that reinsurance has on the insurance market.

Hull market 2023 outlook

Historically, marine hull has been seen to fluctuate, with other lines of business outperforming it. Turn to present day however and marine hull is helping to support these now under-performing lines of business.

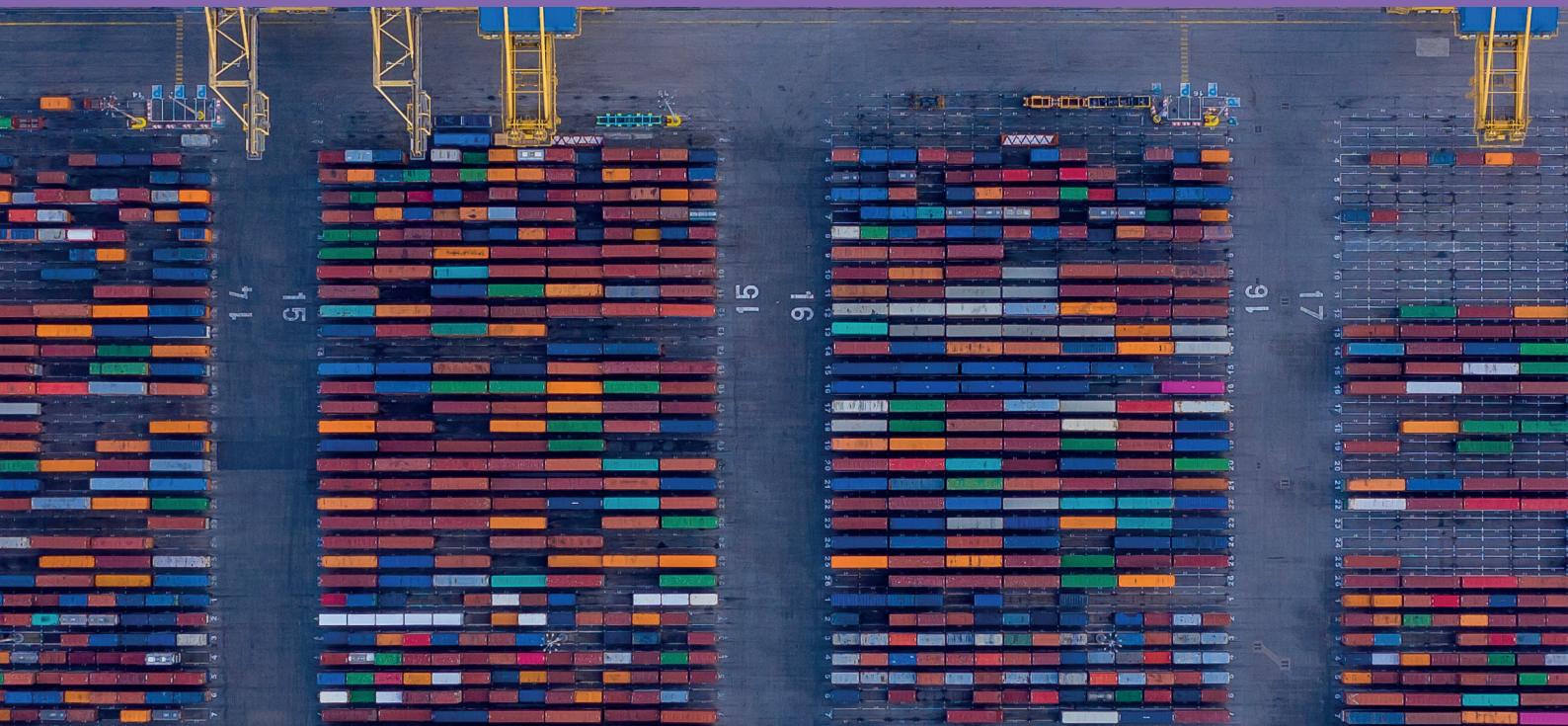
Capital providers do not look at hull business in isolation, but at the insurance market holistically. If the market is generally under-performing, then all lines of business come under pressure. The large losses in the second half of 2022 weigh heavily on the improved rating environment.

The prognosis is likely a continuing fragile equilibrium for the Hull market. This is predicated upon rates in the Marine market presently being broadly flat, despite losses from other lines of business. This reflects the attraction of the class to underwriters, the remedial action that has been taken and the perceived profitability given the current rating environment. Although, global inflation is providing upward pressure, making renewal negotiations challenging.

This year's issue is not pricing, however. It is coverage and wordings, largely brought about by the Russian invasion of Ukraine, and revolves around three aspects:

- **Reinsurers are restricting the aggregation of vessels** to prevent a repeat of the multiple losses due to invasion. The wordings being imposed restrict any recovery to a single risk. At a stroke, this shifts the accumulation risk from reinsurers to the direct underwriters and the potential for this increased retained loss instantly reduces the direct underwriter's capacity for war risks.
- **Sanctions.** War risks are typically insured under covers and lineslips, whereby the leader assumes the sanctions checking responsibility for the market. Many underwriters are finding this unacceptable and are demanding to make their own sanctions checks. This requirement nullifies all value of these facilities if each underwriter is required to make their own decision as to sanctions.
- **Russian nexus.** An increasing number of underwriters look to distance themselves from having any risks in the region, irrespective of whether the risks are exposed to war perils. For hull risks, some underwriters are excluding any Russian exposure or touchpoint. This is in addition to any sanctions check.





In other matters

Lithium-ion batteries - the new threat

In March 2022, the US Coast Guard received a report on a container from China which caught fire at LA/Long Beach. The bill of lading indicated that the box contained 'synthetic resins' (non-hazardous), when in fact it held used lithium-ion batteries - a hazardous cargo that is extremely sensitive to high temperatures. The container was mis-declared. This is a common problem, as reported by the National Cargo Bureau (NCB) following a survey of 500 containers, where more than half failed with one or more deficiencies. Overall, 69% of the import containers contained dangerous goods, alongside 38% of the export ones. There have been several catastrophic car carrier fires as a direct result of battery fires, with the most recent being the total loss of the Felicity Ace in late February 2022.

ESG impacts

The world needs a new generation of ships that can use the most efficient fuels and integrate them with smart digital systems. With an aging fleet, this is clearly more challenging and the total CO2 emissions of the world's merchant fleet (annualised monthly) continues to increase rather than diminish. UNCTAD recorded annualised emissions in April 2022 of 847 Mt, up from 782 Mt only two years prior.

As shipping accounts for around 3% of global emissions, the industry is likely to clamp down on pollutants as 'soft' legislation morphs into a firmer regulatory environment, and shipping will likely become caught in the cross hairs of GHG emissions.

Looking to the future

For the Hull insurance market, 2022 was largely positive; for other markets, less so. Looking to the future, there are simply too many uncertainties to be able to predict trends beyond the next few months. We continue to believe that a fragile equilibrium of rates may continue however, a material shift in any of the underlying factors, endogenous or exogenous, could result in a change in the market.

We hope that a resolution can be found in 2023 to the Ukraine invasion and hope for a less turbulent review at the end of this year. However, if we are to follow the trend of recent history, it may be another eventful year.





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