Capital management methodology
(How the board assesses the appropriate level for the club's free reserves)

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The Standard
for service and security

Standard Club

All P&I clubs must have free reserves to protect members against shocks, but how large should these reserves be? This bulletin explains how The Standard Club works out the appropriate level of reserves to protect against such shocks – and when to give some of the reserves back.

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Introduction

Providing members with first-class financial security is one of The Standard Club's four strategic objectives. This includes holding free reserves large enough to cushion members from paying extra calls to cover shock claims or losses.

But in setting the level for its free reserves, the club must also consider its regulatory and rating requirements.

This bulletin explains how the club works out the appropriate level of its free reserves, enabling it to:

- minimise the risk of making extra calls
- continue to benefit from its 'A' rating from Standard & Poor's
- comply with financial regulations
- ensure its free reserves are no higher than needed to meet these objectives.

Free reserves are measured as the surplus of the club's assets (investments, cash, reinsurance recoverables, premiums due) over its liabilities (principally outstanding claims provisions). Additional sources of capital may be used to top up the level of free reserves, such as the potential for clubs to make unbudgeted supplementary calls. The Standard Club has not had to make an extra call for 25 years.

Free reserves – the drivers

Future financial risks

The Standard Club's free reserves are designed to provide protection to members against a financial loss that might happen in the future. Strong free reserves also help to ensure pricing stability for members in the long term.

Calculating the anticipated financial risk requires complex modelling of future claims, planned reinsurance and pooling arrangements, proposed investment strategy and expected overhead costs.

The club has developed and maintains internal actuarial model to estimate the probability of different levels of profit or loss occurring in the coming year and how this will affect the free reserves. The model inputs include the business plan for the next three years, expected volatility in investment markets, variability in the number and severity of large claims, variability in premium rates and vessel numbers, and the potential for claims inflation to rise or fall.

The model outputs allow the club to understand the effect of future financial risks on profit, loss and free reserves. It is also used to calculate the probability of specific outcomes, for example how likely it is that the club could lose $20m, $50m or $100m in one year.

In practice, the biggest sources of financial risk – and therefore risk to the free reserves – are the number of large Pool claims (both the club's own and its share of other clubs' claims) and returns on higher yielding but potentially more volatile investments such as equities.

Regulatory authorities
The Standard Club's free reserves must meet the minimum levels required by insurance regulators.

90% of the club's P&I business is reinsured to Standard Re (the club's captive Bermudian reinsurer) from the club's operating subsidiaries in the UK and Singapore. This enables the group to concentrate risk retention in one entity, thereby providing more effective capital management and optimising investment opportunities. While these subsidiaries must comply with local regulatory requirements, the club's main regulator is the Bermuda Monetary Authority (BMA).

The free reserves required by the BMA's 'solvency capital requirement' (BSCR) are calculated using a standard formula, which includes premium volume, value of claims reserves and exposure to different categories of investment risk and reinsurance credit risk.

Standard Club risk management
The club performs a free reserve calculation tailored to its own risk profile based on a 1-in-200 year worst-case outcome, generally known as an 'own risk and solvency assessment' (ORSA). The club uses its internal model to calculate this figure, which it refers to as 'ORSA capital'.

If the club's free reserves were to drop below the ORSA capital level, it is highly likely that the club would need to make extra calls on members to maintain financial stability and to meet regulatory expectations.

Rating agencies
The Standard Club's free reserves are a key metric used by credit-rating agencies to assess the club's financial strength (along with pricing stability).

The main agency for rating P&I clubs is Standard & Poor's (S&P). The club's current S&P 'A' (strong) financial strength rating supports members in meeting their own minimum insurance security objectives, ensures the club's guarantees for members are readily accepted around the world and helps it to get the best deals in reinsurance and other key services.

The most important component of the rating is the level of free reserves compared with the risk taken, which S&P calls 'capital adequacy'. S&P calculates this using factors such as planned premium volume, size of claims reserve and nature of investments.

Unlike larger global insurers, P&I clubs tend to be limited in their ratings by their relatively small size, lack of diversity and therefore higher underwriting risk. To achieve and keep an 'A' financial strength rating, S&P therefore looks for an 'extremely strong' capital adequacy rating and a significantly higher level of free reserves than is required from a regulatory capital perspective.

If the free reserves were to drop below the S&P capital adequacy level, it could put downward pressure on the club's S&P 'A' financial strength rating.

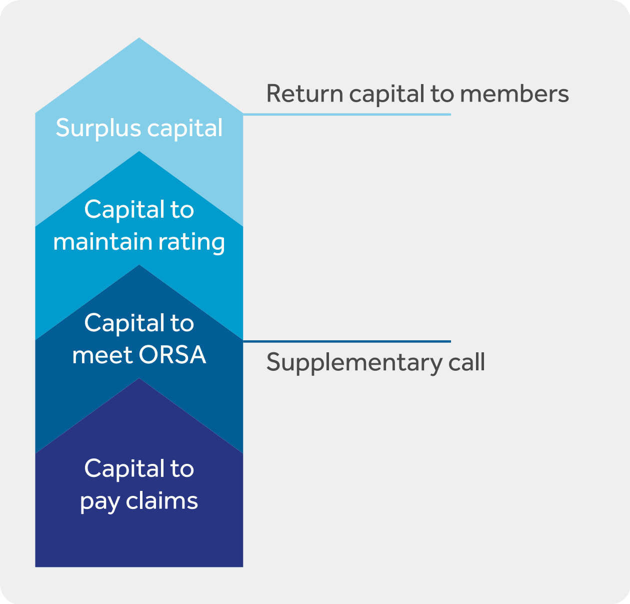
Risk appetite of the club
The Standard Club's free reserves must reflect the boundaries set by the club's board for its risk appetite.

The club's board regularly reviews the overall risks taken by the club. This includes risks from activities other than its core mutual P&I business – such as equity investments, The Standard Syndicate at Lloyd's and fixed-premium insurance products. The club's internal model is the primary tool used to measure this.

The club has several ways to control risks, for example, by varying the volume of business it accepts, varying the amount of reinsurance it buys, and adjusting its investment strategy. To ensure consistency in decision-making, the board has risk-appetite statements which set the boundaries for each risk.

The club's capacity to take risk is guided by its objectives as a mutual P&I insurer controlled by and operating for the benefit of its members. The board has therefore set its overall risk appetite in terms of the risk that it may have to make extra calls on members.

The club's main risk appetite requirement with respect to the minimum amount of free reserves is to avoid risks that would lead to a more than a one-in-ten chance that the free reserves would fall to a level that would require the club to make a supplementary call. In practice, the club holds free reserves considerably above this level, partly in order to meet rating agency requirements, and partly to maintain a surplus over this one-in-ten board tolerance.



Calculating the target free reserves

The Standard Club's board wishes to ensure that there is never more than a one-in-ten chance that the free reserves will fall to a level that would make extra calls on members likely.

The club uses its internal model to calculate the required one-in-ten 'cushion' above this level. As this is normally above the regulatory requirement, it can be regarded as setting a minimum level for the free reserves.

Generally, the club holds significantly higher free reserves than the minimum level to ensure it maintains its 'A' credit rating. As a result, the chance of an extra call is significantly less than one in ten. Indeed, the club has not had to make an extra call for 25 years.

The club also uses its internal model to assess the probability that free reserves could fall below the level necessary to support the club's 'A' financial strength rating.

This allows the board to make an informed assessment of whether the club's free reserves are too high and, if so, whether there is enough surplus to give money back to members.

As a guideline, the board would view a cushion that suggests a less than one-in-ten chance that capital could fall below the level required to support the club's 'A' financial rating as more than sufficient. In these circumstances, the board would be likely to consider a distribution of this surplus.

In summary

The Standard Club is very much aware that the free reserves are being held to cover events that might not happen. As such, it is important to have a reliable way of regularly checking the level of free reserves needed.

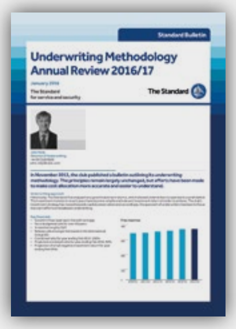
The club's internal model gives a considered assessment of the range of outcomes that could occur in the future based on past and current claims experience and market data. Using the model to assess potential one-in-ten events ensures that the club remains aware of the target range for the free reserves.

In the event of big investment gains or a period of very low claims, the free reserves could exceed their target and create a surplus. The model then allows the club to assess how much of the free reserves can be safely given back to members, for example, by making a return of premium. This was the case in both 2016/17 and 2017/18, with 5% of the total call being returned to members.

- **The free reserves protect members against additional unbudgeted calls.**
- **They need to be kept at a level that gives financial security and certainty to members.**
- **The club has a model to assess minimum and maximum levels.**

Further reading

Annual report and financial statements 2017



Underwriting Methodology Annual Review 2016/17

Loss Prevention methodology

Claims methodology

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The Standard P&I Club

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