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Research Update:

The North of England Protecting & Indemnity Association Affirmed At 'A' After Insurance Criteria Change; Outlook Stable

Primary Credit Analyst:
Tufan Basarir, CFA, London (44) 20-7176-7126; tufan.basarir@standardandpoors.com

Secondary Contact:
Peter McClean, London (44) 20-7176-7075; peter.mcclean@standardandpoors.com

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Research Update:

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Overview

- Following a review of U.K.-based The North of England Protecting & Indemnity Association Ltd. (NEPIA) under our revised insurance criteria, we are affirming our 'A' ratings on the company.
- The ratings predominantly reflect our view of the company's strong business risk profile and strong financial risk profile, built on a strong competitive position and strong capital and earnings.
- The stable outlook reflects our expectation that the club will not damage its capital adequacy position or its strong competitive position, because we anticipate only limited growth during 2013-2015.

Rating Action

On July 18, 2013, Standard & Poor's Ratings Services affirmed its 'A' insurer financial strength and counterparty credit ratings on U.K.-based mutual marine insurer The North of England Protecting & Indemnity Association Ltd. (NEPIA). The outlook is stable.

Rationale

The ratings reflect our view of the company's strong business risk profile and strong financial risk profile, built on a strong competitive position and strong capital and earnings. Under our criteria, these factors lead to anchors of either 'a-' or 'a'. We have used an 'a' anchor because we consider that NEPIA's strong business risk profile and strong financial profile understate their contribution to its overall creditworthiness. The insurer financial strength rating is the same as the anchor because we view enterprise risk management (ERM) and management and governance practices as neutral for the ratings.

We assess the industry and country risk for NEPIA as intermediate, reflecting that for the global marine protection and indemnity (P&I) sector. The overall country risk assessment is low because the insurers operating in this sector typically write business in multiple countries around the world, resulting in high levels of geographic diversification. Our industry risk score is moderate, chiefly based on our negative view of profitability and product risk, offset by the operational barriers to entry in the sector, which we view as a positive factor.

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The marine mutual sector does not tend to focus on profitability and is more exposed to high-risk assets than other non-life insurers, increasing earnings volatility. Therefore, we view profitability as negative. The size and frequency of claims are also unpredictable, increasing product risk.

NEPIA is a member of the International Group of Protection and Indemnity Clubs (IG), a group of 13 mutual marine clubs providing P&I insurance cover to more than 90% of world shipping. Members operate within the framework of the IG Agreement (IGA) and benefit from a substantial excess-of-loss reinsurance program and the pooling of risks. The IG's dominance of the market is the key factor in our assessment of the operational barriers to entry. Historically, non-IG players and fixed-premium providers have enjoyed limited success in the sector.

NEPIA has a strong competitive position, in our view, mainly stemming from its membership of the IG, of which NEPIA enjoys a market share of about 10%, as measured by its gross premium. Our assessment also reflects the club's close, service-driven relationship with its shipowner members, which engenders member loyalty.

The club ranks as the second-largest member by owned tonnage. In our view, the club has carefully managed its growth and continues to strongly emphasis financial strength. This was exemplified by the club's realistic approach to 2013 renewals, when it announced a sizable 15% P&I general premium increase; across the IG, premium increased by an average of only 7.5%. We consider that this shows the strength of the club's competitive position.

We consider that despite the economic downturn, NEPIA has displayed resilience. Its gross premium has increased by 11.7% year-on-year on average over the past five years, mainly through organic growth. We anticipate that NEPIA will maintain its competitive position and organic growth in the financial year (FY) ending February 2014; gross premium is expected to grow by about 4%. In FY2014, we expect gross premium to grow by 4% to about $370 million. These anticipated growth rates are considerably lower than those seen in recent years and we consider that they indicate that the club has reached its desired size.

The group reports strong capital and earnings and we anticipate it to maintain this in our base-case scenario. In FY2012, capital adequacy improved from the lower end of the 'AA' range to the higher end due to timely actions taken by management. In our base case, we give credit for reserves that exceed the Standard & Poor's indicated level by $40 million and deducted $29.3 million for the pension deficit.

The management team reduced the club's investment risk by the end of 2012 following increased claims levels in 2011 and 2012, keeping overall risk levels stable.

Our base-case expectation for 2015 is that NEPIA's total adjusted capital

(TAC; our definition of risk-adjusted capital) will be around our benchmark for the 'AA' level. However, forecasts for the capital adequacy ratio are sensitive to growth rate and profitability assumptions. Our forecasts include the following assumptions:

- After-tax operating income will contribute to TAC by around $10 million-$20 million for FY2014 and FY2015. We are expecting a small deficit in FY2013 due to a one-off pension top-up payment that will affect the combined ratio by around 11%-13%.
- The risk-based capital (RBC) requirement will increase in line with or by slightly more than premium growth due to measured reinvestment in risky assets.

Our view of NEPIA's capital and earnings is reinforced by its estimating and reserving practices, which we consider to be very conservative by insurance industry standards.The club reserves at a 95% confidence level, which is higher than most IG club peers.

In 2012, NEPIA posted a net combined ratio of 104%, indicating an underwriting deficit of $1.8 million. (Lower combined ratios indicate better profitability. A combined ratio of greater than 100% signifies an underwriting loss.) For 2013, our base-case scenario assumes that the company's underlying net combined ratio will be about 95% to 100%, but that it will make a one-off payment to top up its pension fund and so report a net combined ratio of 105%-110%. We anticipate that in FY2014 and FY2015, NEPIA will produce combined ratios of about 98%-100%, unless there is an abnormally high claims pattern. We also expect it to outperform most of its IG peers in terms of operating performance.

In our view, NEPIA's risk position is intermediate, benefiting from the diversity of its investment risks and a less-volatile operating performance than its peers'. We consider risk position to be a neutral factor for its financial risk profile. Within the limit of our expectations, the club's appetite for investment risk has risen slightly during 2013 from the end of 2012, as it searches for yield. The club invested $25 million in equities in March 2013 and set its risk appetite at around $50 million (6% of portfolio).

Credit quality and other exposure risks are good, overall. At 8% of February 2013 TAC, exposure to equities is low compared with most other IG clubs. We do not expect any material changes in the credit quality of NEPIA's investment portfolio in 2013.

We view NEPIA's financial flexibility as strong. The club has no debt and strong liquidity. Like its IG marine mutual peers, NEPIA can impose premium increases at renewal and has a legally enforceable right to collect unlimited additional premiums by making unbudgeted supplementary calls. However, unlike many of its IG peers, NEPIA has never utilized this latter right. NEPIA's need for financial flexibility is limited because it has strong capital and earnings and its expected growth is limited.

We regard NEPIA's enterprise risk management (ERM) and management and governance practices as consistent with the ratings. Our assessment of ERM as adequate with strong risk controls reflects our positive view of the organization's risk-management culture and risk controls. Consequently, we consider it unlikely that the company will experience losses that exceed its risk tolerance. The importance of ERM to the rating is low under our definition, given the club's size compared with non-life European peers, relatively simple structure, and focus on a single line of business.

NEPIA's management and governance is satisfactory, in our opinion. The company has a track record of diligent strategic planning, consistent strategy, strong execution, and positive financial management with conservative risk and financial standards. In our opinion, the experienced management team at NEPIA has successfully improved its market position through organic growth and delivered good profitability.

We regard NEPIA's liquidity as strong, owing to the strength of available liquidity sources--mainly premium income and an asset portfolio that contains around $913 million in cash and marketable securities. There is no debt to be repaid over the next 12 months and we consider the company capable of managing unexpectedly large claims.

Outlook

The stable outlook reflects our expectation that NEPIA's capital adequacy will remain above the 'A' range. We also anticipate the club will maintain operating performance consistent with our base case, and at least a strong competitive position.

We might lower the ratings if, contrary to our expectations:
- Capital adequacy deteriorates below the 'A' rating category for a prolonged period. This could result from investment losses or a growth in the underwriting exposure that is not matched by a corresponding increase in TAC;
- Earnings weakens to substantially less than our base-case assumptions due to either substantial uncontrolled growth or an extraordinary growth in the size or frequency of claims; or
- The club proves unable to maintain its strong competitive position. This could occur if it reverts to more aggressive growth, thereby weakening financial strength and diluting the level of member service.

We do not anticipate raising the ratings over the next two years.

Rating Score Snapshot

Financial Strength Rating	A/Stable
Anchor	a

Business Risk Profile	Strong
IICRA	Intermediate Risk
Competitive Position	Strong
Financial Risk Profile	Strong
Capital and Earnings	Strong
Risk Position	Intermediate Risk
Financial Flexibility	Strong
Modifiers	0
ERM and Management	0
Enterprise Risk Management	Adequate With Strong Risk Controls
Management and Governance	Satisfactory
Holistic Analysis	0
Liquidity	Strong
Support	0
Group Support	0
Government Support	0

IICRA--Insurance Industry And Country Risk Assessment.

Related Criteria And Research

Related criteria

- Insurers: Rating Methodology, May 7, 2013
- Enterprise Risk Management, May 7, 2013
- Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Principles Of Credit Ratings, Feb. 16, 2011
- Refined Methodology And Assumptions For Analyzing Insurer Capital Adequacy Using The Risk-Based Insurance Capital Model, June 7, 2010

Related research

- List Of Issuers With Ratings Under Criteria Observation Due To S&P's New Insurers Rating Methodology, May 7, 2013
- Standard & Poor's Assigns Insurance Industry And Country Risk Assessments, May 7, 2013

Ratings List

Ratings Affirmed

The North of England Protecting & Indemnity Association Ltd.	
Counterparty Credit Rating	
Local Currency	A/Stable/--
Financial Strength Rating	
Local Currency	A/Stable/--

Additional Contact:
Insurance Ratings Europe; InsuranceInteractive_Europe@standardandpoors.com

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