Changes in ship values - Influence on hull and machinery and P&I covers

The market value of ships is closely linked to the insured value under vessels' hull and machinery insurance and may influence the cover. There is also a possible influence on the P&I cover. Lately there have been large fluctuations in the market value of ships. This article examines the insurance implications.

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The hull and machinery cover

The sum which the assured can recover in respect of a loss on a hull and machinery policy normally is, in the case of an unvalued policy, the extent of the insurable value (i.e., the market value of the ship at the commencement of the risk),[1] or, in the case of a valued policy (in which the value insured is, by agreement between the insurer and the assured, fixed at a certain amount), the value fixed by the policy.[2] In practice the vast majority of hull and machinery policies are valued policies.

If the hull and machinery insurance is effected based on the Norwegian Marine Insurance Plan (NMIP), an assessed insurable value can only be set aside if the person effecting the insurance has given misleading information which is relevant for the assessment.[3] Similar provisions can also be found in the English Marine Insurance Act (MIA),[4] which will apply to insurances based on English conditions.

A special feature of the NMIP is that, if due to market fluctuations the market value of the vessel changes significantly after the insurance was entered into, both the assured and the insurer may require the assessed insurable value to be changed by giving fourteen days' notice.[5] The NMIP does not say what a significant change is, but has a provision that a Norwegian average adjuster chosen by the assured shall finally decide any disagreement in this respect.

What could then be the consequences of an assessed insurable value that is too high or too low? The insured value may influence: – The premium, as this is calculated based on the insured value. – Conditions for condemnation of the vessel and therefore the right to claim for a constructive total loss (CTL). – The right to recover the vessel's share of general average (GA) and salvage in full from the hull and machinery insurers.

Premium

It is obvious that if the assessed insurable value is too high, the owners will pay a premium that is too high for the risk of particular damage to the vessel (i.e., not total loss). The premium is calculated on the basis of the assessed insurable value, but the damage is compensated based on the actual cost of repairs.

Condemnation of vessel

The NMIP provides that the conditions for condemnation of the vessel are met when the cost of repairing a ship amounts to at least 80 per cent of the assessed insurable value or the market value of the vessel after repairs, whichever is the higher.[6] If the assessed value is too high compared to the vessel's actual market value, the owners will not be able to claim for a CTL unless the repair cost is at least 80 per cent of that value. The consequence may be that in order to receive full compensation from hull underwriters, the owners may have to accept compensation for a partial loss and effect repairs that do not make economic sense, instead of being compensated for a CTL.

1. Marine Insurance Act 1906, Section 16.1; Norwegian Marine Insurance Plan § 2.2.
2. The value agreed in valued policies is referred to as "insured value" in the Marine Insurance Act 1906, while the Norwegian Marine Insurance Plan (NMIP) refers to "assessed insurable value". The terminology from the NMIP is used in this article.
3. NMIP § 2-3.
4. MIA S. 27.
5. NMIP § 2-3.
6. NMIP § 11-3.

Example

A ship has a market value of USD 2 million but is insured for an assessed insurable value of USD 4 million. Damage occurs, and based on a survey the repair cost is estimated at USD 2.4 million. As shown above, the owners can not claim a CTL unless the repair cost amounts to at least 80 per cent of the assessed insurable value or the market value of the vessel after repairs, whichever the higher. In this example, 80 per cent of the assessed value is the higher figure, at USD 3.2 million. Consequently, a ship with a market value of USD 2 million will have to be repaired at a cost of USD 2.4 million. Furthermore, in damaged condition the ship has a market value of USD 0.5 million, so that the USD 2.4 million spent will only lead to a USD 1.5 million increase in the ship's value.

It should be mentioned that the owners might have an interest in carrying out such repairs for commercial reasons, like for instance a favourable freight contract or expectations of a rise in ship values.

If the assessed insurable value is too low, the consequence will be that the owners will not be compensated for the full market value in case of a total loss. The conditions for condemnation will be considered on the basis of repair costs amounting to 80 per cent of the market value, which is higher than the assessed value. There is of course no cover for repair costs exceeding the assessed insurable value.

Example

A ship has a market value of USD 4 million, but is insured for an assessed insurable value of only USD 3 million. The owners can not claim a CTL unless the repair cost amounts to at least 80 per cent of the market value, or USD 3.2 million. If the ship suffers damage for which the repair cost reaches an amount between USD 3 million and USD 3.2 million, the assured may be left without recourse to underwriters for part of the cost, as the hull underwriters will compensate actual repair costs only up to a maximum of USD 3 million (the assessed insurable value).

Increased value insurances

Frequently, separate insurances are taken out against total loss, often referred to as increased value insurances. The NMIP refers to two such insurances, namely hull interest insurance[7] and freight interest insurance.[8] In addition to total loss, hull interest insurance also covers collision liability in excess of the hull policy. The NMIP allows such insurances to be taken out for a maximum of 25 per cent of the assessed insurable value under the hull insurance.

A rule of thumb is that the total assessed insurable values under the hull and hull interest insurances should as a minimum equal the market value of the ship. The freight interest insurance should cover loss of future freight income in case of a total loss.

Institute Time Clauses (Hulls)

As mentioned above, the link between market value and conditions for condemnation of a ship is relevant for insurances based on the NMIP. Other conditions, such as the frequently used Institute Time Clauses (Hulls) 1.10.83 (ITCH 83) do not have such a link.[9] However, shipowners who base their hull and machinery insurances on the latter conditions may run into other problems, such as the right to recover the vessel's share in GA and salvage.

If the market value of the ship on which the apportionment of GA, salvage or salvage charges is based (the contributory value) is higher than the assessed insurable value, under ITCH conditions the vessel is considered to be under-insured. The clauses state that the vessel's proportion of GA or salvage is covered, but reduced in respect of any under-insurance.[10]

Example

A vessel's share of GA is USD 100,000. The apportionment is based on a market value of USD 4 million. However, the vessel's assessed insurable value is USD 3 million. In this case, under ITCH conditions the hull insurers would compensate only three fourths of the vessel's share of GA, or USD 75,000. Under the NMIP, the vessel's share of GA would have been covered in full regardless of the contributory value.[11]

The P&I cover

The P&I cover does not extend to liabilities, losses, costs or expenses which are covered by the vessel's hull policy.[12] It is a requirement that the hull policy is on standard terms and that it covers the vessel's current market value. In order to comply with Rule 71 the shipowner is therefore required to monitor the second hand market in order to ensure that the assessed insurable value is adequate. It is the general market value which is of interest. The vessel's commercial commitment at the time of the assessment is disregarded.

7. NMIP § 14-1.
8. NMIP § 14-2.
9. The Institute Time Clauses (Hulls) 1.10.83 remain the most widely-used version of English conditions. Their later versions (ITCH 1995, International Hull Clauses 2002 and International Hull Clauses 2003) also do not have a link between actual market value and conditions for condemnation.
10. ITCH Clause 11.1.
11. NMIP § 4-8.
12. See Rule 71 of Assuranceforeningen Gard's 2004 Rules for Ships.

The exclusion concerning assessed insurable value is for example of practical importance in relation to Rule 36 (Collision with other ships) and 37 (Damage to fixed and floating objects). All standard hull policies limit the extent of the insurer's collision liability. As a supplement to the hull policy, P&I covers the so-called excess collision liability, i.e., collision liability in excess of the sum insured by the hull policy. However, if the vessel is under-valued for hull insurance purposes, the P&I cover for excess collision liability will not cover the amount of liability which would have been covered by the hull policy had the vessel been insured according to the current market value.

Example

A vessel is insured for hull and machinery on conditions including four fourths collision liability with an assessed insurable value of USD 3.2 million. In addition, hull interest insurance (which includes excess collision liability) is taken out with an assessed insurable value of USD 0.8 million, making a total of USD 4 million. The vessel's market value, however, is USD 4.5 million. Collision liability is imposed on the assured amounting to USD 5 million. The owners will be able to recover USD 3.2 million from the hull insurers and USD 0.8 million from the hull interest insurers. The P&I Club will pay the amount exceeding the vessel's market value, i.e., USD 0.5 million. The remaining USD 0.5 million will have to be borne by the owners themselves.

Other implications to P&I

Changes in ship values will also have significance in connection with Rule 25 (Cesser), which describes certain events which have the effect of automatically terminating the P&I cover. According to Rule 25(d), cesser occurs if the entered vessel suffers damage and the cost of repairs determined by the Club equals or exceeds 80 per cent of the assessed insurable value or the value in repaired condition, whichever is the highest.

A vessel's market value is also of relevance in relation to Rule 49 (Confiscation of the Ship). Cover under this Rule shall under no circumstances exceed the market value of the vessel at the date of the confiscation.

Finally, the limit of the International Group Club's additional war risk cover is set as a fixed amount in excess of the proper value of the entered ship (or any other P&I war risk cover which the owner has arranged). This is an excess cover only. The shipowner must have a primary P&I war risk cover up to a minimum limit of the proper value of the ship, and this value is determined in accordance with Rule 71.

Conclusion

The conclusion to be drawn from the above is that the vessel's market value and assessed insurable value must be monitored at all times and, in case of market value changes, the underwriters should be contacted in order to change the assessed insurable values accordingly.

Any comments to this article can be e-mailed to the Gard News Editor.

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