

RatingsDirect®

The North of England Protecting & Indemnity Association Ltd.

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Table Of Contents

Major Rating Factors

Rationale

Outlook

Corporate Profile: Mutual Provider Of P&I Cover

Competitive Position: Strong, Supported By IG's Current Structure

Management And Corporate Strategy: Strong Emphasis On Service And Revised Strategic Goals

Enterprise Risk Management: Adequate With Strong Risk Controls For Key Risks, Reflecting The Club's Structure

Accounting: Financials Amended To Account For IG Pooling Agreement

Operating Performance: Good, Outperformed Most Of The IG Members in 2011-2012 But A Deficit Is Expected for 2012-2013

Investments: Conservative Investment Strategy

Liquidity: Strong, Backed By A Very Liquid Asset Base

Table Of Contents (cont.)

Capitalization: Strong, Despite Expected Operating Deficit In Financial Year 2012/2013, Supported By Conservative Reserving

Financial Flexibility: Strong, Driven By The Ability To Collect Unlimited Additional Premiums

Related Criteria And Research

The North of England Protecting & Indemnity Association Ltd.

Major Rating Factors

Strengths:

- Strong capitalization benefiting from conservative reserving and investment policies.
- Strong competitive position benefiting from a loyal customer base and enhanced by the significant barriers to entry within protection and indemnity insurance.
- Strong financial flexibility based on the club's ability to make unbudgeted supplementary calls and impose significant premium increases at renewal.

Weaknesses:

- Recent deterioration in underwriting results highlights concentration on a volatile insurance class where unpredictable size and frequency of claims constrain operating performance.

**Operating Company Covered
By This Report**

Financial Strength Rating

Local Currency

A/Stable/--

Rationale

The ratings on The North of England Protecting & Indemnity Association Ltd. (NEPIA) reflect the club's strong capitalization, strong competitive position, and strong financial flexibility. These positive factors are partly offset by the club's concentration on a volatile insurance class where the unpredictable size and frequency of claims constrain operating performance.

Standard & Poor's considers the club's capitalization to be strong, supported by its very strong capital adequacy, measured using our capital model. Free reserves increased by 0.5% to \$314 million at year-end February 2012. However, we expect them to have decreased by about \$11.5 million by the end of financial year 2012. Also, under our base-case scenario, we would expect NEPIA to maintain capital adequacy, as measured by Standard & Poor's risk-adjusted model, at least at a "strong" level ('A' rating category) for 2012/2013. Our view of capitalization is supported by the club's comprehensive reinsurance program and conservative reserving and investment philosophy, which has consistently produced run-off gains. We regard NEPIA's operational needs for additional capital as limited over the next 24 months, given limited growth expectations.

We consider NEPIA's competitive position to be strong, primarily because of NEPIA's core protection and indemnity (P&I) product. This sector enjoys high barriers to entry relative to the insurance industry as a whole. However, we have concerns that the sector's competitive position may suffer as a result of the poor trading conditions its members are facing. Following substantial growth since February 2006, the club ranks as the second-largest member of the International Group of Protection & Indemnity Clubs (IG) by owned tonnage (first half of financial year 2012/2013: 130 million gross tons (gt), first half of financial year 2011/2012: 116 million gt). Its net premium has continued to grow on average (compound annual growth rate) by 12.3% year-on-year over the past five years. This growth is far above

the average global growth in non-life premium of 0.8%. The club's avoidance of any unplanned supplementary premium calls in the past has, in our opinion, aided this growth. In our view, the club is carefully managing the additional growth with continued strong emphasis on quality of its services.

We anticipate that the club will maintain its competitive position; gross premium is expected to increase by about 0.5% at financial year ending February 2013, although 1%-3% premium growth is forecast in developed markets for 2012. The smaller-than-expected increase in premiums for financial year 2012 has been as a result of less-than-anticipated activity in the charter business due to low global trading activity. In financial year 2013, we expect gross premium to grow by 9%-11% to reach about \$377 million-\$384 million. In financial year 2014, we expect gross premium to grow further by 8% to \$407 million-\$415 million.

We believe that NEPIA's financial flexibility is strong, and derives from its ability to collect unlimited additional premiums by making unbudgeted supplementary calls on open policy years if needed. In addition, the club can impose significant premium increases at renewal. We believe that the club is unlikely to make an unplanned call over the next two years because of its strong capitalization.

We view the club's operating performance as good (at the higher end of the 'BBB' rating category) in the context of its mutual status. Overall however, we consider it to be a ratings weakness. NEPIA has managed growth carefully to ensure that operating performance is not weakened. However, the club's concentration on a volatile insurance class where the size and frequency of claims are unpredictable somewhat constrains our assessment of operating performance. This is demonstrated by the club's five-year average combined ratio of 93.0%, with a high standard deviation of 13%. We have seen an underlying improvement since 2008, and levels of growth appear to be far less volatile than historic levels (see Operating Performance section). For February 2012, the club posted an acceptable combined ratio of 102.5%, which is better than the average of its IG peers; it benefited from 7 percentage points from prior year run-off gains. This, coupled with a positive investment return, resulted in a net gain of \$7.6 million. For the year to October 2012, the club posted an investment return of 1.7%. However, for financial year 2012, our base-case forecast is for a net combined ratio (based on our definition) of about 108%-113%. This is below the typical level we would expect at this ratings grade. We anticipate that, in financial years 2013 and 2014, NEPIA will produce combined ratios of about 98%-101% barring an abnormally high claims pattern (see Operating Performance section).

Outlook

The stable outlook reflects Standard & Poor's view that the club will maintain its strong capitalization, strong financial flexibility, and strong competitive position. Against this positive backdrop, we would not expect to see NEPIA's capitalization exposed to high-risk assets above the current target allocation. We believe that the club is likely to maintain its good operating performance, which should help NEPIA to achieve our base-case assumption that capital adequacy will sit above the 'A' category over the next 12-24 months. We believe that the club will maintain its strong competitive position by continuing to manage the growth in its tonnage to ensure that financial strength and member service are not weakened, nor the club's portfolio quality diluted.

We consider a positive rating action to be remote, reflecting the club's focus almost entirely on the P&I sector and its

recent operating performance. We could take a negative rating action if the capital adequacy, as measured by our capital model, falls below the 'A' range or operating performance materially deteriorates compared with our expectations, due to either substantial uncontrolled growth or an extraordinarily adverse claims environment.

Corporate Profile: Mutual Provider Of P&I Cover

NEPIA is a U.K.-based mutual insurance association. It provides cover (mainly P&I) for its members, who are predominantly international owners and operators of commercial shipping concerns. The club is based in Newcastle, U.K., with offices in Hong Kong, Greece, Singapore, and Japan, for which NEPIA recently obtained its operating license (see Competitive Position section).

NEPIA has grown materially in recent years; it ranks as the second-largest club within the IG by owned tonnage (Feb. 20, 2012: 125 million gt, 130 million gt by the end of August 2012). Total entered gt (including chartered) at October 2012 was 170 million gt (spread across 4,000 ships – this number excludes vessels under 1000 gt), compared with about 61 million gt in 2006. As of October 2012, the club had 400 members in total compared with 400 in 2003 (see Competitive Position section). Like other P&I clubs, NEPIA writes almost all of its policies for owned tonnage (accounting for 83% of the club's total premium at the February 2012 renewals). The club's membership profile remains largely unchanged compared with the previous year (see charts 1 and 2).

In November 2011, NEPIA assumed the assets and liabilities of its sister marine hull insurer Marine Shipping Mutual Insurance (MSMI; not rated), which ceased underwriting on June 30, 2011.

Chart 1

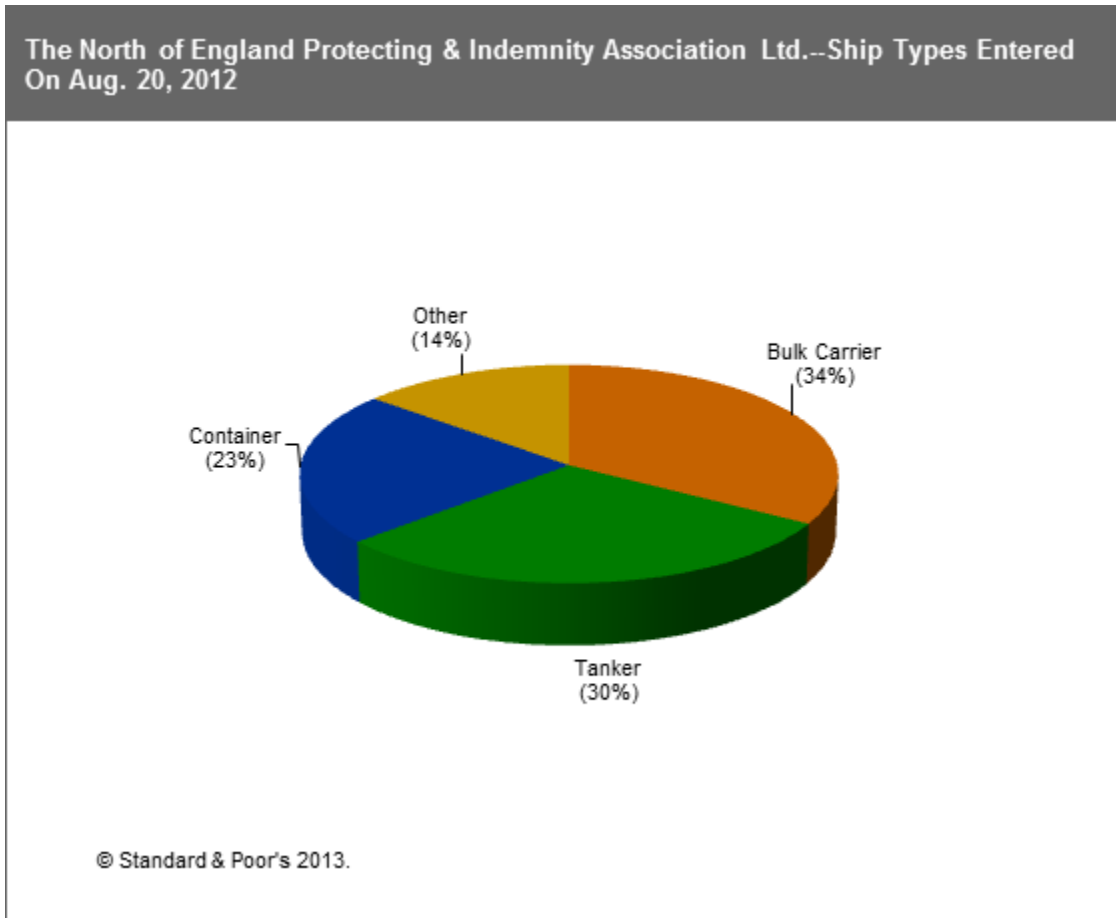
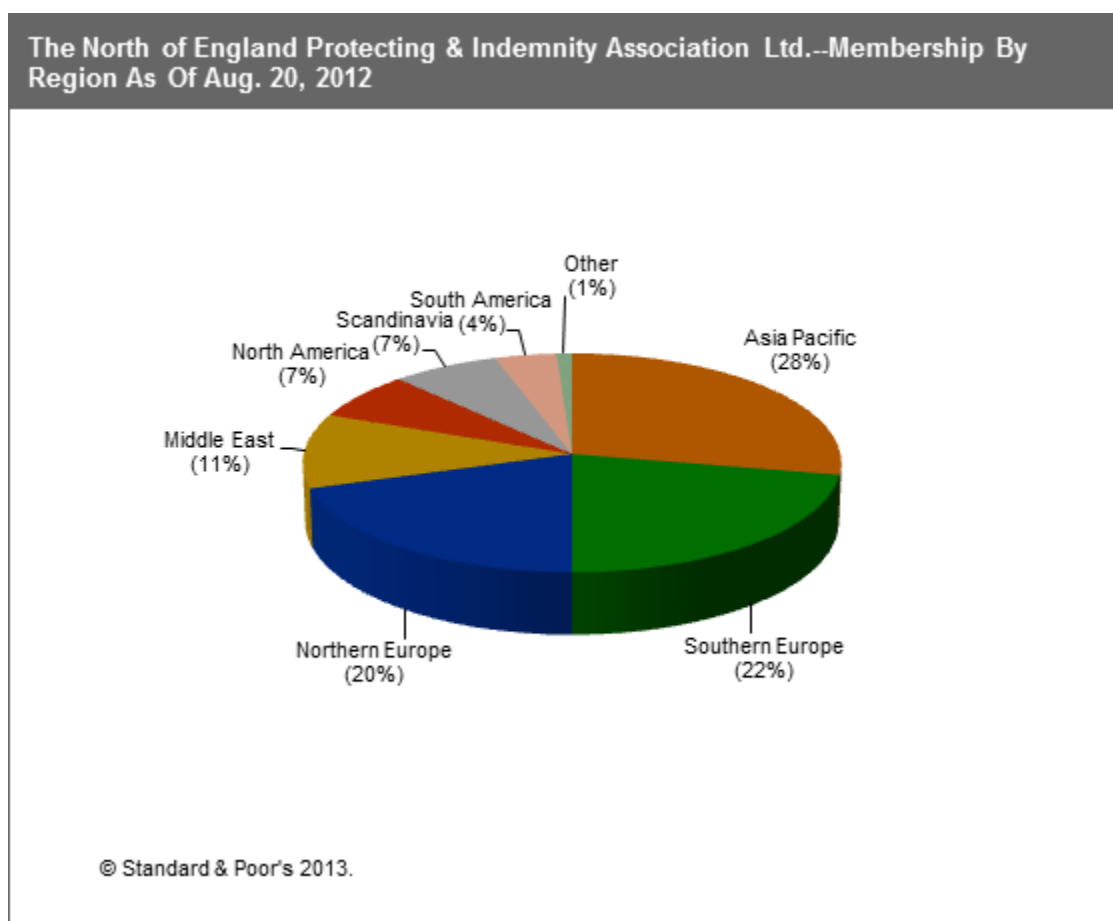


Chart 2



Competitive Position: Strong, Supported By IG's Current Structure

We consider NEPIA's competitive position to be strong. This reflects the club's membership of the IG, which provides P&I cover to more than 90% of the world's merchant fleet via 13 clubs, and the resulting barriers to entry. The club's competitive position within the IG is strong, demonstrated by its continued ability to source new business mainly from existing members, while maintaining its membership diversity and providing marine industry services.

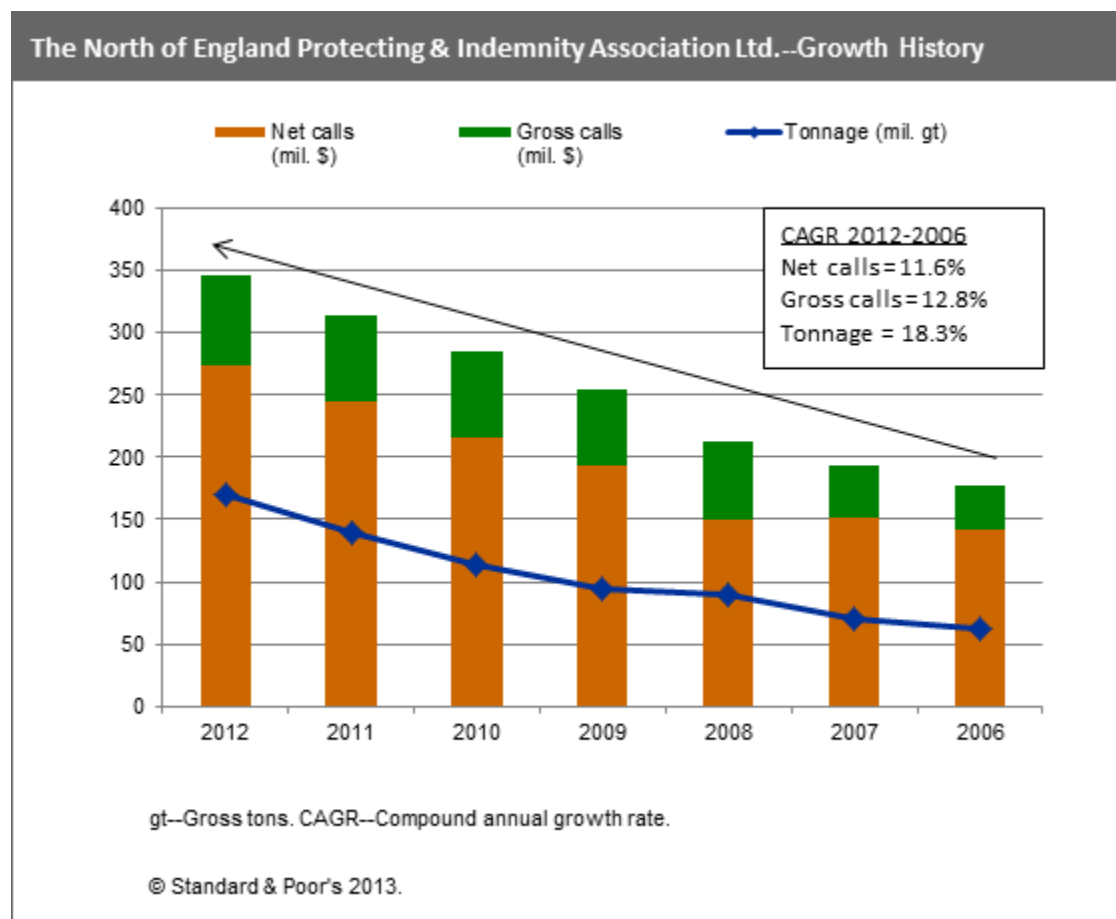
As a member of the IG, NEPIA operates within the framework of the IG Agreement (IGA). The key benefits to the clubs include access to the IG pool, the excess of loss contract, and the IGA quotation procedures which have together created high barriers to entry into the P&I sector. In August 2010, the European Commission opened an investigation into certain aspects of the IG's pooling and reinsurance arrangements. In August 2012, the Commission announced that it had closed its review and its conclusions did not change our view of competitive position of the sector. In our opinion, weakening of the barriers to entry into the P&I would have a negative effect on the competitive position and possibly the ratings on all IG clubs, including NEPIA.

Competitive pricing on NEPIA's mutual business (accounting for 85% of the gross premium income in 2011-2012, with

93% being P&I products) is restricted within the IG by the IGA. The agreement dictates that competition on rates can only exist for new entries and ships in split fleets, for which the club competes with its peers within the IG. Furthermore, the IG mutual system has hindered the development of a fixed-premium alternative outside the IG by operating on a not-for-profit basis for the core (nonchartered) business. The chartered tonnage, which operates on a fixed-premium basis and accounts for about 7% of the total premium at February 2012, is subject to higher competition within the IG.

Following substantial year-on year growth since the February 2006 renewal, the club ranks as the second-largest member of the IG by owned tonnage, which was at 130 million gt in August 2012 (February 2012: 125 million gt) and third largest by total tonnage (February 2012: 168 million gt, October 2012: 170 million gt). This contrasts with a total tonnage of 61 million gt in February 2006. Although this additional tonnage has generally been evenly spread between new and existing members, the trend during the last couple of years has tended toward the latter (renewal 2011 to renewal 2012 :87%, post renewal 2012 : 91%), as opposed to new members with whom NEPIA are less familiar. The fact that the number of members is stable, at about 400, limits our possible concerns about the impact of growth on the club's service quality and competitive position. However, financial year 2012 has so far showed that claims arising from current members can also be as high. NEPIA's avoidance of unplanned supplementary calls, in our opinion, has contributed positively to this growth.

Chart 3



NEPIA's membership is considered well diversified (see charts 1 and 2) and is well spread in terms of size. The club has no appetite for U.S. cruise, and a limited appetite for tug and barge risks, and focuses on "blue-water" (ocean-going), rather than "brown-water" (coastal) business. The largest member by net premium written accounts for 2.1% of the club's total; the top-five members account for 10.1% and the top-10 members account for 18.3%. Approximately 75% of the premiums are derived via brokers.

Currently, about 65% of vessels insured by the club are less than 15 years old, compared with 45% four years ago. Although the younger ships improve the club's risk profile, having them means that the club has been exposed to the churning effect caused by insuring new builds, which attract lower premium rates than older tonnage. In recognition of this, the club incorporates explicit loading into its general increases.

In addition to P&I, NEPIA also writes freight, demurrage, and defense (FD&D) business, which accounted for 6% of the club's gross premium written at February 2012, and a very small war risks account. The main benefits of FD&D include some small diversity of membership/premium, the availability of a large pool of legal experience in-house, and a broadening of the service offering available to the club's membership. Although NEPIA's members have had access to hull insurance via its sister company MSMI, this entity has now been placed into run-off following its acquisition by NEPIA. NEPIA do not rule out the possibility of emulating some of their peers by offering hull cover at some time in the future, should market conditions improve.

Standard & Poor's considers that NEPIA has a strong service ethic and a high level of member support. NEPIA's competitive position is also enhanced by the provision of a number of value-added services; in particular, the club's loss prevention department, which provides members with free practical advice on loss prevention. This is seen as a competitive advantage.

We believe obtaining a license to operate in Japan will add to the geographical diversification of the club in the long term and help it to build long-term relationships. Although there is no tonnage target in the Asia Pacific region, we expect the club to benefit from its new Tokyo office by picking up more Japanese fleets and some growth in the Asia Pacific region. In addition, the club is seeking further growth in Greece.

Prospective

Our base-case expectation is for NEPIA to maintain its strong competitive position over the rating horizon. We do not expect NEPIA's strong competitive position to change materially in the absence, for example, of transformational mergers and acquisitions activity. Our expectations do not preclude additional growth in membership and/or tonnage. We also expect that growth will continue to be conditioned by profitability. We believe that the club will continue to carefully manage growth to ensure that financial strength and member service are not harmed, nor the club's portfolio quality diluted.

NEPIA achieved a general increase of about 2.3% (4% with deductible adjustments) for its P&I business at the February 2012 renewal. We expect the club's gross premium income to increase by about 0.5% to over \$348 million at February 2013 and a further 10% to about \$380 million by the end of February 2013. For the 2013 renewals, the club has announced a P&I general increase of 15% (FD&D cover is 10%) but collection of the 30% will be deferred until December 2014. This level of renewals is higher than the IG average of 7.5%. We believe this will be a test to the loyalty of the customer base and the club's competitive position. We expect the club to manage churn to avoid

deterioration of the underwriting results. However, we believe that a continued reduced level of activity in the global shipping sector, evidenced by historically low Baltic Dry Index (BDIY) levels, is likely to constrain growth in premium calls.

We believe that the operating environment in shipping markets over the rating horizon (24 months) will remain precarious. There is a considerable supply and demand imbalance in the shipping industry due to the increase in available tonnage over the past few years and reduced anticipated global demand. We anticipate that the growth rate in new ship deliveries will exceed the estimated growth rate in tonnage demand by about 2x on average over the coming year, which is depressing charter rates to below break-even cash costs for most ship classes.

We do not expect the club to make supplementary calls in the near term because of its strong capitalization. We believe that if a supplementary call were to be made, it could place some downward pressure on the club's competitive position. The P&I sector's barriers to entry mean that we do not expect competition from outside the IG to significantly affect the club.

Management And Corporate Strategy: Strong Emphasis On Service And Revised Strategic Goals

We think that NEPIA's management is strong and therefore it contributes positively to the rating. The club is led by joint managing directors who place a strong emphasis on quality of service and commitment to member support. This commitment, together with the stability of membership numbers, alleviates our previous concerns over the strong growth in tonnage in recent years.

Strategic positioning

NEPIA has clear strategic goals. First and foremost is the continued development of a quality portfolio within a framework of financial strength, and comprehensive service and support for members. The club has passed its goal of increasing its market share of the mutual (owned tonnage) business to 12.5%. NEPIA reached its growth target rather faster than expected due to newbuilding orders and expansion by existing members. This growth will yield economies of scale for operational expenses. A strategy review is currently under way and NEPIA is taking a cautious approach for further growth. We do not expect overall further growth in terms of tonnage over the next two years. There might be some strategic growth especially in Asia. The club has managed the growth carefully up to this point to ensure that financial strength and member service are not weakened. We will continue to monitor developments in this area.

We believe that NEPIA management is taking a credible and realistic approach in response to the challenges facing the industry. After increased claims levels in 2011 and 2012, management has taken corrective actions by announcing a high general increase (see Competitive Position) and increasing all deductibles of under \$25,000 by \$1,500. Also, NEPIA will require members to make a 10% contribution to the cost of external claims fees up to a maximum of \$5,000. In addition, NEPIA will change the way it collects premiums in 2013-2014. Managers decided to collect annual premium for the next policy year in five instalments instead of four in a move to help shipowners' cash flow. We do not anticipate a significant credit risk given the profile and record of the membership and also the retrospective cancellation rights in the club's documentation.

Operational effectiveness

The club has extensive operational controls in place that ensure a high level of accountability. In particular, it frequently runs detailed, high-quality management reports to help estimate and manage claims.

The club is managed by 30 board members from ship-operating companies, representing all categories of shipping covered by the club. Currently, the board makes up about 30% of the club's total tonnage. As part of the preparation for the EU's Solvency II regulations, the club is currently reviewing its legal structure and corporate governance function to ensure it complies with the potential requirements under Solvency II directives.

Most of the executive directors of the management company have worked there for more than 20 years, which is the average length of service of the senior management team. This underlines an extremely strong continuity of management in common with most of the IG clubs. Broader staff retention and growth have also been key to the maintenance of service standards against the backdrop of the club's substantial growth. In response to this growth since February 2006, the club has recruited a number of experienced staff, notably claims handlers, accountants, and actuarial support.

Reflected in its consistent operating performance track record, NEPIA's quality-control (membership- and vessel-selection) processes appear to be sound. On average, NEPIA surveys approximately 10% of the entered tonnage annually. In addition, all vessels older than 12 years that enter the club are surveyed, with follow-up inspections to confirm that any defects noted during a condition survey have been rectified.

Financial management

Standard & Poor's considers NEPIA's financial controls to be very strong. The club's active approach to financial management is illustrated by the active management of its investment risk. This strategy has limited NEPIA's investment losses, even throughout the sharp decline in the financial markets in 2008-2012. One of the key financial management indicators of the club is the maintenance of its capital position under the U.K. Financial Services Authority's (FSA) individual capital assessment (ICA) and the anticipated requirements under the Solvency II directive. In addition, the club's target is to have a minimum capital adequacy, measured using our capital model, at the 'AA' level. Also, the club manages its investments such that any investment losses in a policy year should not be greater than 10% of NEPIA's free reserves.

In recognition of the reduced investment income and its excess capital, the club has limited exposure to equity markets via absolute-return funds to 10% of total invested assets during 2012, to generate investment income that is competitive with other IG clubs. In the absence of sufficient levels of investment income, or in the presence of material investment losses, we believe that the club will carefully adjust its premium increases to protect its strong capitalization.

Also, the club hedges all of the pound sterling overheads exposure with an extendible collar.

Enterprise Risk Management: Adequate With Strong Risk Controls For Key Risks, Reflecting The Club's Structure

We consider the club's enterprise risk management (ERM) to be adequate, with strong risk controls for its main risks,

underwriting and reserving risk. We view ERM as having relatively low importance to the ratings given the club's size compared with non-life European peers, relatively simple structure, and marine-focused status. We have observed improvements to NEPIA's ERM framework as the club has placed greater focus on this function.

NEPIA's risk-management culture is strong. Because the organization is relatively small, NEPIA has no formal and separate risk-management department, nor a chief risk officer. Nevertheless, all managers are seen as responsible for risk management. The club has an ERM committee comprising four directors and two managers. There is widespread, robust, and embedded assessment and management of risk within the club. The club's individual capital assessment process and its ongoing participation in Quantitative Impact Studies (QIS) for Solvency II have contributed positively to management's risk culture. Preparations for Solvency II have seen enhancements being made to the club's financial reporting structures to enable automated quarterly balance sheet reporting, which supports the solvency capital calculations. Other improvements include an external review of NEPIA's corporate governance from a regulatory and tax perspective; an extensive updating of the club's risk register; and the development of an internal capital model to support the quantitative element of the club's own risk and solvency assessment.

Insurance underwriting-related risk controls are strong. NEPIA's process reflects the inclusive nature of the club's risk management department, in that an enhanced and extensive review of individual members is carried out by the underwriting team, which has underpinned the renewal strategy determined by senior management. Individual underwriters carry out performance monitoring during the year, and senior management monitors claims movements weekly. There is continual dialogue, involving staff visiting members to identify changes to member operations and, in particular, shipownership-owner management practices. Finally, the club's rules allow for 30 days' notice of cessation of entry for any reason if underwriters deem a risk to be unacceptable.

Reserve-related risk controls are strong. Standard & Poor's considers that NEPIA's estimating and reserving practices are very conservative by insurance industry standards, as demonstrated by prior-year reserve releases. The club's reserves are regularly reviewed by external actuaries. The club's relatively small size enables regular feedback and communication between the claims and underwriting teams.

The ERM process influences the club's strategic decisions, which are largely influenced by the ICA process and its participation in QIS5 for Solvency II. Management of extreme and emerging risks is regarded as adequate. The approach to such risks is relatively simplistic, with the club placing emphasis on some extreme underwriting loss and investment loss scenarios. Nevertheless, this approach is regarded as adequate when set against the club's risk profile. Under the current structure, the club does not need to develop complex models.

Accounting: Financials Amended To Account For IG Pooling Agreement

Our analysis focuses on the combined financial statements of NEPIA and The North of England Mutual Insurance Association (Bermuda) Ltd. (not rated). These statements are prepared for illustrative purposes only and have no legal standing. They do, however, form the basis of the club's return to the FSA. Financial statements have been prepared in accordance with International Financial Reporting Standards since February 2006. The club's share of the IG's Bermuda-based protected cell captive reinsurer, Hydra Insurance Co. Ltd. (not rated), is consolidated within the

financial statements.

The financial statements include payments and recoveries relating to the IG pooling agreement. As the pooling agreement provides a mutual reinsurance mechanism for IG, we have treated the amount paid into the pool of \$17.6 million at February 2011 (\$9.2 million in 2010-2011) as ceded reinsurance premiums, rather than gross claims incurred.

The key adjustments made within Standard & Poor's risk-based capital model from published financial statements are:

- Recognition of a loss reserve discount;
- A deduction of pension deficit from capital (about \$30 million); and
- Credit for reserve surpluses (about \$40 million).

Operating Performance: Good, Outperformed Most Of The IG Members in 2011-2012 But A Deficit Is Expected for 2012-2013

Table 1

The North of England Protecting & Indemnity Association Ltd.--Operating Statistics*							
--Year ended Feb. 20--							
(Mil. \$)	2012	2011	2010	2009	2008	2007	2006
Surplus for financial year	7.6	71.6	28.4	(5.7)	29.9	20.7	23.1
Change in estimated free reserves (%)	0.5	30.0	13.8	(4.0)	15.7	13.2	18.1
Pretax result/average estimated free reserves	3.3	25.5	11.8	8.0	7.4	11.3	33.3
Incurred loss ratio (%)	83.6	59.8	78.2	64.3	89.0	109.8	84.3
Expense ratio (%)	18.9	17.8	16.6	17.7	19.0	18.2	16.3
Combined ratio (%)	102.5	77.6	94.8	82.0	108.0	127.9	100.6
Paid loss ratio (%)	58.2	47.0	71.7	67.7	78.9	63.3	63.2
Portfolio performance							
Net investment income	7.1	8.8	7.2	12.2	12.2	15.6	11.2
Investment yield (%)	1.0	1.2	1.1	1.8	1.9	2.7	2.2
Total investment return (excluding unrealised gains/losses)	2.6	1.8	0.3	1.1	3.4	9.1	11.1

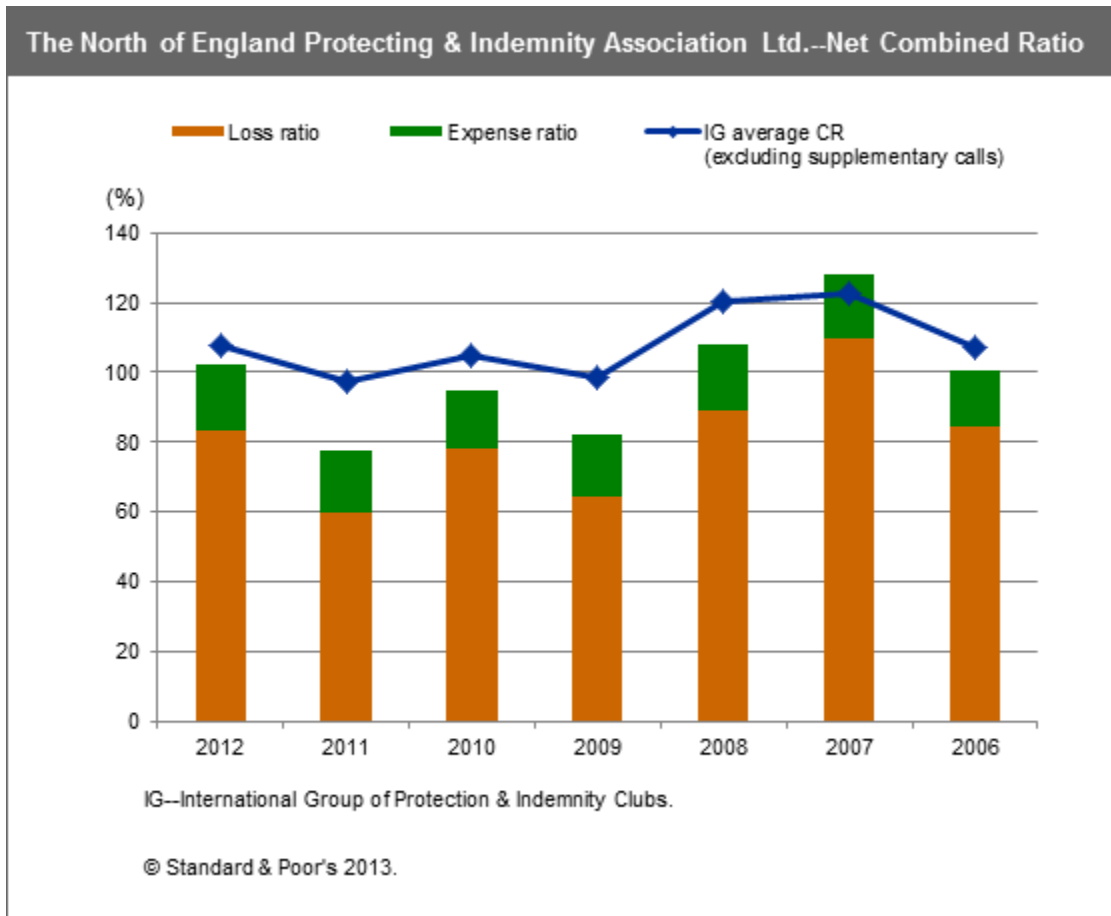
*Combined figures with The North of England Mutual Insurance Association (Bermuda) Ltd.

We consider NEPIA's operating performance to be good but volatile, although less so than historical levels. NEPIA has managed growth carefully to ensure that operating performance is not weakened, although financial year 2012 has been weaker than expected. However, the club's concentration on a volatile insurance class where the size and frequency of claims are unpredictable somewhat constrains our assessment of operating performance. This is demonstrated by the club's five-year average combined ratio of 93.0%, with a high standard deviation of 13%. However, we have seen an underlying trend of improvement since 2008, it is much more stable in terms of volatility than historical levels. For February 2012, the club posted an acceptable combined ratio of 102.5%, which is better than the average among its IG peers; it benefited from 7 percentage points from prior year run-off gains. This, coupled with a positive investment return, resulted in a net gain of \$7.6 million.

For the year to October 2012, the club posted an investment return of 1.7%. However, we are expecting a deficit for

financial year 2012 (see Prospective section).

Chart 4



The mutual nature of the club in theory reduces the incentives to underwrite profitably. However, the club has a long-term track record of outperforming most of its peers. This can be attributed to the club's firmer underwriting of risks (maintaining premium levels and tightening terms and conditions) and low expense base. This is best illustrated by the club's 15-year average combined ratio over 1998-2012 of 102%, compared with IG clubs' average (excluding the impact of unbudgeted supplementary calls) of 114% over the same period. Like some other IG members, the club makes use of high-level reinsurance contracts to partly reduce the impact of adverse claims development.

Prospective

For Feb 2013, our base-case expectation is a net combined ratio (based on our definition) of about 108%-113%. This forecast is based on a very conservative (95th percentile) reserving policy. For the eight months to October 2012 the club has experienced an increased number and value of retained claims compared with the same period in 2011 (the number of claims between \$500,000 and \$8 million has gone up to from 47 in October 2011 to 63 in October 2012). This growth in claims numbers is consistent with increased business volumes of the club. Also, the number and value of pool claims has increased significantly in 2012 (August 2012 pool claims \$245 million with NEPIA's share being \$12.1 million compared with August 2011 pool claims of \$108.3 million with NEPIA's share being \$4.5 million). If loss

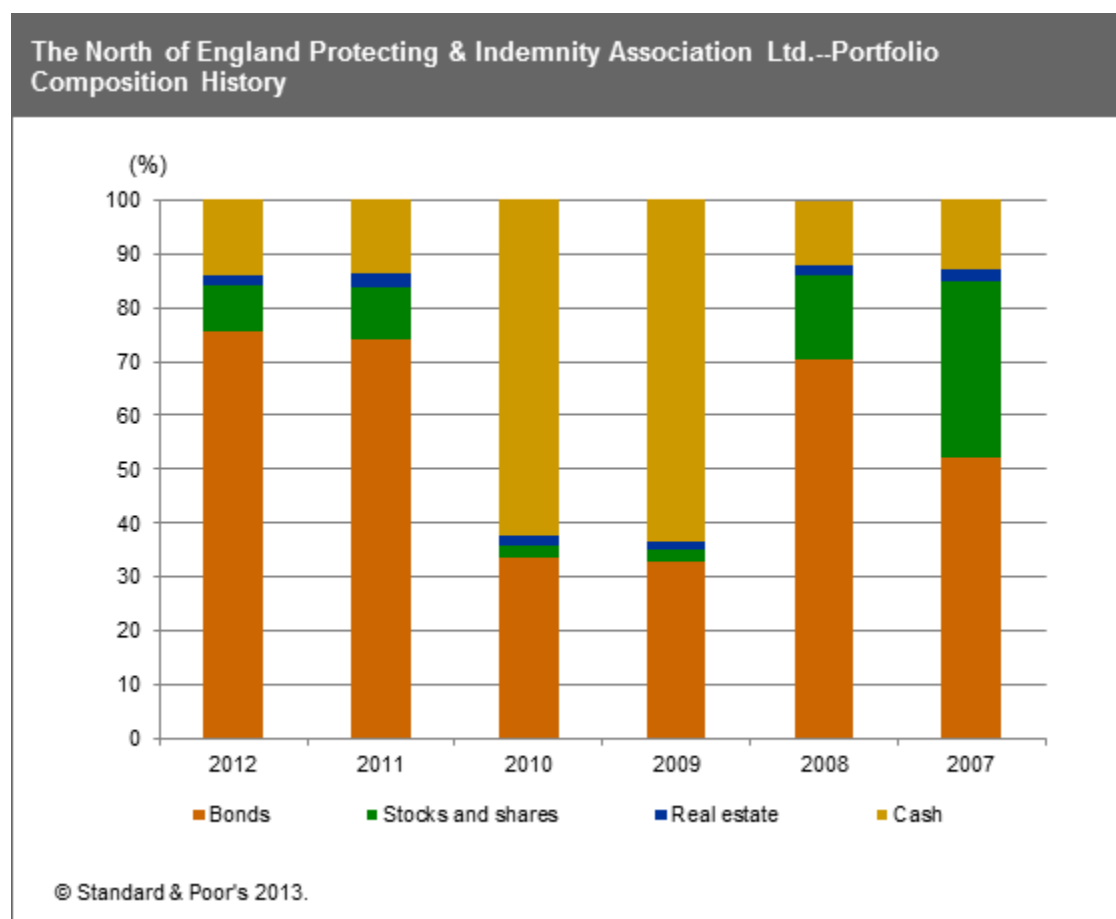
experience for the remainder of the financial year continues as the first half, we believe that the club is likely to post a weak bottom-line result for a mutual at February 2013, with a deficit in excess of \$11 million.

We anticipate (given the corrective actions taken--see management and Corporate Strategy section) that, in financial years 2013 and 2014, NEPIA will produce combined ratios of about 98%-101% barring an abnormally high claims pattern.

We believe that the club will carefully manage the churn effect (our forecast is about 5%) and the significant level of new business to maintain its good operating performance. If the club's underlying underwriting performance deteriorates to such a level that it becomes a threat to its strong capitalization, it could place downward pressure on the club's ratings.

Investments: Conservative Investment Strategy

Chart 5



In line with our expectations, the club's appetite for investment risk has remained stable during 2012. That said, the search for yield has caused a slight increase in credit risk, albeit to a level we still consider conservative considering

adequacy of capital resources (February 2012: equity type products to free reserves equalled 26.8%; the second lowest level in the IG).

Market risk

The club has no direct exposure to equity markets but has kept its holdings in ARFs stable at about 11% during 2012. At the end of October 2012, the remaining invested assets were held in cash and cash equivalents (41%), and bonds (non-government bonds: 13% and government bonds: 35%). The club employs a fixed income manager for active currency management. This is separate from its underlying portfolio, which seeks to add value.

Credit risk

The credit quality of the fixed-income portfolio is very strong. Bonds rated 'AA' or higher represented 75% of the portfolio, although the search for yield has caused it to place a large proportion (about \$100 million) of its non-ARF investments into a short-dated corporate bond portfolio through unitised funds with a minimum rating of 'A'. Of the corporate bond portfolio, 25% has a duration hedge which protects part of the portfolio against the risk of rising interest rates. NEPIA has no exposure to Greek government bonds and very little exposure to Italian (1% of forecast February 2013 free reserves) and Spanish government bonds (3% of forecast February 2013 free reserves).

NEPIA actively seeks to produce a stable investment return, doing this via an investment strategy oriented toward capital preservation. NEPIA has reduced the disadvantage in terms of yield by investing in ARFs and corporate bond funds. However, we believe that the investment allocation will remain conservative compared with IG peers in the medium term.

Liquidity: Strong, Backed By A Very Liquid Asset Base

We view NEPIA's liquidity as strong, with cash and highly-rated bonds accounting for about 76% of total invested assets at October 2012. At February 2012, liquid assets covered net technical reserves by 1.5x (February 2011: 1.5x). In our view, the above-mentioned investment in corporate bonds is unlikely to hinder the club's liquidity position. Also, we anticipate that the new instalment set for premiums (see Management and Corporate Strategy section) will mean a move away from the club's traditional positive cash flow over the course of the 12 months from Feb. 20, 2013, to being marginally negative over the same period. However, if this is the case we believe that the club can easily meet commitments from investment assets.

Capitalization: Strong, Despite Expected Operating Deficit In Financial Year 2012/2013, Supported By Conservative Reserving

Table 2

The North of England Protecting & Indemnity Association Ltd.--Financial Statistics*							
(Mil. \$)	--Year ended Feb. 20--						
	2012	2011	2010	2009	2008	2007	2006
Adjusted free reserves	314	312.4	240.2	211	220	190.2	168
(Technical reserves + adjusted free reserves)/net premiums written (%)	327.9	330.4	327.9	344.5	453.6	417.4	382

Table 2

The North of England Protecting & Indemnity Association Ltd.--Financial Statistics* (cont.)							
Outstanding claims reserve/net claims paid (%)	366.2	432.2	301.9	347	388.4	461.8	416.5
Reinsurance utilization ratio (%)	21.1	21.9	24.4	24.5	29.8	21.5	20

*Combined figures with The North of England Mutual Insurance Association (Bermuda) Ltd.

NEPIA's strong capitalization benefits from conservative reserving practices and reflects its very strong capital adequacy, measured using Standard & Poor's proprietary model. The club actively manages the potential volatility in its balance sheet by purchasing high-level reinsurance, and adjusts its investment risk appetite to ensure that its capitalization is maintained at a strong level. These positive factors are partially offset by its less-strong capital quality, caused by its high reinsurance dependence (in common with some IG clubs), despite the generally strong quality of reinsurers used.

Capital adequacy

NEPIA's capital adequacy, measured using Standard & Poor's risk-based model, is likely to remain at a very strong level over the next two years given the corrective actions taken by the managers. Nonetheless, the club's risk-based capital is exposed to high volatility due to the inherent risk in its underwriting profile (see Operating Performance section). The major risks remain those related to insurance (underwriting and reserving). Insurance accounts for over one-half of required capital (based on Standard & Poor's model), insurance risk represents around 65% (28% underwriting, 37% reserving) of total target capital at 'AA' level. The growth in the underwriting profile over the past couple of years has increased the underwriting risk charges. The club has a minimum target of 'AA' for its risk-based capital, measured using our model, and maintained a capital record in line with its target. The board of the club has a maximum target capital of 125% of gross premium. At Feb 2012, the club was positioned at the middle lower end of the 'AA' range. We expect the club to be rated well within the 'AA' range by February 2013, although the club is expected to lose about \$11.5 million.

Reserves

We view NEPIA's estimating and reserving practices as very conservative by insurance industry standards, as demonstrated by ongoing prior-year positive run-offs. The club reserves at a 95% confidence level, which is higher than most IG club peers. Our last actuarial review of the club's reserves indicates a good level of conservatism over the club's best estimate.

Reinsurance

Like some other IG clubs, NEPIA's business model is highly dependent on reinsurance. As a member of the IG, NEPIA benefits from the group's excess-of-loss program and, through pooling of risks, from the IGA. These arrangements provide individual IG members with protection--either via reinsurance or pooling--on individual claims of more than \$8 million (IG announced that it is to increase the individual retention of its member clubs to \$9 million at the next renewal on Feb. 20, 2013), of up to \$3.06 billion. We expect the overall cost of IG's reinsurance programme for the 2013 policy year will be subject to an increase of about 30%-40% for all clubs due to losses in relation to the RENA and Costa Concordia cruise liner disasters.

In addition, the club purchases significant reinsurance to protect its subpool exposure. Currently, the club has two excess of loss reinsurance programs. The first is \$4 million in excess of \$2 million with Swiss Reinsurance Company

Ltd. (AA-/Stable/A-1) accounting for 80% and Hannover Re (AA-/Stable/A-1) accounting for 20%. The second is \$2 million in excess of \$6 million with Munich Re (AA-/Stable/--) accounting for 57.5 %, Lloyd's (A+/Positive/--) accounting for 20%, Hannover Re (AA-/Stable/A-1) accounting for 12.5%, and Transatlantic Re accounting for 10% (A+/Stable/--). Both end in February 2013, reducing its exposure to a substantial increase in total claims. The club is currently reviewing its reinsurance program.

Reinsurance counterparts are generally rated at least in the 'A' category, with about 90% of recoverables due from reinsurers rated 'A-' or higher.

Prospective

The club's capitalization is expected to remain strong. We anticipate that consolidated free reserves will decrease to about \$303 million at February 2013. However, we expect it to rise to about \$325 million-\$330 million by the end of February 2014 barring an abnormally high claims pattern, with capitalization in terms of capital adequacy expected to improve relative to the risks assumed.

Financial Flexibility: Strong, Driven By The Ability To Collect Unlimited Additional Premiums

In our view, NEPIA has very strong financial flexibility, principally derived from its ability to collect unlimited additional premiums (by making unbudgeted supplementary calls) from members on open policy years, and to impose significant premium increases at renewal. We do not expect the club to rely on such calls to maintain its free reserve position over the rating horizon.

Needs

The club's capitalization is at a level above that indicated by the rating. We also believe that the club's commitment to underwriting profitability and our expectation of a measured exposure to alternative asset volatility will limit any need for additional funding in the absence of further underwriting profile growth.

Sources

The obligation to pay unlimited calls is contractually enforceable and NEPIA, like other IG members, has significant powers to obtain funds due from members, including the ability to impound ships and pursue other connected parties for payment. In addition, in the event of nonpayment, the club can withdraw cover from inception and refuse any claims payments.

Related Criteria And Research

All articles listed below are available on RatingsDirect on the Global Credit Portal, unless otherwise stated.

- Principles Of Credit Ratings, Feb. 16, 2011
- Management And Corporate Strategy Of Insurers: Methodology And Assumptions, Jan. 20, 2011
- Refined Methodology And Assumptions For Analyzing Insurer Capital Adequacy Using The Risk-Based Insurance Capital Model, June 7, 2010
- Interactive Ratings Methodology, April 22, 2009

- Group Methodology, April 22, 2009
- Counterparty Credit Ratings And The Credit Framework, April 14, 2004

Ratings Detail (As Of January 9, 2013)

Operating Company Covered By This Report

The North of England Protecting & Indemnity Association Ltd.

Financial Strength Rating

Local Currency

A/Stable/--

Counterparty Credit Rating

Local Currency

A/Stable/--

Domicile

United Kingdom

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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