

An hourglass-shaped graphic with a globe inside. The top bulb is dark blue, and the bottom bulb is light blue. The globe is centered in the narrow neck of the hourglass. The text is overlaid on this graphic.

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Ocean Piracy and Its Impact on Insurance

Rawle O. King, Analyst in Financial Economics and Risk Assessment

December 3, 2008

Abstract. Many Members of Congress are concerned about the sharp rise in pirate attacks in the strategic waterways in the Gulf of Aden off the East coast of Africa. The hijacking of a Saudi Arabia-owned oil tanker, *Sirius Star*, off the coast of Kenya on November 17, 2008, by pirates was another in a series of seizures that have focused worldwide attention on economic and humanitarian threats posed by pirates to the global seafaring community and the smooth flow of international trade. Given the sharp increase in the number of pirate attacks, the cost of transporting cargo in international waters could rise dramatically because of the sharp increase in ocean marine insurance rates for ships transiting the Gulf of Aden. Commercial insurers, for example, could require a special "war risk" insurance premium costing an additional ten of thousands of dollars a day. These additional costs could adversely impact international trade during the current global economic slowdown.

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Prepared for Members and Committees of Congress

Summary

Many Members of Congress are concerned about the sharp rise in pirate attacks in the strategic waterways in the Gulf of Aden off the East coast of Africa. The hijacking of a Saudi Arabia-owned oil tanker, *Sirius Star*, off the coast of Kenya on November 17, 2008, by pirates was another in a series of seizures that have focused worldwide attention on economic and humanitarian threats posed by pirates to the global seafaring community and the smooth flow of international trade. Given the sharp increase in the number of pirate attacks, the cost of transporting cargo in international waters could rise dramatically because of the sharp increase in ocean marine insurance rates for ships transiting the Gulf of Aden. Commercial insurers, for example, could require a special “war risk” insurance premium costing an additional ten of thousands of dollars a day. These additional costs could adversely impact international trade during the current global economic slowdown.

In addition to proposals for military deterrence and diplomatic engagements, policymakers may elect to consider adjustments to the federal statute (Title XII of the Merchant Marine Act of 1936, as amended) that authorizes the federal government to underwrite marine war risk insurance in circumstances such as piracy. Title XII, administered by the U.S. Department of Transportation’s Maritime Administration, authorizes the federal government to act as an insurer or reinsurer of last resort to facilitate waterborne commerce should private ocean marine insurance markets not be able to ensure that financial losses due to war risks (and piracy) will be largely covered.

Policymakers may also elect to maintain the status quo on this statutory authority. The property and casualty insurance industry policyholder surplus is calculated to be approximately \$505 billion (as of June 2008). Vessel hull and war risk premiums in the U.S. market paid to insurers totaled approximately \$350 million in 2007, and the total value of cargo insurance premiums paid in that year was approximately \$833 million, according to industry data. Some may contend, as a result, that the insurance industry appears to be financially capable of handling U.S. exposure to the current piracy threat and that the existing policy “backstop” will be adequate.

This report will be updated as events warrant.

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Introduction

In the wake of the unprecedented number of pirate attacks on merchant ships off the Coast of East Africa in recent months, including the hijacking of a Saudi Arabia oil tanker (*Sirius Star*) carrying \$100 million worth of crude, the global shipping industry and its insurance companies have called on governments to take immediate action to stop piracy in the Gulf of Aden and Indian Ocean.¹ Public attention has now focused on suspected Somali pirates who use sophisticated vessels and high-powered weapons to take control of large ocean-going ships carrying valuable cargoes. When pirates seize the ships they usually hold the crew hostage and demand money for the return of the crew, tanker and its contents (cargo). There are no reports of cruelty or destruction of vessels or the cargo. Piracy in the international waters off the East coast of Africa is arguably becoming viewed by the shippers, insurers, and pirates themselves as a well-established practice that functions in a business model that includes precise, well-established calculations of the amount to be paid as a ransom and professional assurances of the safety of crew, ship and cargo while negotiations proceed.

Shippers generally purchase ocean marine insurance to protect against a financial loss or injury to their crew, cargo and the ship itself. Still, pirates pose an economic threat to the global seafaring community and the smooth flow of international trade by commercial shipowners and operators. Also, the cost of transporting cargo could rise dramatically because of the sharp increase in commercial shipping insurance rates for ships transiting the area. By one estimate, due to piracy in the Gulf of Aden, the cost of insuring a container went from \$900 in 2007 to \$9,000 in the closing months of 2008.² These increases could trigger further rises in later phases of manufacturing and production.

The Current Situation

Piracy Events and Impacts

The Gulf of Aden was identified as an area of concern by Lloyd's Market Association (LMA) in May 2008.³ The Gulf of Aden is considered a strategically important international waterway that carries a third of the world's crude oil. Over 20,000 vessels pass through this area each year. The Gulf of Aden lies between Yemen and Somalia and connects the Indian Ocean to the Red Sea and the Suez Canal. Other areas of the world that are viewed at risk for ocean piracy include Indonesia, Nigeria, Bangladesh and India.

Ocean marine insurers have urged shippers to stay at least 200 miles off the coast. On November 17, 2008, the *Sirius Star*, a Saudi-owned crude oil tanker, was seized in the Indian Ocean by suspected Somali pirates 450 nautical miles off the coast of Kenya in the Indian Ocean. The

¹ Piracy may be defined as an act of violence at sea by passengers who mutiny and rioters who attack the ship from a boat launched from the shore.

² See *Maritime Reporter and Engineering News*, "American Officials Address Piracy," located at <http://www4.marinelink.com/Story/American-Officials-Address-Piracy-213633.html>.

³ The Lloyd's Market Association (LMA) is the representative voice of the Lloyd's underwriting community.

vessel remains anchored by the pirates near Harardhere, Somalia. The pirates are now in negotiation with the shipper for ransom.⁴

The seizure of the *Star* was an unprecedented attack given its distance from shore (450 nautical miles) in the Indian Ocean and the size of its target (supertanker) compared to the majority of recent attacks. Shippers believe they can avoid the pirates by sailing farther offshore, but this means more time at sea and extra costs. As a result, ocean marine insurers are considering enlarging the war risk zone, a decision that would escalate the cost of shipping. Part of the higher cost would be the extra time and fuel consumed by going via the Cape of Good Hope rather than the Suez Canal. Also, insurers could require special “war risk” insurance costing tens of thousands of dollars more per day to cover travel across a much greater area of water.⁵ Merchant shippers would also have to incur additional expenses to hire a security force to protect their vessels. One estimate of the added cost for security ranges as high as \$60,000 per trip.⁶

On November 19, 2008, Pentagon officials released statistics showing that in 2008, there had been 95 reports of piracy attacks on merchant vessels in the Gulf of Aden, with 39 of these resulting in the capture of vessels.⁷ The U.S. government has responded militarily to such piracy by sending four U.S. Navy warships from the Fifth Fleet to the Gulf of Aden off the coast of Somalia. Officials have also expressed an interest in working through the United Nations to encourage Somalia to curb piracy activities operating from its shores; an outcome that would be difficult to achieve since Somalia has no functioning government. The U.S. warships have joined other warships from different countries now patrolling the area.⁸ According to Pentagon officials, many attacks were thwarted by the presence of military forces or by defensive measures taken by ship captains. U.S. military officials are encouraging merchants to sail with armed guards and to travel within lanes now patrolled by U.S. warships.

Insurance Industry Effects

Despite the increased threats and estimates of rising costs, the impact on the insurance industry appears negligible. Given the size of the property and casualty insurance industry’s policyholder’s surplus of about \$505 billion, as of June 2008, and the relatively low total cost of vessel hull and war risk premiums of approximately \$350 million and total cargo premiums written by U.S. marine insurance market in 2007 of \$833 million, it appears that the insurance industry would be financially capable of handling U.S. exposures to acts of piracy in international waterborne commerce.

⁴ According to media reports, the *Sirius Star* is a Liberian-flagged crude tanker owned by Saudi Aramco, the Saudi Arabia’s state oil company, and operated by Vela International, an Aramco subsidiary.

⁵ John W. Miller, *The Wall Street Journal*, “Piracy Spurs Threats to Shipping Cost,” November 19, 2008, p. A. 12.

⁶ *Ibid.*

⁷ See *Maritime Reporter and Engineering News*, “American Officials Address Piracy,” located at <http://www4.marinelink.com/Story/American-Officials-Address-Piracy-213633.html>

⁸ Thom Shanker, “U.S. Urges Merchant Ships to Try Steps to Foil Pirates,” *New York Times*, November 20, 2008, p. 10.

The Economic Costs and Consequences of Piracy

In May 2008, insurance underwriters at the Lloyds of London designated the Gulf of Aden a “war-risk” zone subject to a special insurance premium. London-based ocean marine insurers have raised rates for ships making the voyage through the Gulf of Aden and the Suez canal. These levels of increase can only be estimated because of the competitive nature of the ocean marine insurance business. One group of London insurance brokers and underwriters estimates extra premiums at \$10,000 to \$20,000 per trip through the Gulf.⁹ U.S. rates, however, apparently have not changed. According to representatives of the American Institute of Marine Underwriters (AIMU), U.S. ocean marine insurers have not had to pay ransom for any act of piracy; therefore, they say, hull and cargo insurance rates for vessels leaving the United States remain the same.

The global shipping industry is most concerned about vessels that carry oil, chemicals, coal, iron ore, wheat and other commodities, because these vessels tend to be more vulnerable to pirate attacks than container vessels that carry manufactured goods. Container vessels are considered more difficult to seize by pirates because they ride higher in the water and are more difficult to board and seize from a small boat.

The increase in pirate attacks is occurring at a time when the shipping industry is expressing concerns about its financial health. One development is that the frequency of hiring dry bulk carriers, a key industry component, has decreased; the “hire” rates have dropped over 90% in the last six months.¹⁰ (In some cases, the hire rate has dropped because the financial industry has stopped financing trade due to the global economic crisis.)¹¹ In addition, many ship owners and other key industry participants apparently face severe losses from the global financial market crisis. Some major dry bulk shippers lost money speculating on the market in shipping derivatives that offered potential for strong investment returns.¹² Shipping derivatives were developed to manage risk stemming from fluctuations in freight rates, vessel prices, interest rates, and foreign exchange rates, more effectively, in a cheaper and more flexible manner. Many shippers made derivative bets mistakenly on the direction of dry bulk rates during 2008.

With respect to the piracy issue, besides the *Sirius Star*, there are an estimated 14 other ships and their crews currently being held by pirates.¹³ London-based shipping firms usually are, at times, prepared to pay ransom because the demanded sums are considered low, ranging from \$500,000 to \$2 million, compared with the value of the ships and its cargo. Such payments are reimbursed because the hull insurance policies issued in London explicitly cover the peril of piracy.¹⁴ (Hull

⁹ *Piracy Threat Hikes Insurance Premiums: Insurers to Raise Rates in High-Risk Areas After Piracy Heists Off Somali Coast*, November 20, 2008, located at <http://www.msnbc.msn.com/id/278262>.

¹⁰ Robert Wright, “Shipping in Crisis: Sector Must Navigate Rates Challenge,” *Financial Times*, November 19, 2008, p. 18.

¹¹ *Ibid.*

¹² A derivative is a financial instrument whose price is dependent upon or derived from one or more underlying assets. The derivative itself is a contract between two or more parties. Its value is determined by fluctuations in the underlying asset. The most common underlying assets include stocks, bonds, commodities, currencies, interest rates and market indexes. Most derivatives are characterized by high leverage.

¹³ *The Associate Press*, “Pirates Open Fire on U.S. Cruise Ship,” December 2, 2008, located at <http://www.msnbc.msn.com/id/28011013/>.

¹⁴ Robert F. Worth, “Pirates Seize Saudi Tanker off Kenya: Ship Called the Largest Ever Hijacked,” *New York Times*, November 18, 2008, p. A. 6.

insurance forms used by American insurers generally exclude coverage for the peril of piracy.) Most of the 18 vessels, however, have cargo valued low enough that shippers likely will not pay the ransom demanded by the pirates; the ransom demanded exceeds the value of the cargo. One exception is a Ukrainian freighter currently being held by pirates, whose cargo includes military tanks, rocket-propelled grenades and antiaircraft guns. According to media reports, a deal has been reached for the ship's owners to pay an undisclosed ransom in exchange for the return of the ship.¹⁵ In this case questions of public safety and threats of civil instability were considered along with financial calculations.

Basics of Marine Insurance

Marine insurance is coverage for goods in transit, and for the commercial vehicles that transport them, on water and on land. Marine insurance is divided into *inland marine* and *ocean marine* insurance. Inland marine insurance covers transportation-related or transportable property on land and air transportation as well as bridges, tunnels, and other modes. It is insurance for shipment that does not involve ocean transport.

American ocean marine insurance provides coverage for vessels and their cargo on the high seas, lakes or inland waterways. There are four basic types of ocean marine insurance:

- hull insurance that covers physical risk to the ship, like grounding or damage from heavy seas, collision, sinking, capsizing, being stranded, fire, piracy, and jettisoning cargo to save other property;
- cargo insurance that covers the goods transported in the ship;
- hull war risk insurance (including automatic termination and cancellation provisions in the event of war); and
- protection and indemnity (P&I) which covers liability involving the crew, docks and piers. Ship owners can purchase separate kidnap and ransom insurance for crew members.¹⁶

Hull Insurance

Hull insurance primarily covers physical damage to vessels (hull) and the machinery and equipment. The insurance also covers collision liability associated with damage to other vessels and their cargoes resulting from collision with the insured vessel. The hull insurance policy indemnifies the insured shipowner for these damages.

Most American shippers use the hull insurance form called *American Institute Hull Clauses* (AIHC), developed by the American Institute of Marine Underwriters, a trade association for marine insurers.¹⁷ The AIHC is used primarily for oceangoing cargo and passenger vessels.

¹⁵ Jeffrey Gettleman, Mediator Says Ransom Deal Has Been Reached for Pirated Ukrainian Freighter, *The New York Times*, December 1, 2008, p.

¹⁶ In addition to hull, cargo, war risk and P&I insurance, other marine insurance policies are available to meet special needs. These policies include freight insurance, loss of charter hire insurance, builders risk insurance, and ship repairers legal liability policies. These policies are not at issue in the piracy threat.

¹⁷ See *American Institute of Marine Underwriting*, "American Institute Hull Clauses," located at <http://www.aimu.org/> (continued...)

Another form, named the Taylor form, is often used for insuring vessels that traverse American rivers and coastal waters. In addition, it is customary for some insurance brokers to develop their own marine forms for submission to underwriters. This is possible because there is no standard form of marine insurance policy recognized by law in the United States.

American ship owners, operators, and merchants may also purchase marine insurance overseas, especially through the London market, which uses its own form. The London Institute hull form (known as the 1983 clauses or “Institute Time Clauses Hulls”) explicitly covers loss or damage caused by piracy (page 58 of the form).¹⁸ There is no exclusion. In order to provide uniformity, Great Britain codified its marine insurance law in the landmark *Marine Insurance Act of 1906*. This act established the Lloyd’s form of policy as an example but is not a required policy form. The approach developed in Great Britain is to provide constant rules of interpretation so that there would be certainty of meaning and stability in ocean marine insurance transactions.

With respect to coverage for acts of piracy, it is instructive to note that the AIHC includes piracy as a named peril (on line 71) but excludes piracy (on line 245) as an insured peril in the event of war. Recognizing the war risk exclusion, U.S. shippers have the option of purchasing a separate war risk policy, called the *American Institute Hull War Risk and Strikes Clauses* which effectively covers the excluded war perils, including piracy.¹⁹ However, even under the hull war risk insurance policy, the marine insurer retains the right to cancel the policy at any time. In the event the private insurer’s war risk insurance is cancelled, the U.S. Department of Transportation’s Maritime Administration’s marine war risk insurance and reinsurance federal backstop automatically provides insurance and/or reinsurance to the ocean marine shipping industry (see “War Risk Insurance” discussion below).

Ocean Cargo Insurance

Ocean cargo insurance policies are written as separate coverage from hull insurance because merchants typically ship cargo via vessels owned by others. Ocean cargo insurance may be classified in two ways: policies issued to cover river and harbor cargo, and those issued to cover international trade that occurs on the oceans and seas. Cargo policies may also be classified by whether they are designed to cover a particular voyage, a specific time period, or a commodity such as grain, cotton, iron ore, or whether they are adapted to cover cargo general in its nature. Cargo policies may be issued for a single cargo risk (special or single risk cargo policies), and those that cover automatically all shipments of an insured (open or floating policies), subject to cancellation with 30 days’ notice.

War Risk Insurance

Hull insurance usually does not cover the risk of a vessel sailing into a war zone, but such insurance can be purchased separately as “war risk insurance.” War risk insurance is special coverage on cargo in transcontinental ships that protects against the risk of confiscation by a

(...continued)

aimuforms/7.pdf.

¹⁸ See *Institute Time Clauses (Hulls)*, located at:<http://alterisk.ru/download/CL280.pdf>.

¹⁹ See *American Institute of Marine Underwriting*, “American Institute Hull War Risk and Strikes Clauses,” located at <http://www.aimu.org/aimuforms/87B-108.pdf>.

government in wartime. War risk insurance coverage protects, at an additional premium, against the danger of loss in a war zone. The war risk zones are established by the London-based Lloyd's Market Association's Joint War Committee (JWC), which has recently included the Gulf of Aden as a war risk area due to piracy.²⁰ (About a decade ago, the Malacca Straits were similarly designated a war risk area due to piracy.) The JWC represents the interests of underwriters writing war and related risks within the London ocean marine insurance market.

The U.S. Department of Transportation's Maritime Administration's (MARAD) marine war risk insurance program under Title XII, Merchant Marine Act, 1936, as amended, includes a provision of vessel war risk insurance, as follows.²¹

The Secretary (of Transportation), with the approval of the President, and after such consultation with interested agencies of the Government as the President may require, may provide insurance and reinsurance against loss or damage by war risks in the manner and to the extent provided in this subchapter, whenever it appears to the Secretary that such insurance adequate for the needs of the water-borne commerce of the United States cannot be obtained on reasonable terms and conditions from companies authorized to do an insurance business in a State of the United States.²²

During times of national emergency, at the request of the Department of Defense, the MARAD underwrites marine insurance risk insurance for DOD-chartered vessels during national emergency. Commercial shippers can obtain war risk insurance coverage from MARAD.

Protection and Indemnity Insurance

The hull insurance policy, even with the collision clause, does not protect the vessel owner against liability for damage to: cargo in the custody of the insured; injury to passengers, crew members, or laborers handling cargo; and damage to docks, piers, and other fixed objects. Vessel owners typically purchase a Protection and Indemnity (P&I) marine insurance policy to cover these risks from shipowners' clubs that form to mutually insure these risks. In the 19th century, shipowners banded together in mutual underwriting clubs to insure liability risk amongst themselves. These clubs are still in existence today. Members of the clubs are generally levied an initial sum that is used to purchase reinsurance to cover their mutual liability risks. If a club experiences unfavorable losses, the members are assessed a supplementary premium. The club attempts to build up loss reserves.

Options for Congress

Federal policy (Title XII of the Merchant Marine Act of 1936, as amended) authorizes the federal government to administer a maritime war risk insurance program that insures or reinsures, as a last resort, ocean-going commerce should private ocean marine insurance markets prove

²⁰ For information on the Joint War Committee, see, http://www.lmalloyds.com/AM/Template.cfm?Section=Joint_War1&Template=/TaggedPage/TaggedPageDisplay.cfm&TPLID=3&ContentID=3888.

²¹ Merchant Marine Act, 1936, 46 U.S.C. App. 1282, 64 Stat. 773.

²² *The White House*, "Presidential Memo on Marine War Risk Insurance Coverage," December 12, 2001, located at <http://www.whitehouse.gov/news/releases/2001/12/print/20011214-9.html>.

insufficient. Available statistics suggest that industry resources are adequate, given the property and casualty insurance industry surplus and the relatively low cost of insurance premiums. As a result, despite the increased activity of pirates, some may contend that Congress does not need to amend the existing federal insurance statutory construct. Others, however, may urge increased levels of oversight and investigation into the situation in an effort to ensure that international commerce remains stabilized, particularly at a time of global economic crisis.

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