



CIRCULAR REF: MSMI 2011/005

**CIRCULATED TO ALL MEMBERS, BROKERS AND DIRECTORS
ATTENTION INSURANCE DEPARTMENT**

**21 MARCH 2011
AAW/PAJ/JI**

Cessation of Underwriting and Proposed Sale of MSMI (in run off) to North of England Protecting & Indemnity Association Limited

As advised in circular No 2011/01 dated 27 January, 2011, at a meeting on 21 January, 2011 the Board of Directors of MSMI (the "Board") considered the possibility of MSMI continuing to underwrite, and concluded that although the Company was financially sound and well reserved, the Company's relatively small scale business model was unlikely to be viable in the foreseeable economic climate. The Board therefore resolved that MSMI would cease to underwrite business with effect from 30 June, 2011.

In light of the decision to cease underwriting the Board has given consideration to the options available to the Company with respect to the handling and run off of its outstanding liabilities. The Board is mindful that the run off should be handled in the most efficient manner to maximise value in the Company for the benefit of the membership, whilst also ensuring so far as possible that Members' outstanding claims continue to be handled fairly and consistently.

The Board identified two general options available, namely the continued management of the run off of claims by MSMI, or the sale of MSMI's run off liabilities to a third party. The Board instructed PricewaterhouseCoopers ("PwC") to investigate the possibility of a sale of MSMI (in run off) to a third party. A number of indicative offers were made to the Company in the range of 43% to 71% of the Company's Net Asset Value (NAV) at 30 June 2010, however these were rejected by the Board, who strongly felt that such offers would not be in the best interests of the MSMI membership, as they would not provide Members with any certainty as to the manner in which claims would be handled and settled in the future.

The North of England Protecting & Indemnity Association Limited ("North"), whose management company North Insurance Management Limited ("NIML") also manages MSMI, announced that it will launch a fixed premium product for Hull & Machinery cover on 1 July, 2011 (the "North Hull Class").

Marine Shipping Mutual Insurance Company Limited
Baltic Place, South Shore Road, Gateshead, Tyne & Wear, NE8 3BA
Telephone: +44 (0)191 232 1346 Fax: +44 (0)191 261 0540 Email: msmi@nepia.com www.msmi.co.uk

The Board invited North to make an offer to purchase MSMI in run off. An offer was subsequently received from North which the Board duly considered at a meeting on 3 March, 2011 (the "North Offer"). At the meeting the Board resolved (by a majority of 6 to 1) to approve the North Offer, subject to contract and due diligence, and to recommend this for approval by the MSMI membership.

North Offer

The North Offer comprises two elements:

1. A "basic payment" to MSMI of an amount equal to 67% of its NAV on 30 June, 2011; and
2. An "incentive payment" which shall be payable to existing MSMI Members in respect of any ship that they enter for insurance in the North Hull Class at 1 July, 2011.

1. Basic Payment

The amount of this payment will be determined with reference to the NAV of MSMI on 30 June, 2011.

For the purposes of illustration, based on the NAV of MSMI at 30 June 2010 (estimated to be US\$25.4M), North's offer would result in a payment of approximately US\$17M. The actual amount of the payment may, however, be more or less than this sum.

It is envisaged that the parties will seek to agree the basis upon which the NAV will be determined and any areas of disagreement will be referred to a jointly appointed expert for determination. North will make the basic payment within 30 days of determination of the NAV, which is anticipated to be some time in October/November, 2011.

The Board instructed PwC to conduct an independent review of the basic payment. PwC has subsequently confirmed to the Board that:

- the basic payment is consistent with ranges observed for comparable run off transactions and is in excess of a number of indicative independent third party offers from market participants; and
- overall the basic payment does not seem unreasonable.

2. Incentive Payment

North has also offered to make an "incentive payment" to any existing Members of MSMI in respect of any ship that they enter for insurance (for a minimum period of 12 months) in the North Hull Class at 1 July, 2011 (a "Qualifying Policy"), subject to the following:

- the total aggregate amount of all incentive payments shall be capped at 12% of the NAV at 30 June, 2011;
- the incentive payments shall be satisfied by way of a credit against the 2011/2012 annual premium payable to North for the Qualifying Policy;
- the amount of the credit due will be determined with reference to the 2010/2011 annual premium payable to MSMI in respect of Hull & Machinery cover for the relevant ship (the "Relevant Premium") by applying a percentage rate to the Relevant Premium;
- the percentage rate used to determine the amount of the credit shall depend upon the NAV agreed between the parties and the total 2010/2011 MSMI premium for Hull & Machinery cover. It is currently anticipated that the credit will equate to approximately 7.5% of that 2010/11 premium (although the final rate could be higher or lower);

- entitlement to an incentive payment in respect of any ship is subject to a minimum placement of 25% of the agreed Hull & Machinery value of that ship in the North Hull Class for a period of 12 months.

It is also a term of North's offer that in respect of those MSMI Members who place ships in the North Hull Class for 2011/2012, North will undertake to maintain the 2010/2011 MSMI premium or to apply the terms of any pre-existing agreement, pro rata to the percentage of the agreed Hull & Machinery value placed for insurance in the North Hull Class.

Members will of course be free to seek insurance on the open market (with North or any other hull insurance provider) in respect of all or any part of the remaining 75% of the agreed Hull & Machinery value of each vessel it enters in the North Hull Class.

3. **Worked Example of Incentive Payment**

For the purposes of illustration only, based on the NAV of MSMI at 30 June, 2010 (approximately US\$25.4M), the total aggregate amount of all incentive payments would be capped at approximately US\$3M (i.e. 12% of the NAV). On the basis of the total MSMI Hull & Machinery premium income for 2010/2011 (approximately US\$40M) each Qualifying Policy would be subject to a credit equal to approximately 7.5% (i.e. $(US\$3M/US\$40M) \times 100$) of the relevant 2010/2011 annual premium.

Therefore, in the case of a ship entered with MSMI for 2010/2011 in respect of 100% of the agreed value of that ship for Hull & Machinery cover at an annual premium of US\$100,000, the following would arise upon that ship being entered in the North Hull Class for 2011/2012:

- Annual premium payable to North in respect of cover for 25% of agreed Hull & Machinery value (i.e. 25% of 2010/2011 premium) = US\$25,000
- Amount of credit (i.e. 7.5% of the Relevant Premium) = US\$7,500
- North Annual Premium less credit = US\$17,500

In this example the Members would receive a 30% reduction to the annual premium payable in respect of the 25% placement of the ship in the North Hull Class. For the avoidance of doubt, the amount of the credit given would remain the same in circumstances where more than 25% of the agreed Hull & Machinery value of the vessel is placed in the North Hull Class.

MSMI Self Run Off

In addition to considering offers for a third party sale of MSMI (in run off), the Board has also carefully considered the option of MSMI managing the run off of claims itself. In doing so the Board identified a number of factors which together it considered to be persuasive when comparing a self run off with a third party sale:

- Firstly, it was considered unlikely that if the Company conducts its own run off there would be an immediate distribution of reserves to Members, and it was reasonable to assume that it could be as long as five years from cessation of underwriting before significant funds would be available for distribution (subject to FSA approval). A third party sale allows for funds to be distributed to Members within a significantly shorter timescale and it is therefore reasonable to allow a discount to be applied to the finally agreed NAV;
- Secondly, the outstanding liabilities of the Company are subject to large reinsurance recoveries, and whilst the financial standing of the reinsurers is excellent, a third party sale removes any possibility of reinsurance default and provides certainty to the membership;

- Thirdly, although the claims liabilities of the Company are carefully and conservatively assessed, there is still the possibility of claims deterioration. A third party sale removes this possibility and again provides certainty for the membership;
- Fourthly, the funds of the Company are cautiously invested, but in an uncertain economic climate, a sale of the Company eliminates completely any investment risk and provides immediate certainty;
- Finally, the precise duration of the run off is unknown, and the costs associated with this would also be uncertain, once again a sale of the Company removes this uncertainty.

After careful consideration the Board concluded that there was no certainty that a self run off would ultimately achieve a higher residual value than a third party sale and that overall, a sale of MSMI (in run off) to North was in the best interests of the membership as a whole.

Next Steps

The Board recommends the North Offer to the Members and has therefore convened a General Meeting on 6 April, 2011 to consider and, if deemed appropriate, approve the North Offer.

In the event that the Members approve the North Offer, the Board will seek to agree the terms of a legally binding sale and purchase agreement (including the agreed basis of valuing the NAV) with North in order to effect the sale of MSMI (in run off) to North on the basis of the North Offer.

At the same time, the Board will seek advice from its solicitors, Norton Rose, with regard to the overall legal structure of the transaction and to ensure a timely and equitable distribution of the proceeds of sale to the Members, in the event that the transaction proceeds to completion. The Board together with its advisors will in due course consider the most appropriate method of distribution and Members will be advised accordingly.

Members should note that, depending upon the advice received from Norton Rose, Members may be required to take further actions in order to complete the proposed transaction and to enable a timely distribution of the sale proceeds. Such actions may include:

- Approving amendments to the existing Articles of Association of MSMI;
- Executing contractual documents or ancillary transactional documents required to complete the transaction.

A notice convening the General Meeting on 6 April, 2011 together with appropriate documentation will be sent to Members separately.

The Board sincerely regrets that it has been necessary to cease underwriting after 39 years of operation, however the Board believes this is in the best overall interest of the membership. The Board recommends acceptance of the North Offer which the Board considers achieves the best combination of certainty of value with continuity of claims servicing.

The Board will advise Members of any further actions required if and when matters progress.