THE AMERICAN CLUB

# The American Club 2003 Annual Report

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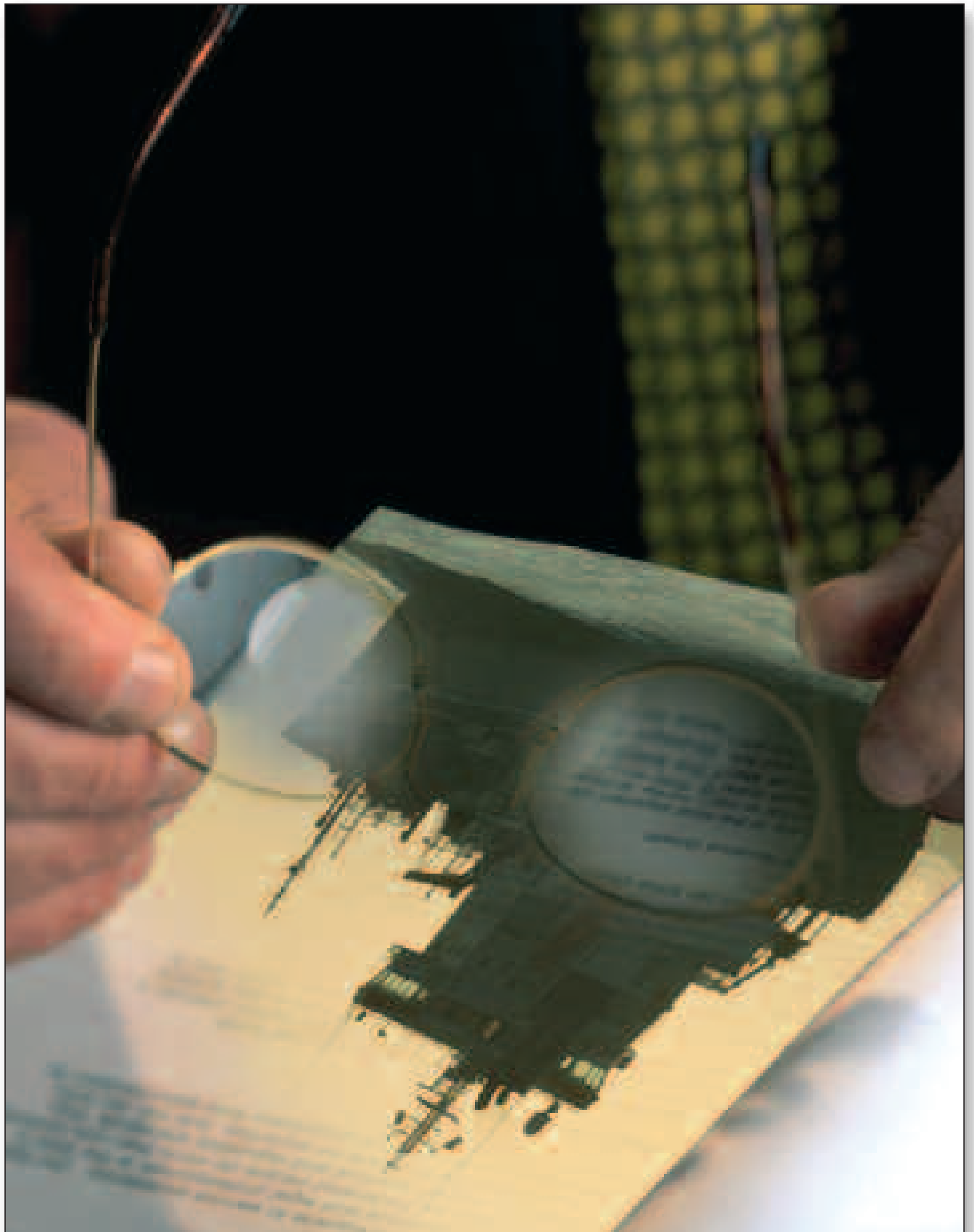
# Highlights

- 2003 represents eighth consecutive year of new business development: entered tonnage hits new peak.
- Premium levels move upward: pricing cycle maintains reaction to earlier period of rating softness.
- Regional diversification of membership progresses: domestic market share remains solid.
- Investment markets improve: downward trend of earlier years reversed.
- New initiatives in safety and loss prevention implemented: scope of Member engagement expands.
- 2004 renewal features further growth: Club experiences new highs of entered tonnage and premium income.
- Policy year results prove patchy: 1999 closed within latest forecast, but 2000, 2001 and 2002 require additional calls to eliminate open year deficits. 2002 features unusual deterioration toward end of calendar 2003.
- Despite calls setback, recent operating results develop well as balance sheet strengthens.
- Liability climate remains hostile: poor juridical standards, unreasonable government demands and oppressive use of criminal sanctions continue to cause industry concern.
- Club resources in New York and London expand: service capabilities amplified by decision to establish Greek office.
- Overall P&I market tone matches expectations: despite geopolitical uncertainties, continuing Club progress points to encouraging prospects for the future.



# *The American Club 2003 Annual Report*

*2003 was a mixed year for the American Club. It opened with a significant increase in new business. The months which followed featured steady progress. Conditions in the securities markets improved. Rating levels continued to rise after a lengthy period of weak pricing. The 2004 renewal saw new highs in entered tonnage and premium income. However, the continuing deficit position on open years, exacerbated by the rapid deterioration of results on the 2002 policy year, prompted the levy of unbudgeted supplementary calls for 2000, 2001 and 2002 in mid-2004. Nevertheless, against a background of excellent – and apparently sustainable – freight markets, clouded only by persistent geopolitical uncertainties, the American Club looks with optimism to a future committed to unsurpassed standards of Member service and refortified financial integrity.*

# Report of the Directors

*The Directors of American Steamship Owners Mutual Protection and Indemnity Association, Inc. (the American Club) are pleased to present the Club's Annual Report and Accounts for the year ended December 31, 2003.*

The American Club's principal activity continued to be the insurance of marine Protection and Indemnity and Freight, Demurrage and Defense risks on behalf of its Members, both owners and charterers.

The Club's Annual Meeting took place in New York City on June 12, 2003. At that meeting, the Directors listed on page 27 were elected to serve for the ensuing twelve-month period. Mr. Chih Chien Hsu of Eddie Steamship Company, Taipei, was elected as a new member of the Board. His fellow Directors welcomed Mr. Hsu, knowing that he would make a distinguished contribution to the Club's affairs over the years to come.



It was with regret that, at the Annual Meeting, the Board received the resignations of Mr. Rogelio D. Salinas G. of Grupo Protexa, Monterrey and of Mr. Earl G. Jackson of Midstream Fuel Service, Inc. of Mobile. The Board thanks both gentlemen for their outstanding service to the Club and wishes them well for the future.

At its meeting in New York City on September 11, 2003, the Board elected Mr. Michael L. Murley of Martin Midstream Partners L.P. of Mobile as a Director pursuant to Article II, Section 2 of the By-Laws. Mr. Murley attended his first meeting in November, 2003 at which time his fellow Directors were able to welcome him in person in the expectation that he would contribute greatly to the Club's affairs.

At the Annual Meeting, Mr. Paul Sa of Standard Shipping, Inc., was reelected as Chairman. Mr. James P. Sweeney of Penn Maritime, Inc. was reelected as Deputy Chairman. Mr. Lawrence J. Bowles was reappointed General Counsel to the Club and Mr. Joseph E.M. Hughes, the Chairman and CEO of the Managers, was reappointed as Secretary.

Since this year's Annual Report is being published a little later than is usually the case, it is possible to announce herein the election, at the Club's most recent Annual Meeting, which took place in New York City on June 17, 2004, of Mr. Vassilios Bacolitsas of Sea Pioneer Shipping Corp., Athens, Mr. Keith Denholm of Pacific Carriers Ltd, Singapore and Mr. Victor S. Restis of Enterprises Shipping and Trading S.A., Athens as new Directors. They were welcomed most warmly to the Board, knowing that they would make a great contribution to its affairs over the years to come. A full list of all current Directors – and the Secretary – is set out on page 27.

In addition to their participation in the Annual Meeting, the Directors, in 2003, convened on five occasions during the year. Four meetings took place in New York while the fifth was held in the Danish capital of Copenhagen for the Board's customary "out of town" session.

In the course of their meetings during 2003, the Directors considered a wide range of matters, including:

- Election of Directors.
- Policy year accounts.
- Settlement of claims of the Club's Members.
- Settlement of International Group of P&I Clubs' Pool claims.
- Settlement of premium levels for the subsequent policy year.
- Reinsurance.
- Investment policy.
- Outcome of renewal negotiations.
- Budgeting policy for relevant policy years.
- Changes to the Club's By-Laws and Rules.
- Reports of the business of the Club's London liaison office.
- Development of the Club's new IT system.
- Club publications.
- Meetings of Managers of the International Group of P&I Clubs.
- Developments in international shipping regulations.

The Club continued to benefit from meetings of the Finance and Safety and Environmental Protection Committees. Under the auspices of the latter, a further edition of *Currents* – the Club's in-house newsletter – was published. The Club also undertook new initiatives in loss prevention through the establishment of a Member Alert system of web-based issued safety and claims control notices by way of adjunct to Club Circulars issued in the more conventional way. Other activity also took place. They are dealt with in greater detail in the Report of the Managers which follows.

On the investment front, the Finance Committee continued to review the Club's strategy and received regular reports from the Club's investment advisors in order to monitor the optimum posture for the commitment of the Club's funds. Again, this subject is dealt with in greater detail in the Report of the Managers.

The Directors take this opportunity of thanking Members for their continuing support of the Club. Thanks were also due to the many others who worked hard in 2003 to progress its aims. Following on the heels of the solid progress made in recent years, 2003 was a year of further achievement. The results of the most recent renewal – as well as the many other initiatives currently underway – speak to the promise which the future holds for the Club.

It was a source of regret to the Directors that the need to levy further unbudgeted supplementary calls arose during 2004. The background to the circumstances which made this levy necessary is described in the report of the Managers. Nevertheless, the Club remains, under the close supervision of its Board, single-mindedly committed to impeccable results under examination as to any component of P&I service supply.

# Report of the Managers

*2003 was a good year for the American Club. It featured further growth in tonnage and increasing diversification by reference both to vessel type and domicile of operation. The positive trends of previous years continued. The year began with an excellent renewal season and steady progress was made over the months which followed.*

Most importantly, the Club was able to continue its policy of improving standards of service to Members, the specific elements of which are discussed in greater detail below.

### Entered tonnage, underwriting and reinsurance

The 2003 renewal once again featured growth in entered tonnage. February 20 saw total entries rising to over 17.5 million gross tons – a record figure. During the remainder of the year, tonnage remained largely stable. An increase in mutual entries – adjusted for smaller vessels to take account of their actual rather than a notional minimum tonnage – was balanced by a reduction in the relative proportion of chartered entries, broadly reflecting the state of the freight markets over the period.

2003 renewal ratings were subject to a general increase of 25% for expiring P&I estimated total premium. The Directors also determined that the estimated supplementary call proportion of total premium be reduced from 40% to 20%. Fixed premium rates for charterers' cover attracted the 25% general increase applicable to estimated total premium for mutual entries.

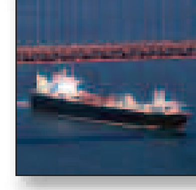
For Freight, Demurrage and Defense cover, it was ordered that advance call rates remain as expiry, but that premium for this class of business be taken as estimated total premium for the year rather than by way of advance and supplementary calls.

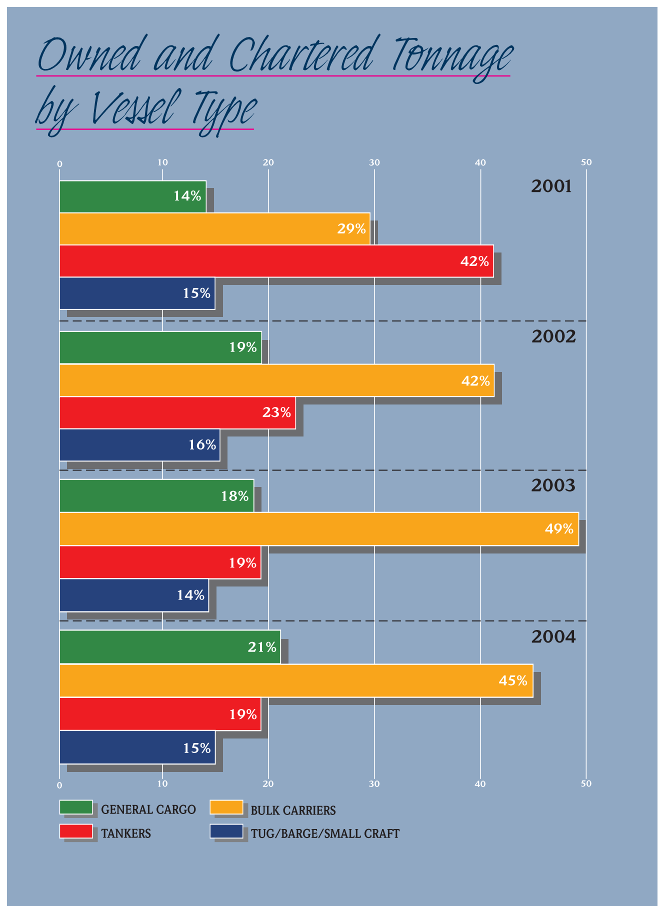
As usual, the general increases were subject to adjustment by reference to the renewal cost of the International Group of P&I Clubs' general excess of loss reinsurance contract then being negotiated on the Group's behalf by its brokers in the Lloyd's and other markets. Adjustments were also made in individual cases to take account of Members' loss records.

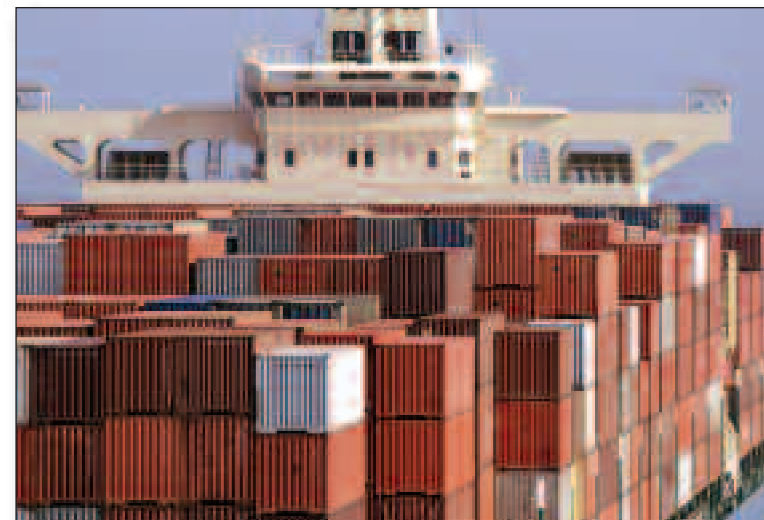
At the Annual Meeting, the 1999 year was closed without further contribution in excess of the latest forecast. The deficit for the year was funded from the Club's contingency fund, well within the parameters established for the deployment of the reserve when it was established several years ago.

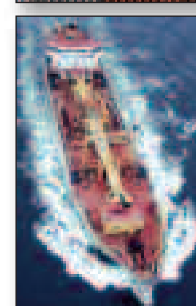
For 2004, the Directors ordered a 17.5% general increase on expiring rates. The Board also determined that the advance call for all classes of mutual business for 2004 represent the estimated total premium for the year – i.e. that there should be a zero supplementary call forecast at its commencement.

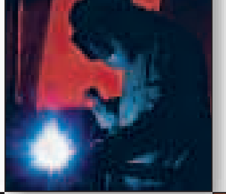
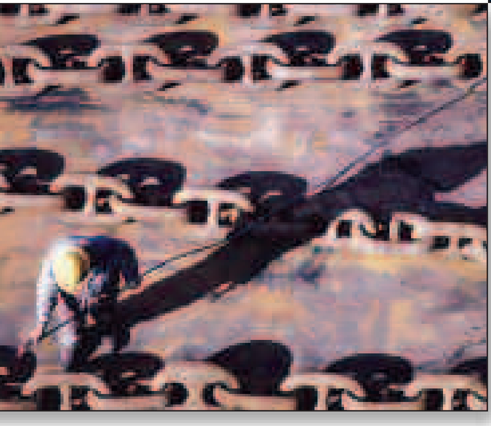
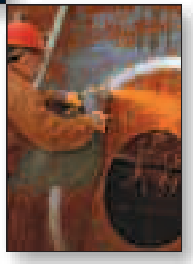
The 2004 renewal saw further growth. Total entered tonnage rose to nearly 20 million tons as of February 20, 2004 – a record figure. In addition to the uplift in tonnage, premium volume also increased, bringing projected total premium for the year to about $120 million – another record.







Reflecting a trend of several years, many new entries came from overseas. As a result, and as indicated in the table set on page 13, the tonnage of operators from foreign domiciles continues to exceed that of Members managed from within the United States. As to the balance of vessel types covered by the Club, it will be seen from the table on page 7 that the dry bulk and general cargo sectors continue to account, in tonnage terms, for the largest part of the entry.

As foreshadowed above, however, the proportion of entries attributable to charterers' insurances declined somewhat both in absolute and relative terms. This is reflected in the table set out on page 13.

Most recent growth has been seen outside the US. However, the commitment of domestic operators to the American Club has remained solid. The last renewal featured significant new business from the US – particularly in the tug, barge and specialist operations sector.

The Club's reinsurance arrangements during 2003 remained essentially unchanged from those of 2002 save for the significant increase in overall rates noted in last year's Annual Report.

The American Club continued to protect its underlying retention in 2003. The Club was able to obtain renewal of its underlying policies on favorable terms, covering $3 million excess of $2 million per claim within its retention. 75% of this protection was placed with Munich Re and 25% at Lloyd's.

For 2004, the International Group's program reflects a broadly-held desire to retain more risk within the "working layer" of the program and to preserve market reinsurance cover for more serious or catastrophic losses.

Accordingly, the Pool retention for 2004 has been increased from $30 million to $50 million, resulting in a premium saving of approximately $32 million for the first $500 million layer of excess cover. This saving will be used as pre-funded premium for the new $20 million Pool layer – along with the net retained premium from the 25% co-insured element of the first tranche of the market program. The premium will be allocated to the International Group's new Bermuda-based cell-captive Hydra Re, which is expected to become operational later in the year.

Otherwise, the familiar four-layered (in cumulative tranches of $500 million each) structure of the program has been maintained, providing a total of $2 billion cover for non-oil pollution risks and $1 billion oil pollution cover, with a marginal reduction in premium for the upper layers. In the end, all categories of vessels enjoyed a rating reduction of between 3% and 6%, save for passenger ships, which attracted a 7% increase.

The "overspill" provisions of the Pooling Agreement, which provide for an additional $2 billion protection in respect of claims which may exceed cover for non-oil pollution claims under the market program, have also been continued in 2004 in the same format as that which applied during the previous twelve months.

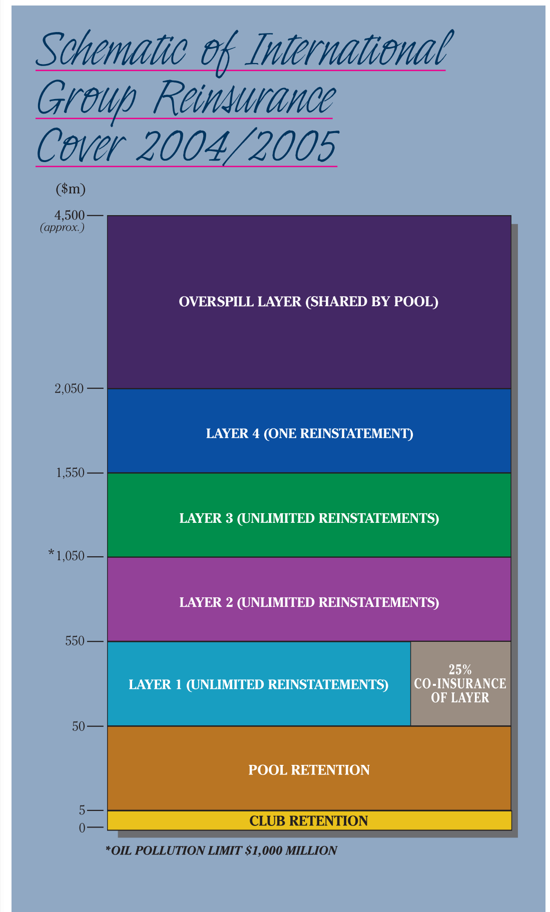
The Group's War Risks cover was renewed on expiring terms and conditions for 2004, with a $400 million limit for each vessel, each event, excess of a vessel's proper value (or $100 million, whichever is less), except for vessels within the Athens Olympics exclusion zone during the summer of 2004, which will be subject to an individual $50 million limit.


As to protection of the Club's retained exposure for 2004, the arrangements with both Munich Re and Lloyd's have been maintained in the same form (and in the same proportions) for 2004. The annual aggregate deductible on the policy has increased somewhat in recognition of tonnage growth over the previous twelve months. However, while the minimum and deposit premium on the policy has risen slightly, the adjusting rate per ton has reduced.

A schematic of the Club's reinsurance arrangements is set out below.

### *Supplementary Calls*

As mentioned in the previous section, the 1999 policy year was closed without further call in excess of the latest estimate in June 2003. While it had been the intention to close the 2000 year without further call in June 2004 by way of subsidy from the contingency fund, a confluence of negative trends had emerged by the end of the first quarter of 2004 which began to cast doubt on this plan. These were as follows.




It had been known for some time that 2000 and 2001 were developing in deficit. The slight improvements on those years seen in the Club's retained exposure were offset by a worsening in other clubs' pool claims and an upturn in final figures payable for other reinsurance costs attributable to its increased tonnage and premium income.

However, the seismic change which affected the generality of the plans of only nine months earlier was the extent to which 2002 deteriorated, particularly during the last six months of 2003. The pattern of deterioration was also highly unusual – mainly impacting a layer of claims between $100,000 and $500,000 in respect of which the Club's reinsurance policies provided only modest relief.

Because 2002 deteriorated so quickly, and because problems with a recently-installed IT system delayed awareness of the extent of the problem, it was decided that the Club's financial position needed to be decisively strengthened. In doing so, the decision was made to preserve the contingency fund which was felt should remain intact to maintain levels of solvency required for general strategic purposes.

In addition, the need to demonstrate to rating agencies such as Standard & Poor's that definitive action was being taken was linked to the need to show increased surplus under the requirements of New York State Risk Based Capital testing.

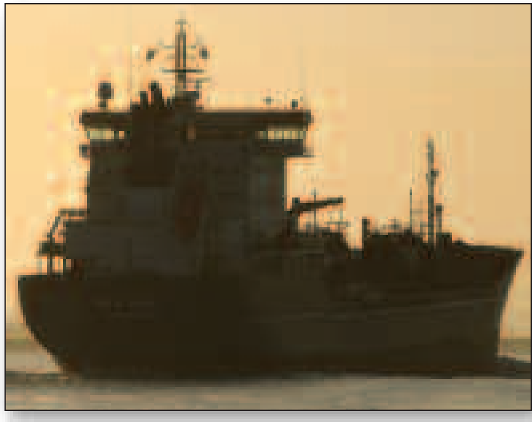
These factors, collectively, led the Club to the decision that it was best to have the open year deficits dealt with in a timely manner, strengthen the balance sheet to a point where it compared favorably with its peers elsewhere within the International Group and do so in a way which, although unlikely to generate popularity, would in retrospect be seen to be responsible and farsighted.



Accordingly, in June 2004 the Directors ordered additional supplementary calls of 40%, 35% and 30% of relevant advance calls for the 2000, 2001 and 2002 years respectively to be payable at the end of August 2004, January 2005 and September 2005 respectively at which time each year would be closed.

### *Finance and Investments*

At year-end 2002, the equity markets had undergone a three-year period of successive annual declines not seen since 1932, a year typically viewed as that which marked the end of the beginning of the Great Depression.



It was with some relief, therefore, that 2003 brought a significant improvement in investment returns, buoyed by a recovery in the prospects for North American growth linked to the global stimulus created by Chinese demand for raw materials to supply its massive infrastructural development and growing market share of world exports.

Although the continuing decline of the US Dollar against most other currencies remained a source of concern – coupled with a US budgetary deficit which seemed to balloon from month to month – the overall investment climate remained buoyant despite geopolitical uncertainties which continued to affect long-term prospects.

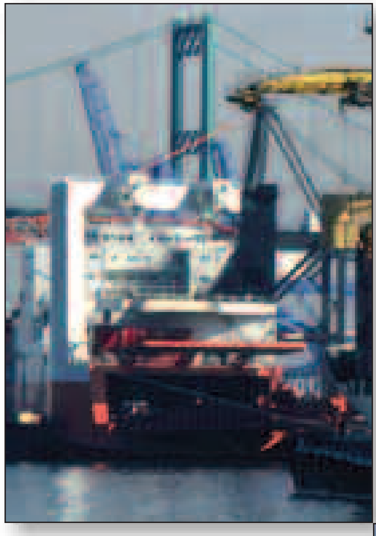
The Club's own investment posture remained broadly similar during the period under review to that which had applied over the earlier twelve months of account. Bonds and cash remained the major instrument of investment which, at 71% of the total portfolio, was somewhat lower than the proportion applying at the end of 2002, although much in line with the historical position taken by the Club. The improvement in the equity markets, however, resulted in the Club enjoying respectable gains in this sector of its portfolio by year-end.

Overall, the Club made a return of 10.45% on its entire portfolio with the fixed interest and equity sectors yielding 4.02% and 27.88% respectively. This compares with 4.20% and 28.70% benchmark figures (the Lehman Brothers Index and S&P 500 respectively, weighted averages). However, it is worth noting that while the Club did not benefit from the exchange gains reported by other clubs as a component of investment income, its results, correlatively, remain less susceptible to fluctuations in the value of the US dollar.

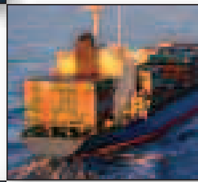
As mentioned in earlier Annual Reports, it is part of the Finance Committee's duty to ensure that appropriate oversight of the management of Club investment is maintained. During the period under review – and as continues – it was the Club's policy to maintain, over time, a balance of approximately 30% of total assets and equities and the remaining 70% in fixed-interest securities and cash. The weighting as between these sectors responds to market conditions. Accordingly, the steps taken during the course of 2003 to reverse the retreat from equities was in fulfillment of this policy – which proved, in the circumstances, to be a sensible direction.

### *Claims*

Save for the rapid deterioration in the overall volume and value of claims attributable to the 2002 policy year, 2003 featured a pattern of exposure similar to that experienced during the previous twelve months. As a reflection of the growth and widening diversity of entered tonnage, the number of notified cases and the incidence of their origin in overseas locations both increased, although the average severity of individual claims remained broadly constant.



Cargo and personal injury claims continued to account for the bulk of the Club's exposure both by number and net aggregate value. Collision and fixed and floating object claims also made up a significant proportion of claims, again broadly in line with prior years' experience.



It was in the field oil pollution and wreck removal, however, that the Club experienced its most significant claim during the year. The grounding of the TASMAN SPIRIT at Karachi in July 2003 resulted in a protracted period of intense activity by the Club, its professional advisors and the many parties engaged to act on its behalf in dealing with the oil pollution created by the wreck, as well as its ultimate removal.

Serious though it was, the casualty would have amounted to no more than the type of substantial claim with which all Clubs are occasionally challenged, but for the egregious treatment of members of the vessel's crew and the master of the salvage team originally commissioned to intervene in the stranding.

Given the wide publicity the incident and its aftermath have attracted, it would be otiose to recount here the many issues raised by the case. However, the detention of the crew has sharpened the global industry's focus upon the often iniquitous, and sometimes scandalous, manner in which seafarers are treated by local authorities following marine accidents.

The American Club mobilized every resource at its disposal to ensure the swift clean-up of the pollution and the restoration of the local environment to recently unparalled levels of cleanliness. Through the employment of Smit International, the wreck was removed with professionalism and dispatch. Claims for compensation remain, at the time of writing, completely out of touch with reality. The Club's attempts to apply the tried and tested CLC approach to arranging recompense have been unsuccessful.

The Club's efforts to secure the release of the "Karachi Eight", conducted in a wide range of commercial, political and diplomatic fora, caught the attention of the global maritime industry and stimulated the IMO, the International Chamber of Shipping, the International Shipping Federation, INTERTANKO, the International Group of P&I Clubs and others to examine in broad policy terms the whole issue of seafarer treatment following maritime casualties



Happily, these efforts proved successful and, by the end of April 2004, the Karachi Eight were free to return to their homes. The general approbation of the Club's efforts on their behalf by the shipping and insurance communities was at least some small source of comfort in the unfolding of these disturbing events.

Another important development concerned a change in the Club's treatment of unreserved and unreported claims in closed policy years. At the end of May, 2004 the Club's Board decided to terminate a previous discretionary practice to pay such claims and to seek a Declaratory Judgment in regard to its new policy.

The Board's decision arose out of litigation with a former Member as to the interpretation of the previous discretionary practice which raised to prominence the equity of that practice vis-à-vis the Club's current Members so as to move the

Board to seek the Declaratory Judgment as a means of achieving a public definition of the Club's legal rights on the subject.

A further report will be made to Members as and when the court hands down its decision. When, as is expected, this is in support of the Club's case, it will have a positive effect upon its financial outlook.

### Changes to the By-Laws and Rules

The major rearrangement of the format of the Club's Rules which was undertaken by the Managers during 2002 was brought into effect in 2003.

The new structure did not contain any wholesale changes in the substance of Club cover, but rather made the general part of the Rules more comprehensive in application and more focused in meaning.

The major reform was to divide the overall cover into three classes of insurance (being Classes I, II and III) covering Protection & Indemnity insurance, Freight, Demurrage and Defense insurance and insurance for Charterers' Risks respectively.

During 2003, changes were made to the Club's Charter and By-Laws. These changes were designed to bring them more up-to-date and to clarify certain elements of Club governance in view of the great changes which have taken place in its size and make-up in recent years.

The Charter and By-Laws in their revised form were approved by both the Directors and the New York State Department of Insurance during the early fall of 2003. The changes were notified to Members by way of Circular well in advance of the commencement of the 2004 policy year to which they now apply.

Developments in maritime regulation also prompted some minor changes to the language of the Rules for 2004, notably in respect to the provisions of the new International Ship and Port Facility Security (ISPS) Code which entailed modification to the conditions governing a Member's obligation to comply with the statutory requirements of an insured vessel's flag state.

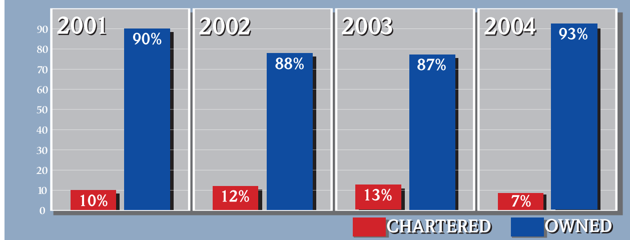
### Club Publications

As Members will have noticed, the Club's By-Laws and Rules for 2004 have, for the first time, been combined, for ease of reference, into a single manual together with the updated List of Correspondents.

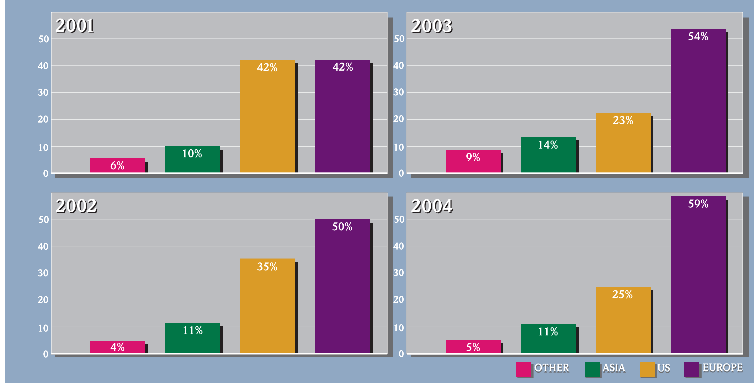
In addition to this change, the Managers continued in 2003 to broaden the scope of Club publications available to Members, with the aim of communicating information in a timely and user-friendly format.

Nineteen Club Circulars were issued during 2003, many of which dealt with important matters of maritime security and pollution. These were supplemented by seventeen Member Alerts, a new form of notice introduced by the Managers for posting on the Club's website.

## Split Between Owned and Chartered Entries




## Owned and Chartered Tonnage by Management Domicile



These notices aim to provide speedy advice on topical issues affecting certain sections of the membership, without detracting from the weight of Club Circulars, which are generally reserved for important issues affecting all Members. A wide variety of subjects were covered by Member Alerts during the year. They ranged from civil unrest in Nigeria to steel claims in China.

The distribution of key reports on safety and loss prevention from the International Maritime Organization (IMO) was another innovation. These reports, which are published on a regular basis by the IMO's Maritime Safety, and Marine Environmental Protection, Committees, are intended to raise Members' awareness of current maritime issues and to notify them of any imminent regulatory changes.

The new-look Club magazine – *Currents* – continued to provide a twice-yearly digest of information about the Club, combined with topical loss-prevention and legal features in an easily readable format.

### *Activity within the International Group of P&I Clubs*

War risks and maritime security featured prominently in the International Group's deliberations during 2003 and into the new policy year. The introduction of a "cyber" exclusion clause by market underwriters, excluding cover for liabilities caused by any chemical, bio-chemical or electromagnetic weapon or computer virus, created an anomaly in Members' war risks cover. This required attention.

For example, while the International Group's Pooling Agreement specifically excludes liability for pollution caused by chemical / biological weapons as the result of an act or omission by a third party, the Civil Liability Convention and certain US legislation at best limit the right of exclusion. In view of this, the Group agreed that cover, in circumstances where liability might attach by reason of a Club having issued certification in pursuance of such provisions, should nonetheless apply.

More generally, the Group also proposed to pool "Bio-Chem" risks on a broader basis up to a $20 million limit each vessel, each incident, being a collective insurance of $15 million excess of a Club's normal $5 million retention.

Because concerns were expressed that such a risk could be perceived as being unquantifiable, as well as not truly mutual – since passenger ships and containerships were perhaps more vulnerable to this type of attack than tankers and bulk carriers – it has been agreed to restrict the cover to crew liabilities and defense costs only.

In the United States, final amendments to the Terrorism Risk Insurance Act of 2002 (TRIA) were considered by the US Treasury. However, a submission by the International Group that the benefits of TRIA should be made available to non-MARAD as well as MARAD-subsidized vessels (in terms of providing federal compensation to market reinsurers of terrorist risks) was not allowed. In the meantime, the American Club participated in advice and support to Members regarding implementation of the US Customs' Automated Manifest System and International Carrier Bond regulations (effective March 2004) and the ISPS Code (effective July 2004).

Pollution was another major issue. The perceived intention of certain European Union countries to revise the existing 1992 Civil Liability and Fund Conventions in order to raise the level of compensation payable by shipowners in the event of an oil spill and to restrict their rights of limitation, prompted the International Group to offer an alternative: to withdraw the STOPIA

scheme, which provides for an enhanced level of compensation payable by owners of smaller tankers, and, instead, for shipowners to share the burden of the Supplementary Fund – the higher tier of compensation – which at present is funded solely by the oil companies.

This, together with a proposal to share information on ships' standards among Clubs and to make available such information to outside parties, was considered at a meeting of the IOPC Fund Working Group in February 2004. It was agreed to postpone any recommendation regarding the revision of the Convention, until an historical analysis of oil spill costs had been reviewed.

Passenger cover was also debated by the International Group during the year. Following an initiative by a number of European countries, a new Protocol to the Athens Convention was introduced in October 2002, raising the statutory limit on passenger compensation to SDR 250,000 for maritime accidents and SDR 400,000 in cases where the carrier was unable to discharge the presumption of fault or neglect. Although the Protocol has not yet been ratified, the potential cost of an accident involving a large cruise ship continued to raise questions as to whether such a risk was acceptable within the mutual system. While the International Group remained divided on this key issue, full cover was maintained for passenger vessels.



As outlined in the section on reinsurance above, considerable progress has been made toward the establishment of Hydra Re, the Bermuda-based cell-captive which is intended to reduce the International Group's dependence on market reinsurers. The scheme was presented to the Bermuda authorities for approval in early 2004 and, although certain technical issues remain outstanding, it is expected that this new self-insurance facility will become operational during the course of 2004.

### *Safety and Loss Prevention*

The Club's focus on safety and loss prevention gained extra sharpness during 2003. The Managers strengthened the Club's Loss Prevention & Technical Services Department as part of their commitment to enhancing capabilities in this area.

The Club maintained its policy of requiring condition surveys of ships entering the Club of ten years of age or more. During the year, the Technical Department coordinated and reviewed 165 entry survey reports. The Club continues to use the entry survey as a core monitor of management quality and an important claims prevention measure.

In January 2004, an extended revision and update of the Club's entry survey forms was completed, new preliminary survey forms were developed and user-friendly instructions to surveyors were provided in order to facilitate entry survey activity.

The regular review of port state inspections of insured vessels was commenced in 2003, as were periodic risk assessments and reviews of selected fleets. The Club has also instituted an extensive analysis of claims to determine the impact on key risk areas of claims as a benchmark to target risk control and loss prevention initiatives.

A long standing concern of many Members, as well as other insurers, has been the employment of seafarers with pre-existing medical conditions. In March 2004, the Club instituted programs in the Ukraine and the Philippines to approve selected clinics performing pre-employment medical examinations for seafarers to ensure their physical fitness. Members participating in this voluntary program will, it is hoped, reduce their risk of employing seafarers with pre-existing medical conditions.



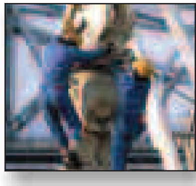
### *The American Club's strategic plan – new IT systems*

The elements of the new strategic plan – adopted by the Club's Annual Meeting in June 2001 – continue in the direction intended, although, inevitably, greater progress has been made in some areas than in others.

Part of the plan was the implementation of new Information Technology systems designed better to respond to the needs of a growing Club in a more demanding and international environment than that for which its original systems had been designed.

The new arrangements went "live" as of October 1, 2003 and, despite teething troubles in certain areas, have enhanced the Club's underwriting and claims processing capabilities in particular, although further work needs to be done in certain key areas, notably on accounting interfaces. Indeed, problems in the migration of data from the old system to the new created delays in the submission of statutory filings to the New York State regulator and in the completion of the GAAP accounts.

However, most of the difficulties have now been overcome and, although the experience has been unpleasant, there is comfort in the knowledge that it is unlikely to be repeated!



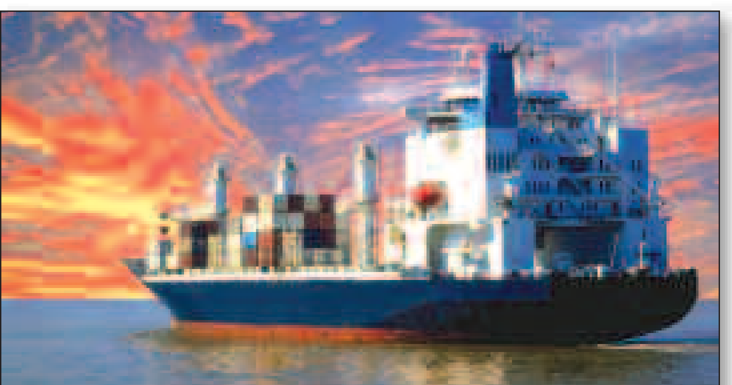
Taken as a whole, the strategic plan remains under constant review by the Managers who make regular reports to the Board. As was mentioned last year, the success of the strategic plan has given the Club the opportunity of consolidating the gains it has made in recent years as well as extending its potential going forward.

### *The Future*

Recent Annual Reports have been consistent in their optimism as to the American Club's future. Some commentators have referred to the Club's positive outlook as a strength which invigorates those who pursue its aims.

The recent news in regard to additional supplementary calls could scarcely be regarded as welcome, but there is no doubt that the calls will have the effect of substantially refortifying the Club's balance sheet.

Overall, the optimism continues to be justified. The American Club is bigger, more diverse, more self-confident and more resilient than at any time in its history. But serious challenges remain. Some challenges bear upon the life of the Club specifically but most have significant implications for the industry as a whole.



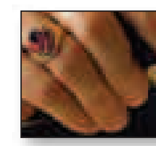
A major problem remains the commercial and legal backwardness which continues to afflict a stubborn rump of jurisdictions which appear to indicate no interest in improving their performance in these key areas of modern mercantile relations.

This would be enough in itself as a source of concern, but the irrational – and politically driven – hostility of some states toward shipowning interests has led to serious breaches of seafarers' rights. The Club's experience over the year in relation to the TASMAN SPIRIT is a case in point.

Twelve months ago, the Club reported that recent geopolitical developments suggested uncertainty for the years ahead. It was said that many of the more comfortable elements of received wisdom were undergoing fundamental change. It was hoped that these changes would ultimately lead to a more peaceful and prosperous future.

Despite progress in many areas, the future remains uncertain. The only certainty is change – and the new challenges this will bring. But whatever the years ahead may hold, the American Club remains dedicated to responding to those challenges and the Member expectations they will engender. It will be tireless in the application of resources to the achievement of exceptional service results.

The Managers join the Directors in thanking all of those who have helped the Club in progressing its aims over the past twelve months – most importantly, of course, the Members themselves. Enthusiastic in their desire to engage the future in a positive and constructive manner, the Managers dedicate themselves to being of service to all Members in seeking to ensure the American Club's continuing success at the forefront of the P&I world.



# 2003 Financial Report





# Report of the Independent Auditor


**Deloitte & Touche LLP**
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*To the American Steamship Owners Mutual Protection and Indemnity Association, Inc.*

*We have audited the accompanying balance sheets of American Steamship Owners Mutual Protection and Indemnity Association (the "Association") as of December 31, 2003 and 2002, and the related statements of operations and comprehensive income, changes in members' equity, and cash flow for the years then ended. These financial statements are the responsibility of the Association's management. Our responsibility is to express an opinion on these financial statements based on our audits.*

*We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.*

*In our opinion, such financial statements present fairly, in all material respects, the financial position of the Association as of December 31, 2003 and 2002, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.*

Deloitte & Touche LLP

*August 30, 2004*

Member of
**Deloitte Touche Tohmatsu**

# Balance Sheets

| IN THOUSANDS | NOTE | DECEMBER 31, 2003 | 2002 |
|---|---|---|---|
| **Assets:** | | | |
| *Investments* | 3 | **$ 77,417** | $ 55,665 |
| *Cash and cash equivalents* | | **11,425** | 7,320 |
| *Members' balances receivable* | | **30,365** | 31,123 |
| *Unbilled assessments* | 6 | **24,644** | — |
| *Reinsurance recoverable* | 5 | **23,304** | 18,243 |
| *Other* | 4 | **5,879** | 6,871 |
| *Total Assets* | | **173,034** | 119,222 |
| **Liabilities:** | | | |
| *Unpaid losses and allocated loss adjustment expenses* | 5 | **$ 97,262** | $ 70,491 |
| *Unreported losses* | 5 | **18,300** | 11,950 |
| *Unearned premiums* | | **13,012** | 8,706 |
| *Reinsurance payable* | | **7,607** | 6,991 |
| *Other* | 4 | **4,904** | 777 |
| *Total Liabilities* | | **141,085** | 98,915 |
| *Commitments and contingencies* | 8 | | |
| **Members' Equity:** | | | |
| *Retained earnings* | | **29,560** | 19,797 |
| *Accumulated other comprehensive income* | | **2,389** | 510 |
| *Total Members' Equity* | 10, 12 | **31,949** | 20,307 |
| *Total Liabilities and Members' Equity* | | **$173,034** | $119,222 |

# Statements of Operations & Comprehensive Income

| IN THOUSANDS | NOTE | DECEMBER 31, 2003 | 2002 |
|---|---|---|---|
| **Income:** | | | |
| *Net premiums and assessments earned* | 6 | **$101,530** | $53,317 |
| *Net investment income* | | **1,476** | 1,384 |
| *Realized investment gain (loss)* | | **1,549** | (1,627) |
| *Total Income* | | **104,555** | 53,074 |
| **Expenses:** | | | |
| *Losses and loss adjustment expenses incurred* | 5 | **74,072** | 35,713 |
| *Other operating expenses* | 7 | **20,705** | 14,117 |
| *Total Expenses* | | **94,777** | 49,830 |
| **Income Before Income Taxes** | | **9,778** | 3,244 |
| *Provision for income taxes* | | **(15)** | — |
| **Net Income** | | **9,763** | 3,244 |
| **Other comprehensive income, net of tax:** | | | |
| *Unrealized gains (losses) on investments* | | **1,879** | (613) |
| *Other comprehensive income (loss)* | | **1,879** | (613) |
| **Comprehensive Income** | | **$11,642** | $ 2,631 |



*See Notes to Financial Statements.*

# Statements of Changes in Members' Equity

| IN THOUSANDS | NOTE | RETAINED EARNINGS | ACCUMULATED OTHER COMPREHENSIVE INCOME | TOTAL MEMBERS' EQUITY |
|---|---|---|---|---|
| *Balance, January 1, 2002* | | **$16,553** | **$ 1,123** | **$17,676** |
| *Net income* | | **3,244** | **—** | **3,244** |
| *Unrealized investment losses* | | **—** | **(613)** | **(613)** |
| *Balance, December 31, 2002* | *9* | **19,797** | **510** | **20,307** |
| *Net Income* | | **9,763** | **—** | **9,763** |
| *Unrealized investment gains* | | **—** | **1,879** | **1,879** |
| *Balance, December 31, 2003* | *10, 12* | **$29,560** | **$ 2,389** | **$31,949** |



*See Notes to Financial Statements.*
*American Steamship Owners Mutual Protection and Indemnity Association, Inc.*

# Statements of Cash Flow

| IN THOUSANDS | NOTE | DECEMBER 31, 2003 | 2002 |
|---|---|---|---|
| **Cash Flows from Operating Activities:** | | | |
| *Premiums and assessments collected, net* | | **$81,231** | *$49,766* |
| *Loss and loss adjustment expenses paid, net* | | **(48,032)** | *(35,723)* |
| *Underwriting and other expenses paid* | | **(12,924)** | *(9,154)* |
| *Interest received, net of expenses* | | **1,565** | *1,458* |
| *Income taxes recovered* | | **8** | *51* |
| *Other, net* | | **(962)** | *(677)* |
| *Net cash provided by operating activities* | | **20,886** | *5,721* |
| **Cash Flows from Investing Activities:** | | | |
| *Proceeds from sales/maturities of investments* | | **57,634** | *34,609* |
| *Payments for purchases of investments* | | **(72,285)** | *(34,745)* |
| *Payments for purchases of computer equipment* | | **(2,130)** | *(181)* |
| *Net cash used in investment activities* | | **(16,781)** | *(317)* |
| **Net Change in Cash and Cash Equivalents** | | **4,105** | *5,404* |
| *Increase in value of Euro Account* | | **—** | *18* |
| | | **4,105** | *5,422* |
| **Cash and Cash Equivalents, Beginning of Year** | | **7,320** | *1,898* |
| **Cash and Cash Equivalents, End of Year** | | **$11,425** | *$ 7,320* |

# 2003 Notes to Financial Statements

## 1 Organization

The American Steamship Owners Mutual Protection & Indemnity Association, Inc. ("the Association"), domiciled in New York State, was organized in 1917 to provide protection and indemnity insurance to maritime organizations. Pursuant to the terms of the agreements between the Association and its Member-insureds, the Members are charged premiums and subsequent assessments in amounts adequate to cover the Association's net operating expenses which are its total operating expenses, including net losses, less amounts earned by the Association from investment activities.

The Association is managed by Shipowners Claims Bureau, Inc. ("SCB"), an unrelated party. SCB provides administrative, underwriting, accounting and claims processing services to the Association for an annual fee.

## 2 Summary of Accounting Policies

The accompanying financial statements have been prepared on the basis of accounting principles generally accepted in the United States of America. Significant accounting policies include the following:

**Investments –** Debt securities and equity securities with readily determinable fair values that the Association does not intend to hold to maturity are classified as available for sale securities and are reported at fair value. Unrealized investment gains/(losses) are shown in Members' equity. The Association has no investments in securities classified as held-to-maturity securities. Securities' transactions are recorded on the trade date.

A review of investments is performed as of each balance sheet date with respect to investments where the market value is below cost. If, in management's judgement, the decline in value is other-than-temporary, the cost of the investment is written down to fair value with a corresponding charge to earnings.

**Cash equivalents –** Cash equivalents include short-term highly liquid investments with an original maturity of three months or less.

**Computer Equipment –** Computer equipment consisting of computer hardware, systems and application software, and associated design, programming and installation costs have been capitalized and are being depreciated using the straight-line method over the estimated useful life of five years.

**Liabilities for Losses and Loss Adjustment –** The liability for unpaid losses and allocated loss adjustment expenses represents the Association's best estimate of the gross amount of losses and loss expenses to be paid on ultimate settlement and is provided on the basis of management's and counsel's evaluation of claims filed with the Association. The liability for unreported losses represents the Association's best estimate of the gross amount required to ultimately settle losses which have been incurred but not yet reported to the Association as well as an estimate for future development on reported losses. Given the nature of the coverages written and the size of the Association, fluctuations in the liabilities for losses from year to year are possible.

**Reinsurance –** The Association's reinsurance contracts do not relieve the Association of its obligations, and failure of a reinsurer to honor its obligations under a reinsurance contract could result in losses to the Association. The Association evaluates the financial condition of each potential reinsurer prior to entering into a contract to minimize its exposure to losses from reinsurer insolvency.

The Association records, as an asset, its best estimate of reinsurance recoverable on paid and unpaid losses, including amounts relating to unreported losses, on a basis consistent with the reserves for losses and in accordance with the terms of its reinsurance contracts. The Association reduces such reinsurance recoverables for amounts not collectible. Substantially all amounts recoverable from reinsurers are due from underwriters at Lloyds of London, Munich Re, and Swiss Re.

**Premiums and Revenue Recognition –** The statements of operations include those premiums which have been billed in the current year, together with estimates of unbilled assessments, representing an estimate of those assessments expected to be billed during the following calendar year.

**Income Taxes –** The Association is exempt from income taxes except for Federal and New York State taxes on taxable interest and dividends received. Deferred income tax relating to accrued taxable interest and dividends is recorded.

**Estimates –** The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported period. Actual results could differ from those estimates.

**Reclassifications –** Certain items in the 2002 financial statements have been reclassified to conform with the 2003 presentation.

## 3 Investments

All of the Association's investments are classified as available-for-sale. Such investments are publicly traded; accordingly, fair values have been determined using quoted market prices.

| | AMORTIZED COST | GROSS UNREALIZED GAINS | GROSS UNREALIZED LOSSES | FAIR VALUE |
|---|---|---|---|---|
| December 31, 2003: | | | | |
| US Treasury and obligations of other US government corporations and agencies | $ 310 | $ 1 | $ — | $ 311 |
| Short term investments | 5,340 | 1 | (1) | 5,340 |
| Obligations of states and political subdivisions | 48,296 | 1,159 | (33) | 49,422 |
| Common stocks | 21,082 | 1,704 | (442) | 22,344 |
| Total | $75,028 | $2,865 | $ (476) | $77,417 |

| | AMORTIZED COST | GROSS UNREALIZED GAINS | GROSS UNREALIZED LOSSES | FAIR VALUE |
|---|---|---|---|---|
| December 31, 2002: | | | | |
| US Treasury and obligations of other US government corporations and agencies | $ 310 | $ 12 | $ — | $ 322 |
| Short term investments | 2,235 | 9 | — | 2,244 |
| Obligations of states and political subdivisions | 39,805 | 2,210 | (11) | 42,004 |
| Common stocks | 12,823 | 896 | (2,624) | 11,095 |
| Total | $55,173 | $ 3,127 | $(2,635) | $55,665 |

The fair value and amortized cost of available-for-sale debt securities at December 31, 2003 by contractual maturity are shown below. Expected maturities may differ from stated maturities because borrowers may have the right to call or prepay certain obligations with or without pre-payment penalties.

| | AMORTIZED COST | FAIR VALUE |
|---|---|---|
| Due in one year or less | $ 8,120 | $ 8,162 |
| Due after one year through five years | 16,135 | 16,515 |
| Due after five years through ten years | 17,039 | 17,509 |
| Due after ten years | 12,652 | 12,887 |
| Total bonds and notes | $53,946 | $55,073 |

Proceeds from sales of investments and gross realized gains and losses on such sales are shown below:

| | 2003 | 2002 |
|---|---|---|
| Proceeds from sales of investments | $58,200 | $24,736 |
| Gross realized gains | 3,182 | 847 |
| Gross realized losses | 1,633 | 2,474 |

There were no realized losses recorded in 2003 or 2002 that were a result of an investment being other-than-temporarily impaired.

At both December 31, 2003 and 2002, United States Government Treasury notes in the amount of $310 and $310 par value, respectively, were deposited with regulatory authorities as required by law.

## 4 Other Assets and Other Liabilities

| | 2003 | 2002 |
|---|---|---|
| **OTHER ASSETS** | | |
| Computer equipment and software – net of accumulated depreciation of $1,545 and $1,301, respectively | $ 3,005 | $ 1,220 |
| Recievable for securities sold | 609 | 687 |
| Accrued interest receivable | 522 | 511 |
| Income tax recoverable | 85 | 89 |
| Deferred income tax | — | 9 |
| Prepaid reinsurance premiums | 1,267 | 1,580 |
| Management fee receivable | 263 | 231 |
| Other Assets | 128 | 1,300 |
| Other receivables | — | 1,244 |
| | $ 5,879 | $ 6,871 |
| **OTHER LIABILITIES** | | |
| Accrued expenses | 598 | 328 |
| Liability for securities purchased | 4,306 | 449 |
| | $ 4,904 | $ 777 |

## 5 Unpaid Losses and Reinsurance Recoverable

Activity in the liability for unpaid losses and allocated loss adjustment expenses and unreported losses is summarized as follows:

| | 2003 | 2002 |
|---|---|---|
| Gross balance at January 1 | $ 82,441 | $71,968 |
| Less reinsurance recoverables | 14,131 | 10,224 |
| Net balance at January 1 | 68,310 | 61,744 |
| Incurred related to: | | |
| Current year | 52,695 | 34,072 |
| Prior years | 21,377 | 1,641 |
| Total net incurred | 74,072 | 35,713 |
| Paid related to: | | |
| Current year | 9,522 | 4,561 |
| Prior years | 34,009 | 24,586 |
| Total net paid | 43,531 | 29,147 |
| Net Balance at December 31 | 98,851 | 68,310 |
| Plus reinsurance recoverables | 16,711 | 14,131 |
| Gross Balance at December 31 | $115,562 | $82,441 |

In 2003, loss emergence for prior years increased by $21.4 million. The increase reflects unfavorable emergence of $18.1 million for the 2002 policy year, $5.5 million of which is expected development through the policy year end date of February 20, 2003, and unfavorable emergence of $3.3 million for policy years prior to 2002.

Current year net losses incurred reflects continued growth in tonnage at February 20, 2003 and losses on increased non-American business, with their apparent greater frequency and lesser severity. Net claims paid increased by $14.3 million, and loss reserves increased by $31.1 million reflecting growth in tonnage on risk.

In 2002, loss emergence for prior years increased by $1.6 million. Most of the increase reflects expected development for the 2001 policy year through the policy year end date of February 20, 2002.

| | 2003 | 2002 |
|---|---|---|
| Reinsurance recoverable on unpaid losses | $ 16,711 | $14,131 |
| Reinsurance recoverable on paid losses | 6,593 | 4,112 |
| Total reinsurance recoverable | $23,304 | $18,243 |

## 6 Premiums and Assessments

| | 2003 | 2002 |
|---|---|---|
| Premiums written and billed assessments | $ 94,843 | $63,856 |
| Increase in unbilled assessments | 24,644 | — |
| Return premiums | (528) | (107) |
| Reinsurance premiums ceded | (12,810) | (8,819) |
| Net premiums and assessments written | 106,149 | 54,930 |
| Increase in unearned premiums | (4,619) | (1,613) |
| Net premiums and assessments earned | $101,530 | $53,317 |

Budgeted assessments billed of $12.8 million at December 31, 2003 for the 2003 policy year are collectible in one installment due May 20, 2004. Billed assessments at December 31, 2002 are collectible in two installments due May, 2003 and August, 2003. Revenue from estimated net unbilled assessments of $24.6 million at December 31, 2003 is included in the accompanying statements of operations and members' equity. There were no unbilled assessments at December 31, 2002. Additional assessable amounts will be billed as, and if, management deems appropriate.

## 7 Other Expenses

| | 2003 | 2002 |
|---|---|---|
| Management fee | $ 4,284 | $ 3,494 |
| Bad debts | 1,729 | (130) |
| Brokerage | 9,236 | 5,707 |
| Other | 5,456 | 5,046 |
| Total operating expenses | $20,705 | $14,117 |

## 8 Commitments and Contingencies

**Letters of Credit –** At December 31, 2003, the Association had outstanding letters of credit for $28.6 million, $3.4 million of which is a Designated Reserve that is required by the International Group Pooling Agreement.

**Exposure to Asbestos Related Claims –** Since the early 1980's industry underwriting results have been adversely affected by claims developing from asbestos-related coverage exposures. The majority of such claims allege bodily injury resulting from exposure to asbestos products.

The Association establishes reserves for reported claims as well as an estimate for unreported losses. While management believes that reserves for unpaid losses, net of related reinsurance coverages, are adequate in the aggregate, uncertainties exist with respect to estimating the ultimate future amounts that may specifically be needed for unreported asbestos-related claims. Such uncertainties include estimations of the number and value of claims that may be reported, court decisions affecting the Association's liability, and the continuing solvency of reinsurers who provided coverage during the applicable policy years.

| **Asbestos-Related Claims** | 2003 | 2002 |
|---|---|---|
| Aggregate gross losses paid to date at December 31 | $5,800 | $4,360 |
| Loss reserves – reported | $ 519 | $ 912 |
| Loss reserves – unreported | $2,500 | $2,500 |

**Other Contingencies –** From time to time, asserted and unasserted claims are made against the Association in the ordinary course of business. Management of the Association does not believe that the outcome of any such proceedings will have a material adverse effect on the Association's financial position or result of operations.

## 9 Related Party Transactions

On December 31, 2001, the Association purchased the outstanding capital stock of SCB from Marsh USA, Inc. for consideration of $1,500,000 ($750,000 paid upon execution and the remainder paid on December 31, 2002). This transaction was recorded as a purchase. On the date of purchase, SCB contributed the net book value of its fixed assets ($750,000) to the Association as a return of capital.

Also on December 31, 2001, the Association subsequently sold its interest in SCB to Eagle Ocean Management, LLC ("EOM"), a related party to SCB. No gain or loss was recorded as a result of these transactions. The Association maintains a promissory note receivable from EOM totaling $608,818 as of December 31, 2003 in satisfaction of the sale price.

## 10 Statutory Filings

The Association is required to report the results of its operations to the Insurance Department of the State of New York ("Insurance Department") on the basis of accounting practices prescribed or permitted by the Insurance Department ("statutory accounting practices"), which differ in some respects from accounting principles generally accepted in the United States of America.

The principal differences affecting the Association are described below:

**Premiums and Revenue Recognition –** Under statutory accounting practices, the Association may only record those premiums which are billed at the balance sheet date plus those that are unbilled for which either a letter of credit is held or which may be offset by unpaid losses. Unbilled and unsecured assessments are not reflected in the statutory financial statements, except that the Association is permitted by the Insurance Department to reflect as an admitted asset future assessments up to the difference between the ultimate and present values of unpaid losses. Such amount has been recorded as a direct credit to statutory surplus.

**Nonadmitted Assets –** Under statutory accounting practices, certain assets, principally premiums receivable over 90 days past due, are not reflected in the statutory statement of assets, liabilities and surplus. Such nonadmitted assets are charged directly against surplus. Under accounting principles generally accepted in the United States of America, such amounts are recorded as assets, net of an allowance for doubtfull accounts.

**Computer Equipment, Furniture & Supplies –** Under statutory accounting practices, the Association is not permitted to capitalize costs relating to applications software, consultants' fees, and furniture and supplies.

**Liability for Unauthorized Reinsurance –** Under statutory accounting practices, the Association may take credit for reinsurance coverage from reinsurers who are "unauthorized" in New York State where letters of credit or funds are held by the Association as of the balance sheet date, or are qualified for additional credit pursuant with Part 125.4(e) & (f) of Title 11 of the Rules and Regulations (11 NYCRR), also referred to as Regulation 20. Additionally, the Association may not take credit for reinsurance recoverables from authorized reinsurers where such amounts are overdue. Such unsecured and overdue balances are reflected as a liability charged directly against surplus. Under accounting principles generally accepted in the United States of America, such amounts are recorded as assets, net of an allowance for uncollectible reinsurance.

A reconciliation of statutory surplus as reported to the Insurance Department to Members' equity on the basis of accounting principles generally accepted in the United States of America is as follows:

| | 2003 | 2002 |
|---|---|---|
| Statutory surplus, as reported | $11,264 | $14,737 |
| Future assessments receivable up to difference between ultimate and present values of losses | (12,116) | (8,546) |
| Unbilled assessments, net | 24,644 | — |
| Nonadmitted assets | 6,077 | 9,080 |
| Carrying value of applications software and consultants' fees | 2,900 | 1,081 |
| Reserve for reinsurance | 2,186 | 4,216 |
| Allowance for doubtful accounts | (4,133) | (2,508) |
| Unrealized gain on available-for-sale securities | 1,127 | 2,238 |
| Deferred income tax | — | 9 |
| Members' equity on the basis of Generally Accepted Accounting Principles | $31,949 | $20,307 |

State insurance statutes require the Association to maintain a minimum statutory surplus of $250,000, and permit the Insurance Department to specify a higher amount at its discretion. The Insurance Department has specified $7.5 million as the minimum surplus to be maintained by the Association.

## 11 Cash Flow Statement

Reconciliation of net gain to net cash provided by operating activities:

| | 2003 | 2002 |
|---|---|---|
| Net income | $ 9,763 | $ 3,244 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Amortization of bond premium | 281 | 93 |
| (Gain) loss on long term securities sold or redeemed | (1,549) | 1,627 |
| Depreciation | 326 | 301 |
| | (942) | 2,021 |
| Change in: | | |
| Premiums and assessments receivable, net | 757 | (5,495) |
| Unbilled assessments, net | (24,644) | — |
| Reinsurance recoverable | (5,060) | (5,965) |
| Other assets | 2,699 | (1,301) |
| Liabilities for unpaid and unreported losses and loss adjustment expenses | 33,121 | 10,473 |
| Unearned premiums | 4,306 | 2,361 |
| Reinsurance payable | 616 | 516 |
| Other liabilities | 270 | (133) |
| | 12,065 | 456 |
| Net cash provided by operating activities | $20,886 | $5,721 |

## 12 Open and Closed Years and Contingency Fund

The Association maintains separate accounting for each policy year, which runs from February 20 through February 20, and keeps policy years open until the Board of Directors resolve to close the year. Years are closed after the ultimate liabilities for that year are known with a high degree of probability. The 1999/00 policy year was closed March 31, 2003 without further calls.

The Association accounts for premiums, assessments and paid and incurred losses by policy year on a specific identification basis. Other amounts, such as investment income, gains and losses and expenses are allocated to policy years in a systematic and rational manner, so as to maintain equity between policy years.

In 1996 the Board of Directors resolved to create a Contingency Fund from the closed policy years' surplus and investment income of the Association. The purpose of the Contingency Fund would be to moderate the effect of supplementary calls in excess of those originally forecast for a particular policy year by reason of claims for that year having exceeded originally expected levels.

### Development of Open Policy Years at December 31, 2003

| | 2000-01 | 2001-02 | 2002-03 | 2003-04 |
|---|---|---|---|---|
| **Income:** | | | | |
| Calls and premiums | $21,600 | $27,994 | $38,479 | $61,093 |
| Supplementary calls debited | 16,302 | 8,697 | 17,273 | 10,986 |
| Provision for estimated future calls | 6,437 | 7,757 | 10,450 | — |
| Investment income | 2,111 | 1,594 | 950 | 522 |
| Total income | 46,450 | 46,042 | 67,152 | 72,601 |
| **Expenses:** | | | | |
| Net paid losses | 26,588 | 18,257 | 23,093 | 9,653 |
| Net pending losses | 4,319 | 14,743 | 27,277 | 34,422 |
| Undiscounted IBNR | 500 | — | 2,000 | 8,750 |
| Reinsurance premiums | 9,045 | 6,983 | 10,287 | 10,060 |
| Other operating expenses | 6,965 | 7,619 | 8,578 | 8,700 |
| Total expenses | 47,417 | 47,602 | 71,235 | 71,585 |
| **Retained earnings** | (967) | (1,560) | (4,083) | 1,016 |
| Unrealized investment gain | — | — | — | — |
| **Members' equity : open years** | $ (967) | $(1,560) | $(4,083) | $ 1,016 |

(a) A 10% assessment in each of the following open policy years would generate the following net income for the Association (in thousands):

| | |
|---|---|
| 2000/01 | $2,163 |
| 2001/02 | $2,810 |
| 2002/03 | $4,001 |
| 2003/04 | $6,266 |

(b) All amounts are reported in nominal dollars and do not give effect to any discounts.

(c) For the 2003/04 policy year calls and premiums are stated on an earned basis to December 31, 2003. Expenses are stated on an accrued basis for the same period.

### Development of Closed Policy Years and Contingency Fund

| | 2003-04 | 2002-03 |
|---|---|---|
| **Closed years' balance, January 1** | $ — | $ — |
| Total income earned | 1,530 | (1,605) |
| Net paid losses | 6,308 | 4,674 |
| Net pending losses | (4,267) | (5,137) |
| Unreported losses (IBNR) | — | (2,700) |
| Reinsurance premiums | 251 | (84) |
| Other operating expenses | 422 | 463 |
| Total expenses incurred | 2,714 | (2,784) |
| Unrealized investment (loss) gain | 1,879 | (613) |
| Transfer from closed policy year 1999/00 | (4,495) | — |
| Transfer from closed policy year 1998/99 | — | 483 |
| Net change | (3,800) | 1,049 |
| Transfer to contingency fund | 3,800 | (1,049) |
| **Closed years' balance, December 31** | $ — | $ — |
| **Contingency fund balance, January 1** | $41,343 | $40,294 |
| Transfer from closed policy years | (3,800) | 1,049 |
| **Contingency fund balance, December 31** | 37,543 | 41,343 |
| **Open policy years' equity** | | |
| 1999/00 | — | (4,498) |
| 2000/01 | (967) | (8,117) |
| 2001/02 | (1,560) | (8,016) |
| 2002/03 | (4,083) | (405) |
| 2003/04 | 1,016 | — |
| **Total members' equity** | $31,949 | $20,307 |

(a) All amounts are reported in nominal dollars and do not give effect to any discounts.

## 13 Leases

**Lessee Leasing Arrangements**

On January 1, 2002, the Association assumed the noncancelable operating lease for its occupied offices that is due to expire August 1, 2010. Rental expense for 2003 was approximately $360,000. Future minimum rental payments are as follows:

| Year | Amount |
|---|---|
| 2004 | $ 360,195 |
| 2005 | 375,458 |
| 2006 | 396,825 |
| 2007 | 396,825 |
| 2008 | 396,825 |
| Thereafter to end of lease | 628,306 |
| Total | $2,554,434 |

## 14 Average Expense Ratio

In accordance with Schedule 3 of the International Group Agreement 1999, the Association is required to disclose its Average Expense Ratio, being the ratio of operating expenses to income, including premium and investment income, averaged over the five years ended December 31, 2003.

The operating expenses include all expenditure incurred in operating the Association, excluding expenditure incurred in dealing with claims. The premium income includes all premiums and calls. The investment income includes all income and gains whether realized or unrealized, exchange gains and losses less tax, custodial fees and internal and external investment management costs. The relevant calculations entail adjustments to calls and premiums to reflect policy years rather than accounting periods. Adjustments are also required for transfers from operating costs to internal claims handling costs and internal investment management costs.

For the five years ended December 31, 2003 the ratio of 11.5% has been calculated in accordance with the Schedule mentioned above and the guidelines issued by the International Group. This compares with a ratio of 11.9% recorded twelve months previously – that is to say a small decrease.

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