

CIRCULAR

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CIRCULAR NO. 16/04

TO MEMBERS OF THE ASSOCIATION

Dear Member:

CLOSURE OF THE 2000 POLICY YEAR: DEVELOPMENT OF OPEN POLICY YEARS: SUPPLEMENTARY AND RELEASE CALL REQUIREMENTS FOR THE 2001, 2002 AND OTHER POLICY YEARS

At its meeting in New York yesterday, your Board reviewed the status of the 2000 policy year prior to ordering its formal closure. They also gave consideration to the development of open policy years, particularly 2001 and 2002.

The remainder of this Circular describes your Board's decisions in regard to the status of these years and, specifically, the need to make an additional, and final, call to close 2000 and additional supplementary calls to bring the 2001 and 2002 policy years into balance. It is also intended that the latter years be closed on a more accelerated basis than has been the Club's practice in the past.

Closure of the 2000 Policy Year

Contrary to earlier expectations, this year has not developed as favorably as the trend of prior years had suggested it would. Although claims for the Club's own account have shown improvement, there has been a concomitant deterioration in the cost of claims within the International Group's Pool. In addition, consequent upon the decisions taken by your Board at the end of May, and as reported in Circular 14/04 of June 7, 2004, it has been considered prudent to increase the Club's provisions for occupational disease claims.

Given the size of the Club's contingency fund, it would have been possible – as indeed had originally been intended – to subvent the deficit from reserves. However, in view of the unlikelihood that 2001 will show much improvement, and the fact that claims results for the 2002 policy year have exhibited an unprecedented deterioration over the past twelve months (both of which issues are discussed in greater detail below), your Board has decided that the shortfall should be eliminated at closure through the debiting of a Final Call of 40% of relevant Advance Calls for the year.

This will be levied as of June 30, 2004 and be payable on August 31, 2004.

In light of the impending closure of 2000, the Release Call requirement for the year has been reduced to zero.

Additional Supplementary Call for the 2001 Policy Year

Some of the comments made in respect of the 2000 policy year are of equal pertinence to 2001. The loss cost per ton for that year has proved better than its predecessor but, despite hopes to the contrary twelve months ago, the shortfall in funding remains at a level where, given actuarial advice and the demands of the New York regulator, it would not be in the Club's best long-term interests to allow a subsidy from reserves.

Accordingly, in order to extinguish the deficit on the 2001 policy year, your Board has ordered an additional Supplementary Call of 35% of the Advance Call. This will be levied as of September 30, 2004 and will be payable on March 31, 2005. Moreover, it is your Board's intention that the year be closed as of that date without further call.

In the interim, the Release Call margin for the year remains at 25% of the Advance Call over and above the Supplementary Call notified above.



Additional Supplementary Call for the 2002 Policy Year

The development of claims in the 2002 year has, over the past twelve months, been both unusual and disappointing. During the currency of the year itself, particularly during its first nine months, the incidence and severity of claims appeared to be in considerable decline and, although it was recognized that some deterioration was inevitable as the year progressed, there were grounds for cautious optimism that, given also a marked uplift in premium income for the year over 2001 (by some 52% in total), 2002 would be a year of underwriting surplus and contribution to overall Club reserves.

Regrettably, this was not to be. Over the last six months of calendar 2003, the results of 2002 began to deteriorate sharply. The worsening occurred mainly at an attritional level of exposure involving claims valued at between \$100,000 and \$500,000 per incident. No particular theme appears to link them, although US personal injury and larger cargo claims characterize the Club's analyses. Indeed, a significant uplift in claims for this year has been noted by several other clubs in the International Group.

Figures for year-end 2003 – forming the basis for both statutory reporting and the GAAP accounts which will be circulated to the Members soon – show unfavorable emergence of just over \$16 million for 2002 turning what was considered twelve months ago to be a potential surplus into a significant deficit.

While there are grounds for considering that the dimensions of this deficit may be overstated, the exigencies of the regulatory regime to which the Club is subject makes it necessary to take immediate action to remedy the impairment and bring the year back into balance.

Accordingly, your Board has ordered an additional Supplementary Call for the 2002 policy year of 30% of the Advance Call. This will be levied as of September 30, 2004 and will be payable September 30, 2005 at which time it is intended to be closed.

In the interim, the Release Call margin for the year remains at 25% of the Advance Call over and above the Supplementary Call notified above.

Summary

2000 Policy Year: Final Call

- Additional 40% of Advance Call.
- To be levied as of June 30, 2004.
- To be payable on August 31, 2004.
- Release Call reduced to zero.
- Year closed.

2001 Policy Year: Additional Call

- Additional 35% of Advance Call.
- To be levied as of September 30, 2004.
- To be payable on March 31, 2005.
- Release Call to remain at 25% of the Advance Call over and above current Supplementary Call estimate.
- Year intended for closure as of March 31, 2005 without further call.



2002 Policy Year: Additional Call

- Additional 30% of Advance Call.
- To be levied as of September 30, 2004.
- To be payable on September 30, 2005.
- Release Call to remain at 25% of the Advance Call over and above current Supplementary Call estimate.
- Year intended for closure as of September 30, 2005 without further call.

Other Open Policy Years

Although both 2003 and, more particularly, 2004 are highly immature at this stage, they are both progressing satisfactorily, buoyed by significant increases in income and an apparent abatement in net claims cost per entered ton.

However, given the experience of 2002, which it is hoped will prove to be an aberration, expectations must be tempered with caution given the increasingly hostile global claims environment in which shipowners and charterers find themselves.

Nevertheless, there are encouraging signs that 2003 and 2004 will lead the Club into years of respectable underwriting surplus – the only certain means of maintaining cost and service stability over time. This, and the strengthening of the Club's capital base through the action described in this Circular, together with the measures it has already taken in regard to claims for occupational disease, are intended to provide it with a firm platform for the future.

Closed Years

As foreshadowed earlier, the Club's contingency fund – being the balance of assets over liabilities attributable to closed policy years – has remained solid year-on-year at somewhat over \$37 million in total. The protection of this fund has been enhanced recently by your Board's decision, communicated in Circular 14/04 of June 7, 2004, to discontinue its discretionary practice of reimbursing unknown and unreserved claims in respect of closed policy years prior to 1989.

Putting these calls into context and looking to the future

Your Board is acutely conscious of the fact that levying unbudgeted supplementary calls is about as unpopular a step as it is possible to take in the P&I world. It has only done so after a great deal of careful thought and thorough debate.

Moreover, your Board has been prevented from performing as early a review of relevant figures as it would have preferred by the difficulties encountered in the implementation of the Club's new IT system which, as many Members will be aware, has delayed the Club's submission of both its statutory and GAAP year-end reports. These difficulties are at last being overcome and Members can expect to see definitive, audited statements reflecting the calls announced in this Circular over the forthcoming weeks.

In the meantime, it is hoped that the remaining paragraphs will assist Members in gaining a clear picture of where this action will leave the Club as it goes into the second half of the 2004 policy year and into 2005 and beyond.

As mentioned earlier, the underwriting results for 2003, and so far for 2004, appear to be developing positively. This augurs well for the future. In particular, the rate rises achieved over the last two renewals suggest that the underlying premium base of the Club is sound. Indeed, these rises, coupled with a substantial growth in new business over the last three years, have created circumstances where the Club's surplus has recently been under technical pressure to increase in order to fit more comfortably with the New York regulator's revised Risk Based Capital requirements irrespective of your Board's own judgment as to the proper level of contingency funding.



As a result of the additional calls notified herein, the Club's surplus for GAAP purposes as of December 31, 2003 will be a little under \$35 million. This will have substantially eradicated the deficit in open years. In balance sheet terms, it will increase the Club's solvency margin (i.e. its free reserve as a percentage of its claims reserves including IBNR) from 24% at year-end 2002 to about 30% at year-end 2003. This statistic compares favorably with most other International Group clubs. Moreover, the growth of the Club's funds under investment continues: cash and cash equivalents, together with investment securities, grew by nearly 20% in the five months to the end of May 2004 and it is expected that this positive trend will continue for the balance of the current year.

The past year has been a period of unprecedented challenges for the Club both at home and abroad. It has been characterized not only by a capricious claims environment – the TASMAN SPIRIT being a case in point – but also, curiously enough, by the consequences of the Club's own recent success.

During this time, its pure underwriting results have been among the best in the P&I market – verifiably so by reference to independent benchmarks. But the historical disinclination of the American Club to over-accumulate reserves – preferring to leave assets in the hands of Members – has left it more vulnerable to the development of deficits in those recent years, particularly 2000 through 2002, where the support of investment earnings fell away as they developed in deficit – but *operating* deficits significantly smaller than most of its competitors. At the same time, persistent US dollar weakness has created inflationary pressure on claims and expenses paid in non-US currencies.

In any event, taking all these circumstances into account, your Board has felt it prudent to take the action described above which, although deeply regretted, should ensure that, against a background of decent results for 2003 and 2004, the Club is placed in a strong position for continuing success in the years ahead. Your Board believes that this is further supported by the Club's solid rating policies and its realistic investment strategy.

In addition, and recognizing that uncertainty as to the final cost of insurance is a perennial concern within the mutual system, your Board will over the forthcoming months be investigating long-term reinsurance schemes which will seek to provide certainty of cost to Members so as to ensure that the fluctuations of the recent past can be avoided for the future.

Once again, your Board is aware that the making of unbudgeted supplementary calls is never a popular course of action. However, it is firmly of the view that this is in the best interests of the Club going forward and will be seen, in retrospect, to have been a decision sensibly taken to promote a sound financial future.

Yours faithfully,

A handwritten signature in black ink that reads "Joseph E.M. Hughes". The signature is written in a cursive, flowing style.

Joseph E.M. Hughes, Chairman & CEO
Shipowners Claims Bureau, Inc., Managers for
THE AMERICAN CLUB