

CIRCULAR REF: 2013/041

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

**12 DECEMBER 2013
JMD/CWN/KAH**

PROPOSED MERGER OF THE NORTH OF ENGLAND P&I ASSOCIATION LIMITED (NORTH) AND SUNDERLAND MARINE MUTUAL INSURANCE COMPANY LIMITED (SMMI)

We refer to Circular number 2013/026 of 7 August 2013 where we advised that the North of England P&I Association (North) had entered into formal merger discussions and was conducting a due diligence exercise in respect of Sunderland Marine Mutual Insurance Company (SMMI).

We are now pleased to confirm that, following completion of both financial and legal due diligence, North and SMMI will be entering into a framework agreement which, subject to the satisfaction of various conditions, forms the basis of the proposed merger.

In accordance with North's mutual ethos, the Directors wish to ensure that they have a clear mandate from the Club's mutual membership before proceeding with the proposed merger and the Framework Agreement is therefore conditional upon the Club's Members approving the transaction at a General Meeting. The Directors have agreed to submit formal merger proposals to the Club's membership for approval at a General Meeting on 16 January 2014.

It is important that as a matter of transparency and good governance, Members have sufficient information to enable them to properly consider the potential benefits and risks of the proposed merger in advance of the General Meeting. This Circular and the attached Explanatory Notes have therefore been prepared to provide Members with information on the merger and to explain why the Directors consider that the merger is in the best interests of North's Members.

Also provided with this Circular is formal notice of the General Meeting of the Members on 16 January 2014 setting out the resolutions which Members are being asked to consider and, if thought fit, approve at that meeting.

The merger proposal has received the unanimous support of the Directors, the Members Board and the senior management team. It represents a unique low risk opportunity to satisfactorily deliver North's strategic objective of diversification of non-core fixed premium business to produce a profitable income stream for the benefit of the Club's mutual membership. As a result of the merger transaction, North will assume ownership (at no cash consideration) of

CIRCULAR

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SMMI's assets and liabilities. The surplus of assets over liabilities is calculated to be in the region of £30M - £35M (US\$48M – US\$56M).

The Directors strongly recommend that Members support the proposal by voting in favour of the resolutions to be proposed at the General Meeting on 16 January 2014.

AA WILSON and PA JENNINGS

JOINT MANAGING DIRECTORS - North Insurance Management Limited

As Managers on behalf of the North of England P&I Association Limited

PROPOSED MERGER OF THE NORTH OF ENGLAND P&I ASSOCIATION LIMITED (NORTH) AND SUNDERLAND MARINE MUTUAL INSURANCE COMPANY LIMITED (SMMI)

EXPLANATORY NOTES ATTACHING TO AND FORMING PART OF CIRCULAR 2013/041

1. What is the purpose of the Members Meeting on 16 January 2014?

Members will be aware from North's Circular 2013/026 of 7 August 2013 that North has been engaged in discussions regarding a potential merger with SMMI. North and SMMI will be entering into a Framework Agreement, which sets out the agreed roadmap for completing a merger.

Under the Framework Agreement there are a number of conditions that must be satisfied before North and SMMI are legally bound to complete the merger, which includes approval of the merger by North's Members. The main purpose of the Members Meeting therefore is to obtain Member approval of the merger in accordance with the Framework Agreement.

The Framework Agreement also requires North to obtain Member approval of other matters related to the merger such as amendments to North's Articles of Association, the appointment of new Directors and the approval of minor amendments to the terms of reference for the Directors and Members Board to reflect the proposed group structure. Resolutions will therefore also be proposed at the Meeting of the Members to deal with these matters.

The Directors of North have considered the proposed merger carefully and unanimously recommend that Members support it by voting in favour of the resolutions to be proposed at the meeting.

2. What is the background to the merger?

North has been involved in a strategic alliance via a P&I Quota Share reinsurance agreement with SMMI since 1 January 2012 (the reinsurance arrangement was subsequently renewed for a further 12 months from 1 January 2013). This strategic alliance has allowed both North and SMMI to identify a range of clear synergies between their respective organisations and which have provided strong foundations for the development of substantive merger proposals:

- **Cultural** - as mutual organisations, both companies have highly respected reputations for service excellence based on a demonstrable longstanding commitment to mutual principles.
- **Operational** - both companies specialise in marine insurance underwriting but do not engage in direct competition with one another.
- **Strategic** - one of North's key strategic objectives is to diversify and develop new sources of business income for the Club, for example through the establishment of non-core, fixed premium lines of business, whereas SMMI is seeking to provide its mutual membership with the certainty of fixed premiums and promote stable and competitive pricing, at a time where

continuing volatility in the global financial markets have limited SMMI's ability to generate significant investment income from its reserves.

- **Geographic** - North and SMMI are two of the longest established businesses in the North East of England. The respective offices are based just 17 miles apart.

3. Who is SMMI?

Founded in 1882, SMMI is a mutual insurer of hull and machinery, protection and indemnity, personal accident and aquaculture risks, serving circa 29,000 policyholders in over 50 countries. SMMI has expanded to become a worldwide specialist insurer. SMMI's focus is on maintaining an exemplary level of service to its policyholders whilst also providing them with financial security. Its head office is based in the North East of England with Group operations also spanning across 13 other offices in Australia, Canada, the Netherlands, New Zealand, South Africa and the USA, employing around 120 people across the Group.

SMMI has a 'BBB+' financial strength rating and stable outlook from Standard & Poor's and 'A-' ratings from Fitch and AM Best. For the year ending 31 December 2012, SMMI reached premium income of £95.3 million (US\$156.3M), total assets and liabilities were £169.8 million (US\$278.3M) and £134.5 million (US\$220.5) respectively, with the free reserve reaching £35.3 million (US\$57.8M). These ratings have recently been reaffirmed via the various agencies, which have all reacted positively to the news of the proposed merger.

In addition to its core insurance underwriting activities SMMI also operates a number of subsidiary companies involved in insurance brokerage business, one of which is jointly owned by SMMI and the senior managers of the relevant business. Associated risk management services are also provided to SMMI's Aquaculture policyholders.

4. What are the potential benefits of the proposed merger with SMMI?

Following detailed consideration of the potential risks and benefits of the merger, and after detailed consultation with the Members Board, North's Directors have concluded that the merger represents a unique low risk opportunity for North to provide greater diversification and a broader spread of business consistent with its strategic objectives. The Directors therefore believe that there are significant benefits to North's membership arising from the merger which include the following:

- **Larger financial and capital resource** – through a stable financial and capital base in the combined Group, North will be able to enhance financial security and stability for the membership.
- **Strategic fit** - SMMI has a mutual ethos and service culture which is consistent with North's own objective of delivering the highest levels of service to its membership.
- **Diversification and underwriting opportunities** – the merger will provide an alternative source of income which will benefit North's mutual membership and allow the potential for further controlled development within the marine insurance industry.

- **Synergies and economies of scale** – the merger will deliver cost savings to North’s Members through the potential for reduced reinsurance and corporate governance costs. North’s Members will also benefit from the shared employee and other operational resources available across the combined Group.
- **Low transaction risk** – the merger delivers these benefits to North’s Members with the lowest possible degree of risk through a low integration strategy, utilising the benefit of the knowledge gained through the strategic alliance and the successful experience of both North and SMMI of transactional activity in the past.

5. What are the key features of the proposed merger?

The key features of the proposed merger are as follows:

- ***Demutualisation and Change in Control of SMMI***

North will acquire 100% control of SMMI through the termination of the membership of all existing SMMI Members and the appointment of North as sole member of SMMI. As a result of this change in control, SMMI will be demutualised and its current membership will become fixed premium, non-Member policyholders of SMMI with no further liability to pay supplementary calls. SMMI will also become part of North’s group of companies as a wholly owned subsidiary.

- ***North Assumption of ultimate responsibility for SMMI’s liabilities***

North will not be required to provide any cash consideration to SMMI or its Members upon completion of the proposed merger and will instead agree to assume ultimate responsibility to meet all liabilities of SMMI’s business to the extent that SMMI is unable to do so as a standalone entity.

North’s assumption of ultimate responsibility for SMMI’s liabilities will be achieved by North providing a parent company guarantee to SMMI. The practical implication of this guarantee is that in any circumstances where SMMI has insufficient funds (after exhaustion of the surplus referred to in point 7) to meet its liabilities, the shortfall will ultimately have to be provided from the surplus assets of North and, only in highly exceptional circumstances where North’s surplus assets are also insufficient, by way of a funding obligation to North’s mutual Members.

- ***Directors appointments***

To ensure effective governance of the merged group and provide SMMI representation and continuity at a group level, a number of current SMMI directors will be appointed to the North board of Directors with effect from completion of the merger:

- **Geoff Parkinson** - Geoff is an experienced member of the SMMI senior management team and is the current Chief Executive Officer of SMMI. He will be appointed as an Executive Director of North for the furtherance of his role as SMMI CEO within the merged group.
- **Trevor Hart** - Trevor is the current Chairman of SMMI’s Board of Directors and has extensive marine insurance underwriting experience in Lloyds.

- **Peter Johnson** – Peter is a chartered accountant and former senior partner of KPMG in Newcastle. He has been a Non-Executive Director of SMMI since 2000 and is currently Chairman of SMMI’s Audit Committee.

- ***“Anti-embarrassment” arrangements***

As SMMI members are being asked to transfer control of SMMI, and all its surplus assets, to North without payment of cash consideration, and on the understanding that North intends to retain and operate SMMI’s business within the merged group structure, it is acknowledged that SMMI’s members would suffer embarrassment if North were to dispose of SMMI’s business for a financial gain soon after completion of the merger. “Anti-embarrassment” arrangements have therefore been agreed which entitle SMMI members to share in a proportion of any proceeds received by North in the event that a disposal is made of SMMI’s business within three years of completion of the merger.

- ***Amendments to North’s Articles of Association***

North’s Articles of Association will be amended to include a transitional quorum requirement at Directors meetings. The arrangement will last for 24 months from completion of the merger and will require at least one of SMMI’s current Directors joining the North Board to be present before any business can be transacted.

However, in circumstances where all SMMI directors fail to attend a meeting, the other directors will be entitled to adjourn the meeting and proceed in their absence if they also fail to attend the adjourned meeting. This is to ensure that the quorum requirements do not unfairly disrupt the governance process.

- ***SMMI Policyholders committee***

An SMMI Policyholders’ Committee will be established to promote the interests of the industries insured by SMMI. It will also make recommendations to the SMMI Board with regard to the exercise of the SMMI Board’s discretion in connection with policy scope. It will meet twice a year and receive reports on the integration of the two businesses and also feed into the Group Nominations Committee with regard to senior appointments to the SMMI business. Whilst the Committee will not have any executive powers, it will be an important mechanism to ensure the views of SMMI policyholders are heard within the group governance structure.

- ***Memorandum of Understanding***

North and SMMI will enter in to a non-binding Memorandum of Understanding providing an overview of how the SMMI business is envisaged to be developed immediately following completion of the Merger, particularly in relation to matters that SMMI considers to be key in maintaining its mutual ethos and service culture.

The Memorandum of Understanding is not legally binding as it would not be in the interests of SMMI and/or North to fetter the future ability of either organisation to manage their respective businesses against prevailing economic and market conditions.

6. What resources does SMMI have to meet its own liabilities?

SMMI currently has surplus assets over liabilities in the region of £30M - £35M (US\$48M – US\$56M). This surplus is equivalent to a free reserve, and will form part of North's combined assets from the date of the merger. The Directors are satisfied from the results of North's financial due diligence that SMMI has sufficient capital reserves for its current business, which are also materially protected through a comprehensive reinsurance programme. These capital reserves will be available to meet SMMI's liabilities in the event that other sources of funding, such as insurance premiums and investment returns, are insufficient to do so and it would therefore require a significant and very unexpected deterioration to SMMI's financial position and surplus assets before North would be required to provide additional funds to SMMI under the parent company guarantee.

7. Under what circumstances could North be required to provide funding to SMMI under the parent company guarantee?

Whilst it is not possible to provide an exhaustive list of potential scenarios where North could be required to provide funding to SMMI under the parent company guarantee, Members may wish to take into account the following matters when considering the proposed merger:

- **SMMI Insurance Policies** – as guarantor North will ultimately be responsible for ensuring that SMMI continues to meet its obligations to SMMI policyholders. If, for example, SMMI were to suffer a deteriorating claims experience with the need to increase claims payments and claims technical provisions, any additional funds required to cover such deterioration in SMMI's net claims experience would ultimately have to be provided by North, if SMMI had insufficient funds to do so itself.
- **Reinsurance Default** – Like North, SMMI purchases reinsurance as a means of reducing volatility, maintaining balance sheet strength, improving credit agency ratings and providing enhanced budgetary certainty. If one or more of SMMI's reinsurers were to default on their liabilities to SMMI, the additional funds required by SMMI would have to come from North if and to the extent that SMMI was unable to provide such funds itself.
- **SMMI Employer Liabilities** – North will have responsibility for ensuring that SMMI continues to honour its obligations to employees and will ultimately be responsible for meeting any shortfall in funding these obligations by SMMI.
- **Defined Benefit Pension Scheme** – SMMI operates a defined benefit pension scheme. This scheme has been closed to new members for some years but not to future accruals, therefore current liabilities remain in existence and are subject to ongoing funding requirements for existing members' benefits. As is common with pension schemes of this nature, SMMI's scheme currently has a funding deficit which is recognised in the financial statements. North will take ultimate responsibility for meeting this funding deficit and any deterioration to it in the future, if SMMI is unable to do so itself.
- **Maintenance of Regulatory Capital** – North will be ultimately responsible as guarantor for ensuring that SMMI has sufficient capital to meet regulatory requirements and providing additional capital to SMMI for these purposes where required.

8. What work has North undertaken to assess the potential liabilities of SMMI?

North has undertaken extensive financial and legal due diligence to obtain an understanding of SMMI's business and the nature and extent of the associated risks and liabilities. After careful consideration of the results of North's financial and legal due diligence, the Directors are satisfied that they have not revealed any material impediment or reason for the merger not to proceed.

9. How will the proposed merger affect Corporate Governance Arrangements?

Board strategy and senior management will be unified across the group and oversee all of the business lines currently offered by the two organisations. The organisation structure will be integrated at a Board and senior management level from completion. Please see Appendix A for further details of the combined group management structure following the proposed merger.

10. When is the proposed merger expected to be completed?

The merger can only take place once all merger conditions are satisfied. Following North and SMMI Member approval, the principal merger condition is regulatory approval by UK and various other overseas regulators. North and SMMI are currently working to a target completion date of 20 February 2014. However, if the conditions cannot be satisfied so as to enable completion to take place by the target date, completion will take place as soon as possible thereafter.

The Framework Agreement requires completion to take place by a long stop date of 31 December 2014 and if the conditions cannot be fulfilled by that date the agreement will terminate and neither party will be under any obligation to complete the merger. However, North and SMMI are able to agree an extension to that date if considered appropriate in the circumstances.

11. What should I do next?

If you wish to vote either for or against the proposed resolutions you should do so by either attending the meeting in person or appointing a proxy to attend and vote at the meeting on your behalf. Full details of how to do this are set out in the Notice of the Meeting.

12. Where can Members obtain copies of the merger documentation?

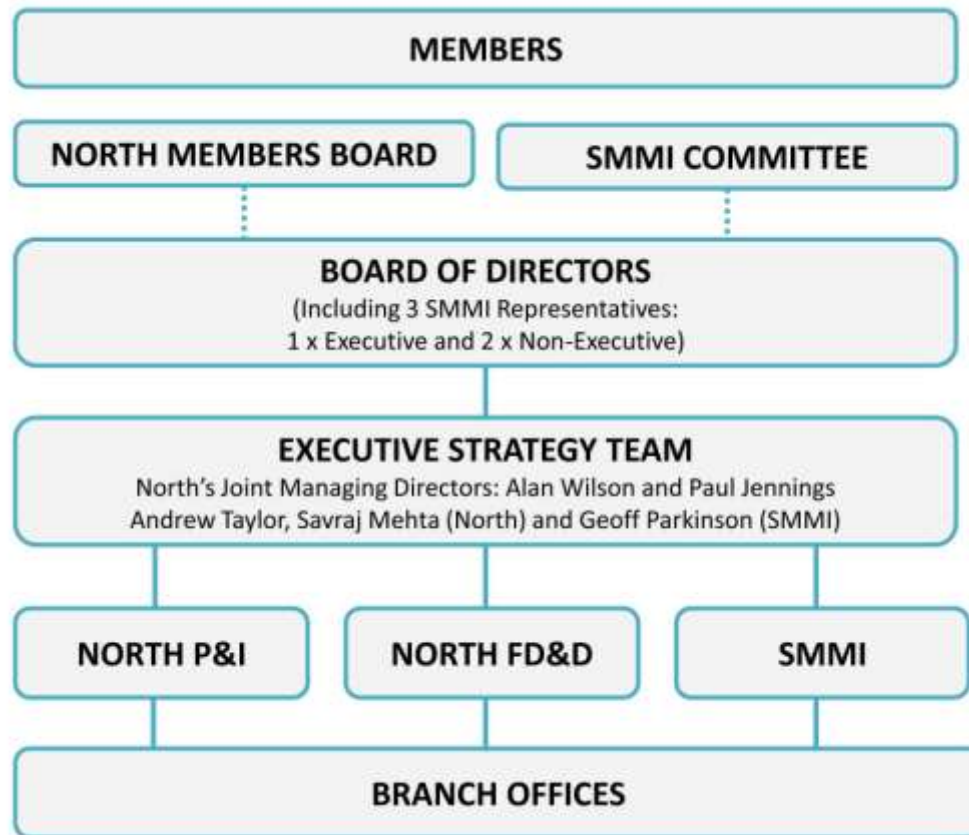
Copies of this Circular, the Framework Agreement, the Memorandum of Understanding and the changes to both North's and SMMI's Articles of Association to facilitate the Merger will be available for Members to view at North's head office at The Quayside, Newcastle upon Tyne, NE1 3DU between 9.00am and 5.00pm on any weekday (Monday to Friday inclusive), excluding bank or public holidays from Monday 9 December 2013 until Wednesday 15 January 2014 and also at the General Meeting of the Members on 16 January 2014.

13. Who should I contact for more information?

Should you have any queries relating to the General Meeting of the Members or wish to view any of the merger documentation at our office, please contact your Underwriter for more information.

APPENDIX A: POST-MERGER CORPORATE GOVERNANCE STRUCTURE

COMBINED MANAGEMENT STRUCTURE



SMMI policyholder representation on SMMI Policyholder Committee:

- Appointment of representatives
- Consultation rights

Board responsible for strategic direction:

- Sets unified Group strategy
- Capital and risk management on Group-wide basis

Group executive strategy team responsible for delivering Group strategy:

- North and SMMI represented

Divisional operational structure:

- Operations organised by business line with overseas support
- Sharing and exchange of best practice across divisions
- Development opportunities for employees