UNDERTAKING

Insurance Act 1973 (Cth)

Section 126

THIS UNDERTAKING IS GIVEN BY:

Mr John Byrne ("Mr Byrne")
C/o Byrne and Partners, 77 St John Street, London EC1M 4NN, United Kingdom;

AND IS ACCEPTED BY:

Australian Prudential Regulation Authority ("APRA") of Level 26, 400 George Street, Sydney, New South Wales 2000, Australia;

UNDER SECTION 126 of the *Insurance Act 1973 (Cth)* ("the Act"). A copy of section 126 is in Schedule 1.

RECITALS

Mr Byrne

A. Mr Byrne is an accountant. He was employed as an auditor and in a management position at a life insurance company in Ireland before joining Cologne Reinsurance (Dublin) Ltd ("CRD") as Underwriting Manager in approximately March 1998.

B. CRD was a subsidiary of Kolnische Ruckversicherungs-Gesellschaft AG ("Cologne Re"), having been established in 1990. Cologne Re was acquired by General Re Corporation in 1994 (collectively, "General Re"). General Re's Alternative Solutions ("Alt Sol") business unit, was established in September 1997 to build on the work of the Financial Reinsurance Department to develop and market financial reinsurance products. It was based in offices in London, Cologne, Dublin and Stamford.

C. Mr Byrne became Chief Executive of CRD in 2001 and, in September 2002, Chief Executive of Alt Sol.

Part 1

BACKGROUND

APRA's investigation

1. In April 2005, APRA commenced an investigation under section 52 of the Act ("the Investigation") into the following affairs of General Reinsurance Australia Limited ("GRA", General Re's Australian subsidiary), and related bodies corporate:

   (a) the provision by GRA to Australian insurers of contracts of financial or finite reinsurance or reinsurance contracts not involving a material transfer of risk, or other like products ("financial reinsurance");
   (b) the marketing and promotion of financial reinsurance products by GRA;
   (c) the manner in which GRA has described or disclosed financial reinsurance products to auditors, actuaries, regulators, directors and others;
   (d) any communication between GRA and auditors, actuaries, regulators, directors or any other party concerning financial reinsurance; and
   (e) any other aspect of GRA's business that APRA considers necessary or convenient for APRA to investigate in connection with the above matters.

2. In the course of the investigation, APRA identified three transactions between GRA and three counterparties which constitute unacceptable uses of financial reinsurance in that they were deliberately designed so as to allow the counterparties to pass off to third parties the transactions as contracts of reinsurance when in fact they were not. This in turn allowed the counterparties to account for the transactions inappropriately. These transactions were negotiated with the assistance of Alt Sol. Details of the transactions and of Mr Byrne's involvement in these transactions ("the Three Transactions") are set out below.

FAI Transaction

3. In 1997, the FAI Insurance Group ("FAI") identified a significant reserving shortfall in its international professional indemnity portfolio. In May 1998, GRA entered into an Aggregate Excess of Loss ("AXOL") contract with FAI, incepting on 1 January 1998. Under this contract, FAI retroceded $65m of risk to GRA for a premium of $55m.

Neither the premium nor recovery payments were due until 1 July 2003. The contract contained an offset clause allowing recoveries to be offset against premiums due under the contract or any other arrangements.

4. At the same time, FAI and GRA entered into a series of six contracts reinsuring specific areas of risk for a total of $12.5m premium, commencing on 1 May 1998 ("the six contracts"). A side letter provided that FAI would make no claims under these contracts unless mutually agreed with GRA. Another side letter stated that the six contracts would be suspended and premiums returned to FAI if the AXOL contract was inoperative.

5. FAI renegotiated the first AXOL arrangement and, on 26 June 1998, entered into a second AXOL contract with GRA, incepting on 1 January 1998. Under this contract, FAI ceded risks of $87m for total premiums of $77.25m. A side letter signed at the same time stated that no claim could be made by FAI under an additional section included in the second AXOL contract unless both parties agreed.

6. The substance of the transaction as recorded in the documents referred to in paragraphs 3, 4 & 5 above was that there was no material transfer of risk from FAI to GRA. As such, FAI was not entitled to account for the transaction as one of reinsurance.

7. The combined effect of the second AXOL, the six contracts and the side letters was that GRA accepted no risk transfer while FAI was able to book a profit of nearly $29m at 30 June 1998. FAI improperly accounted for these transactions as traditional reinsurance and misled APRA and FAI's auditors by failing to disclose the true nature of the transactions as required to properly identify the limitations on GRA's liability. APRA believes that GRA knew that FAI intended to mislead APRA and its auditors and proposed to account for the transaction inappropriately.

Mr Byrne's involvement

8. Mr Byrne was involved in the steps taken by GRA to increase the amount of cover provided under the first AXOL contract which eventually became the second AXOL. He was aware that the second AXOL, the six contracts and the side letters should be considered as one arrangement, the substance of which involved GRA assuming no risk.

9. Mr Byrne was aware that FAI's motivation for entering into the AXOL contract was to obtain an improvement to its current financial position by accounting for it as a standard reinsurance contract. He knew that FAI intended to show only some of the documents to third parties including its auditors and APRA and proposed to account for the transaction as if it were one of reinsurance when in fact it was not.

Zurich Transaction

10. In 2000, Australian licensed insurer, Zurich Australia Insurance Limited ("ZAIL"), and its ultimate Swiss-based parent, Zurich Insurance Corporation ("ZIC"), entered into a number of contracts with various entities within General Re, namely, GRA, the Australian branch of Cologne Re ("CRAUS") and CRD.

11. The initial contract was a Loss Portfolio Transfer ("LPT") contract between ZAIL and GRA. The effect of the LPT contract was to improve ZAIL's capital by approximately $61 million at 31 December 2000. At the time of entering into this contract it was probable that losses would exceed the premium amount plus investment income. The losses under this contract were retroceded to CRD and ultimately ZIC.

12. Subsequently, ZAIL was required by ZIC to fund the loss on the LPT contract through premiums paid under a separate stop loss contract. The stop loss agreement ("Stop Loss") was entered into between ZAIL and CRAUS and was also retroceded to CRD and ultimately ZIC.

13. The mechanism for the payback to ZIC was the establishment by CRD of "Pool Z" investment fund into which the stop loss premiums would be paid and investment income would be earned. The balance of Pool Z would be used to offset any losses under the LPT. Any shortfall in Pool Z would be retroceded to ZIC.

Mr Byrne's involvement

14. My Byrne was involved in structuring and facilitating the entire transaction. Mr Byrne was aware that ZAIL's motivation in entering into this arrangement was to improve its financial position. This was achieved by giving the false impression that the LPT contract was a stand-alone contract involving the transfer of real reinsurance risk to GRA. However, Mr Byrne knew that GRA was not accepting any reinsurance risk, but only taking on a contingent credit risk, because the LPT and the Stop Loss were connected. Mr Byrne knew that certain General Re subsidiaries including CRD would not retain any underwriting risk in the transaction and, further, that these subsidiaries would not account for the transaction as reinsurance.

New Cap Reinsurance Transaction

15. Individuals from New Cap Reinsurance Group ("NCR") commenced negotiations with GRA in May/June 1998 with a view to quarantining the deterioration in the results for the 1997 and 1998 books of business. The initial objective was to ensure that NCR did not report a loss at 30 June 1998, having posted a loss at 31 December 1997. By the end of August 1998, the objective had changed to ensuring that NCR did not breach a key covenant with its bankers, Dresdner Bank. Dresdner Bank provided NCR with a loan of US$25m. At this point in time, the directors of NCR were considering putting NCR into run-off if it was unable to raise further capital.

16. GRA proposed a financial reinsurance arrangement to allow NCR to report an uplift to profits in the 1998 year (undiscounted US$6.5m) and then report corresponding costs in future years. The arrangement was made up of two contracts: the first allowed for the uplift and the second for payback to GRA. The terms of the overall final arrangement were designed so that GRA received a guaranteed margin of $700,000. No specific provision was made in NCR's 30 June 1998 accounts for the second contract. Neither the second contract nor its connection to the first contract was disclosed to the external auditors or actuaries of NCR. GRA knew that NCR would at least not disclose the connection between the two contracts to its external auditors or actuaries and knew that NCR proposed to account for the transaction as if it were reinsurance when in fact it was not.

Mr Byrne's involvement

17. Although Mr Byrne's direct involvement in negotiating these contracts was limited, he knew the structure of the entire transaction. Mr Byrne knew that this was a circular transaction without risk transfer, the purpose of which was to enable the client insurer to ameliorate a loss that it was going to incur in the first year of the contract by recognising a reinsurance recovery in its accounts, which GRA would recover in subsequent years. Mr Byrne's role in this transaction was to finalise the documentation.

18. Mr Byrne knew that the client insurer would be likely to account for both contracts as reinsurance and he has told APRA that it would not have mirrored GRA's accounting. In fact he know that GRA would account for the transaction as a deposit or loan.

19. Mr Byrne also knew that the true substance of this transaction would not be made transparent and would be likely to be misrepresented by the client insurer to its auditors. This transaction allowed the client insurer to continue trading when otherwise prudential requirements would have prevented it.

Part 2

ACKNOWLEDGMENTS

20. Mr Byrne acknowledges that:

(a) he knew that the Three Transactions contained either no or insufficient risk transfer to be accounted for as reinsurance;
(b) he knew that GRA would not itself account for the Three Transactions as reinsurance;
(c) he knew that if properly accounted for the client insurers should account for the Three Transactions as deposits;
(d) he knew that the client insurers would account for the Three Transactions as reinsurance although they contained either no or insufficient risk transfer;

he knew that the client insurers would be highly likely to use or attempt to use the Three Transactions to misrepresent their accounts as to their true financial position to regulators, auditors, tax authorities and the market;

(f) his involvement in the negotiation and/or execution of each of the Three Transactions was inappropriate and unacceptable;

(g) he should have refused to be involved in the negotiation or facilitation of each of the Three Transactions;

(h) he has voluntarily agreed to give this Undertaking;

(i) he has obtained legal advice before executing this Undertaking;

(j) the Recitals to this Undertaking form part of the Undertaking;

(k) APRA may issue a media release on execution of this Undertaking, being a media release which fairly reflects the terms of this Undertaking and the concerns of APRA which led to its execution, and may:

(i) from time to time publicly refer to this Undertaking; and

(ii) make this Undertaking available for public inspection;

(l) APRA may enforce this Undertaking regardless of whatever publicity this enforcement action may cause; and

(m) APRA may monitor Mr Byrne's compliance with the Undertaking by, inter alia, periodic reviews of relevant public filings and databases at its disposal;

APRA acknowledges that:

(a) this Undertaking is given by Mr Byrne and is accepted by APRA pursuant to section 126 of the Act, which section also addresses, among other matters, the variation, breach, and enforcement, of the Undertaking; and

(b) it will not take civil or administrative proceedings against Mr Byrne arising from any statement or evidence provided to APRA pursuant to paragraphs 22 (b) or (c) of this Undertaking.

Part 3

THE UNDERTAKING

22. Mr Byrne undertakes as follows:

(a) at any time at or before 30 June 2011 he will not be, or act as:

(i) a director or senior manager of a general insurer (other than a foreign general insurer) (as those terms are defined in section 3(1) of the Act);

(ii) a senior manager, or agent in Australia for the purposes of section118 of the Act, of a foreign general insurer (as those terms are defined in section 3(1) of the Act); or

(iii) a director or senior manger of an authorised NOHC (as those terms are defined in section 3(1) of the Act).

(b) to provide APRA with assistance in relation to the Investigation touching on or relating to the Three Transactions referred to in this Undertaking;

(c) to give evidence in Australia, if required, in any subsequent proceedings (whether of a criminal, civil penalty or administrative nature) against any person arising from the Investigation.

Part 4

INTERPRETATION

23. If any obligation imposed on Mr Byrne by this Undertaking is invalid or unenforceable, it shall be severed but all other obligations shall continue to apply.

24. For the purposes of this Undertaking, notification may be given to APRA by leaving written notice, addressed to the Chair of APRA, at APRA's office at Level 26, 400 George Street, Sydney NSW 2000, Australia, or by posting it by pre-paid post to that address.

DATED 12th July 2006

Signed by JOHN BYRNE)

In the presence of:)

John Byrne

Witness

SIGNED by me as delegate of the)

Australian Prudential Regulation Authority)

In the presence of:)

Witness

SCHEDULE 1

INSURANCE ACT 1973

SECTION 126

Acceptance and enforcement of undertakings

(1) APRA may accept a written undertaking given by a person in connection with a matter in relation to which APRA has a function or power under this Act.

(2) The person may withdraw or vary the undertaking at any time, but only with APRA's consent.

(3) If APRA considers that the person who gave the undertaking has breached any of its terms, APRA may apply to the Federal Court for an order under subsection (4).

(4) If the Federal Court is satisfied that the person has breached a term of the undertaking, the Federal Court may make all or any of the following orders:

(a) an order directing the person to comply with that term of the undertaking;

(b) an order directing the person to pay to the Commonwealth an amount up to the amount of any financial benefit that the person has obtained directly or indirectly and that is reasonably attributable to the breach;

(c) any order that the Federal Court considers appropriate directing the person to compensate any other person who has suffered loss or damage as a result of the breach;

(d) any other order that the Federal Court considers appropriate.