

**FAI Insurances Limited**  
**ACN 004 304 545**  
**(In liquidation and subject to Schemes of Arrangement)**

Scheme Administrators' annual report to  
creditors

30 June 2008

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# 1 Introduction & background

## 1.1 Introduction

This is the second annual report to the Creditors of FAI Insurance Company Limited - in liquidation and subject to Schemes of Arrangement (“FAI”).

The report has been prepared in accordance with clause 43.2 of the Scheme of Arrangement, which became operative in Australia on 30 May 2006. Under the terms of the clause: “Within three months after each anniversary of the date, being either 31 December or 30 June, at the discretion of the Scheme Administrators, after The Australian Scheme becomes effective, the Scheme Administrators shall report to the Scheme Creditors on the progress of The Australian Scheme, including details of remuneration paid to the Office Holders, since the date of the last such report”. Accordingly this report has been prepared for the period to 30 June 2008.

An annual report has also been prepared by the Scheme Administrators of the UK Scheme of Arrangement for FAI. This will be published on the HIH website as a supplement to the Australian annual report for this company.

## 1.2 Background

HIH Insurance Limited and certain of its major subsidiaries were placed into Provisional Liquidation on 15 March 2001, and subsequently into liquidation on 27 August 2001. To date, eighty-one HIH Group companies in Australia have been placed into liquidation.

Summary details of the history of the group; its failure; and background information are available on the HIH website at [www.hih.com.au](http://www.hih.com.au). Extensive information on the failure of the group, including the final report of the HIH Royal Commission established by the Australian Federal Government, is available on the website [www.hihroyalcom.gov.au](http://www.hihroyalcom.gov.au)

Schemes of Arrangement for the eight licensed insurance companies in the HIH Group in Australia became effective on 30 May 2006, following approval by Creditors and the Court. Schemes of Arrangement for the UK branches of the four of these companies, detailed in section 3 of this report, became effective in the UK on 13 June 2006. Each of the Schemes has a Record Date (the date at which liabilities are measured) of 27 August 2001. The earliest bar date permissible under the terms of the Schemes is 30 May 2011. At this stage the Scheme Administrators expect the actual bar dates to be 30 May 2013.

## 2 Principal developments to report during the period

The principal developments to report during the period were:

- + Agreement of Scheme Payment Percentages by the members of the requisite Scheme Creditor Committees, which now total as follows:

	Creditors with insurance liabilities in Australia	All other creditors worldwide
HIH C&G	12.64%	9.00%
FAIG	30.00%	30.00%
CIC	30.00%	30.00%
WMG	5.00%	5.00%

More detail on Scheme Payments and the estimated ultimate Scheme Payment Percentage for FAI is included in section 3 of this report.

- + The Australian Scheme Administrators were successful in their appeal to the House of Lords. Their Lordships ruled that funds held by the English Scheme Administrators should be remitted to Australia for distribution by the Australian Scheme Administrators in accordance with Australian Corporations Act and Insurance Act priorities. This is explained in more detail in section 3.2 of this report.
- + Following settlement with some of the defendants to the Liquidators' major litigation actions last year, discussions have continued with the defendants to the FAI Takeover claim. Further details of this, and other major litigation matters, are included in section 5 of this report.

## 3 Current and projected Scheme Payment Percentages

### 3.1 The current Scheme Payment Percentage

To date no Scheme Payment Percentage has been set for FAIL. In view of the small estimated final Scheme Payment to creditors and the complexity of the guarantee group of which FAIL is a member, it is not expected that an interim Scheme Payment will be made within the next twelve months.

### 3.2 Agreement of the current Scheme Payment Percentage

The Scheme Administrators review the Scheme Payment percentages on a regular basis, as major asset recoveries are made and claims estimates are updated. This review is undertaken in consultation with the Creditors' Committees. Factors taken into account when estimating these percentages include current cash held, the level of expected future agreed claims, and the remaining potential volatility of the account.

### 3.3 The House of Lords Appeal decision

The English Scheme of Arrangement was originally designed to complement the Australian Scheme by adopting most of the provisions of the Australian Scheme, with the exception of the distribution priorities that were to apply to the English Assets.

As a result of the different statutory distribution priorities that apply to liquidators' distributions in Australia and the UK, and following a formal request to the UK Court by the Australian Court under section 426 UK Insolvency Act, the English Provisional Liquidators sought directions from the English High Court as to whether the assets they controlled should be released to the Australian Liquidators for distribution in accordance with the Australian statutory distribution priorities.

The High Court directed that the English Assets should not to be remitted to the Australian Liquidators for distribution in accordance with the Australian statutory distribution priorities. The English Scheme therefore applied the distribution priorities of the English statutory regime to the English Assets.

The Australian Liquidators and two Australian creditors (the James Hardie Trusts) unsuccessfully appealed the initial court directions obtained by the English Provisional Liquidators, and subsequently appealed that decision further to the House of Lords. The appeal was heard in December 2007.

In anticipation that the appeal process would otherwise hold up the adoption of the Schemes and the commencement of payments to creditors, the English Scheme contained an inbuilt alternative – if the House of Lords maintained the status quo of the first instance judgment and the Court of Appeal decision, the English Assets would continue to be distributed *pari passu* to all creditors worldwide. If however the House of Lords overturned the Appeal Court decision, the English Assets would be distributed in accordance with the Australian distribution priorities.

In May 2008, judgement was handed down in favour of the Australian Scheme Administrators. The practical effect of the judgement is that assets realised and held by the English Scheme Administrators will now be distributed to creditors in accordance with Australian priorities.

### 3.4 Scheme Payments for reinsurance creditors

In the last annual report to creditors it was explained that agreed claims (described as "Acknowledged Creditor Claims" under the Scheme) of HIH C&G's reinsurance creditors had generally not yet been accepted as Established Scheme Claims by the Scheme Administrators, and so reinsurance creditors would not generally have yet been paid any Scheme distributions.

The reason for this is the difficulty in identifying all potential future set-off. The HIH companies wrote both inwards reinsurance business and outwards reinsurance business, in more than one location, and significant set-off is expected. In common with many solvent insurers, prior to insolvency the HIH Group did not maintain their insurance records on a principal to principal basis, which meant that the Scheme Administrators were not able readily to identify all transactions with a particular principal.

The Scheme Administrators have been willing to consider making Scheme Payments to reinsurance creditors with Acknowledged Creditor Claims before all potential set off has been finalised, provided the creditor is willing to give an undertaking to refund any amounts which subsequently prove to have been overpaid. Payment has been made to a number of such creditors over the last year and creditors interested in this should continue to contact the Scheme Administrators.

### 3.5 Estimated ultimate Scheme Payment Percentage

The Scheme Administrators' current best estimates of the ultimate Payment Percentage for FAIL is shown below. This estimate is dependent on a wide range of factors including the volatility of claims; levels of set-off; levels of reinsurance recovery; the class of creditor claim; and litigation outcomes. It is possible that the ultimate Payment Percentage could vary significantly either above or below that predicted.

<b>Scheme Company</b>	<b>Estimated Total Scheme Payment Percentage at Scheme date</b>	<b>Updated Total Scheme Payment Percentage at 30 June 08</b>
FAIL	Less than 5%	7%

Further work on the HIH Group's financial affairs has revealed that FAIL is part of a guarantee group comprising three subsidiaries within the HIH Group. Membership of the guarantee group has had the effect of pooling the assets and liabilities of the three HIH companies making up the group. Continued work on the liquidations of the other companies within the guarantee group has helped further marginally improve the estimated final position of FAIL's creditors. More detail is provided in section 6 of this report.

## 4 Interaction between Australian and English Scheme

### 4.1 Claiming under the Australian and English Schemes

All creditors worldwide are entitled to claim in both the Australian and English Schemes for FAIL. The Australian and English Scheme Administrators co-operate fully. Creditors do not need to lodge separate claims in each jurisdiction. Creditors need to lodge claims in one location only, which is then effective under both Schemes.

The Australian and English Scheme Administrators, and the respective run-off managers, operate a unified principal to principal ledger system and a unified distribution payment system.

The entitlements of individual creditors under both schemes are automatically calculated, and when a Scheme Payment is made, the creditor receives a statement showing how their liability has been classed, and from which classes of assets their distribution has been paid.

Both the Australian and English Schemes contain a “hotchpot” clause. The effect of the hotchpot clause is to prevent a creditor who has already been paid a distribution under one of the schemes, from receiving further payments under the other scheme until such time as all other creditors with similarly ranked claims have received an equal proportionate distribution.

### 4.2 Distribution Priorities

The English Scheme is designed to complement the Australian Scheme. Following receipt of the House of Lords judgement the English Scheme will adopt all of the provisions of the Australian Scheme, including the Australian distribution priorities, which will now apply to the English Assets.

## 5 Major Litigation

### 5.1 Background

Following the collapse of the HIH Group in 2001, the Australian Government established the HIH Royal Commission to inquire into the reasons for the failure of the Group. The Hon Justice Neville Owen was appointed as Royal Commissioner and began his enquiry in September 2001. He presented his findings on the outcome of the enquiry in April 2003.

Considerable work was undertaken by the Commissioner and his team in investigating the circumstances behind the HIH collapse. This provided an extremely useful background against which the Liquidators could assess which of those HIH Directors, auditors and former advisors may be liable under any successful recovery action.

Having reviewed the potential courses of action open to them, the Liquidators decided to focus on two major recovery actions:

- + The Trading Loss & Dividend claim; and
- + The FAI Takeover claim

### 5.2 The Trading Loss & Dividend claim

The Trading Loss and Dividend claims were brought by the Liquidators against a number of defendants including HIH and FAI directors, the Groups' auditors, the Groups' actuaries, reinsurers and a broker.

In June 2007, after filing but before serving the claims, the Liquidators settled with certain of the defendants. One of the consequences of those settlements is that the Liquidators have discontinued all of the Trading Loss and Dividend claims.

### 5.3 FAI Takeover claim

This claim arises from the takeover by the HIH Group of the FAI Group in 1998/99. The defendants to the claim include General Cologne Re, Guy Carpenter, Arthur Andersen and Goldman Sachs, who the Liquidators allege should compensate HIH for losses suffered through the takeover of the FAI Group.

The Liquidators have requested that the Court allow a three month standstill to the Court timetable to allow settlement discussions to be further explored. The matter is before the Court again on 18 December 2008 at which time it will be provided with a further update on the settlement discussions.

## 6 Financial position

### 6.1 Estimated balance sheet at 30 June 2008

Included as Appendix 3 to the Australian Explanatory Statement section of the Scheme of Arrangement documentation, which was sent to creditors prior to the creditors' meeting on 29 March 2006, were balance sheets for each of the Scheme companies at 25 September 2005. Included as Appendix 1 to this report is an updated balance sheet for FAIL, as at 30 June 2008.

The Scheme Administrators have not commissioned a further full actuarial review of the insurance liabilities of the eight Scheme companies since the last annual report. It is their intention, however, to commission a further such review in the coming months, in order that there is an updated estimate of the final total insurance liabilities for the next annual report.

Factors that have led to adjustment to the FAIL balance sheet over the last year include:

- + Further work on the validity of large inter-company balances; and
- + Removal of the provision for claims lodged on behalf of the shareholders of HIH Insurance Limited, which were rejected by the Scheme Administrators. This decision has been endorsed by both the Supreme Court and the Court of Appeal.

The other main factor has been ongoing work on the liquidations of the other members of the cross guarantee group including the following other HIH Group companies:

- FAI Leasing Finance Pty Ltd; and
- FAI Home Security Holdings Pty Ltd

As previously explained, membership of the guarantee group has had the effect of pooling the assets and liabilities of the three FAI companies making up the group. This has helped marginally improve the estimated final position of FAIL's creditors.

### 6.2 Receipts and payments to 30 June 2008

A summary of the Scheme Administrators receipts and payments from the commencement of the Scheme on 30 May 2006 to 30 June 2008 is set out in Appendix 2 to this report.

During this period no fees have been approved by FAIL's Creditors' Committee, and paid to the Scheme Administrators in their role as Office Holders.

## 7 Closure

The scheme for FAll provides for an Estimation Date of seven years after the Australian Scheme became effective, which means that the Estimation Date is expected to be in June 2013. By that time the Scheme Administrators expect that the majority of the reinsurance asset will have been collected or commuted, and the remaining tail of insurance liabilities will be sufficiently small to justify closure of the insolvency on cost benefit grounds.

The Scheme provides that the Estimation Date may be moved two years either way from the expected seven years (to be as early as five years or as late as nine years after the Effective Date) by special resolution of creditors, on the recommendation of the Scheme Administrators and Creditors' Committees. Under the terms of the Scheme all creditors will be given notice of the actual Estimation Date between six and three months prior to the time.

Following the Estimation Date all remaining outstanding and IBNR creditor claims will be crystallised by estimation, to allow for the closure of the insolvency.

At the date of this report, the Scheme Administrators consider that June 2013 remains the most likely Estimation Date for the Scheme.

## 8 Responsibilities

### 8.1 Scheme Administrators

The Australian Scheme Administrators are Tony McGrath and Chris Honey, partners of McGrathNicol, based in Sydney. The English Scheme Administrators of FAI are John Wardrop and Tom Riddell, partner and senior advisor respectively of KPMG LLP, based in London.

### 8.2 Run-off Managers

The day to day claims handling and reinsurance recovery activities of FAI have been outsourced to specialist run-off organisations in Sydney and London, who work in close co-operation. The run-off managers for all business of the company, except business written with the UK branch, are Capita CMGL. The run-off managers for all business written by the UK branch of FAI are Whittington Insurance Services Limited.

### 8.3 Creditors' Committee

The interests of creditors in the Australian Scheme are represented by a Creditors' Committee. The Committee sanctions significant transactions (such as commutations), is involved in the setting of the Scheme Payment Percentage, and approves the Scheme Administrators' fees. It is reported to, and meets as required, usually at least once a year. The current constitution of the Committee is as follows:

<b>Member</b>	<b>Represented by</b>
FAI (NZ) General Insurance Company Ltd (In Liquidation)	Mr Callum Reid
HIH Casualty & General Insurance (NZ) Ltd (In Liquidation)	Mr Callum Reid

## 9 Contact Details

Contact details for the Australian Scheme Administrators, the English Scheme Administrators, and the Australian and English Run-Off Managers are set out on the HIH website, [www.hih.com.au](http://www.hih.com.au).

### 9.1 Creditor Enquiries in Australia

Scheme Creditors with claims adjustment queries (excluding those in relation to branch business) should call Capita CMGL on +61 (0) 2 9650 5777. Written claims adjustment queries should be directed in the first instance to Capita CMGL at the following address: Capita CMGL Level 2, 117 Clarence Street, Sydney, NSW, 2000, Fax +61 (0) 2 9650 5710.

Scheme Creditors with enquiries in relation to the Scheme or Scheme Payments should call the HIH Help Desk on +61 (0) 2 9650 5777. Written scheme queries should be directed to the Scheme Administrators at the following address: McGrathNicol, GPO Box 9986, Sydney, NSW, 2001 or to the HIH Help Desk at [enquires@hih.com.au](mailto:enquires@hih.com.au).

Yours faithfully

*For FAI Insurances Limited – in liquidation and subject to Schemes of Arrangement*



Tony McGrath  
Scheme Administrator



Chris Honey  
Scheme Administrator

## Appendix 1

Updated balance sheet for FAII as at 30 June 2008

***FAI Insurances Limited - (In Liquidation and subject to Schemes of Arrangement)***  
***Balance Sheet***  
***as at 30th June 2008***  
***All values in AUD***

	RATA as at 30 June 2008	RATA as at 30 June 2007
	\$'000	\$'000
<b><i>Assets not specifically charged</i></b>		
<b>Cash</b>		
Cash at bank	2,754	773
	<u>2,754</u>	<u>773</u>
<b>Receivables</b>		
Amounts owing by related bodies corporate (excluding amounts owing by companies in the cross guarantee group)	17,577	16,405
GST Recoverable	33	11
	<u>17,610</u>	<u>16,416</u>
<b>Investments</b>		
Short term deposits	0	3,377
Managed Investments	14,838	7,510
Shares in controlled entities	15,423	10,109
	<u>30,261</u>	<u>20,997</u>
<b>Reinsurance recoveries receivable</b>	426	553
<b>Renewal rights</b>	0	0
<b>Other</b>		
Prepayments	0	0
Other receivables	0	0
	<u>426</u>	<u>553</u>
<b>Total company assets not specifically charged</b>	<u>51,052</u>	<u>38,739</u>
Dividends receivable from other companies in the guarantee group	22,826	20,013
<b><i>Total assets not specifically charged</i></b>	<u><u>73,878</u></u>	<u><u>58,752</u></u>
<b>TOTAL ASSETS</b>	<u><u>73,878</u></u>	<u><u>58,752</u></u>
<b><i>Unsecured creditors</i></b>		
<b>Accounts payable</b>		
Trade Creditors	(17,360)	(17,360)
	<u>(17,360)</u>	<u>(17,360)</u>
<b>Borrowings</b>		
Medium term note issues	(77,914)	(92,937)
	<u>(77,914)</u>	<u>(92,937)</u>
<b>Provisions</b>		
Other - Shareholder class action & guarantor for CHF bonds	(18,161)	(118,161)
	<u>(18,161)</u>	<u>(118,161)</u>
<b>ACC's</b>	(1,602)	(969)
<b>Claims Reserves - Deferred</b>	(338)	(1,627)
<b>IBNR Claims</b>	(2,390)	(1,855)
<b>Outstanding claims</b>	<u>(4,330)</u>	<u>(4,451)</u>
<b>Unearned premiums</b>	0	0
<b>Other liabilities</b>		
Other creditors and accruals	(11,125)	(11,125)
Amounts owing to related bodies corporate (excluding amounts owing to companies in the cross guarantee group)	(461,853)	(461,853)
	<u>(472,978)</u>	<u>(472,978)</u>
<b>Total company unsecured creditors</b>	<u>(590,743)</u>	<u>(705,887)</u>
Liabilities from other companies in the cross guarantee group	(213,384)	(215,888)
<b><i>Total unsecured creditors</i></b>	<u><u>(804,127)</u></u>	<u><u>(921,775)</u></u>
<b>TOTAL LIABILITIES</b>	<u><u>(804,127)</u></u>	<u><u>(921,775)</u></u>
<b>NET DEFICIT</b>	<u><u>(730,249)</u></u>	<u><u>(863,023)</u></u>

## Appendix 2

Summary of the Scheme Administrators' receipts and payments from 30 May 2006  
to 30 June 2008

**FAI Insurances Limited (In Liquidation and subject to Schemes of Arrangement)  
Receipts and Payments Account to 1 July 2007 to 30 June 2008**

	\$
<b>Balance brought forward 1 July 2007</b>	<b>10,933,951.47</b>
<b>Receipts</b>	
Settlement proceeds reallocated from HIH C&G	8,542,210.00
Reinsurance Recoveries	680,489.10
Interest	74,872.01
Scheme Dividends received	554,528.92
GST Refund from ATO	34,363.07
Other receipts	380.95
	<hr/>
<b>Total receipts</b>	<b>9,886,844.05</b>
<b>Payments</b>	
Professional Fees	(2,945,057.47)
Unrealised Foreign Exchange Movements on Foreign Currency Accounts	(947,656.24)
Outsourced Claims Management Fees	(154,622.38)
Transfer of funds to UK Scheme	(317,162.61)
Central Expense paid to HIH C&G	(107,230.95)
GST	(57,630.38)
State Cut through Payments	(120,879.00)
Unrealised Loss on Investments	(82,320.18)
St George 11 am Dep transferred to FAI General	(11,037.84)
Reimbursement of expenses to HIH C&G	(10,789.31)
Consultancy Fees	(9,305.28)
Other Sundry Payments	(50,379.28)
	<hr/>
<b>Total payments</b>	<b>(4,814,070.92)</b>
	<hr/>
<b>Balance at 30 June 2008</b>	<b>16,006,724.60</b>

\*It should be noted that any unrealised exchange rate gains or losses on foreign currency holdings are fully offset by corresponding movements in the Australian dollar liability of foreign currency denominated creditors.