

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

Scheme Administrators' annual report to
creditors

30 June 2010

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1 Introduction & background

1.1 Introduction

This is the fourth 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 2010.

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. In total, eighty-two 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. 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

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 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:

- + To date, no interim Scheme Payments have been made to creditors of FAI. More detail on Scheme Payments and the estimated ultimate Scheme Payment Percentage for FAI is included in section 3 of this report.
- + A confidential settlement was reached in respect of the FAI Takeover litigation.
- + Court approval has been obtained allowing the HIH Group to be treated as a consolidated group for tax purposes. This has allowed the winding up of a number of HIH Group subsidiaries and the payment of surplus capital to the parent companies within the Group. The treatment of the HIH Group as a consolidated group for tax purposes has allowed any taxable income earned by these companies after they entered liquidation to be offset against losses existing in other parts of the HIH Group.

To date the liquidations of 13 group subsidiary companies have been completed and a further 9 companies are close to completion. The flow of funds up to FAI has been as follows:

- Receipt of \$4.7 million surplus distribution from FAI Finance Corporation.

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 Scheme Payments for reinsurance creditors

As explained in previous annual reports, the Scheme Administrators are 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.

3.4 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.

Scheme Company	Estimated Total Scheme Payment Percentage at Scheme date	Updated Total Scheme Payment Percentage at 30 June 10
FAIL	Less than 5%	1% - 10%

The range of estimated outcomes can be further analysed across the various creditor groups as follows:

	Range of estimated Scheme Payment percentage
Creditors with insurance liabilities in Australia	5% - 10%
Creditors with insurance liabilities outside of Australia	1%
Creditors with non insurance liabilities in Australia	5% - 10%

The previous estimated range was 8% to 30%. The forecast percentage payments in last year's report were based on calculations that the majority of FAI Insurance creditors were creditors with non insurance liabilities in Australia and would receive a Scheme payment in the range of 8% to 10%. There were a small number of creditors with insurance liabilities in Australia who would have received priority to a small balance of non Australian reinsurance recoveries which would have paid them an estimated further 20% bringing their total estimated recovery to 30%.

During the year the Scheme Administrators' have become aware of a significant balance of creditors with insurance liabilities not in Australia, not previously recorded as FAI Insurance creditors. They will share with the creditors with insurance liabilities in Australia in the return from any non Australian reinsurance recoveries thus reducing the recovery from these assets to approx' 1%. They will not be eligible to prove against the other Australian assets which are still forecast to pay between 5% - 10% to all creditors with liabilities in Australia.

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 has adopted 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 which was settled in 2007; and
- + The FAI Takeover claim

5.2 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 Special Purpose Liquidator appointed specifically to deal with the claim by other HIH Group companies against FAI Insurance reached a confidential settlement with the defendants to this claim in early 2010. As part of an overall settlement, FAI Insurance which was one of the defendants to the FAI Takeover claim has admitted the HIH Group plaintiffs as unsecured creditors in the liquidation for the sum of \$65 million.

6 Financial position

6.1 Estimated balance sheet at 30 June 2010

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 2010.

6.2 Receipts and payments to 30 June 2010

A summary of the Scheme Administrators receipts and payments from the commencement of the Scheme on 30 May 2006 to 30 June 2010 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 FAIL 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 FAIL 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 FAIL 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:

Member	Represented by
HSBC	Mr Joseph Lee
FAI Leasing Finance Pty Ltd (In Liquidation)	Mr Harry Neesham
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.

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.

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 FAll as at 30 June 2010

FAI Insurances Limited - (In Liquidation and subject to Schemes of Arrangement)
Balance Sheet as at 30 June 2010
All values in AUD

	RATA as at 30 June 2010 \$'000	RATA as at 30 June 2009 \$'000
Assets not specifically charged		
Cash		
Cash at bank	2,780	1,822
	<u>2,780</u>	<u>1,822</u>
Receivables		
Amounts owing by related bodies corporate (excluding amounts owing by companies in the cross guarantee group)	16,711	18,406
GST Recoverable	5	7
	<u>16,716</u>	<u>18,413</u>
Investments		
Managed Investments	19,930	15,408
Shares in controlled entities	18,337	17,635
	<u>38,267</u>	<u>33,043</u>
Reinsurance recoveries receivable	0	0
	<u>0</u>	<u>0</u>
Total company assets not specifically charged	57,763	53,277
Dividends receivable from other companies in the guarantee group	24,679	23,147
Total assets not specifically charged	82,442	76,424
	<u>82,442</u>	<u>76,424</u>
TOTAL ASSETS		
Unsecured creditors		
Accounts payable		
Trade Creditors	(17,360)	(17,360)
	<u>(17,360)</u>	<u>(17,360)</u>
Borrowings		
Medium term note issues	(87,997)	(92,433)
	<u>(87,997)</u>	<u>(92,433)</u>
Provisions		
Other - Shareholder class action & guarantor for CHF bonds	(18,161)	(18,161)
Other - Settlement of FAI Takeover Claim	(0)	(100,000)
	<u>(18,161)</u>	<u>(118,161)</u>
ACC's	(22,806)	(1,057)
Claims Reserves - Deferred	(194)	(204)
IBNR Claims	(1,177)	(1,238)
Outstanding claims	<u>(24,177)</u>	<u>(2,499)</u>
Other liabilities		
Other creditors and accruals	(11,125)	(11,125)
Amounts owing to related bodies corporate (excluding amounts owing to companies in the cross guarantee group)	(526,853)	(461,853)
	<u>(537,978)</u>	<u>(472,978)</u>
Total company unsecured creditors	(685,674)	(703,431)
Liabilities from other companies in the cross guarantee group	(213,384)	(215,383)
Total unsecured creditors	(899,057)	(918,814)
	<u>(899,057)</u>	<u>(918,814)</u>
TOTAL LIABILITIES		
	<u>(899,057)</u>	<u>(918,814)</u>
NET DEFICIT	<u>(816,615)</u>	<u>(842,389)</u>

Appendix 2

Summary of the Scheme Administrators' receipts and payments from 30 May 2006
to 30 June 2010

FAI Insurances Limited (In Liquidation and subject to Schemes of Arrangement)
Receipts and Payments Account 1 July 2009 to 30 June 2010

Balance at 1 July 2009		15,622,134.89
Receipts		
Distribution from FAI Finance Corporation	4,720,770.76	
Unrealised Gain on Investments	1,863,900.23	
Transfer from FAI Home Security Trust	30,747.37	
GST Refund from ATO	50,314.05	
Interest	24,383.29	
Reinsurance Recoveries	26,018.64	
Other receipts	<u>780.87</u>	
Total receipts		6,716,915.21
Payments		
Professional Fees	(127,155.82)	
Unrealised Foreign Exchange Movements on Foreign Currency Accounts	(918,875.35)	
Outsourced Claims Management Fees	(127,709.49)	
GST	(25,612.29)	
Central Expense paid to HIH C&G	(102,735.73)	
Other Sundry Payments	<u>(2,879.14)</u>	
Total payments		(1,304,967.82)
Balance at 30 June 2010		21,034,082.28