

# UNDERTAKINGS

## Insurance Act 1973 Section 126

THESE UNDERTAKINGS ARE GIVEN BY:

**Zurich Australian Insurance Limited** ABN 13 000 296 640 ('ZAIL')  
5 Blue Street, North Sydney, New South Wales; and

**Zurich Financial Services Australia Limited** ABN 11 008 423 372 ('ZFSA')  
5 Blue Street, North Sydney, New South Wales;  
(together referred to as the 'the Zurich entities').

AND ARE ACCEPTED BY:

**Australian Prudential Regulation Authority** of Level 26, 400 George Street, Sydney, New South Wales ('APRA')

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

### Part 1

#### Overview

- A On 17 May 2004 APRA appointed an inspector to make (amongst other things) an investigation into the affairs of ZAIL and ZFSA.
- B The Zurich entities acknowledge, on the basis of information made available to them by APRA during the course of the investigation, that information was withheld and misstatements were made that resulted in APRA, auditors and approved actuaries, the independent directors of ZFSA and ZAIL, and other officers not having complete and accurate information and being misled about the true nature of the arrangements. As a result of this, a number of people knowingly misled APRA about the true nature of the Reinsurance Transactions over an extended period of time by a course of conduct and actions. APRA acknowledges that on becoming aware of the reinsurance transactions in April 2004 the independent directors and other employees of ZFSA, ZAIL and Zurich Insurance Company ("ZIC") took all reasonable steps to ensure that the reinsurance transactions and their prudential effects were properly disclosed to APRA.
- C ZAIL and ZFSA regret without reservation the circumstances which led to APRA being misled and the need for the current investigations. They acknowledge that in the past conduct occurred which fell seriously short of acceptable practice. ZIC, ZAIL and ZFSA accept that prudential regulation requires full, frank and timely disclosure from regulated entities. APRA acknowledges the open and co-operative

spirit shown by the Boards of ZAIL and ZFSA and the assistance and co-operation provided by ZIC in their dealings with APRA since APRA began its enquiries into these transactions in early 2004.

- D APRA is separately considering the role of individuals in these transactions.
- E In light of APRA's investigations, the Zurich entities have not independently investigated the role of any particular individual.

## Background

- A During 2000 ZAIL negotiated and entered into two transactions with companies in the General & Cologne Re Group in Australia (the "Reinsurance Transactions") with the knowledge and approval of former employees of ZIC. ZAIL entered into a Loss Portfolio Transfer Agreement on 28 September 2000 with General Reinsurance Australia Limited ABN 16 008 427 450 (formerly General & Cologne Reinsurance Australasia Limited) (the "LPT Agreement") and a calendar-year Stop Loss Reinsurance Agreement on 11 December 2000 with the Australian Branch of the General & Cologne Re Group (the "Stop Loss Agreement") replacing earlier stop loss arrangements.
- B Later, APRA in the course of its normal prudential supervisory activities obtained information which made it concerned about the substantive nature of the Reinsurance Transactions. It then became aware of a series of further transactions not previously disclosed to APRA which appeared to be related. In the light of this fresh knowledge, the way in which the Reinsurance Transactions were accounted for by ZAIL and reported in the statutory returns provided to APRA by ZAIL under section 44 of the Act (as it then was) and other disclosures to APRA, APRA decided these were issues of prudential concern.
- C APRA has, in the course of the inquiries made by the inspector, found that there were fundamental misstatements/mistreatments of the Reinsurance Transactions in ZAIL's accounts in 2000. ZAIL and ZFSA have acknowledged this to be the case as in response to the matters uncovered by APRA the Boards of ZFSA and ZAIL met on 29 November 2004 to consider the accounting treatment of the LPT Agreement and resolved to:

*"DETERMINE, on the basis of the information before the Board concerning the transactions, that the Loss Portfolio Transfer Agreement dated 28 September 2000 (the "LPT") under which ZAIL purportedly reinsured certain insurance liabilities to General & Cologne Reinsurance Australia and related transactions involving Cologne Re Dublin and Zurich Insurance Company did not involve a transfer of risk from ZAIL and so the LPT ought properly to be characterised as financial reinsurance."*

- D As a result of the accounting misstatement/mistreatment of the Reinsurance Transactions, ZAIL's profits in 2000 were overstated by about \$61.3m in its audited accounts as well as the Annual Financial Position return lodged with APRA for 2000. Moreover, if the Reinsurance Transactions had been correctly reported by ZAIL in relation to 2000, ZAIL would (in the absence of any other corrective action) have failed to meet the statutory solvency requirements under the Act triggering regulatory action.

- E ZAIL and ZFSA have reviewed, with their auditors and ASIC, the accounting treatment for the accounts for the years 2000 to 2003, and ZAIL and ZFSA acknowledge that those accounts, on the basis of the determination of the Board, contained a fundamental error which must now be corrected in accordance with the applicable accounting standards.
- F ZAIL also acknowledges that its quarterly Financial Position Returns to APRA from September 2000 to September 2003 were also incorrect to the extent that, in all the circumstances considered together, there was ultimately no transfer of risk by ZAIL in relation to the risks which were the subject of the LPT Agreement.
- G The Zurich entities have progressively taken a number of steps to systematically strengthen their corporate governance and compliance frameworks. This process has included:
- (a) new document authorisation and execution procedures;
  - (b) a 'good faith' internal reporting process;
  - (c) recruitment to the senior legal and compliance roles within the organisation and enhancement of the status of those roles through elevated reporting lines;
  - (d) extensive enhancement of key risk areas and governance, training and related awareness programs and clear communication from both Board and executive level of the importance of governance issues to the business; and
  - (e) The Zurich Risk Policy has been revised to include an expanded section on the Group Reinsurance Policy, under which contracts are not to be classified as reinsurance unless the reinsurer has assumed both underwriting and timing risk. Additionally, this policy restricts the use of financial reinsurance to those transactions whose risk characteristics in totality support reinsurance accounting treatment. Such transactions must meet all Group Accounting standards and local statutory accounting and reporting requirements.
- H The Zurich entities have conducted appropriate inquiries and are not aware of any reinsurance contracts involving or affecting ZFSA or ZAIL other than those which have been reported to APRA which raise the same or similar issues. Further, at APRA's request, ZAIL engaged an external consultant to undertake a review of its processes and systems in relation to its reinsurance function to identify any appropriate operational and risk management improvements.
- I By letter dated 22 December 2004, and at APRA's request, ZIC has undertaken to APRA, without prejudice to its legal position, to provide necessary and appropriate financial support to ZAIL to procure that ZAIL has a capital base of eligible capital of not less than 1.5 times its Minimum Capital Requirement ("MCR") under Prudential Standard GPS110 'Capital Adequacy for General Insurers' for two years from the date of the letter or such shorter period as APRA may agree.

- J ZIC has also advised APRA of a number of initiatives which have been pursued in relation to governance, control and reporting improvements throughout the Zurich Group worldwide.
- K APRA is satisfied on the information available to it that ZAIL and ZFSA are presently financially sound, and that ZAIL as an authorised insurer exceeds APRA's MCR. Nothing has come to the attention of APRA to indicate that any policy-holder has suffered any loss as the result of the Reinsurance Transactions.
- L APRA is further satisfied, based on the information available to it, that the Reinsurance Transactions, ZAIL's entry into the LPT Agreement and the Stop Loss Agreement or the manner in which those agreements were accounted for do not presently increase the risk to ZAIL's policy-holders.
- M APRA notes:
- (a) the agreement which has been entered into in August 2004 between ZFSA and ZIC in relation to the commutation payment made by ZIC to Cologne Reinsurance Company (Dublin) Limited;
  - (b) that ZIC is aware of the undertakings set out in Part 2 below by the Zurich entities and that ZIC has given its approval and support to these actions by the Zurich entities;
  - (c) assurances from ZIC that it understands the current regulatory framework in Australia and the position of the boards of ZAIL and ZFSA under Australian legislative and regulatory requirements; and
  - (d) that ZIC has provided undertakings to the Zurich entities that ZIC will use reasonable endeavours to provide to the Zurich entities in Australia copies of all Relevant Documents (as defined in paragraph 14 below) produced by or which come into the possession of ZIC outside Australia and are not already in the possession of any of the Zurich entities.
- N ZAIL and ZFSA have delivered a training course to all senior managers that emphasises the commitment of the Zurich entities to full and truthful disclosure of all business dealings and other relevant matters in discharging their responsibilities to APRA and their employer.
- O APRA has power under section 126 of the Act to accept undertakings from the Zurich entities.
- P In light of the matters referred to in these Recitals, the Zurich entities have given the undertakings set out in Part 2.
- Q The Zurich entities acknowledge that they have obtained legal advice before executing these undertakings.
- R ZAIL and ZFSA have the approval of ZIC to enter into these undertakings.

## Part 2

### THE UNDERTAKINGS

#### *Assistance*

- 1 The Zurich entities will continue to give all reasonable assistance to APRA in the conduct of its inquiries into any matter relating to the Zurich entities, subject to any other overriding legal obligations or privileges.

#### *No further financial obligations*

- 2 The Zurich entities undertake that they will not assume any further financial obligations in relation to the Reinsurance Transactions or any commutation of retrocession arrangements related to those transactions without APRA's prior approval and that they have not assumed any financial obligations in relation to any such commutation.

#### *Training*

- 3 ZFSA will work with an accredited industry body (such as the Australian and New Zealand Institute of Insurance and Finance or the Insurance Council of Australia) acceptable to APRA to develop an industry training programme that has as its key focus:
  - (a) What APRA's expectations are in respect to disclosure and reporting;
  - (b) How to deal with regulators in an open, transparent and honest fashion; and
  - (c) Gaining an understanding of the vital importance of adopting a suitably probing mindset in connection with the collection and provision of information that is used to meet disclosure and reporting requirements under the Insurance Act and relevant prudential standards.

The programme will be directed to Directors, management and key staff of APRA regulated general insurance companies with relevant disclosure and reporting responsibilities.

ZFSA will use its best endeavours to ensure the programme is ready for release within 12 months of the date of these undertakings.

#### *Corporate Governance*

- 4 The Zurich entities will maintain an appropriate corporate governance framework which will deal with the following matters in particular:
  - (a) a delineation of the respective roles of the board and management;
  - (b) a clear understanding on the matters reserved for determination by the board and matters within the delegated authority of management;
  - (c) a matrix setting out the matters reserved for approval by ZIC as the sole shareholder of ZFSA and an acknowledgment by ZIC that directions or

guidance to ZFSA must be consistent with the Australian legal and regulatory environment;

- (d) a communication procedure between the directors and senior management of the Zurich entities on the one part and ZIC on the other;
- (e) a code of conduct for management and employees of the Zurich entities;
- (f) records management and retention systems,

in accordance with the principles set out in Annexure A to these undertakings. The Zurich entities shall report on their compliance with this undertaking within 6 months of the date of these undertakings.

- 5 The Zurich entities undertake to obtain prior approval from APRA for any material changes to the corporate governance framework (as described in Annexure A) which are proposed to be made by ZFSA or ZAIL within five years after the date of these undertakings, subject to any overriding legal obligations. APRA will review this obligation after 3 years from the date of these undertakings, and may in its discretion waive the requirement for approval.
- 6 The Zurich entities undertake within 6 months of the date of these undertakings to engage an independent, qualified corporate governance consultant acceptable to APRA (acting reasonably) to review, assess, make recommendations and report in writing (the “**Initial Report**”) on:
  - (a) processes and procedures underpinning the operation of the Board;
  - (b) the adequacy and timeliness of information provided to the Boards of the Zurich entities; and
  - (c) the manner in which the Boards of the Zurich entities interact with management.

The appointment and terms of reference of the consultant must be approved by APRA (such approval not to be unreasonably withheld). The Initial Report is to be addressed to the Zurich entities and APRA. The Initial Report must be completed by no later than 9 months after the date of these undertakings or other date agreed with APRA.

- 7 The Zurich entities must engage a consultant to produce a further report in relation to the matters set out in paragraph 6 of this Part 2 (the “**Subsequent Report**”) on the first anniversary of the Initial Report. The consultant engaged to provide the Subsequent Report must be the same consultant who provided the Initial Report (unless APRA agrees otherwise). The Subsequent Report is to be addressed to the Zurich entities and APRA and to report upon the extent to which the first report has been successfully implemented. The Subsequent Report must be completed and a copy provided to APRA no later than three months after the first anniversary of the Initial Report (or by a date otherwise agreed with APRA).
- 8 (a) Within 30 days of receiving the Initial Report and Subsequent Report, the Zurich entities will:

- (i) provide APRA with a report from each company detailing the steps taken or to be taken by the relevant company to comply with any reasonable recommendations of the consultant; and
  - (ii) promptly implement the reasonable recommendations of the consultant unless otherwise agreed with APRA, and promptly comply with APRA's reasonable directions in that respect;
- (b) Within three months of receiving the Initial Report and Subsequent Report, provide APRA with a report signed by a senior officer of ZAIL or ZFSA confirming that the Zurich entities have fully complied with the reasonable recommendations to be implemented under subparagraph (a)(ii) above.
9. The Zurich entities undertake not to classify contracts as reinsurance unless the reinsurer has assumed both underwriting and timing risk. The Zurich entities will not within a period of two years after the date of these undertakings enter into, without obtaining the prior written approval of APRA, reinsurance agreements, arrangements or understandings which (on their own terms and in light of any related agreements, arrangements or understandings) do not involve the transfer of both underwriting and timing risk.

#### *Internal Audit*

- 10 The Zurich entities have appointed a new Head of Internal Audit. The Zurich entities undertake to conduct a thorough review of the Internal Audit framework and processes following the appointment of the new Head of Internal Audit. The Zurich entities will implement appropriate actions to strengthen the Internal Audit framework and processes to APRA's reasonable satisfaction following that review and in any case by 31 December 2005.

#### *Direct and Confidential Access*

- 11 The Zurich entities undertake to ensure that persons with the position of General Counsel, Head of Internal Audit and Head of Compliance and Risk Management (or equivalent functional positions) continue to have direct access to the Boards of the Zurich entities and to the Australian Group Risk & Compliance Committee. Those persons shall have unfettered and confidential access to the Boards of the Zurich entities and the Australian Group Risk & Compliance Committee to raise issues of a corporate governance, compliance, risk management or internal audit nature.
- 12 ZFSA will report to APRA by 30 June 2005 about its reorganisation of the management structure of its Asia-Pacific region.

#### *Capital maintenance*

- 13 ZAIL undertakes to use its best endeavours to maintain a capital multiple of not less than 1.5 times MCR until the earlier of 22 December 2006 or when released by APRA in writing. ZIC has agreed to ZAIL's giving this undertaking, and ZAIL undertakes to notify APRA should its capital multiple fall below the level required by this undertaking. ZAIL and ZFSA undertake that all terms of group internal reinsurance (being reinsurance between ZAIL and a Related Company) including any future charges for group internal reinsurance which either of them agrees to pay will be on

terms no less favourable to ZAIL than they would be on an arms length basis, and APRA will be notified of any such reinsurance.

### *Records Retention*

- 14 In paragraph 15 and recital M(d), “**Relevant Documents**” means Contracts created after 1 January 2005 that:
- (a) impose obligations, duties or requirements on a Zurich entity of an amount exceeding A\$500,000; or
  - (b) negate, vary or modify rights conferred or obligations imposed on a Zurich entity under another Contract where the financial impact of the negation, variation or modification of such rights or obligations exceeds A\$500,000,
- except for any Contracts which have broad application to the Zurich Group globally (including procurement Contracts) where the financial impact of those Contracts on the Zurich entities does not exceed A\$1 million.
- 15 The Zurich entities undertake to use reasonable endeavours to ensure that copies of all Relevant Documents which:
- (a) are created or executed by the Zurich entities;
  - (b) are provided to the Zurich entities by ZIC pursuant to the undertaking given by ZIC to the Zurich entities referred to in Recital M(d); or
  - (c) otherwise come into the control or possession of the Zurich entities in Australia,
- are retained in the possession or under the control of the Zurich entities in Australia.

## **Part 3**

### **FINALISATION OF ISSUES**

- 1 ZAIL and ZFSA are released from the terms of the undertakings originally given to APRA on 11 May 2004 and subsequently renewed.
- 2 APRA will not
  - (a) take any legal proceedings or take any action against ZAIL or ZFSA or any other Zurich Group company in relation to matters arising from the investigations; or
  - (b) seek to exercise any statutory power or take any other action against ZAIL, ZFSA or any other Zurich Group company, based upon any matter arising from the investigations, unless
    - (i) fresh evidence emerges of wrongdoing on the part of ZAIL or ZFSA or its officers or agents or

- (ii) APRA has been misled by ZAIL or ZFSA or its present officers in any material respect in relation to, or during the course of the investigation. Nothing in this paragraph or in these undertakings is intended to prevent or inhibit APRA taking any action in relation to any past or present employee or officer of ZAIL or ZFSA.

## Part 4

### INTERPRETATION

- 1 For the purposes of these undertakings, 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 or by posting it by pre-paid post to that address.
- 2 In this document:
  - "Contracts" means contracts, agreements, deeds, letters, memoranda, correspondence or other documents (in physical or electronic form).
  - "Related Companies" has the same meaning as in the Corporations Act.
  - "Zurich Group" means ZFSA, ZAIL, ZIC and Zurich Financial Services and each of their Related Companies.
- 3 APRA acknowledges that nothing in this undertaking or the basis on which the settlement of this matter has been reached:
  - (a) constitutes any admission by any Zurich Group company or any of their officers or employees or creates any estoppel against any of them; or
  - (b) is a concession by any Zurich Group company that APRA has any powers or duties in relation to Zurich Group companies located outside Australia. ZFSA, ZAIL and the Zurich Group note that APRA reserves its position as to its powers and duties.

**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.

**EXECUTED for Zurich Australian Insurance Limited (ABN 13 000 296 640) under common seal in the presence of:**

\_\_\_\_\_  
Signature of director

\_\_\_\_\_  
Signature of director/secretary

\_\_\_\_\_  
Name

\_\_\_\_\_  
Name

**EXECUTED for Zurich Financial Services Australia Limited (ABN 11 008 423 372) under common seal in the presence of:**

\_\_\_\_\_  
Signature of director

\_\_\_\_\_  
Signature of director/secretary

\_\_\_\_\_  
Name

\_\_\_\_\_  
Name

**The promises given by APRA in favour of the Zurich entities and any other Zurich Group companies (which are not a party to this undertaking) are intended to be directly enforceable by each entity which has the benefit of a promise by APRA. These undertakings operate as a Deed Poll by APRA in favour of those entities. Moreover these undertakings are accepted by APRA under subsection 126(1) of the Act:**

**EXECUTED FOR THE AUSTRALIAN )  
PRUDENTIAL REGULATION AUTHORITY )  
UNDER COMMON SEAL IN THE PRESENCE OF: )**

\_\_\_\_\_  
Ross Jones  
Deputy Chair  
*print name*

.....  
Thea Rosenbaum  
Secretary

on 25 May 2005