Financial Services Authority

FINAL NOTICE

To: General Reinsurance UK Limited

Of: 55 Mark Lane
London
EC3R 7NE

Date: 21 November 2006

TAKE NOTICE: The Financial Services Authority of 25 The North Colonnade, Canary Wharf, London E14 5HS ("the FSA") gives you final notice about a requirement to pay a financial penalty.

1. THE PENALTY

1.1. The FSA gave General Reinsurance UK Limited (formerly known as General Reinsurance Limited, General Re Europe Limited and GeneralCologne Re UK Limited) ("the Firm") a Decision Notice on 15 November 2006 which notified the Firm that pursuant to section 206 of the Financial Services and Markets Act 2000 ("the Act"), the FSA had decided to impose a financial penalty of £1,225,000 on the Firm in respect of a breach of Principles 2 and 3 of the FSA's Principles for Businesses ("the Principles") and breaches of Senior Management Arrangements, Systems and Controls Rules, ("SYSC") as detailed below.

1.2. By agreeing to settle at an early stage of the investigation, the Firm also qualified for a 30% discount, without which the penalty would have been £1,750,000.

1.3. The Firm confirmed on 13 November 2006 that it will not be referring the matter to the Financial Services and Markets Tribunal.

1.4. Accordingly, for the reasons set out below, the FSA imposes a financial penalty on the Firm in the amount of £1,225,000.

2. REASONS FOR THE ACTION

Summary

2.1. The FSA has imposed the penalty on the Firm in respect of the breaches set out below. These breaches arose due to the Firm's involvement in certain purported reinsurance transactions between 1999 and 2004. The transactions cover the period both prior to and post the adoption of the Act on 1 December 2001 ("N2"). Prior to the Act coming into force the Firm was regulated by the DTI and HM Treasury. After N2, the Firm was regulated by the FSA.

2.2. The FSA considers that the Firm's systems and controls were not sufficiently robust to enable them to identify and prevent two illegitimate purported reinsurance transactions. The fact that one transaction, initially entered into in 1999, was renewed three times to 2003, (the second and third renewals taking place post N2), and the fact the second transaction also occurred post N2 in 2003 and 2004 is particularly serious. It is the FSA's view that any reasonable systems and controls should have prevented these transactions from occurring. Further, that the failures within the Firm's systems and controls in relation to these two transactions occurred at various levels within the Firm. In particular underwriting, accounting and compliance functions were lacking and senior management failed in their oversight functions. The Firm failed to put in place adequate systems and controls to ensure that the details of the transactions were adequately assessed, monitored and managed, and subject to reasonable internal audit and compliance checks, thereby breaching Principles 2 and 3 and SYSC 2.1.1R and SYSC 3.1.1R.

2.3. The financial penalty in this case would have been significantly higher had it not been for the mitigating factors detailed in paragraph 5.5 below, including the fact that the Firm self-reported these transactions to the FSA. Without this commitment to redress, remedial action and early settlement, the financial penalty would have been substantially higher.

The Firm

2.4. The Firm is a UK subsidiary of General Re, one of the largest reinsurers in the world. The Firm operates as a direct brand reinsurer, dealing direct with its clients rather than through brokers. The Firm is authorised to carry on all classes of insurance business in the UK, with the exception of Classes 2 (sickness), 11 (aircraft), 17 (legal expenses) and 18 (assistance). The business is split into four divisions, Treaty (Casualty, Property and Marine), Casualty Facultative, Property Facultative and Marine Facultative. The business is predominantly non-proportional.

2.4 The transactions under consideration relate to business written by both the Firm and Kölnische Rückversicherungs-Gesellschaft AG ("Cologne Re"), a German subsidiary within the Gen Re Group.

3. RELEVANT STATUTORY PROVISIONS, RULES AND GUIDANCE

3.1. Section 206 of the Act provides:

"if the [FSA] considers that an authorised person has contravened a requirement imposed on him by or under this Act, it may impose on him a penalty, in respect of the contravention, of such amount as it considers appropriate."

FSA Principles for Businesses

3.2. The FSA Principles for Businesses, as set out in the FSA's handbook of Rules and Guidance, represent high level standards of business. The Principles constitute requirements imposed on authorised persons under the Act.

3.3. Principle 2 of the Principles provides:

"A firm must conduct its business with due skill, care and diligence"

3.4. Principle 3 of the Principles provides:

"A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems"

FSA Senior Management Arrangements, Systems and Controls (SYSC)

3.5. The purposes of SYSC, as set out at SYSC 1.2.1G are:

"(1) to encourage firms' directors and senior managers to take appropriate practical responsibility for their firms' arrangements on matters likely to be of interest to the FSA because they impinge on the FSA's functions under the Act;

(2) to increase certainty by amplifying Principle 3, under which a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems; and

(3) to encourage firms to vest responsibility for effective and responsible organisation to specific directors and senior managers."

3.6. SYSC 2.1.1R provides:

"A firm must take reasonable care to maintain a clear and appropriate apportionment of significant responsibilities among its directors and senior managers in such a way that:

(1) it is clear who has which of those responsibilities; and

(2) the business and affairs of the firm can be adequately monitored and controlled by the directors, relevant senior managers and governing body of the firm."

3.7. SYSC 3.1.1R and 3.1.2G provide:

"A firm must take appropriate care to establish and maintain such systems and controls as are appropriate to its business.

(1) The nature and extent of the systems and controls which a firm will need to maintain under SYSC 3.1.1R will depend upon a variety of factors including:

(a) the nature, scale and complexity of its business;

(b) the diversity of its operations, including geographical diversity;

(c) the volume and size of its transactions; and

(d) the degree of risk associated with each area of its operation."

4. FACTS AND MATTERS RELIED ON

Improper Reinsurance

4.1. Insurance transfers the risk of a potential loss from the insured to the insurer in exchange for a premium. Reinsurance is where one party, the reinsurer, for a premium agrees to indemnify the reinsured, for part or all of the liability assumed by the reinsured in respect of insurance which it has issued.

4.2. A traditional reinsurance contract is designed to protect the insured or reinsured from unexpected or cumulative claims. The company selling the protection (the reinsurer) provides compensation for the underwriting loss in exchange for a premium. The insured or reinsured effectively exchanges an uncertain and potentially volatile position (that is exposure to claims from its customers) for a certain and stable position (that is payment of a premium).

4.3. A key characteristic and consequence of legitimate reinsurance is the transfer and assumption of risk. In the transfer and assumption of risk one may distinguish between underwriting risk and timing risk. Either or both is required for a contract to be properly treated as one of reinsurance. Underwriting risk is the uncertainty as to whether a claim will occur and/or the amount of any such claim. Timing risk is the uncertainty as to when a claim will be made.

4.4. It is the FSA's view that the transactions in this case were designed without legitimate commercial purpose and effect, and therefore represented improper reinsurance transactions.

4.5. This view has been proactively disclosed by the FSA to the Irish, US and German regulators with particular reference to the misconduct identified in relation to the Circular Transactions.

The Transactions

4.6. Two transactions have been considered. The first was a circular set of transactions entered into between 1999 and 2003, and the second a compensation layer transaction placed in 2004. Both transactions were entered into for an illegitimate purpose and as a consequence contained no or insufficient risk transfer to be treated for accounting and regulatory purposes as reinsurance.

The Circular Transactions

(1) This series of transactions took place from 1999 to 2003, and were structured so as to accommodate the needs of a German insurer and its Irish subsidiary; both were longstanding clients of Cologne Re. The purpose of the transactions was to enable the German insurer's Irish subsidiary to reduce the amount of connected third party business, and increase the required proportion of its business with independent third parties, so as to achieve tax advantages.

(2) Cologne Re wrote a share of the German parent's business from which it derived considerable profit, even after contractual profit commission. It was agreed between Cologne Re and the German parent that profit would be returned to the German parent. To facilitate this it was agreed that the Irish subsidiary would be offered business through the medium of the Firm so as to derive the tax advantage referred to above. As a previously unconnected party, the Firm was approached by Cologne Re to enable this transfer of funds. The Firm was therefore used to cede a part of their business to the Irish subsidiary, and facilitate the movement of funds for an illegitimate purpose between Germany and Ireland.

(3) The transaction, structured in the guise of a reinsurance contract that enabled this transfer of monies, was a US$15m xs US$15m clash cover retrocession (save for the third renewal when a catastrophe excess of loss retrocession was put in place). In essence the contract provided that the Irish subsidiary indemnify the Firm should the Firm suffer losses caused by an accumulation of retentions from the internal retros held by each of the six underwriting departments within the Firm.

(4) In order to transfer funds from Germany to the UK and to compensate the Firm for the premium it had paid pursuant to the retrocession agreement with the Irish subsidiary, the Firm was offered inwards motor physical damage catastrophe cover by Cologne Re for each year of cover. Over the relevant period, the premium paid by Cologne Re to the Firm under the inwards contracts equalled that paid by the Firm to the Irish subsidiary.

(5) The outwards cover (the clash cover retrocession), although arguably realistically structured, was written for an artificial purpose, namely, to enable monies to be transferred to the Irish subsidiary. Similarly, the inwards cover (motor physical damage catastrophe cover) was designed solely as a mechanism to compensate the Firm for the payment to the Irish subsidiary by transferring funds from Germany to the UK.

(6) Further, the Circular Transactions were initiated and entered into either towards the end of or after the expiry of the policy period, when it would be known to the parties that losses would not be likely to be incurred.

(7) In conclusion the substance of the transactions was not representative of traditional reinsurance contracts. It is the FSA's view that the primary purpose of the Circular Transactions was to facilitate the movement of monies in order to obtain tax advantages for the Irish subsidiary, and as such the transactions were motivated by an illegitimate purpose. As a consequence there was an absence of legitimate risk transfer in the transactions as no claims were expected under these purported reinsurance contracts.

The Compensation Layer

(8) In and around December 2003 the Firm agreed to provide reinsurance cover to a UK based insurer in respect of its Motor portfolio. The Firm was to support the treaty programme for the layers above £1 million with a signed line of 25%. All other reinsurers on the programme agreed to a deduction of 10% (50% of which was payable to the insured and the remaining 50% to the broker). It was also agreed that the Firm would allow a 5% rebate from the gross rate as a reflection of its direct relationship with the insured. However,

the insured did not want the Firm to receive a differential premium to that received by its other reinsurers, who had participated in the treaty programme through the broker.

(9) It was agreed that the Firm would accept the same net premium as the other reinsurers. However, it would be compensated by the creation of a treaty layer in addition to its treaty programme.

(10) The cover was designed to be at a level where there would be no claims. Whilst it is acceptable for a cover to be remote, it is the FSA's view that this treaty layer functioned simply as a mechanism to compensate the Firm for premium lost on other layers of the programme, and as such the transaction was motivated by an improper purpose.

5. FACTORS RELEVANT TO DETERMINING THE ACTION

Penalty

5.1. In consequence of the above actions, the FSA finds that the Firm is in breach of Principles 2 and 3 of the Principles and relevant SYSC Rules. The FSA has therefore imposed a penalty pursuant to section 206 of the Act in respect of those contraventions.

5.2. The FSA's policy in relation to financial penalties is set out at Chapter 13 of the Enforcement Manual, which forms part of the Handbook. The principal purpose of financial penalties is to promote high standards of regulatory conduct by deterring firms who have breached regulatory requirements from committing contraventions, helping to deter other firms from committing contraventions and demonstrating generally to firms the benefits of compliant behaviour (ENF13.1.2). The level of financial penalty should take into account all the relevant circumstances of the case. In setting the level of penalty in this case, the FSA has had regard to the following matters in particular.

The Seriousness of the Misconduct or Contravention

5.3. The Firm is a subsidiary company of Gen Re Group which is one of the largest reinsurers in the world. The Firm has the financial resources at its disposal to ensure that its internal arrangements are compliant.

5.4. The FSA considers that the Firm's systems and controls between 2001 and 2004, in relation to the two transactions under investigation, were inadequate and therefore constituted a breach of the Principles, in a number of respects. Specifically:

(1) Although there was an escalation of the transactions under consideration to senior management both within the Firm, and, to a limited extent, the wider Gen Re Group, there were inadequate systems and controls in place to ensure that the details of the transactions were adequately assessed, monitored and subsequently managed. This led to a failure within the Firm to acknowledge that the transactions had been designed for an improper purpose and as a consequence contained either no or insufficient risk to be accounted for as reinsurance;

(2) The Firm's oversight functions failed to properly assess the purported reinsurance transactions, and as a result failed to assess the professional, ethical and regulatory risks that resulted;

(3) In the absence of clear, communicated control parameters set by senior management and/or any internal compliance department, the purported reinsurance transactions were entered into without sufficient due diligence and verification procedure being satisfactorily followed at the Firm; and

(4) There were inadequate systems and controls governing the monitoring and assessment of client business derived from within Cologne Re in relation to the Circular Transactions set out above. The independent verification or underwriting of the business derived from Cologne Re was not undertaken.

Conduct following the contraventions and mitigating factors

5.5. The FSA acknowledges the significant assistance and cooperation it has received from the Firm during the course of its investigation. The FSA also notes that:

(1) the Firm self-reported both transactions that formed the subject of our investigation, and recognised that they were not legitimate uses of reinsurance and as a result transferred insufficient risk to be treated as reinsurance contracts;

(2) the Firm has undertaken its own significant internal investigation into various reinsurance transactions with the assistance of external advisors to check that no other improper transactions had been entered into;

(3) the Firm has undertaken internal disciplinary action;

(4) the failings identified in relation to the two transactions occurred under the previous management team. The current management team has endeavoured to implement adequate systems and controls (including in the area of risk transfer) and enhance the Firm's compliance function;

(5) the two transactions identified are not representative of the many legitimate transactions that form the Firm's reinsurance portfolio; and

(6) no previous regulatory action has been taken against the Firm.

6. DECISION MAKER

6.1. The decision which gave rise to the obligation to give this Final Notice was made by the Executive Settlement Decision Makers on behalf of the FSA.

7. IMPORTANT

7.1. This Final Notice is given to you in accordance with section 390 of the Act.

Manner of and time for Payment

7.2. The financial penalty must be paid in full by the Firm to the FSA by no later than 5 December 2006, 14 days from the date of the Final Notice.

If the financial penalty is not paid

7.3. If all or any of the financial penalty is outstanding on 6 December 2006, the FSA may recover the outstanding amount as a debt owed by the Firm and due to the FSA.

8. Publicity

8.1. Sections 391(4), 391(6) and 391(7) of the Act apply to the publication of information about the matter to which this notice relates. Under those provisions, the FSA must publish such information about the matter to which this notice relates as the FSA considers appropriate. The information may be published in such manner as the FSA considers appropriate. However, the FSA may not publish information if such publication would, in the opinion of the FSA, be unfair to you or prejudicial to the interests of consumers.

8.2. The FSA intends to publish such information about the matter to which this Final Notice relates as it considers appropriate.

9. FSA contacts

9.1. For more information concerning this matter generally, you should contact Tom Spender of the Enforcement Division of the FSA (direct line: 020 7066 1858 /fax: 020 7066 1859).

Jamie Symington
Head of Wholesale
FSA Enforcement Division