



HIH Case Study

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Conclusions presented in this Case Study are based on my reading of the HIH Royal Commission Report and related material, but are not necessarily an accurate reflection of the Royal Commission's findings or APRA's views.

- Since '98, the prudential regulator of banks, insurers & pension schemes in Australia
- An operationally independent government agency funded by industry levies
- Adopts the usual techniques, eg:
 - licensing, capital, governance standards
 - scrutiny by actuaries & auditors
 - Surveillance & enforcement
- Sister regulator ASIC is responsible for disclosure & companies

- HIH insurance reported \$A940m capital at June 2000, then failed in March 2001 with an estimated deficiency of up to \$A5.3b
- An apparent turnaround of some \$A6b in under a year - how can that be possible?
- Likely to be Australia's largest corporate collapse to date
- AUD1 = USD0.7 = EURO0.6 at august 2006

- Liquidators:
 - Australia: McGrath+Nicol (formerly KPMG)
 - UK: KPMG
 - USA: Californian Liquidation Office
- First payment to creditors 5¢ in \$ in 2006
- Ultimate payment expected to vary from 5¢ to 50¢ in \$ for different creditor groups
- Major creditors include:
 - Australian government
 - State governments
 - Legal & medical PI schemes



- Under-pricing for quick market share
- Underwriting losses accumulate over time
- Losses hidden (flawed systems, false accounts)
- Under-provisioning of outstanding claims
- Policy of thin capitalisation
- Increasing cash-flow pressures

- The impact on retail policyholders, in particular, was dramatic
- Professional groups, community groups, small business owners, homeowners and injured individuals were left stranded with unpaid claims for:
 - Professional indemnity
 - Public liability
 - Home warranty
 - Accident & disability
 - Travel etc

- Australia does not have an ongoing policyholder protection or compensation scheme in place
- An exception is state government arrangements for certain compulsory classes, eg workers compensation
- Any national arrangements to compensate policyholders are established on a case-by-case basis after a failure
- Following the collapse, the Australian Government established the HIH claims support scheme for policyholders meeting specific eligibility criteria

- In August 2001, the Australian Government established a Royal Commission to investigate the circumstances surrounding, and the factors contributing to, the HIH collapse, and to make recommendations to minimise the risk of future failures
- In April 2003, the Royal Commission reported its findings

- The losses were not due to fraud or theft - rather, chronic under-provisioning meant the money was never there in the first place
- Ongoing claims on under-priced past policies were met out of current income, creating a spiral that could not continue indefinitely
- In addition to under-provisioning, there was not enough capital to absorb large losses

- senior managers, auditors and regulators of HIH failed to detect the warning signs, or remedy or report the underlying problems
- acquisitions were made and organic expansion pursued without due diligence
- information systems lagged business expansion and were unreliable & inadequate
- the management ignored or concealed the steadily deteriorating financial position

- The last years of HIH were marked by poor leadership, inept management, and a culture of indifference to, or deliberate disregard for, the underlying problems
- Accounts were falsified and the insurer's external auditors, actuaries and regulators were deceived
- The RC report can be found at:
www.hihroyalcom.gov.au

- Under Australia's accounting and regulatory requirements, insurers could manipulate their technical provisions, eg for profit smoothing
- Claims liability valuation:
 - Actuarial advice not mandated
 - Safety margin not mandated
 - Choice of discount factor not prescribed
- Minimum capital requirement not risk based

- The Palmer report (commissioned by APRA, available at www.apra.gov.au) and royal commission report were critical of APRA
- Although APRA did not cause or contribute to the collapse of HIH, it did fail to:
 - Detect warning signs
 - Follow up information gaps, and
 - Make effective use of its powers
- Once established, APRA was too slow in recognising the need, and to act, to recruit & develop extensive insurance expertise

- In the years following the HIH collapse:
 - Professional indemnity insurance
 - Public liability insurance
 - Home warranty insurancebecame unavailable or unaffordable for many
- A number of professional groups, community groups and small business owners became uninsured or resorted to unregulated 'insurance'

ICP7 - Suitability of Persons

(Fit & Proper - key personnel have requisite ability & integrity to conduct insurance business)

- HIH CEO - jailed on ASIC charges
- HIH CFO - charged by ASIC, disqualified by APRA
- FAI CEO - jailed on ASIC charges
- FAI CFO - charged by ASIC, disqualified by APRA
- Gen re Aust CEO - disqualified by APRA
- Gen re Aust CFO - disqualified by APRA
- 20+ other personnel jailed, charged, or disqualified
- A number of other personnel still under assessment

ICP9 - Corporate governance

(Board responsible for regulatory & legal compliance, and disclosure)

- Board ineffective - deferred to dominant CEO, misled by management, abrogated responsibility

ICP10 - Internal Control

(Decisions properly authorised, systems reliable, internal audit unfettered)

- Major decisions made without due diligence, systems flawed, audit committee controlled by management, internal audit ignored

ICP12 - Reporting to Supervisors and off-site monitoring

(Supervisors receives necessary information to conduct effective off-site monitoring)

- financial reports based on flawed systems, manipulated by management, unreliable, Supervisor mislead

ICP14 - Preventive & corrective measures

(Supervisor should follow-up weaknesses identified and takes preventive and corrective measures)

- regulator failed to notice warning signs, failed to probe & follow up

ICP15 - Enforcement or Sanctions

(powers to give business directions, replace management, ban individuals)

- powers not used

ICP16 - Winding-up and exit from the market

(procedures for insolvent insurers, policyholders protection)

- liquidators managing wind-up, no ex ante policyholder protection scheme

ICP20 - Liabilities

(Adequate technical provisions - standards for claims liabilities valuation, compliance checks)

- Actuarial advice not mandated, safety margin not mandated, choice of discount rate not prescribed

ICP23 - Capital Adequacy and Solvency

(Capital requirements risk based, reinsurance involves genuine risk transfer)

- Minimum capital requirement not risk based, rules requiring genuine risk transfer ignored

Hand out - HIH Corporate History, UK Operations, US operations, Acquisition of FAI, Liability Valuations, Finite Reinsurance, 3 Reinsurance Transactions

4 Questions

- 1) Identify the groups of personnel who contributed to HIH's downfall and what part they played.
- 2) Identify the risk areas that proved to be most material to HIH's downfall.
- 3) With hindsight, what measures would have helped avoid HIH's downfall?
- 4) Consider the FAI-NI reinsurance contract outlined above, and assess:
 - a) whether this arrangement should be booked by FAI as traditional reinsurance or financial reinsurance, and why,
 - b) what the true purpose of the arrangement is for FAI,
 - c) what questions the external auditor and regulator should be asking about the arrangement,
 - d) what the maximum potential dollar commercial value of the arrangement is to FAI as at July 1997, assuming it were correctly booked.