International Forum of Insurance Guarantee Schemes
2016 Asian Meeting

Why and How Insurance Companies Fail?

HIH Insurance Limited- a case study

Jennifer Balding
Senior Manager - Forensic Analysis & Enforcement
Australian Prudential Regulation Authority
18 April 2016

Agenda

1. History of HIH Insurance - failure in 2001 and impact
2. HIH Insurance Royal Commission
3. Why did HIH fail?
    - Poor underwriting practices
    - Under-provisioning
    - Under-provisioning - the cover up
    - Poor governance
    - Poor risk culture
    - Aggressive acquisition strategy with inadequate due diligence
4. Regulatory / Government response

1. History of HIH Insurance

HIH Insurance failed in March 2001

- **Australia's 2nd largest insurer – dominated liability classes**
- **5 authorised insurers/240 corporate entities**
- **Estimate of losses/shortfall:**
  - ➢ initially A$800 million/US$605m
  - ➢ later A$3.6 - $5.3 billion/US$2.7-$4bn – Australia's largest corporate collapse
- **HIH established in 1968 by Ray Williams (CEO) and others**
- **Listed on Australian Stock Exchange in 1992**
- **During late 1990's:**
  - ➢ extensive expansion in UK and US
  - ➢ significant Australian acquisitions

1. History of HIH Insurance (cont'd)

Impact of HIH's failure

- **HIH's collapse had a dramatic impact, particularly retail policyholders**
- **Professional groups, community groups, small business owners, homeowners and injured individuals left stranded with unpaid claims for:**
  - Professional indemnity/Public liability
  - Home warranty/builder's indemnity
  - Accident & disability
  - Travel etc.
- **Also lack of cover available in market for some of these lines (at comparable prices - cover had been under-priced by HIH)**
- **In May 2001:**
  - Government-funded support scheme for HIH policyholders - A$500 million
  - Establishment of Royal Commission to examine collapse

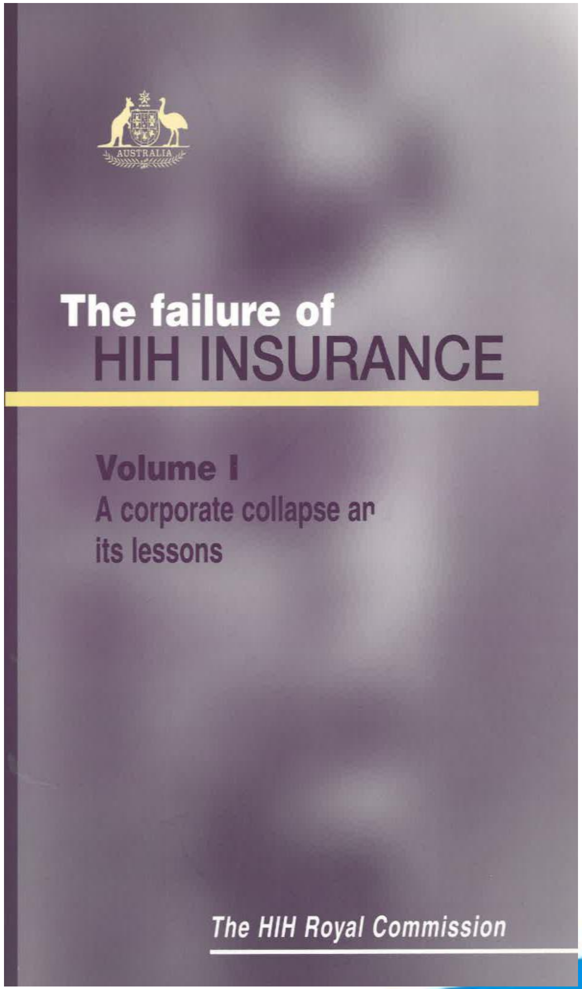
2. HIH Royal Commission

Aug 2001 - HIH Royal Commission established

- Inquire into reasons for the collapse of the HIH Insurance Group

Terms of reference included:

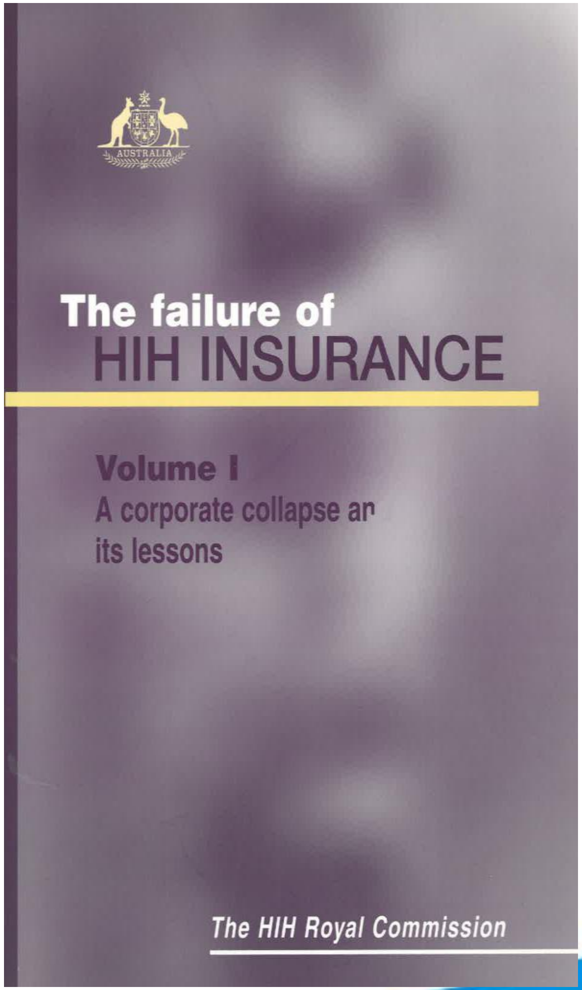
- Whether any of its directors, actuaries etc. contributed to the failure and should be referred for criminal or other legal proceedings
- Focus on any undesirable corporate governance practices and failure to properly disclose financial position of HIH
- Appropriateness of use of regulatory powers by government authorities (including APRA)
- Adequacy and appropriateness of regulation and prudential supervision of general insurance



2. HIH Royal Commission (cont'd)

HIH Royal Commission Report - 4 April 2003

- **3 Volume Report – includes chapters on:**
  - Provisioning and reinsurance
  - Corporate governance
  - Financial reporting and assurance
  - Regulation of general insurance
  - Policyholder support scheme
- **There were 56 referrals of potential misconduct by individuals to ASIC (corporate regulator)**



3. Why did HIH fail?
- Poor underwriting practices

- **Under-pricing for quick market share**

- **Underwriting losses accumulated over time**
  - ➢ Industry accepted position of negative underwriting results offset by investment income
  - ➢ Significant deterioration in claims experience - claims met out of current income

- **Significant exposures underwritten in the liability lines**
  - ➢ Cover written in areas where underwriters had insufficient or no experience
  - ➢ Concentration of large exposures in risky business lines, examples included:
    - Minets International Professional Indemnity (MIPI) - Big Six Australian accounting firms
    - Attorney's Liability Assurance Scheme (ALAS) - American attorney's liabilities
    - US Crane drivers
    - Jamuna Bridge – Bangladesh - 5.6 km bridge, completed 1998
  - ➢ Coupled with weaknesses in provisioning/reserving and claims management led to problems

3. Why did HIH fail?
- Under-provisioning

- **Shortcomings in requirements for valuation of claims liabilities**
  - ➢ Actuarial advice not mandated
  - ➢ Prudential (safety) margin not mandated
  - ➢ Choice of discount factor not prescribed

  (subsequently addressed by improvements in prudential framework – see slide 19)

- **Chronic/systemic under-provisioning**
  - ➢ Significant under-reserving problems either not identified or not addressed

- **Inadequacies in claims divisions practices**
  - ➢ Case estimates deliberately set to nominal amounts
  - ➢ Aggressive valuation assumptions
  - ➢ Manipulation of individual case estimates
  - ➢ Failure to properly deal with broker 'bordereaux'

3. Why did HIH fail?
- Under-provisioning (cont'd)

- **No real understanding by the Board of how claims reserves were set**
  - Failure to understand/appreciate the importance of group's single largest liability: provision for outstanding claims
  - Over-reliance by Board on reports from independent actuaries and assessments by auditors
    - No testing or questioning of critical assumptions eg. discount rates and claims handling costs
    - Actuary's reports not tabled at board meetings and actuaries did not meet with the Board

3. Why did HIH fail?
- Under-provisioning - the cover up

Reasons for the failure: a broad perspective

'HIH is not a case where wholesale fraud or embezzlement abounded. Most of the instances of possible malfeasance were borne of a misconceived desire to paper over the ever-widening cracks that were appearing in the edifice that was HIH.'

(HIH RC Report Volume 1 page xvi)

3. Why did HIH fail?
- Under-provisioning - the cover up

- **Significant under-reserving problems identified but not addressed**
  - July 1997: FAI’s public liability exposures A$40 million under-reserved
  - Dec 1997: FAI’s professional indemnity portfolio A$112 million under-reserved
- **1998 FAI entered into ‘financial reinsurance’ with Gen Re**
  - Reinsurance to ‘smooth’ increase in reserves and avoid reporting losses
    - FAI 30 June 1998 P&L overstated by A$35 million
  - No transfer of risk – use of side letters to remove risk
  - Auditor misled about true nature of contracts
- **Aug 1999 HIH enters into similar reinsurance arrangements with Hannover Re**
  - HIH 30 June 1999: net profit A$92.4 million
  - Avoid provision for claims liabilities and doubtful reinsurance of A$125 million

3. Why did HIH fail?
- Poor governance

Corporate governance – 'a poor role model'

'HIH had a corporate governance model. The directors said so in the annual reports. But there is little, if any, evidence that the board periodically assessed the company's corporate governance practices to ensure that they were, and continued to be, suited to the changing environment in which the company operated… There is little point in having a corporate governance model if the directors fail to examine periodically its practical effectiveness.'

(HIH RC Report Volume 1 page xxxiv)

3. Why did HIH fail?
- Poor governance (cont'd)

- **Systemic corporate governance failures**
  - Lack of process, policies or guidelines
  - No defined limits on authority (investments, donations/gifts)
  - A lack of independent critical analysis
  - Inadequate processes of the audit committee
  - Inadequate board oversight and ineffective chairman
  - Inadequate / misleading provision of information to the Board
  - Inadequate management of conflicts of interest/ related party transactions – misuse of company assets for personal benefit of senior executives
  - 'Unseemly dash for cash' by privileged few in HIH's dying days

- **Case study: *ASIC -v- Adler, Williams & Fodera***
  - 14 March 2002 [2002] NSWSC 174 – leading Australian case on director's duties

3. Why did HIH fail?
- Poor risk culture

'Mismanagement: a failure of culture'

'The problematic aspects of the corporate culture of HIH – which led directly to the poor decision making – can be summarised succinctly. There was blind faith in a leadership that was ill-equipped for the task. There was insufficient ability and independence of mind in and associated with the organisation to see what had to be done and what had to be stopped or avoided. Risks were not properly identified and managed. Unpleasant information was hidden, filtered or sanitised. And there was a lack of sceptical questioning and analysis when and where it mattered.'

(HIH RC Report Volume 1 page xvii)

3. Why did HIH fail?
- Poor risk culture (cont'd)

- **Poor risk culture demonstrated by:**
  - Absence of strategic planning
  - Lack of board deliberation on major transactions/acquisitions
  - Board failed to question and challenge management decisions
  - 'Private company approach'
  - Dominant personalities, particularly Ray Williams as CEO not kept in check
  - Ineffective risk identification or management of risks

3. Why did HIH fail?
- Aggressive acquisition strategy with inadequate due diligence

- **No long term strategy or plan ever critically analyzed by the Board**
  - Absence of a framework to evaluate investment and expansion decisions
  - Company growth was opportunistic/ ad hoc
  - Lacking in direction
  - Under appreciation of strategic risks
- **Entry / expansion into overseas markets - imprudent and costly**
  - ➢ **UK Operations**
  - Risky lines of business: public liability and professional indemnity
  - Lack of controls and adequate reporting structures
  - Estimated losses: A$1.7 billion

3. Why did HIH fail?
- Aggressive acquisition strategy with inadequate due diligence (cont'd)

- **US Operations**
  - Re-acquired in 1997 on limited due diligence
  - No actuarial analysis was sought – no assessment of adequacy of US reserves
  - No testing of reasonableness of assumptions eg. improvement in market conditions, profit forecasts
  - Estimated losses: A$620 million
- **FAI acquisition**
  - Due diligence refused by FAI/Rodney Adler (FAI CEO)
  - Urgent meeting of board convened on 22 September 1998
  - Inadequate time taken by the board to consider the proposal and risks
  - Scant information available
  - Significant under-reserving in FAI's long tail portfolios
  - Substantial impaired assets eg. St Moritz Hotel - New York, Emu Brewery (WA)
  - Estimated cost: A$590 million

4. Regulatory/ Government response

- **APRA regulatory action**
  - ➢ 24 individuals disqualified from holding senior roles in the insurance industry

- **ASIC regulatory action**
  - ➢ 10 individuals criminal convictions, including:
    - ➢ Ray Williams (former HIH CEO) jail term: 4 years 6 months
    - ➢ Rodney Adler (former FAI/HIH director) jail term: 4 year 6 months
  - civil penalty action against Adler, Williams and Dominic Fodera (HIH CFO): banned from acting as company directors, compensation totaling A$8 million to HIH and pecuniary penalties totaling A$1.155 million
  - Enforceable Undertaking from General Re Australia Limited - payment of A$27.2 million by General Re to the liquidator of the HIH Group

4. Regulatory/ Government response

- **Changes to the legislative and prudential framework already underway at the time of HIH's failure**
  - collapse accelerated reform, escalated its perceived importance and public profile
  - APRA resources/staffing increased
  - Minimum entry-level capital requirements for general insurers were substantially increased
    - Many insurers failed to meet new requirements so were placed into run-off
- **Development of risk-based and principles-based prudential framework and supervisory approach by APRA**
  - APRA given power to make prudential standards for general insurance
    - Capital adequacy, Liability valuation, Reinsurance, Governance, Remuneration, Fit and proper, Risk management

- **2001: HIH Policyholder compensation scheme introduced**

QUESTIONS?