

## Developing Next-Gen ASEAN Insurance Leadership Talent

# HIH Case Study: The \$5 billion Question

1:45 - 4:30 pm

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The opinions expressed here are the personal opinions of the author and do not necessarily represent the views and opinions of MSIG.

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# Introduction

Objectives and Agenda

# Objectives

*HIH Case Study - Introduction*

This session aims to highlight the key aspects of:

- Corporate governance;
- Risk management; and
- Insurance provision

based on lessons learnt from the failure of HIH Insurance, Australia in 2001.



# Agenda

*HIH Case Study - Introduction*

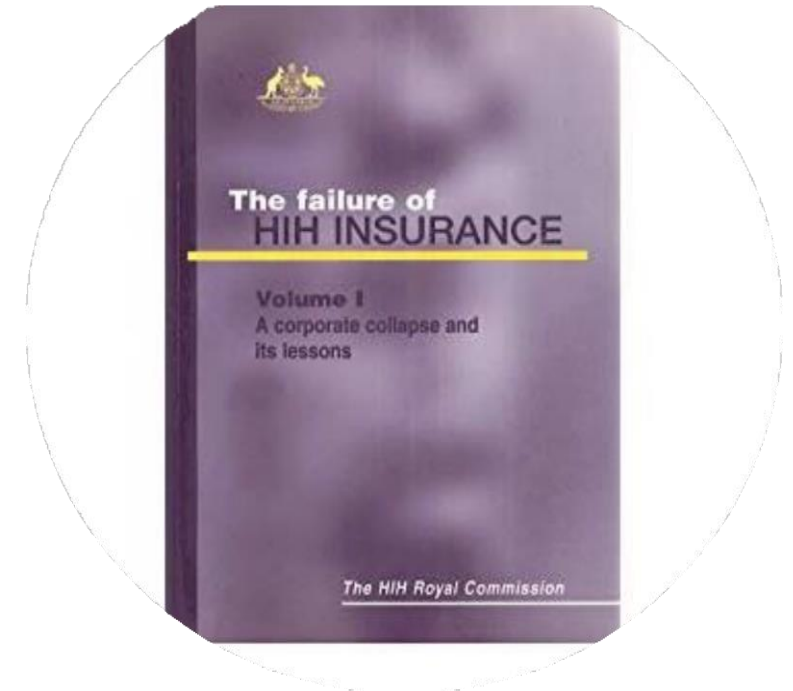
- HIH and the Main Cast
- HIH and Industry Background
- How Did This Happen?
- Disastrous Misadventures
- Under-Provisioning



# References

HIH Case Study - Introduction

- We mainly relied on “*The Failure of HIH Insurance*” published by the **HIH Royal Commission**, Australia.
  - **Royal Commissions**
    - the highest form of inquiry on matters of public importance.
  - **The HIH Royal Commission**
    - took 18 months and costed A\$40 million to prepare the 1500 page report and
    - has made 61 policy recommendations (including APRA’s governance arrangements, the regulation of general insurance and APRA’s internal processes).

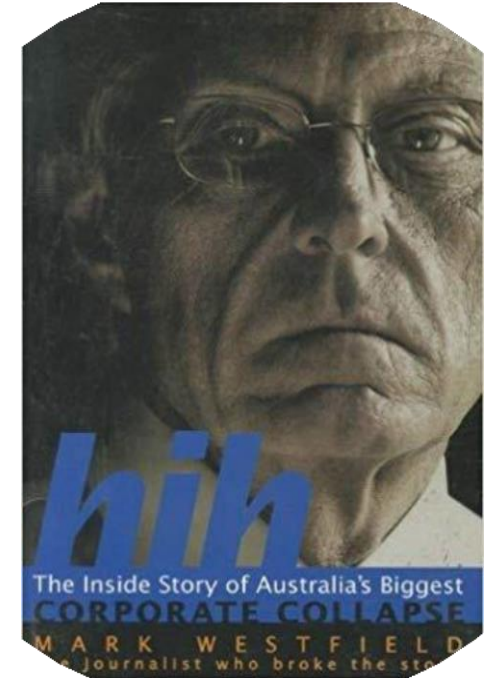




# Other references

*HIH Case Study - Introduction*

- *"HIH – The Inside Story of Australia's Biggest Corporate Collapse"* by Mark Westfield
- Wikipedia articles
- Newspaper articles
- Books
- Others



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# The Company

HIH and what happened



# The Company - HIH Insurance

HIH Case Study – the Company

- **2<sup>nd</sup> largest** non-life insurance company in Australia in early-2000.
- The collapse of HIH Insurance in 2001 was ***“the largest corporate failure Australia has endured to date”***.
- The deficiency was estimated to be between A\$3.6 billion and **A\$5.3 billion**.
- *“Shouldn’t happen in a modern economy”*





# Consequences

HIH Case Study – the Company

- ❑ Harms to individuals:  
*“About 200 permanently disabled people no longer receive their regular payments from HIH”*
- ❑ Community distress:  
*“Sport and recreation centres, including local festivals and amusement parks, have been forced out of business, either because they have been unable to find alternative insurance or because they are no longer able to afford the spiralling costs of premiums”*



# Consequences

HIH Case Study – the Company

## ❑ Harms to industry:

*"HIH was one of Australia's biggest home-building market insurers. Its collapse left the building industry in turmoil. Home owners were left without compulsory home warranty insurance"*

### HIH - Builders warranty insurance

18 Apr 2001  
01:12

One of the areas affected by the provisional liquidation of HIH Insurance Group has been builders warranty insurance.

There has been concern that builders with HIH policies would have difficulties getting replacement cover quickly and at reasonable rates. Such difficulties could have delayed the start of new construction and the completion of work already under way.

The Australian Prudential Regulation Authority (APRA) has had extensive discussions on the impact of the liquidation of HIH on the building industry, as well as with others who have done so previously. Graham Thompson, CEO of APRA said "Following these discussions we can report that the building industry - Royal & Sun Alliance and Allianz (through Delta) - are providing replacement cover for new building work on terms similar to those available before HIH's provisional liquidation."



# Consequences

HIH Case Study – the Company

## HIH rescue package announced

22/05/2001

The Federal Government has announced a rescue package for victims of the HIH Insurance collapse which will see policyholders with outstanding claims receive all or most of what's owed to them. The Government has also bowed to pressure and agreed to a Royal Commission to report on both the insurer's failure as well as the regulation of the insurance industry. The \$500 million hardship package will help fund claims made by individual Australians and small businesses. Claims made by non-Australian residents and businesses with over 50 employees will not qualify for the Federal Government's rescue payments. The NSW State Government also announced its own \$600 million rescue package. This is to be partly funded by a \$69 million tax imposed on the insurance companies. The likely result of this will be an increase in premiums for policyholders.



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# The Main Cast

Who's who in HIH

# Main Cast - 1

HIH Case Study – the Main Cast

## Ray Williams (businessman)

From Wikipedia, the free encyclopedia

**Raymond Reginald Williams** (born 1937) is an Australian businessperson and corporate criminal. In 2005 he was imprisoned for a minimum of two years and nine months for filing false financial statements and failing his duty as a director.<sup>[1]</sup> After Williams' criminal conviction, charities began removing his name from their donor plaques,<sup>[2]</sup> and he was stripped of his Order of Australia medal by order of the Governor-General.<sup>[3][4]</sup>

Raymond Reginald Williams	
<b>Born</b>	1937 (age 79–80)
<b>Occupation</b>	former Company director, HIH Insurance
<b>Criminal penalty</b>	four years six months imprisonment





# Main Cast - 1

HIH Case Study – the Main Cast

## Ray Williams was found guilty of :

- Failure to properly exercise his powers and discharge his duties as a director
- Authorising the issue of a prospectus by HIH Holdings (NZ) for converting notes that contained a **material omission** in October 1998. (It implied that the company underwriting the investment was playing a bigger role than it was)
- Authorising a statement in HIH's 1998-99 annual report which he knew was **misleading**. (This report overstated profit by \$92.4 million as a result of a financial arrangement that was wrongly described as reinsurance)





# Main Cast - 1

*HIH Case Study – the Main Cast*

## HIH Royal Commission. Day 131. Wayne Martin QC examining Raymond Reginald Williams

Martin: "Could you tell us please if, on your frequent first-class trips to London, you booked the seat next to you for your briefcase?"

**Williams: "I don't recall specifically. But that may have been the case, on some occasions."**

Martin: "That your briefcase was also travelling first class?"

**Williams: "That may have been the case."**

Martin: "Did you express the view to Qantas that this briefcase should be eligible for frequent flier points?"

**Williams: "I can't recall that."**

Martin: "And were you subsequently informed that said briefcase would not be eligible for such points on the grounds that it was not, in fact, a person?"

**Williams: "That may have been the airline's position on that issue."**

Martin: "Was that briefcase, from that point on, booked under the name of Casey Williams?"

**Williams: "Casey Reginald Williams, AM."**

# Main Cast - 2

HIH Case Study – the Main Cast

## Rodney Adler

From Wikipedia, the free encyclopedia

**Rodney Stephen Adler** (born 19 August 1959) is an Australian whose family founded the FAI Insurances group, of which he became Chief Executive in 1989, and which was at one stage Australia's third largest general insurer. Adler became a director of HIH Insurance after the acquisition of that company, and resigned in January 2001, two months before HIH collapsed. He was jailed in 2005 for his conduct related to the collapse of HIH, where Adler obtained A\$2 million from HIH by false or misleading statements and being dishonest as a director.<sup>[2]</sup>

<b>Born</b>	19 August 1959
<b>Nationality</b>	Australian
<b>Alma mater</b>	University of New South Wales Macquarie University
<b>Occupation</b>	Businessman, former company director



# Main Cast - 2

*HIH Case Study – the Main Cast*

## Rodney Adler was found guilty of :

- ❑ Two counts of disseminating information on 19 and 20 June 2000 respectively, **knowing it was false** in a material particular and which was likely to induce the purchase by other persons of shares in HIH contrary to Corporations Act 2001 (Cth)
- ❑ One count of obtaining money by **false or misleading statements**, contrary to Crimes Act 1900 (NSW)
- ❑ One count of being **intentionally dishonest** and failing to discharge his duties as a director of HIH in good faith and in the best interests of that company contrary to Corporations Act 2001 (Cth)



# Main Cast - 2

HIH Case Study – the Main Cast

## Back in business

finance

### Disgraced Rodney Adler back in business

RODNEY Adler is back three years after being released from jail, trying to rebuild his lost fortune.

By Sharri Markson

The Sunday Telegraph □ SEPTEMBER 12, 2010 2:23AM

RODNEY Adler is back in business three years after being released from jail, trying to rebuild his lost fortune by telling businesses how to operate ethically and avoid corporate crime.

The banned company director, jailed in 2005 on charges of dishonesty over the collapse of insurer HIH, has rejoined Sydney's business elite, acting as an adviser to at least five companies - one of which is about to float on the London stock exchange at a value of up to \$130 million.

In an interview with *The Sunday Telegraph*, Mr Adler, 51, detailed how he is remaking his life and his wealth.

"It's sad and embarrassing that I went to jail. When you do wrong you get punished. Having come out and having done my time, I have to rebuild."

# The A\$5 billion Question

HIH Case Study – the Main Cast

- How could there be a A\$5 billion dollar deficit from an insurance company?
  - Heavily regulated industry
  - Listed in stock exchange
  - Credit rating of BBB or better
  - “Big-five” auditor
  - Internal auditors
  - Internal and external actuaries
  - Directors
  - Managers



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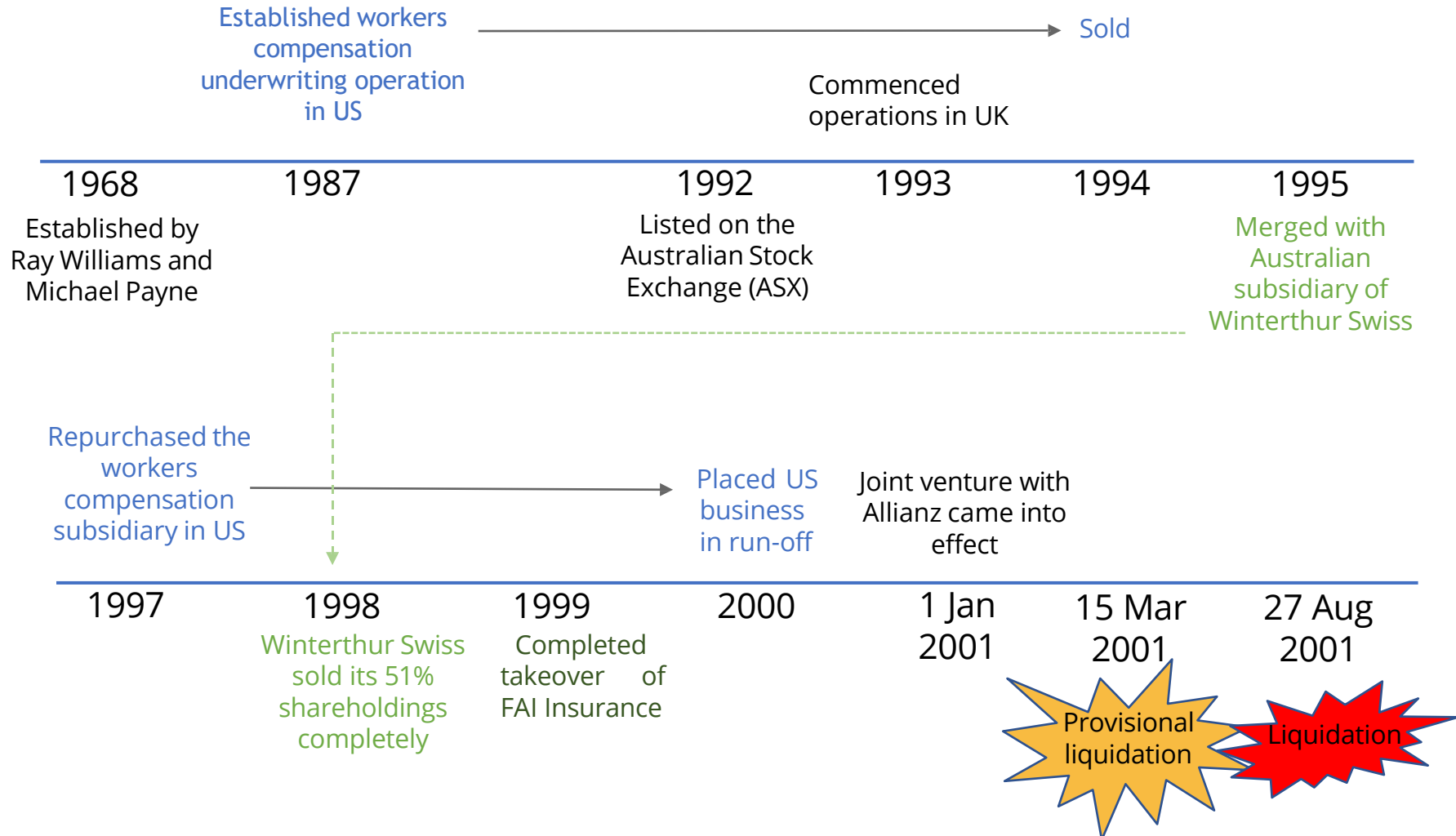
# HIH and Industry Background





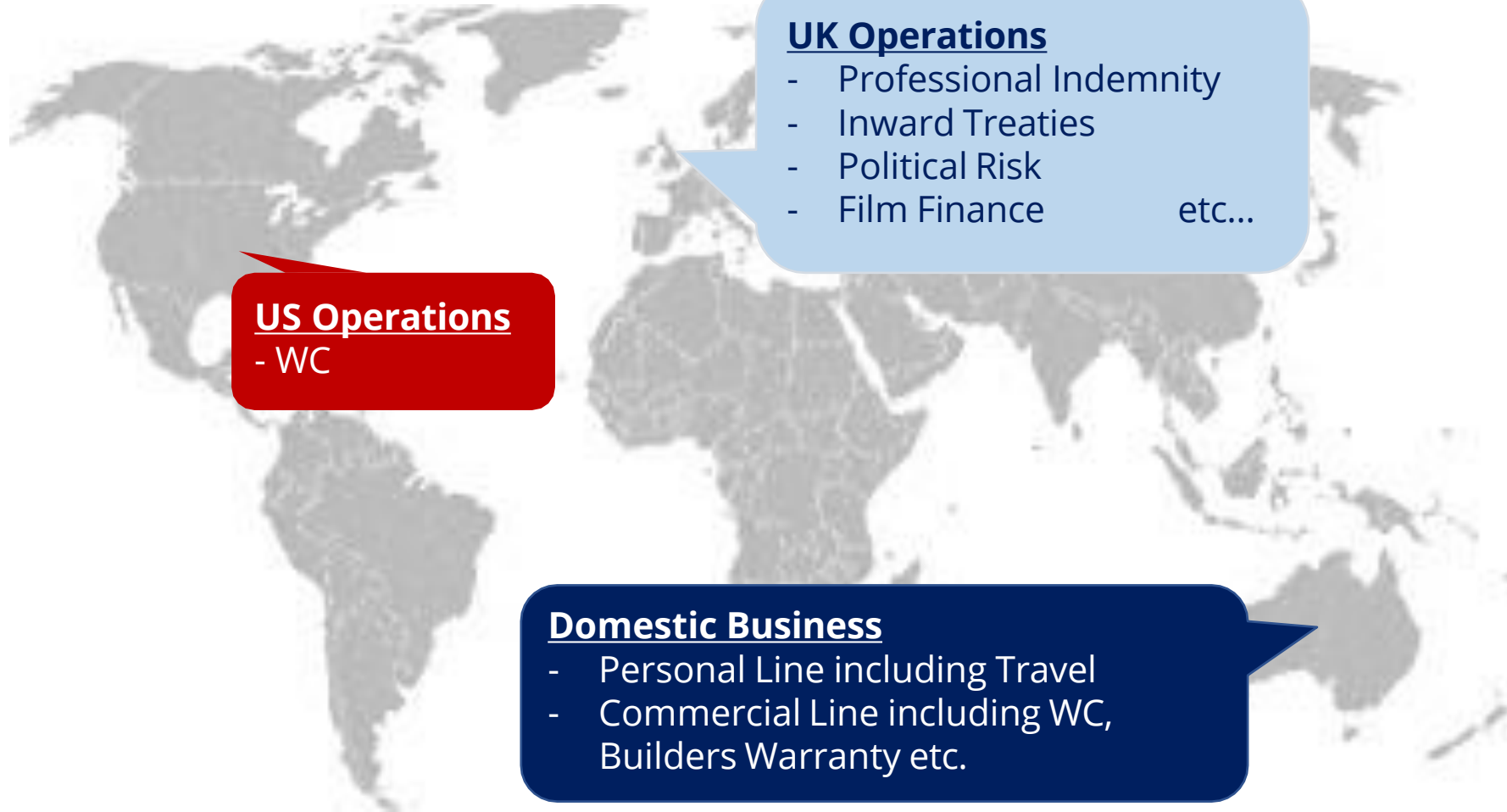
# History of HIH

HIH Case Study – HIH and Industry Background



# "Global" Operation

HIH Case Study – HIH and Industry Background



**US Operations**  
- WC

## UK Operations

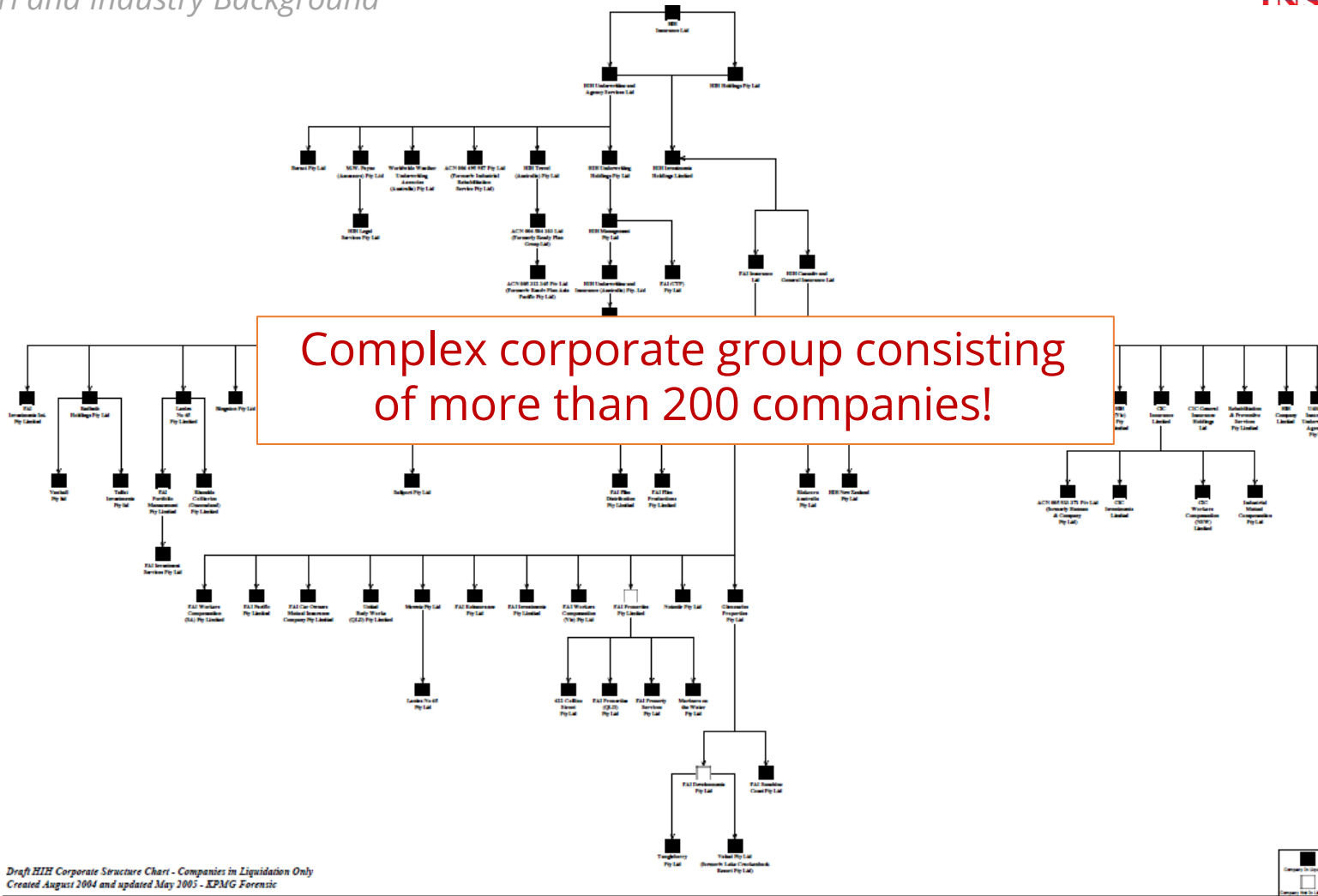
- Professional Indemnity
- Inward Treaties
- Political Risk
- Film Finance etc...

## Domestic Business

- Personal Line including Travel
- Commercial Line including WC, Builders Warranty etc.

# Corporation Chart

HIH Case Study – HIH and Industry Background

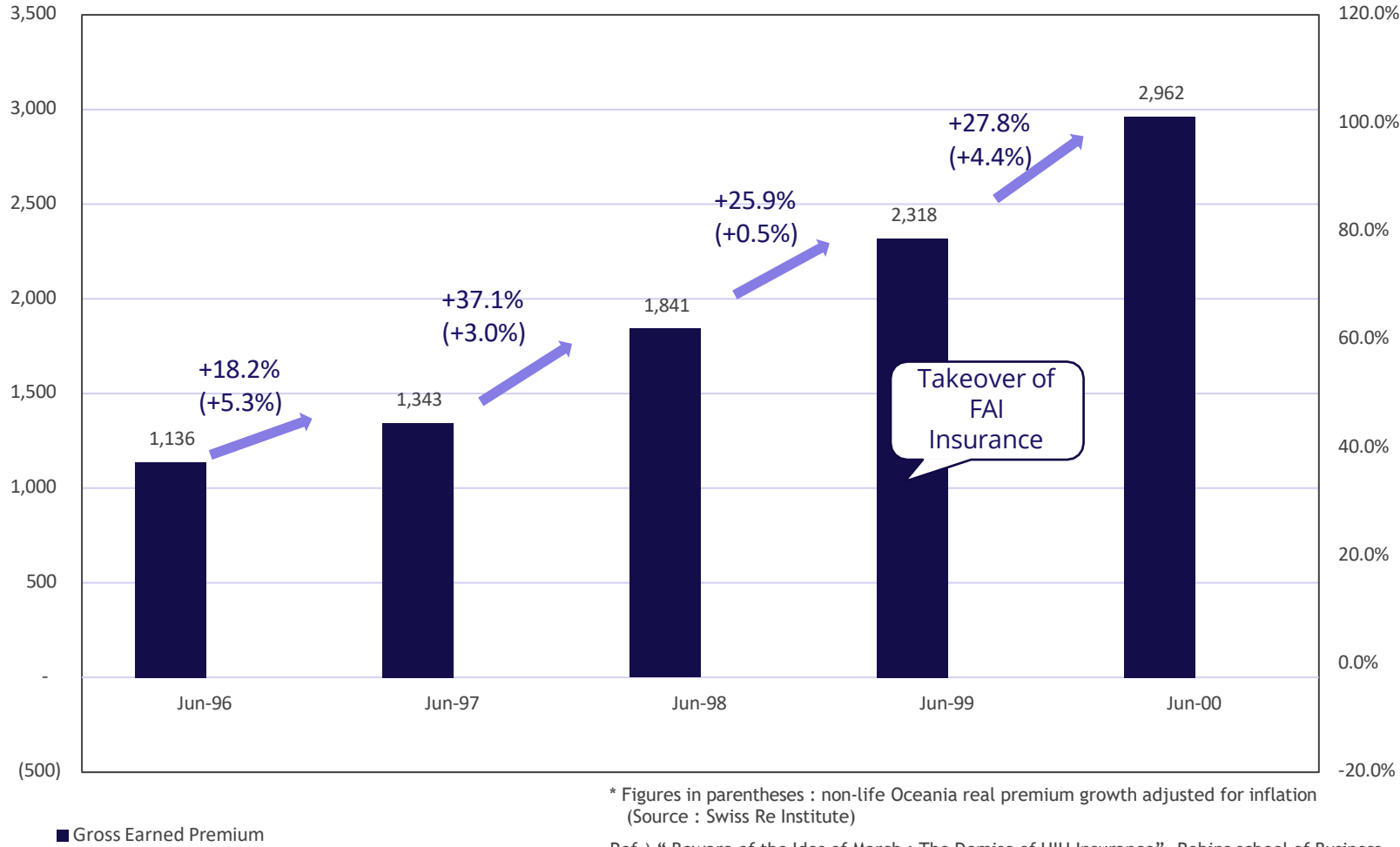


*Draft HIH Corporate Structure Chart - Companies in Liquidation Only  
 Created August 2004 and updated May 2005 - KPMG Forensic*

# HIH Background - Financial Highlights

HIH Case Study - HIH and Industry Background

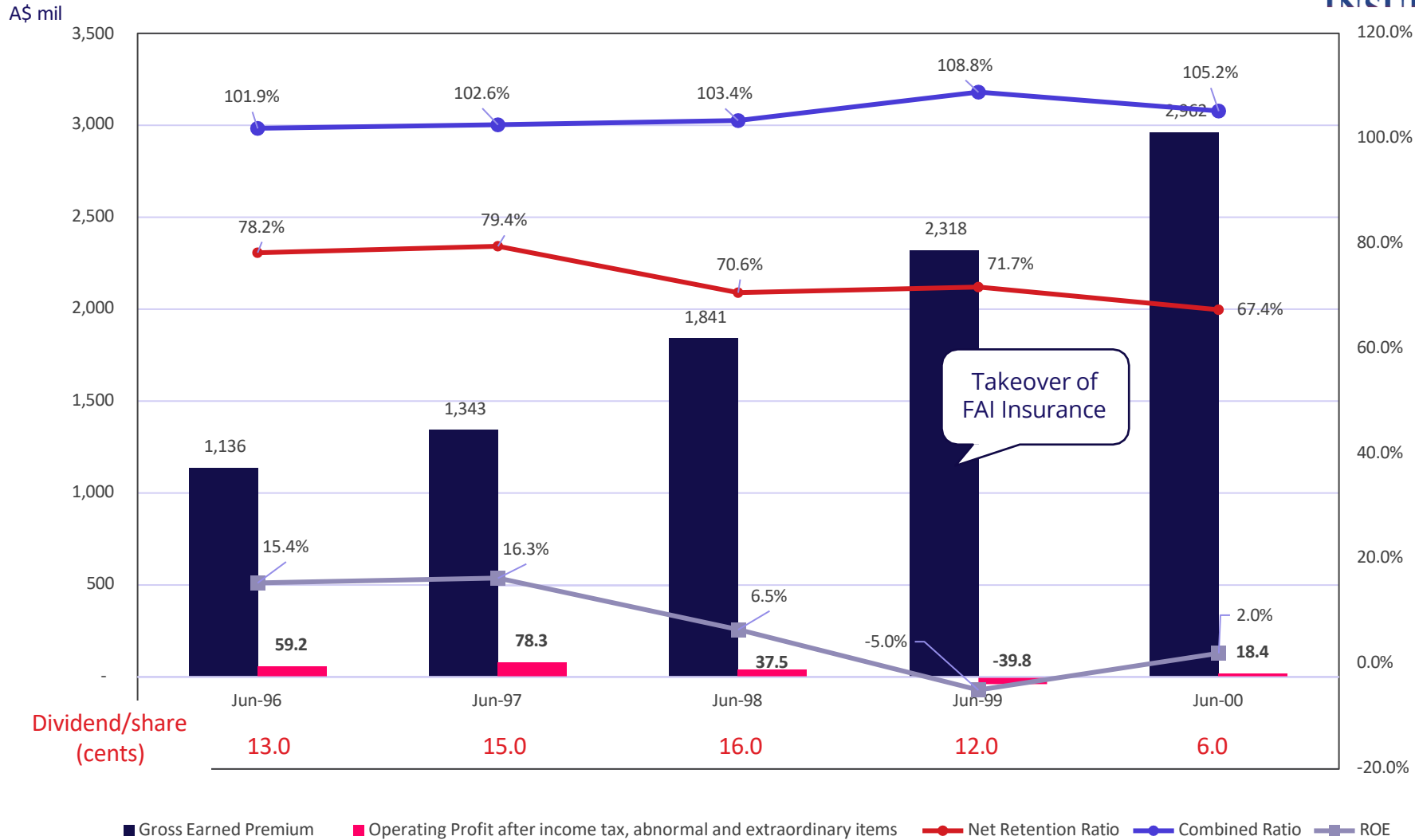
A\$ mil



\* Figures in parentheses : non-life Oceania real premium growth adjusted for inflation  
 (Source : Swiss Re Institute)

Ref.) "Beware of the Ides of March : The Demise of HIH Insurance", Robins school of Business

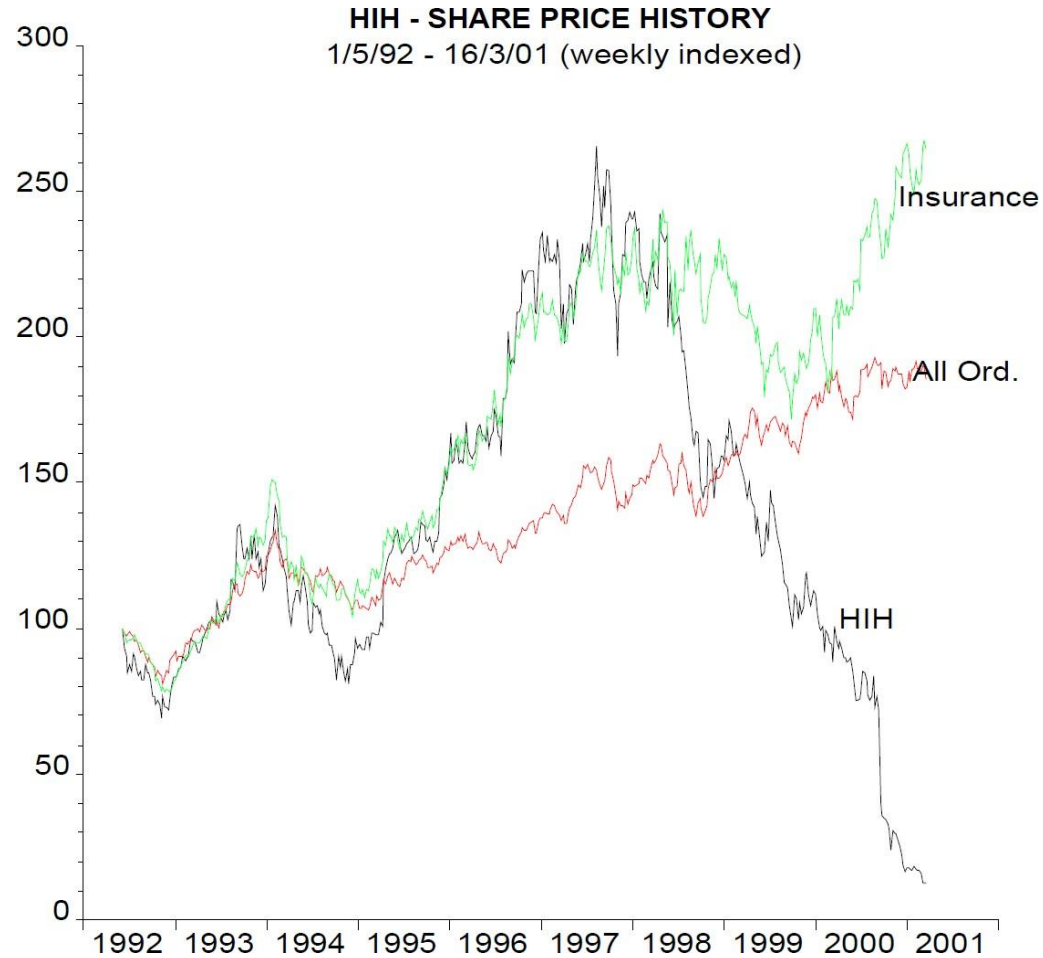
# HIH Background - Financial Highlights



Ref.) "Beware of the Ides of March : The Demise of HIH Insurance", Robins school of Business

# HIH Background - Share Price History

HIH Case Study - HIH and Industry Background





# Industry Background

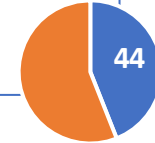
HIH Case Study – HIH and Industry Background



Net Underwriting Loss  
A\$1.5 billion

Top 5 insurance groups  
NRMA, HIH, AMP GI, Suncorp GI and  
QBE

44% Market Share in  
Australian General Insurance



Industry GWP  
A\$19.6 billion

## Year 2000

Escalating claims in long tail classes  
**inadequately reserved**



Collapse of **2 local  
reinsurers** in 1999  
and 2000  
New Cap Re and REAC



# Industry Background: Market Cycle

HIH Case Study – HIH and Industry Background

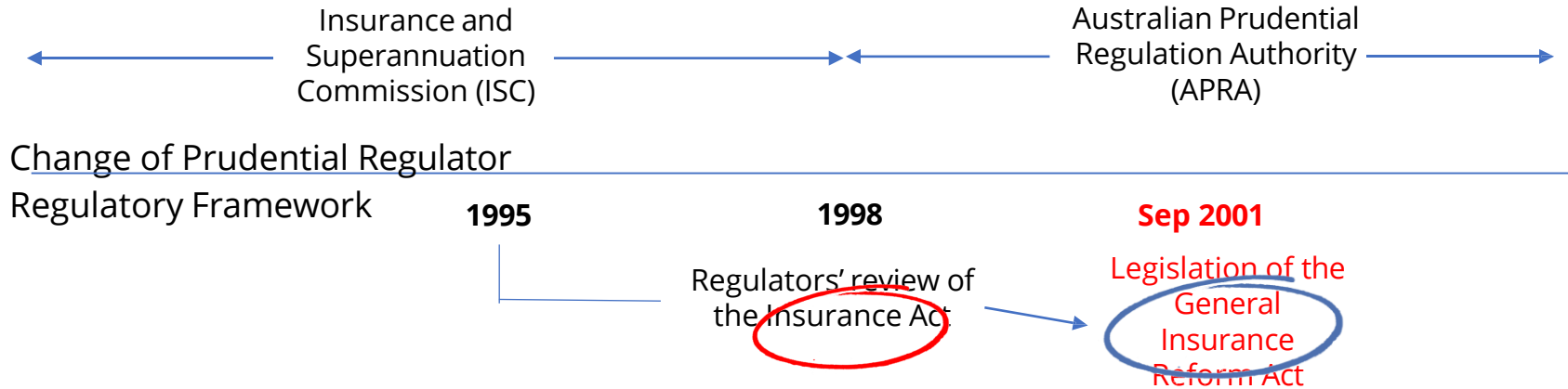
- In terms of performance, the Australian general insurance industry peaked in the mid-1990s.



Note: Paul Ingrey developed the "underwriting clock" in 1985 to illustrate the cyclical nature of the (re)insurance industry. This is a useful tool for determining the cycle's current stage.

# Regulatory Context

HIH Case Study – HIH and Industry Background



## Insurance Act

- Minimum solvency standards required that assets exceed liabilities at all times by not less than the greater of:
  - \$2 million; or
  - 20 per cent of net premium income in preceding year; or
  - 15 per cent of net outstanding claims

## General Insurance Reform Act

- Risk-based capital solvency requirements
- Mandatory prudential margin
- Approval of appropriate formal reinsurance management strategy by Board
- Fit and proper person tests for directors, senior managers, auditors and actuaries
- Greater control and requirements for auditors and actuaries

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# What went wrong?

How did this happen?

# 1. Intentional Under-Provisioning

*HIH Case Study – What went wrong?*

- **Deliberate under-provisioning:**  
*"efficient" and "smart" way to run an insurance operation.*
- **A distorted view of managing provision:**  
*"Reinsurance in place of prudential margin"*
- **Under-provisioning exacerbated**
  - by acquiring under-reserved companies and
  - rapid growth through under-pricing in long-tail products
- **Signing actuary was compromised**



## 2. Disastrous Misadventures

HIH Case Study – What went wrong?

- **A failure:** the UK operations
  - *"The combination of a lack of underwriting controls and a lack of relevant experience and familiarity in those particular lines of business was a formula for financial disaster."*
- **A second failure:** the US operations
- **A third failure:** the FAI acquisition with no due diligence
  - *"HIH proceeded with the takeover solely on the basis of its assessment of publicly available information."*
- **A camel and a straw:** the Allianz joint venture





# 3. Mismanagement

HIH Case Study – What went wrong?

- “HIH... reflected a **“private company approach”** where the hand and influence of Williams were paramount”.
- In 1995 an independent due diligence report described HIH as a:
  - “company which has **not yet made a complete transition** from an entrepreneurially run company influenced strongly by senior management and from which **senior management benefits significantly**, to that of an **ASX listed company run primarily in the interests of shareholders.**”





# 4. "Aggressive" Accounting Practice

HH Case Study – What went wrong?

- **Intangible assets made up 75 per cent of shareholders' equity!**
  - In comparison, QBE and NRMA had 4.9 per cent and 0.4 per cent goodwill, respectively.
- "increasing reliance on intangible assets to support shareholders' equity":
  - *"goodwill"*
  - *"management rights"*
  - *"future income tax benefit"*
  - *"deferred information technology costs"*
- Goodwill was allowed to be amortized over its estimated useful life. Current accounting standards do not allow amortization for goodwill. Instead, annual tests on goodwill impairment is required.



## 5. The Use and Abuse of Reinsurance

*HIH Case Study – What went wrong?*

- Reinsurance: Traditionally a mechanism to transfer risks of future adverse developments and events.
- HIH made use of “**alternative risk-transfer products**” - **financial reinsurance**.



# 5. The Use and Abuse of Reinsurance

*HIH Case Study – What went wrong?*

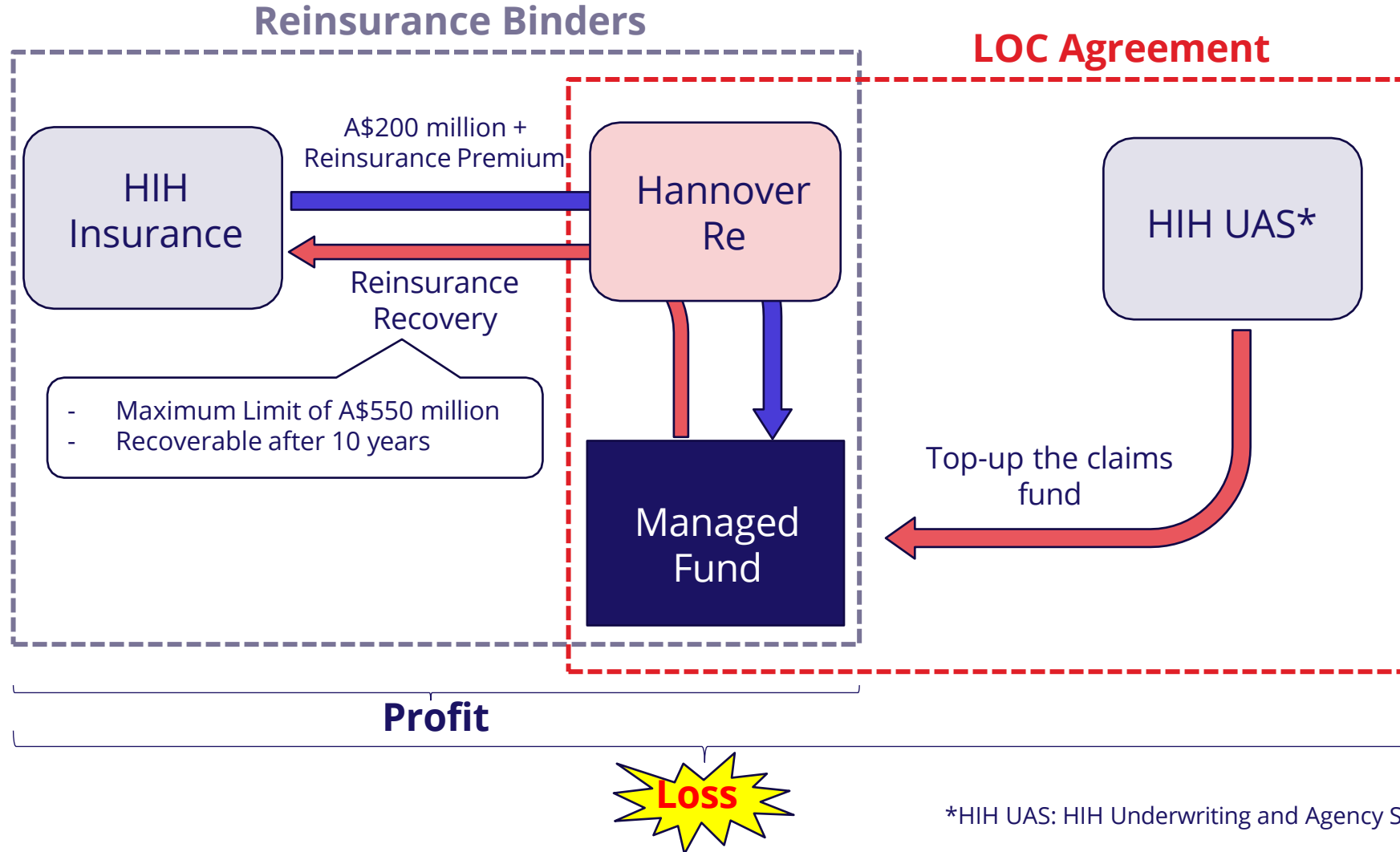
## Hannover Re

- The arrangements were documented in two reinsurance binders and in **separate agreements** relating to some letters of credit and a trust.



# 5. The Use and Abuse of Reinsurance

HIH Case Study – What went wrong?



\*HIH UAS: HIH Underwriting and Agency Services Limited

# 6. Directors' Responsibilities

HIH Case Study – What went wrong?

- **Lack of proper assessment and analysis;** too ready to accept what management says

*“The **directors appear to have expected any warnings or risks would have been brought to their notice.** If this approach were followed through to its logical extension directors would be required to do no more than react to issues raised by management—and thereby leave the board’s agenda and scope of inquiry by directors largely if not entirely to management. That is not, and cannot be, the case.”*



# 6. Directors' Responsibilities

HIH Case Study – What went wrong?

## ➤ No clear understanding of strategy

*"As one director conceded, if he had been asked to commit to writing what the long-term strategy was he would have had difficulty doing so; **the other directors struggled when asked to identify strategic directions.**"*

*"An experienced Australian company director recently commented that if a director could not articulate the strategy of the company he or she should not be on the board. I share that view, and I consider that **this is an area in which the governance of HIH was deficient.**"*



# 6. Directors' Responsibilities

*HIH Case Study – What went wrong?*

- **Failure to ensure coverage of important matters in the Board meeting agenda**
  - *“The agenda for the board was controlled by management and not by the board.”*
- **Fail to address concerns raised by non-executive directors** regarding inadequate Board involvement in important strategic matters
  - *“Head wrote to Cohen to express his unease about HIH’s corporate governance procedures. But he was not prepared to raise at board level matters that did not have Williams’s imprimatur.”*





# 7. Directors' Conflict of Interest

HIH Case Study – What went wrong?

## APRA disqualifies former Chairman of HIH

6 Oct 2005  
05.50

The Australian Prudential Regulation Authority (APRA) today announced the disqualification of Mr Geoffrey Cohen from being or acting as a director or senior manager of a general insurer under the Insurance Act 1973.

Mr Cohen was a non-executive director of HIH Insurance Limited (HIH) and Chairman of the HIH Board of Directors from 1992 to 2001. He was also chairman of Human Resources, Audit, Investment and other due diligence committees during that time.

APRA found that, as Chairman, Mr Cohen failed on a number of occasions to ensure that all relevant matters and materials were properly brought before the HIH Board, and that the audit committee was independent. APRA also found that Mr Cohen failed to address and disclose conflicts of interest arising from his consultancy arrangement with audit firm Andersens and his role on the Audit Committee.

APRA's Deputy Chairman, Mr Ross Jones, said that "APRA expects directors of general insurers to ensure that a high standard of corporate governance is maintained, boards are properly informed, and conflicts of interest are appropriately managed."

# and Many Others...

*HIH Case Study – What went wrong?*

- Provision of information to the board
- Lack of independent critical analysis
- Limits of authority
- Lack of process
- Regulator:
  - ***“Australian Prudential Regulation Authority (APRA) missed every one of the available opportunities to identify and react to the looming financial problems of the group”***



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## Disastrous Misadventures

A closer look at what went wrong

# Disastrous Misadventures

HIH Case Study – Disastrous Misadventures

- **A failure:** the UK operations
  - *"The combination of a lack of underwriting controls and a lack of relevant experience and familiarity in those particular lines of business was a formula for financial disaster."*
- **A second failure:** the US operations
- **A third failure:** the FAI acquisition with no due diligence
  - *"HIH proceeded with the takeover solely on the basis of its assessment of publicly available information."*
- **A camel and a straw:** the Allianz joint venture



# UK Operations — Cotesworth Syndicate

*HIH Case Study – Disastrous Misadventures*

- ❑ Cotesworth was acquired after **extensive due diligence**.
- ❑ The estimated **reserve requirement** for Cotesworth, as calculated by the KPMG actuaries, rose by over A\$500 million to **A\$1077 million**.
  - caused by the expected inability to collect reinsurance assets as a result of the previously undisclosed financial reinsurance arrangements.





# Cotesworth - Oldest insurer at Lloyds

*HIH Case Study - Disastrous Misadventures*

## Oldest insurer at Lloyd's forced to close

By Andrew Cave, Associate City Editor

12:01AM BST 07 Sep 2001

THE oldest insurer on the Lloyd's market has collapsed after being hit by the demise of Independent Insurance and the Petrobras oil rig disaster off the coast of Brazil.

Cotesworth & Co, which has been trading at Lloyd's for 146 years, has placed its two remaining syndicates into "run-off" after failing to raise funds for next year.

The syndicates, which had "capacity" to write premiums of more than £200m, are supported by about £100m of capital and will continue to pay claims from previous years. However, they will write no new business and the workforce of 80 in the City's Gracechurch Street will be reduced to a core staff that will oversee the winding down of business.

The decision to close comes six months after Cotesworth's parent company HIH Australia, which provided 90pc of its capital, went into provisional liquidation in March. Norman Britten, Cotesworth

# UK Operations — UK Branch

HIH Case Study – Disastrous Misadventures

- The main losses occurred in areas where the underwriters lacked relevant experience.
- “The **combination of a lack of underwriting controls and a lack of relevant experience** and familiarity in those particular lines of business was a formula for financial disaster.”
- Examples include:
  - Whole of account XOL marine reinsurance; and
  - Film finance insurance





# UK Operations — UK Branch

*HIH Case Study – Disastrous Misadventures*

- What is film finance insurance?
  - A form of **pecuniary loss indemnity insurance** similar to mortgage indemnity cover
  - To cover film financiers against the risk that film producers do not repay as revenues from completed films are not sufficient
- UK branch fronted film finance insurance for AXA, despite **lack of explicit authority** to front
- Furthermore, **poor quality management information** and **inadequate accounting systems** impaired the Australian management's ability to monitor and control the UK operations effectively.



# Film Finance Insurance

HIH Case Study – Disastrous Misadventures

## A fine romance

Underwriting film productions has been an embarrassment for insurers

Mar 29th 2001



Tweet

WITH attention focused on the Oscars and their oh-so-stunned winners, spare a little thought for the impoverished financiers of the nine Hollywood films out of ten that lose money. In particular, have pity on American and European insurance companies, which thought a while ago that they were charging beautifully fat premiums to insure film productions—but now realise they have been mugged. Almost all of the big insurers that jumped into this market in the past decade have now bailed out.



Insurers liked it even less than filmgoers

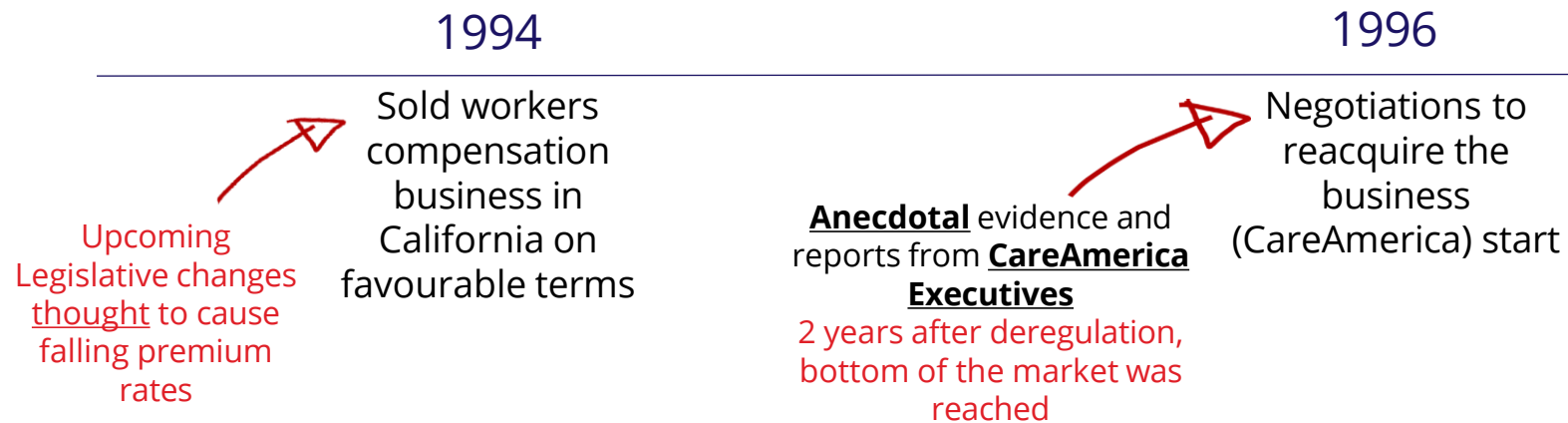
A few years ago, Hollywood's film makers thought that they had found, in insurance companies, the ideal partners to co-finance films. Insurers make a living from risk, and the industry could offer plenty of that. Insurers also faced falling premiums in their traditional insurance markets, while film makers were prepared to pay in premiums almost any sum they demanded.

# A Second Failure: US Operations

HIH Case Study – Disastrous Misadventures

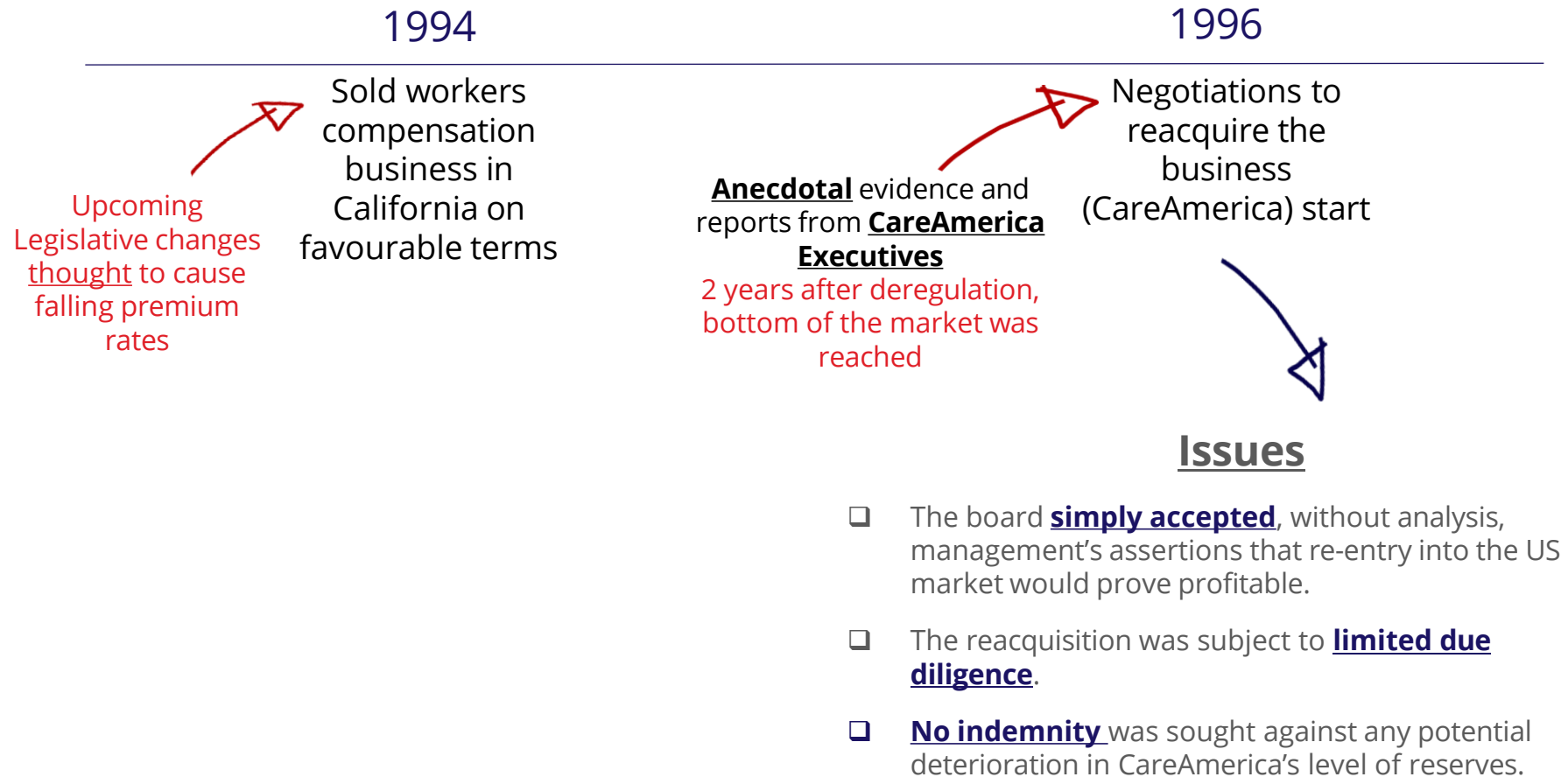
Total deficit in US operations was estimated at

**A\$620 million.**



# A Second Failure: US Operations

HIH Case Study – Disastrous Misadventures



# A Third Failure: The FAI Acquisition

HIH Case Study – Disastrous Misadventures

Gross Earned Premium  
A\$850M (as at June 1998)

- FAI wrote in all states and territories in Australia, all lines of business.
- HIH has been intermittently looking at buying FAI since 1995.
- HIH has always been **advised that a due diligence investigation of FAI is needed.**



# A Third Failure: The FAI Acquisition

HIH Case Study – Disastrous Misadventures

## FAI keen to sell

- **Significant under-reserving** was caused by manipulation of claims estimates by management
- The extent of the under-reserving was **concealed** from the Board, the auditors, the external actuaries and APRA amongst others.



## HIH keen to buy

- HIH wants to broaden the base of its short-tail insurance lines of business so as to **balance its existing and substantial long-tail lines.**
- The acquisition of FAI would provide HIH with a **well-known general insurance brand name** and **access to the direct general insurance market.**

# The FAI Acquisition

HIH Case Study – Disastrous Misadventures



- ❑ The board meeting was called **urgently** and with less than a day of notice.
- ❑ Only **3 of 12 directors** were present in person. 4 participated by video and 5 were not present at all.
- ❑ Despite absence of many directors, the board **approved** the FAI acquisition.
- ❑ HIH proceeded with the takeover of FAI for **A\$300 million** without due diligence.
- ❑ **More than A\$530 million** of losses had been recognised as at 30 June 2000 due to under-reserving in the long-tail portfolio.



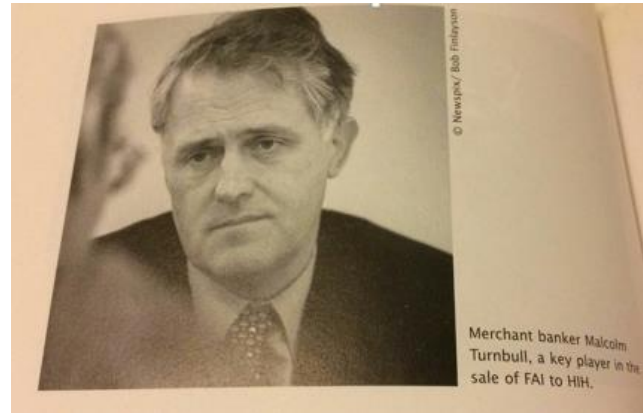


# Connection to current Australia PM

## HIH Case Study – Disastrous Misadventures

### 3. He was at the center of Australia's biggest corporate failure.

Turnbull would become entangled in the collapse of HIH, Australia's then-second largest insurance company. In December 2000, on the back of bulging debts and marginal solvency, HIH would become the **largest corporate collapse** in the country's history, with liquidators estimating losses of up to \$5.3 billion. A Royal Commission was established to probe the collapse, and a portion of the inquisition was dedicated to Turnbull, who was the Goldman Sachs head and primary advisor to FAI, an insurance company that HIH took over for a sum of around \$300 million in 1998. It was later revealed that FAI's assets were grossly misstated, and Turnbull was **accused of** concealing from the FAI board of directors that he was working with FAI CEO Rodney Adler to take the company private. The Royal Commission **later declared** Turnbull and Goldman Sachs free from any wrongdoing.



# A Camel and a Straw: The Allianz Joint Venture

HIH Case Study – Disastrous Misadventures

- The joint venture agreement involving the sale of HIH's **profitable** retail lines was effected on 1 January 2001.
- HIH was attracted by the **A\$200 million upfront cash** from Allianz.
- However, there were **two negative impacts** on HIH's cash flow.
  - HIH was required to contribute a **significant amount of assets and cash** – about A\$500 million – to the trust at the outset
  - HIH **cut off from its main premium income flow** – about A\$1 billion a year
- Within 10 weeks of the start of the joint venture, HIH was placed in **provisional liquidation**.



# The Allianz Joint Venture

HIH Case Study – Disastrous Misadventures

## Pre-Joint Venture



## Post-Joint Venture

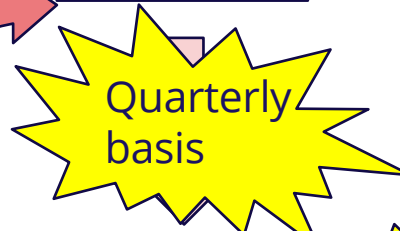
**Current business**

Premium income (A\$ 1 billion a year)



JV Claim Payments ONLY

Initial Top-up A\$500 million

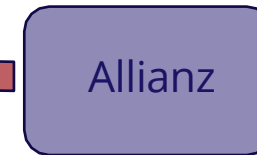


**Prior business**

Up front purchase price A\$200 million



Claims Payment



# In last 3 months Self-serving behaviour by the directors

HIH Case Study – Disastrous Misadventures

*“At a meeting of the board’s human resources committee on 26 February 2001 it was resolved to recommend to the board retrospective **increase in directors’ fees**. The board **approved the recommendation on that day.**”*

*“In the dying days of the corporation, **millions of dollars flowed to a favoured few, some of whom – directors, senior managers, advisers, and so on – were in privileged positions.**”*

## Ray Williams's management by spree

By Margot Saville  
August 8 2002

If Rodney Adler and Brad Cooper were the Wicked Witches of the HIH fable, then chief executive Ray Williams was Father Christmas.

In the final year of the insurance company, three months before it disappeared into a \$5.3 billion black hole, Father Ray spent \$2.4m on lavish corporate entertainment, \$86,000 on gold Swiss watches, and \$4.6 million on executive bonuses

The royal commission into the collapse of the company heard yesterday that HIH's four most senior executives spent almost \$30 million on "discretionary" matters in 2000.

In one three-week period, Mr Williams spent \$9000, including \$2000 in tips, on three dinners at The Nautilus at Port Douglas, The Pier Restaurant at Rose Bay and Buon Ricordo in Paddington.

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# Under Provisioning

A closer look at what went wrong

# Intentional Under-Provisioning

HIH Case Study – Under Provisioning

- **Deliberate under-provisioning:**  
*"efficient" and "smart" way to run an insurance operation.*
- **A distorted view of managing provision:** *"Reinsurance in place of prudential margin"*
- **Under-provisioning exacerbated**
  - by acquiring under-reserved companies and
  - rapid growth through under-pricing in long-tail products
- **Signing actuary was compromised**





# 1. Intentional Under-Provisioning

*HIH Case Study – Under Provisioning*

**Under – provisioning  
Who is responsible?**

# Directors' Responsibility

HIH Case Study – Under Provisioning

- HIH Royal Commission identified **the Board as failing to perform its stewardship duties.**
- Board relied on reports by independent actuaries and on assessment of those reports by the auditors.
- **No real scrutiny or understanding of the key assumptions** underlying the actuaries' recommendations

*"In particular, there is little evidence of attention being given to the 'benefit of hindsight': what the company's actual claims experience said about the accuracy of previous estimates."*



# Management's Responsibility

*HHH Case Study – Under Provisioning*

- Distorted reserving culture
- Deliberate and conscious under-provisioning
- The abuse of financial reinsurance and its susceptibility to manipulation
- Reliance on intangible assets to reduce the impact of reserve strengthening
- **Selecting actuaries**



# Selecting Actuaries

HIH Case Study – Under Provisioning

## HIH fired actuaries who raised US cash warning

August 28 2002

HIH Insurance's US management ignored repeated warnings it did not have enough cash to pay insurance claims, then fired the actuaries who had voiced the concern, the HIH Royal Commission heard yesterday.

Three different actuaries and a US insurance regulator warned the company in 1999 and 2000 that its US branch was under-reserved by tens of millions of dollars, the commission heard. However, finance director Dominic Fodera yesterday acknowledged branch and head office management instead chose to use their own calculations of reserves.

Mr Fodera said the US branch had regularly booked reserves 5 per cent below the level recommended by actuarial firm Milliman and Robertson (M&R)

# Auditor's Responsibility

HIH Case Study – Under Provisioning

- Auditor **did not have any actuarial expertise** nor did it retain such expertise as part of audit process.
- Auditor **did not take necessary steps to satisfy itself** before heavily relying on actuary's work.
- **No direct communication** between the Auditor and the actuary.

*"I must say that I find the **lack of direct communication** between Andersen and Slee surprising. I would have expected the auditor and chief consulting actuary (with responsibility for valuing the entire OCL) of a general insurer the size of HIH to have been in regular contact."*



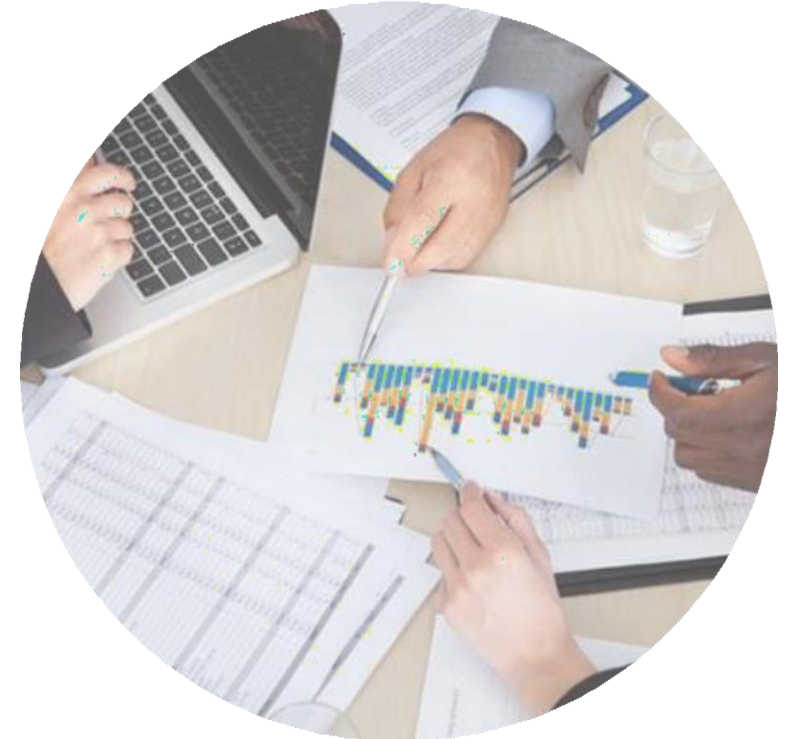
# Actuary's Responsibility

HIH Case Study – Under Provisioning

- In 2000, HIH work contributed a sizeable 80 per cent of the consulting actuary's revenue.
- There were **instances of questionable use of data and choice of methodologies** by the actuary.
- HIH Royal Commission was not convinced that the actuary's independence had been compromised.

*“It comes down to a matter of impression.*

*Overall I have decided against making a finding that Slee was so compromised. There are matters that point in the other direction. But the impression I gained of Slee when he gave his evidence is enough to convince me that I should stop short of what would be an extremely serious finding if made against a professional person.”*





# Under reserving: APRA Ban

HIH Case Study – Under Provisioning

## APRA disqualifies HIH actuary

16 Sep 2004  
04.32

The Australian Prudential Regulation Authority (APRA) today announced the disqualification of Mr David Julian Slee from holding any appointment as an actuary of a general insurer under the Insurance Act 1973 (the Act).

Mr Slee was found not to meet the 'fitness and propriety' requirements set out in APRA's prudential standards under the Act, in particular that "the person has adequate experience and demonstrated competence and integrity in the conduct of business duties."

APRA's decision to disqualify Mr Slee was based on his use of unrealistic assumptions in his capacity as a consulting actuary to HIH to arrive at an unreasonably low estimate of the Group's claims liabilities. APRA also found that Mr Slee allowed his independence to be compromised.

APRA has referred the matter of his conduct and its conclusions to the Institute of Actuaries Australia. APRA's Deputy Chairman, Mr Ross Jones, said the assessment of a number of individuals involved with the collapse of HIH is continuing. "This is a large scale and complex exercise that still has some considerable way to run."

# Under reserving: APRA Ban Upheld

HIH Case Study – Under Provisioning

## APRA disqualification of HIH actuary upheld

8 Mar 2006  
06.11

Mr Slee applied to the AAT on 25 October 2004 for a review of the disqualification.

The AAT made its decision on 6 March 2006 and will publish it at <http://www.aat.gov.au>.

The AAT was satisfied that, among other things, Mr Slee:


- failed to comply with the relevant actuarial code;
- "failed to exercise the professional care and diligence expected of a reasonable and competent actuary";
- "displayed a gross disregard for his professional obligations"; and
- had not demonstrated the competence to meet the relevant standards and regulations set by APRA.

The AAT agreed with APRA's position that actuarial reports must comply with professional standards to ensure they provide an accurate and informed picture of the financial health of the insurance company concerned.

The Tribunal concluded: "The manner in which the Applicant undertook his work was devoid of the appropriate degree of care. He made significant errors that should not have been made. He failed to identify those errors this demonstrating not only a lack of reasonable care in the performance of his work, but a deficiency in his work practises. The Applicant failed to exercise the professional care and diligence expected of a reasonable and competent actuary."

# Under reserving: Actuaries Institute Suspension

HIH Case Study – Under Provisioning



Institute of Actuaries of Australia

**DISCIPLINARY ACTION**

On 7 February 2005 an Appeal Board of the Institute of Actuaries of Australia delivered its unanimous decision in relation to a complaint against David Julian Slee, initiated as a result of the work of the Institute's HIH Royal Commission Taskforce. The complaint was initially considered by an Investigating Sub-Committee and subsequently heard by a Tribunal.

The Appeal Board agreed with the Tribunal's unanimous findings that Mr Slee, as an actuary retained by the HIH insurance group, engaged in actionable conduct:

- (a) in that he failed, in 1999 and 2000, to meet the requirements of paragraphs 52 and 56 of PS300 (dealing with the contents of reports in relation to general insurance); and
- (b) in that his conduct in relation to those reports fell below the standard of professional care and diligence expected of a reasonable and competent actuary.

Having considered the submissions made in relation to penalty, the Appeal Board determined that Mr Slee be suspended as a member of the Institute for a period of 12 months. Mr Slee's suspension is effective from the date of the Appeal Board's decision, namely 7 February 2005.

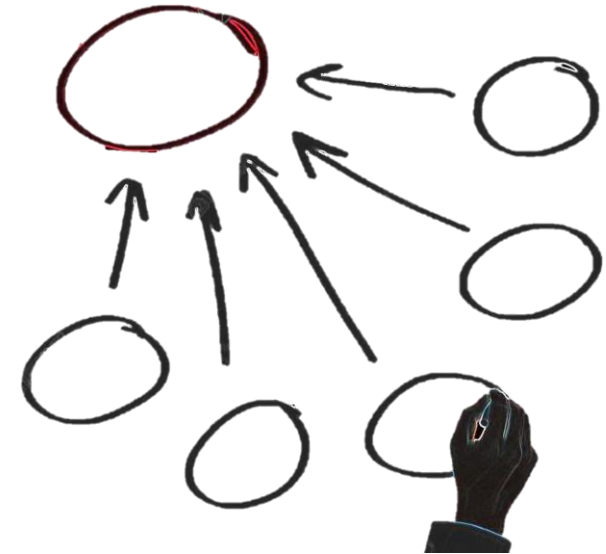
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# Conclusion

# Reasons for Failure

*HIH Case Study – Conclusion*

- Serious under-reserving
- Over-emphasis on growth
- Missing focus on underwriting expertise
- Accounting manipulation
- Reinsurance manipulation
- Entrepreneurial culture
- Absence of checks and balance
- Dishonesty and greed
- Due diligence in M&A



# The A\$5 Billion Question

HIH Case Study – Conclusion

- How could there be a A\$5 billion dollar deficit from an insurance company?
  - ❑ Heavily regulated industry
  - ❑ Listed in stock exchange
  - ❑ Credit rating of BBB or better
  - ❑ “Big-five” auditor
  - ❑ Internal auditors
  - ❑ Internal and external actuaries
  - ❑ Directors



**S&P Global**





# The A\$5 Billion Question

*HIH Case Study – Conclusion*



# Conclusion

HIH Case Study – Conclusion

A personal perspective by Hon Justice Owen:

*“In an ideal world the protagonists would begin the process by asking: **is this right?** That would be the first question, rather than: how far can the prescriptive dictates be stretched? The end of the process must, of course, be in accord with the prescriptive dictates, but it will have been informed by a consideration of whether it is morally right. In corporate decision making, as elsewhere, we should at least aim for an ideal world. As I have said, ‘corporate governance’ is becoming something of a mantra. **Unless care is taken, the word ‘ethics’ will follow suit.**”*

# QnA

*HIH Case Study*



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## Developing Next-Gen ASEAN Insurance Leadership Talent

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**Tea Break**  
**4:30 - 4:45 pm**