

HIH Insurance

When HIH insurance was put into liquidation on March 15, 2001, it represented one of the biggest collapses in Australian corporate history. Shares in the company, once the second-largest Australian insurer, had been suspended two weeks earlier after the Australian Securities & Investments Commission (ASIC) analysed company documents.

Through its many subsidiaries the company had been a key player in Australian and international general insurance; workers' compensation; public and private liability; and property, industrial and commercial insurance. While regulators quickly organised the transfer of much of the company's retail business to other insurers, the nightmare of disentangling HIH's books was only just beginning.

As summer 2001 progressed, the loss estimates mounted. Then in late August 2001, the liquidator revised the estimate sharply upwards, saying that the insurer might be anything from A\$3.6 billion to A\$5.3 billion in the red as a result of over-optimistic valuations of assets and extensive under-estimation of liabilities.

The fundamental problem was that HIH had been offering insurance at too low a price, and had not set aside enough capital to cover its future liabilities. This was exacerbated by management and due diligence failures, which led HIH to acquire other troubled insurance businesses at too high a price during a period of rapid growth in the 1990s, as described below. The

company's more detailed actions and transactions are now the subject of a Royal Commission, which begins its hearings on November 26, 2001.

During the spring and summer of 2001, the Australian federal and state governments were forced to

each dollar they claim – though that figure won't be firmed up until well into 2002.

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underwrite many of the failed company's policies, and to set up funds to cover cases of “genuine hardship”. The bail-out will cost the Australian taxpayer well over A\$1 billion, but won't cover all of HIH's obligations. Many of the company's two million policyholders and other creditors are expected to wait up to 10 years for disbursement of their funds, and might receive only around 50 cents for

have risen in the market sectors in which HIH was most influential.

Meanwhile, the principal regulator of the company, the Australian Prudential Regulation Authority (APRA) has come under fierce criticism for its handling of the affair¹, and concedes that HIH had probably not put aside enough capital to cover its insurance risks for many years. The debacle took on a political flavour in summer 2001 as the

Lessons learned

- Companies that manage risk portfolios with long tails of risk can seem successful for a long time before their risk-taking decisions catch up with them.
- Six months after the liquidators were called in, they couldn't say how much HIH had lost to the nearest billion and a half Australian dollars: risk accounting is a complex business.
- There's room for a lot of trouble to grow in the junction between risk reporting and corporate governance in a structurally complex organisation.
- Reinsurance is a double-edged weapon: it can reduce risk, but it can also leverage or obscure risk if things go wrong.

Australian premier was forced to publicly rebut accusations that insurance company donations to his political party might have led politicians to soft-pedal on insurance industry regulation.

The story: HIH's failed business strategy

Many of HIH's difficulties can be attributed to its aggressive acquisition strategy and the creation of more than 200 subsidiaries. The strategy had the effect of increasing HIH's size by many times in the course of a decade – with premium growth averaging 26 per cent per annum – in insurance markets that

sors on both sides". It has emerged that HIH did not conduct due diligence on FAI, and instead relied on FAI's recently completed accounts. APRA approved the deal, even though it regarded FAI as a relatively risky venture, perhaps because it saw the deal as reducing the risk of any problems at FAI.

Instead, the FAI acquisition put additional pressure on HIH's financial viability at a time that HIH's reserving and pricing strategies were, most likely, already compromised.

The acquisition of FAI was not HIH's only questionable business

HIH believed that rates worked in three-year cycles and left the market at the time of deregulation. It stepped back into the market three years later, at the very time that state courts were awarding large increases in benefits retrospectively and reinsurers were demanding that lead underwriters assume more of the risk.

HIH committed a strategic error in re-entering the California market, and its 'three-year cycle' hypothesis seems to have led it to misjudge the inherent risks. It failed to take the difficult decision to exit the market once it had re-entered the field and had tasted the working conditions. It was not alone in taking losses, however. In the same period, other leading market participants also suffered stunning losses in the California workers' compensation sector.

HIH also encountered severe problems in the London insurance market, which it had entered in 1993, and where through the 1990s it pursued professional indemnity and public liability business. In addition to the substantial losses suffered by the Lloyd's market as a whole in this period, HIH incurred certain high-profile losses associated with the film-financing sector, where it provided leading banks with insurance and reinsurance tied to that business.

Here again, the company chose a sector that has proved problematic for many market participants and that, as an emerging insurance sector, involved HIH in business practices and legal risks it did not fully understand.

The company ended up paying out claims related to a series of failed film projects, all tied to

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were already overcrowded and competitive.

In the most controversial acquisition, Rodney Adler, who later became a member of HIH's board of directors, sold his majority-owned insurance company, FAI Insurance, to HIH in late 1998. HIH borrowed heavily to pay A\$300 million for the company, but the stock market did not respond well to the acquisition and FAI was later thought to be worth just A\$100 million.

Adler has responded to allegations that the purchase price of his company was too high by stating that “the price was set, by definition, between consenting, intelligent parties with appropriate advi-

decision. The company's failure can be partly blamed on its international operations, particularly those in England and the US. It also acquired subsidiaries in Thailand and Hong Kong.

One example is the strategy HIH pursued in the state of California, where it was a leading underwriter of workers' compensation insurance. HIH had been writing workers' compensation policies in California – and pocketing modest profits – until 1995 when a law setting minimum rates was scrapped. This encouraged insurers in the newly deregulated market to compete by offering lower insurance premiums.

Hollywood notes that it backed. It then sought reimbursement from London-based reinsurer New Hampshire Insurance Co, which is a subsidiary of American International Group, and Independent Insurance Co of London (which has coincidentally also suffered a financial collapse).

The reinsurers argued that HIH should not have paid the claim because it could have asserted various coverage breaches. The UK courts sided with the reinsurers and ruled that HIH had not been obliged to pay out on the film claims and, consequently, was not entitled to reinsurer reimbursements. HIH lost hundreds of millions of dollars from its film finance insurance business.

Conclusion: a safety net with many holes

It's not unheard-of for insurance companies to misprice and under-reserve for risks, to have difficulties in their mergers & acquisitions strategy, and to fail in their attempts to create or break into new markets.

But it is unusual for them to be able to do this on the scale that HIH did, in so many markets and for such an extended period of time. Many commentators believe that, if HIH's real condition had been apparent, the company would have quietly failed and been absorbed by more successful rivals many years before. Instead, it was able to carry on expanding and acquiring in a way that leveraged all of its underlying problems and

allowed a massive gap to open up between its assets and its future liabilities. Why was this?

In part, it was because of the nature of many of the insurance markets in which HIH specialised. It's easy for general insurers to get their pricing and reserving wrong (and for that fact to remain obscured) in sectors that exhibit long tails of risk, such as workers' compensation and professional indemnity.

Often the true price of risk in such markets is affected by social and legal trends. Companies are tempted to price keenly to gain market share, only to find that long-term 'tail risks' hit them with unexpected liabilities when it is too late to do much about it.

Timeline of events

1996 HIH embarks upon a programme to finance, both directly and indirectly, more than US\$500 million in movie productions through a complex financing structure.

July 1998 Swiss insurer Winterthur exits Australian insurance industry by selling its 51.1 per cent stake in HIH Winterthur to investors. In the same month, the newly formed Australian Prudential Regulation Authority (APRA) begins to assume responsibility for regulating the insurance industry, including HIH.

Late 1998–January 1999 HIH acquires FAI Insurance for A\$300 million. Later, FAI is estimated to be worth just A\$100 million.

July 2000: A routine external audit by Arthur Andersen fails to raise the alarm. Regulators and others accept the company's declaration that it has A\$939 million in assets.

September 2000 HIH sells off half of its retail general insurance business.

HIH share price falls from A\$1.05 to A\$0.45 after an announcement of losses and rumours in the market about the underlying financial condition of company. Regulators decided not to send in an inspector, as the externally audited accounts seem to show the company is healthy.

December 2000 Ray Williams, founder of HIH, resigns as managing director with a \$A5 million severance agreement.

February 2001 HIH's December financial statements now overdue at APRA, and the regulator begins to think it will have to act. The Australian Securities & Investments Commission becomes concerned that HIH seems able only to put very broad bounds against its possible insurance losses for the period.

27 February 2001 ASIC suspends shares in HIH after analysing company documents that make it concerned that the

company might no longer be solvent. Regulators scramble to control the risk to policyholders and succeed in transferring some of HIH's risk portfolio to other companies.

15 March 2001 HIH forced into provisional liquidation by ASIC. During March, government agencies are obliged to pledge money to cover some of HIH's obligations.

16 March 2001 APRA inspector sent into HIH.

August 2001 The government sets up an independent Royal Commission, announced earlier in May, to investigate the insurance company failure.

September 2001 The liquidator revises loss estimates upwards to somewhere between A\$3.6 billion and A\$5.3 billion.

November 5 2001 New rules for general insurers published by APRA, which are due to come into force during 2002.

The picture is complicated even further by reinsurance strategies. Reinsurance contracts can be used not only to reshape liabilities but to reshape cashflows and company accounts by altering premium payment timing and loss coverage. Without a sophisticated risk measurement and reporting system across the whole enterprise that is linked to capital management strategies, it can be very difficult for those outside a company – and for most of those inside, too – to keep an objective eye on the extent of insurance liabilities.

Up until November 2000, HIH retained a strong credit rating, and although its rating then declined it never reflected HIH's precarious

position. Like many other companies, HIH made the most of its ratings in its business literature, saying they were "the result of a strong business franchise, sound and consistent performance, with solid profits achievements and good capitalisation levels".

Like their credit rating counterparts, equity market analysts did not predict losses at a level that would have made the company insolvent even a few months before the crash, though some observers had voiced deep concerns about the company many years before².

As Graeme Thompson, APRA's CEO, commented in August 2001,³: "It's instructive that after having a substantial team of experts *in situ*

for a couple of months the provisional liquidator's estimate of HIH's deficit still had a range as wide as \$1.3 billion – greater than the net asset position in its last audited accounts."

The difficulty of relating risk to capital wasn't HIH's only problem, however. There were additional mishaps and infelicities at the junction between risk reporting, corporate governance, external auditing and regulation.

The detailed and complex history of HIH's key transactions and the relations between its constituent businesses and various third parties are only gradually becoming clear. As of autumn 2001, certain HIH directors have been defending

Resources and References

WEBSITES

Website of the HIH Royal Commission: useful materials will gradually become available on this site from November 2001 onwards. Hearings begin on November 26.

The Age.com, The HIH Collapse, ongoing collection of Age.com coverage of HIH

Australian Securities and Investments Commission, HIH File, ongoing

The Association of Risk and Insurance

Managers Australia: <http://www.arima.com.au/>

The Australian Institute of Risk Management: <http://www.airm.org.au/>

The Global Risk Management Network: <http://www.grmn.com/pages/default.asp>

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Australian Financial Review, "New audit board sets bar on ethics", October 5, 2001.

Australian Financial Review, "Big five back two-year board wait", October 5, 2001.

Dow Jones, "Australia HIH Insurance losses may reach A\$4B", May 25, 2001

Australian Financial Review, "HIH Insurance: A disaster in just four easy stages", March 24, 2001

Sydney Morning Herald, "HIH Insurance in liquidation", March 16, 2001

Dow Jones, "Three banks have exposure to HIH Insurance", March 15, 2001

themselves against legal action brought by the Australian Securities & Investments Commission in respect of possible breaches in their duties as directors. Meanwhile, an independent inquiry in the form of a Royal Commission, announced by the Australian government in May, is grinding into action and will report by 30 June 2002.

The commission is likely to put on public record details of many transactions and actions by HIH. In particular, the commission is "required to examine whether decisions or actions of HIH or any of its directors, officers or auditors contributed to the failure or involved undesirable corporate governance practices including the failure to make desirable disclosures regarding the financial position of HIH".

Justice Owen, who leads the inquiry, has stressed that he wants to reveal the importance of corporate culture in the debacle as well as making clear any failings in individuals.

The role of the external auditor, Arthur Andersen, has already proved interesting to commentators. The HIH Group's externally audited accounts for the year to June 2000 showed net assets of nearly A\$1 billion, and solvency at almost double the statutory required level.

The company's subsequent collapse spotlighted the fact that three of HIH's board members in 2000 were previously employed by Arthur Andersen. No evidence has been presented to suggest that this compromised the actions of the board members, or the independence of the auditor. However, an independent report commissioned by the Australian government following the

failure of HIH has recommended that, in the future, audit firm partners who are directly involved in ongoing audits ought not to be admitted to the company's board for at least two years after leaving their auditing employers.

The Australian regulator has acknowledged that the HIH case has raised huge issues for how much reliance it should place on information provided by companies and their auditors.

The failure of HIH is one of several remarkable failures in the Australian insurance sector in the past few years. New rules⁴, which will start to come into effect in summer 2002, will tell firms to set out a clear reinsurance strategy, increase capital buffers, oblige companies to measure risks more accurately and to link the value of assets more closely to the likely value of their liabilities. Many of these rules were being formulated well before the HIH col-

lapse; it is thought that if the new regime had been in place, HIH might have failed to live up to its strictures as far back as 1995.

But while the new rules should mean that the capital held by firms is more closely related to the risks they run, it is not clear that the reforms will fully answer the risk reporting concerns of corporate policyholders.

Bruce Ferguson, president of the Association of Risk & Insurance Managers of Australasia, said at the time of the collapse: "We need a watchdog with more teeth, and one that barks a bit more often. It is futile to have a regulatory system which is either not armed with the [timely] information the market requires or is unable to pass it to insurance buyers." ■

This case study was contributed by Penny Cagan at Zurich IC Squared

Notes

¹ The HIH debacle represents the worst financial institution failure since the Australian financial regulatory system was revamped in 1998, in line with the Wallis Inquiry recommendations. The reforms introduced an integrated regulatory body for the financial industries, APRA, which took over responsibility for the supervision of banks, life and general insurance companies and superannuation funds. In a defence that has some parallels with the UK Financial Services Authority's reaction to criticism of its handling of the Equitable Life affair, APRA says that in HIH it inherited both an already-damaged institution and, in its transitional period, a flawed set of legal powers – and that changes already in the pipeline would likely prevent a similar catastrophe.

² For instance, a New Zealand-based credit risk rating firm, Rapid Ratings, published a report in 1996 that warned of HIH's struggles with a heavy debt burden and suggested that the firm was bordering on bankruptcy. The rating firm stated that HIH "showed a persistent pattern of deterioration". HIH was consequently given a 'junk bond' rating.

³ Graeme Thompson, "Perils of the prudential regulator", APRA speech, August 2, 2001; see second half of this regulator speech for some acerbic comments on "hindsight humbug".

⁴ APRA media release, "New prudential standards for general insurance companies", November 5, 2001