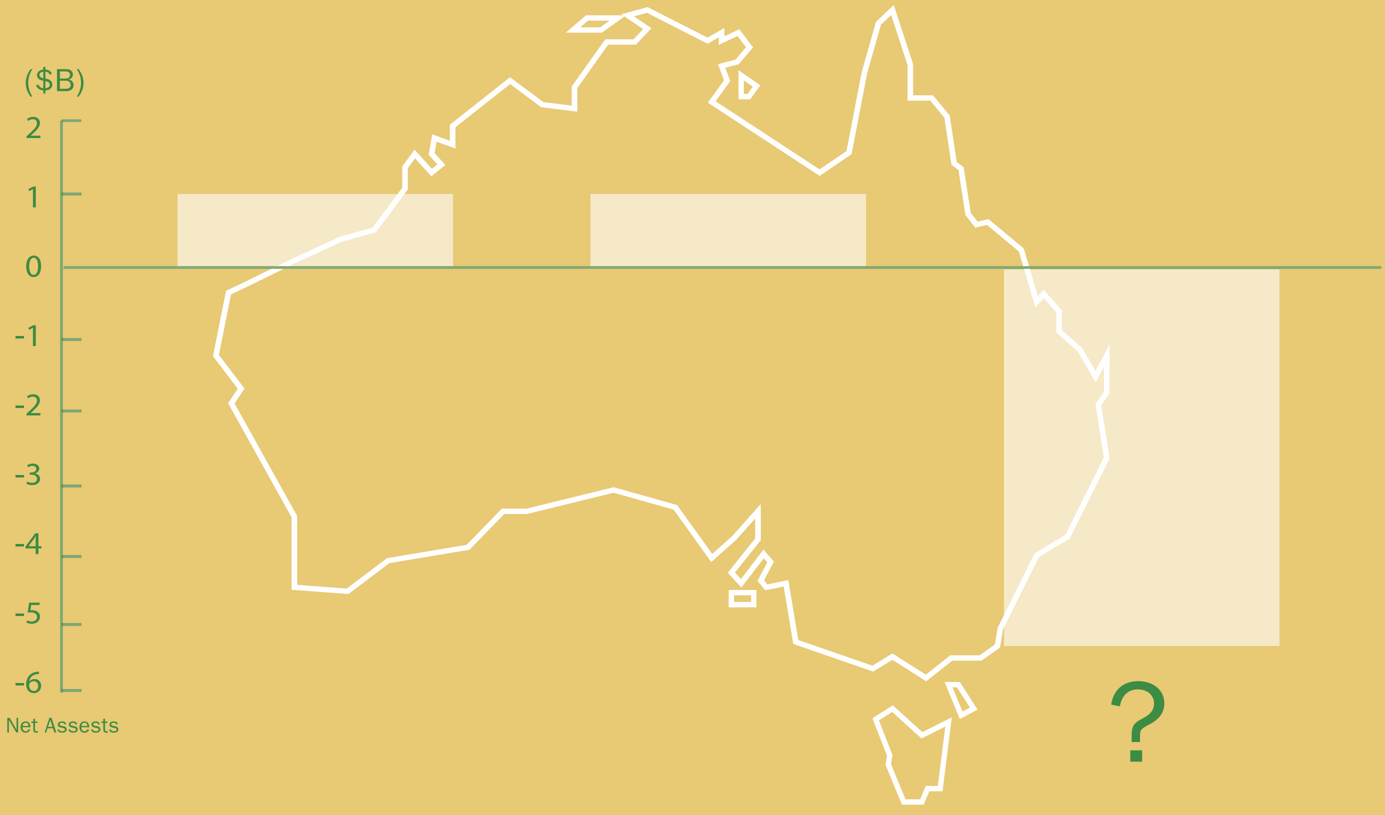
PACICC

Property and Casualty Insurance Compensation Corporation
Société d'indemnisation en matière d'assurances IARD

Why insurers fail

Lessons learned from the failure of HIH Insurance Limited



By

Ian Campbell

2018

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PACICC's vision mission and principles

Mission Statement

The mission of the Property and Casualty Insurance Compensation Corporation (PACICC) is to protect eligible policyholders from undue financial loss in the event that a member insurer becomes insolvent. We work to minimize the costs of insurer insolvencies and seek to maintain a high level of consumer and business confidence in Canada's property and casualty (P&C) insurance industry through the financial protection we provide to policyholders.

Vision

To be, and to be recognized as, the voice of insurance consumers, and as experts in supporting the resolution of severely distressed home, auto and commercial insurance companies.

Principles

- In the unlikely event that an insurance company becomes insolvent, policyholders should be protected from undue financial loss through prompt payment of covered claims.
- Financial preparedness is fundamental to PACICC's successful management support of insurance company liquidations, requiring both adequate financial capacity and prudently managed compensation funds.
- Good corporate governance, well-informed stakeholders and cost-effective delivery of member services are foundations for success.
- Frequent and open consultations with members, regulators, liquidators and other stakeholders will strengthen PACICC's performance.
- In-depth P&C insurance industry knowledge – based on applied research and analysis – is essential for effective monitoring of insolvency risk.

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Acknowledgements
A great number of the observations and conclusions in this report stem from findings in the three-volume HIH Royal Commission Report (*The failure of HIH Insurance*), published in 2003. That comprehensive enquiry focused on the reasons for and circumstances surrounding the failure of HIH Insurance Limited.

Valuable assistance was provided by Amra Porobic (Manager, Library Services, Insurance Bureau of Canada) in sourcing background materials for this paper. A thank you is extended as well to my PACICC colleagues (Paul Kovacs, Jim Harries, Grant Kelly, Denika Hall and Director Bruce Thompson) and editor Nancy Kovacs for their contributions to this paper. The author is responsible for all points made and conclusions drawn in this study, as well as any errors or omissions.

Executive summary

This study examines the insolvency of HIH Insurance Limited (HIH), a corporation established in Australia in 1968. The collapse of this publicly-traded insurer was notable for the size of the organization, the surprising speed of its turn in fortune and the large number of parties affected. HIH was the second largest general insurer in Australia, with more than 200 subsidiaries and extensive worldwide operations. Observers were shocked that such a large entity with annual premium revenue of $2.8 billion and reported net assets of $900 million in June 2000 could be found to have an asset deficiency of between $3.6 billion and $5.3 billion less than one year later, in March of 2001. One question was on everyone's mind – *Where did the money go?* The abrupt turnaround in HIH's reportedly strong financial position sent shockwaves through the business community in Australia and beyond.

HIH's failure had profound and far-reaching effects, impacting some two million policyholders and 1,000 employees. Losses were felt by professional and community groups, small business owners, homeowners and injured individuals. Affected lines of business included workers' compensation, auto, home, professional indemnity, public liability, home warranty, accident and disability and travel insurance. It seemed that everyone in Australia knew someone who had been affected in some way by the insolvency, either directly or indirectly. A Royal Commission enquiry was called immediately to examine the causes and circumstances that led to HIH's collapse. Following almost two years of exhaustive study, the HIH Royal Commission delivered its three-volume report in April of 2003. The report provided much of the resource material for this *Why insurers fail* case study. This study provides an overview of the HIH failure and identifies the primary and contributing causes of its insolvency – described in the Royal Commission report as interrelated and also "many, varied and complex."

Ultimately, the primary causes of the HIH insolvency identified by the Royal Commission proved to be timeless, straightforward and simple – improper pricing of risks and a failure to reserve properly for future claims. HIH experienced a complete failure of its corporate governance and a lack of effective risk management. The corporation's pursuit of rapid international growth and diversification was fueled by underpriced products. Assets were overstated and liabilities were underestimated, particularly long-tail claims in lines of business in which HIH specialized. So…where did the money go? The answer is simple. The money was never there in the first place. HIH relied on cash-flow underwriting. It used current income to pay mounting claims costs from historic policies that had not been properly priced. Deceptive accounting masked an ever-widening shortfall of funds. HIH's flawed business strategy proved unsustainable. Its ambitious entry into new markets and unfamiliar lines of business aggravated its precarious financial position and sent the corporation into a death spiral from which it could not recover.

There was a confluence of secondary factors that did not cause the HIH insolvency but, ultimately, hastened the corporation's collapse. These included poor corporate governance practices, ill-advised business decisions, misleading financial information, uncertainty in regulatory standards and passive supervisory approaches. The secondary factors enabled HIH to hide or explain away early warning signs of trouble and to proceed beyond the point of no return to financial ruin. A point left with the reader is that "perfect storms" can occur, even for large insurers. Although rare, it is entirely possible for circumstances to develop which can lead to the demise of an entity otherwise considered to be too large to fail. This was very much the case with HIH.

Could a similar failure occur in Canada? It is unlikely given the rules governing regulatory capital (e.g. goodwill cannot be counted as capital for reserve calculations) as well as the layers of review in place regarding reserving practices (e.g. peer review by other actuaries, annual regulatory review and independent audit review). Failures are rare, but some Canadian insurers have failed. There is always the risk of a major catastrophe, failure of a foreign parent or chronic underperformance. Large insurers typically have more diverse operations, and may be subject to greater regulatory and shareholder scrutiny than smaller insurers. Nevertheless, HIH provides a specific example that it is possible – unlikely, but possible – for insurance companies to fail, even large companies.

Lessons learned from the HIH insolvency

As with previous PACICC case studies of insolvent insurers, we identify a number of lessons learned from the failure of HIH Insurance. See also pages 68-69:

- **Reserving –** Adequate, provisions for outstanding claims are critical to the financial health of any insurance company. Senior management, the board of directors, independent auditors and solvency supervisors must ensure a fair and honest statement of reserve adequacy.
- **Pricing –** Assessing and properly pricing risks is vital to an insurance company's long-term success. Sustained aggressive pricing to support ambitious growth is often a fatal strategy for insurers.
- **Entering new markets and new lines of business –** Companies must exercise caution and carefully manage uncertainties when expanding into unfamiliar markets and new lines of business where they have no past experience. HIH took great risks entering new lines of business and new markets without clear evidence of the prospects for success.
- **Acquisitions and joint ventures –** Companies must ensure that planned acquisitions and joint ventures are carefully researched and support the strategic objectives of the organization. HIH's gambles with acquisitions and joint ventures cost the organization dearly, hastening its demise.
- **Financial statements –** A company's financial statements must accurately reflect its true financial position. HIH used aggressive accounting practices and creative transactions to mask mounting costs from long-tail claims. This approach was misleading and unsustainable.
- **Reporting systems –** Fully functioning reporting systems are crucial to the timely production of accurate financial statements. Problems with HIH's accounting, budgets and ledger systems undermined the quality and timeliness of critical business information being supplied to the board.
- **Reinsurance arrangements –** When used properly, reinsurance is a legitimate and effective means for an insurer to augment its capital base. Questionable use of finite reinsurance arrangements allowed HIH to produce false and misleading financial statements and thereby overstate its financial position.

- **Director responsibilities –** Boards of financial institutions have an obligation to act on behalf of the corporation and its shareholders and policyholders, and demonstrate independent judgement regarding the company's strategy, performance, resources and standard of conduct. HIH's board was ineffective in this respect.
- **Management oversight –** Boards must exercise effective oversight of management. HIH's board played a passive role in overseeing management operations and financial reporting.
- **Audit function –** An effective audit function requires an external auditor to be rigorous in its work and independent, both in fact and appearance. HIH's external audit function was flawed.
- **Internal controls –** Internal controls help to ensure accountability and encourage the proper use of a company's assets and resources. HIH executive directors' authority was not clearly defined. An independent review of the corporation's organizational structure was never undertaken. HIH lacked a sound internal audit function.
- **Accounting standards –** Accounting standards must be clearly worded to avoid interpretation or abuse by regulated parties. HIH was able to manipulate the meaning and requirement of rules governing the recognition of insurance premiums and reinsurance expenses. This resulted in misleading financial statements.
- **Insurance supervision –** Regulators must ensure that the intensity of their supervision efforts is in relation to the systemic importance of the institution, and be prepared to escalate their intervention activities when they encounter growing evidence of poor governance, weak risk management or financial weakness. The Australian Prudential Regulatory Authority (APRA) missed several early warning signs that HIH was in financial trouble.
- **Consumer protection –** In 1945, Australia set up protection for consumers if a bank fails, however protection for insurance consumers was not introduced until after HIH failed. Financial protection for consumers, like that offered by PACICC, is critical to maintain consumer confidence in the insurance industry.

Introduction

An effective insurance system is vital to a well-functioning economy. Insurance eliminates uncertainties in the marketplace through the pooling of risks and payment of covered losses when they occur. It is in the public interest to protect against insurance company insolvencies in order to protect insureds and third-party claimants.

The March 15, 2001, insolvency of HIH Insurance Limited (HIH) occurred unexpectedly and had profound and far-reaching effects on the Australian economy. The magnitude of loss shook public confidence in the integrity of the insurance industry and regulators' ability to protect policyholders from harm. HIH was the largest corporate insolvency in Australia's history and one of the largest in the world. HIH was the second largest property and casualty (P&C) insurance company in Australia. With an estimated asset base of some $8.1 billion at the end of 2000, HIH was widely viewed as a strong and reliable corporation. It was at the tail-end of a major acquisition campaign throughout the 1990s. In the decade prior to its collapse, HIH created more than 200 subsidiaries, covering almost all insurance business segments, both domestically and abroad.

The HIH insolvency impacted some two million policyholders and 1,000 employees. Losses were felt throughout Australian society – by professional and community groups, small business owners, homeowners and injured individuals. Affected lines of business included workers' compensation, auto, home, professional indemnity, public liability, home warranty, accident and disability and travel insurance. It seemed that everyone knew someone who had been affected in some way by the insolvency, either directly or indirectly.

There were thousands of examples of personal and community loss and significant economic hardship. The impact on average policyholders was particularly dramatic. Some 200 permanently disabled individuals were left without regular monthly support payments from HIH. Numerous retirees who invested their life savings in HIH shares to fund their retirement were suddenly left penniless. A family whose HIH-insured home was destroyed by fire was forced to live in the burned-out shell of the house after HIH defaulted on their motorhome rental payments. Thousands of holders of professional indemnity, public liability, home warranty and travel insurance policies found themselves uninsured for claims made by or against them. A local theatre that had been promised sponsorship funds from HIH was forced to close. Sports and recreation centres, local festivals and amusement parks were put out of business because they could not make alternative insurance arrangements. A municipality in Western Australia was left exposed to a $6 million liability (resulting from a fire at a local dump which destroyed neighbouring farms) because HIH was its lead insurer.[1]

HIH was one of Australia's largest home-building market insurers. Its collapse caused industry turmoil. Homeowners were left without compulsory home warranty insurance. Owners of residential buildings saw their coverage for defective building work disappear. Builders were unable to operate because they could not secure warranty coverage. State governments were forced to spend millions of taxpayer dollars to protect the construction industry from further damage.

Australia's Federal Government immediately announced that it would establish a Royal Commission (headed by Justice Neville Owen) to examine aspects of the company's collapse, with particular focus on the period from January 1, 1995, to March 15, 2001. Recommendations were sought regarding policy, insurance regulation and corporate governance. A key point in the terms of reference was the need to make recommendations for change to the system of prudential regulation of P&C insurance in Australia.

The Royal Commission was given a budget of $40 million and a staff of 70 lawyers, accountants, information technology specialists, secretariat staff and other specialists to complete the work. Deloitte Touche Tohmatsu and Trowbridge Consulting were engaged to provide actuarial and accounting support. The Royal Commission received testimony from 126 witnesses, with another 75 persons presenting written statements. The Commission database spanned 44 million documents.

The surprising failure of HIH was of pressing concern not only to policyholders, investors and other parties with a financial interest, but also to regulators who appeared to let this situation unfold under their watch. HIH was the subject of multiple investigations. Provisional liquidators sought to establish an estimate of policyholders' outstanding claims liability (OCL) and identify claims that might be available to other creditors. APRA appointed an inspector pursuant to Section 52(2)(d) of the Insurance Act 1973 to investigate

[1] Owen, The Hon. Justice Neville, The HIH Royal Commission, The Failure of HIH Insurance, Vol. 1, Commonwealth of Australia, April 2003, pg. xiv

the affairs of companies within the HIH group. As well, the Australian Securities and Investment Commission (ASIC) initiated its own investigation to examine various aspects of the collapse

The Royal Commission stopped short of accusing parties of misconduct. Rather, it noted possible breaches of the law or professional standards. Matters were often referred to the relevant authorities for further investigation. A number of parties ultimately faced criminal prosecution, resulting in jail terms, significant fines, disbarment and prohibition from involvement with the financial industry. The focus of the present study is on factors which led to the corporate collapse and not on the sanctions imposed.

History of HIH Insurance

HIH continually evolved over its 33-year history. The company grew rapidly through numerous acquisitions and underwent a series of corporate name changes. Although HIH operated a number of businesses, its primary focus was P&C insurance. This section of the report provides background on HIH's acquisitions and name changes. While effort is made to identify the firm by its proper legal name at the time, the term "HIH" is used in this report to identify HIH Insurance Limited, related bodies corporate and related entities.

MW Payne Liability...

HIH's origins date back to 1968, when MW Payne Liability Agencies Pty Ltd was incorporated to write insurance business in Australia as an agency for two of Lloyd's of London syndicates. MW Payne's main business was workers' compensation insurance.

...Became CE Health Underwriting...

In 1971, the company was acquired by CE Heath plc (a public listed company in the U.K.) and its name was changed to CE Heath Underwriting Agencies Pty Ltd (CE Heath). Its business expanded until the mid-1980s. Changes to workers' compensation legislation in 1985 and 1986 caused CE Heath to diversify its underwriting into other classes of insurance, including property, commercial and professional liability. CE Heath also decided to expand offshore, first to Hong Kong where it focused on reinsurance, and then into California where it focused on workers' compensation. From the mid-1980s onward, CE Heath expanded its underwriting classes and entered new markets. It expanded into the U.S. market in 1987 through the acquisition of California-based Falcon Insurance Company (later to be renamed CE Heath Compensation and Liability Insurance Company, or Heath Cal), which focused on workers' compensation and marine insurance.

Graph 1: HIH Insurance Limited Corporate Name Changes

1968 - MW Payne Liability Agencies Limited

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1971 - CE Health Underwriting Agencies Pty Limited

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1989 - CE Health International Holding Limited

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1996 - HIH Winterthur International Holdings Limited

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1998 - HIH Insurance Limited

...Became CE Health International...

In 1989, CE Heath changed its name to CE Heath International Holdings Limited. On April 6, 1992, CE Heath issued a prospectus and was listed on the Australian Stock Exchange (ASX) for the first time. Following the flotation, 45 percent of the shares were held by the public, 44 percent by CE Heath plc and 11 percent by local CE Heath directors. Expansion into the U.K. was deemed to be a priority for the newly floated company. Underwriting in the U.K. began in September 1993.[2]

From November 1994 onward, activities of CE Heath's U.K. branch were expanded into a broad mix of global insurance, including reinsurance, marine, property, travel and personal accident, professional indemnity, catastrophe, contingency, film finance and political risk. Problems with the U.K. operations began in mid-1996 and continued throughout 1997. Auditors identified issues with provisioning data, lack of a consistent underwriting approach and coherent business philosophy regarding reinsurance and insufficient and substandard financial information.[3]

CE Heath sold Heath Cal in 1994 for $118.6 million. It had been concerned about pending legislative changes in California that would affect profitability. Until 1995, CE Heath's core business was in long-tail classes of insurance. In Australia, it wrote workers' compensation, public liability and professional indemnity insurance. In California, the focus was on workers' compensation. In the U.K., CE Heath focused on public liability and professional indemnity. After 1995, the company embarked on a period of rapid growth, primarily through acquisitions.

CE Heath plc's first big acquisition was the June 1995 purchase of CIC Insurance Limited (CIC) from CIC Holdings (later named Winterthur Holdings Australia Limited or Winterthur Australia, a subsidiary of Winterthur Swiss Insurance Company) for $154.2 million. CE Heath plc funded the CIC purchase through the sale of CE Heath to Winterthur Australia. The deal would lift CE Heath's earnings and establish it as a major force in the Australian insurance industry. Although the later purchase of additional shares put Winterthur Australia in a 51 percent ownership position, it never pressed for control of the 10-person CE Heath board. This benefited CE Heath management, allowing the co-founder and chief executive (Ray Williams) to run this public company in what appeared to be a

[2] Ibid., Volume 1, pg. 52

[3] Ibid., Volume 1, pg. 58

very controlling, entrepreneurial and self-serving manner. CE Heath's acquisition of CIC was sizeable. CIC was the tenth largest private insurer in Australia, with a market share of 5 percent.

There were a number of perceived benefits of the deal, including improved balance sheet strength and capital-raising ability, share register stability and strategic expertise. It was felt that the acquisition would also provide CE Heath with a launching pad for future growth into Europe. It was about this time that early warning signs began to appear regarding CE Heath's emerging financial difficulties.

By early 1995, Winterthur received reports from its actuary and Ernst & Young expressing unease about CE Heath's reserving and actuarial practices. Both CE Heath and CIC performed due diligence on each other in advance of the acquisition. CE Heath's due diligence on CIC revealed that most lines of CIC's business were worse than CE Heath had originally been told. CIC had inflated its profitability through the release of prudential margins, which had the potential to increase losses. Also, there were questions about its reserving practices. CE Heath was not maintaining a prudential margin, according to APRA.

CIC's due diligence report on CE Heath revealed significant and ominous concerns, including:

- Not transitioning into a public company run in the interests of shareholders;
- A decentralized management structure that raised corporate governance concerns;
- Executive directors benefiting from employee loan schemes, employee share-ownership plans, executive option plans and incentive bonus schemes;
- The firm's auditor (Arthur Andersen, later named Andersen) regarding the CE Heath audit as a "maximum audit risk" – it was suggested that management had the ability and incentive to manage the reported result and adopt potentially invalid positions and practices; and
- Reserving methodology that was aggressive and proved to be inadequate.[4]

[4] Ibid., Volume 2, pg. 6

CE Heath management did not tell its board of the Ernst & Young criticisms in clear and direct terms. The board was passive and did not enquire about findings in the due diligence report that flagged current and potential problems, including under-reserving, lack of internal controls, conflicts of interest and a culture of corporate entitlement. It was perhaps not so surprising, then, to see these same concerns cited when the company failed. Although reservations were expressed on both sides, the deal between CIC and CE Heath proceeded with each party promising the other to address any deficiency in reserves. Throughout 1995, Winterthur became increasingly concerned about the expansion of CE Heath's U.K. operations.

...Became Winterthur International...

In May 1996, CE Heath changed its name to HIH Winterthur International Holdings Limited (HIH Winterthur). It would become the second largest P&C insurance company in Australia. In May 1997, HIH Winterthur acquired Colonial Mutual General Insurance Company Limited in Australia and New Zealand. HIH Winterthur management promoted expansion into the U.S. despite Winterthur's concerns and despite known problems in the California workers' compensation industry. HIH Winterthur management saw expansion into the U.K. and U.S. as a priority. In 1997, HIH Winterthur re-purchased Heath Cal (now known as CareAmerica Compensation and Liability Insurance Company) for $79.3 million. The U.S. operation was subsequently renamed HIH America. Although the business was purchased for substantially less than they had sold it in 1994, the move would later prove costly. By November 2000, all remaining HIH business in the U.S. would be in voluntary run-off.

...Became HIH International Limited

In 1998, Winterthur merged with Credit Suisse to create Credit Suisse Winterthur, a global financial services provider. In August 1998, Credit Suisse Winterthur sold its 51 percent of shares in HIH Winterthur through a public offering to investors in Australia. Winterthur had understood that the focus of operations of HIH Winterthur would be largely, if not exclusively, the Australian market. HIH Winterthur's international operations and overseas expansion caused Winterthur to cut ties with the firm. In hindsight, this was perhaps an early warning sign to outside observers. HIH Winterthur management was concerned that this sell-off would cause the company to lose access to capital and expertise and the security this gave to lenders, investors and policyholders. Management had also been concerned that a new majority shareholder would insist on board control. These shares would become widely held.

Management opposed a business-to-business sale favoured by Winterthur and instead pursued a sale based on demand from institutional investors (book-building) to dispose of Winterthur's shares in HIH Winterthur. HIH Winterthur's board made a grave mistake through its failure to recognize the importance of having a major shareholder to replace Winterthur. Winterthur sought to include as much information as possible in its offering advisory in order to drive the sale price. This included actuarial assessments and a detailed claims-development table for HIH Winterthur for the period 1987-1997 – a move that would inadvertently reveal publicly for the first time the extent of HIH Winterthur's historical under-reserving practices. This deficiency did not attract public attention at the time of the offering.

In October 1998, HIH Winterthur changed its name to HIH Insurance Ltd (HIH, from this point forward). The HIH Winterthur sale jolted what had been a generally favourable, if cautious, market view of the company until that time. It profoundly changed HIH's shareholder base. In December 1997, HIH had 5,265 shareholders. By October 2000, it had some 29,973 shareholders. HIH's institutional shareholder base declined continuously in the interim. The top 20 shareholders held 83 percent of shares in March 1998, 53 percent of shares in September 1999 and just 38 percent of shares in October 2000. No single shareholder held over 10 percent of HIH capital. Lack of a majority shareholder that might otherwise question some management practices meant that HIH management's grip on the company would remain as strong as ever.[5]

[5] Ibid., Volume 1, pg. 55

[6] Ibid., Volume 1, pg. 59

HIH acquired Cotesworth Group Limited in December 1998. Through a subsidiary, it was the managing agent for four active Lloyd's of London syndicates. An aim of the acquisition was to establish HIH's own corporate syndicate within the Lloyd's market in the U.K. HIH's U.K. operation experienced poor results and drained HIH reserves of some $300 million by December 31, 1998. As a result of its acquisition of FAI Insurance Limited (FAI), HIH became further exposed to losses in the U.K. market in January 1999 through earlier operations there of three FAI subsidiaries. HIH management had been interested in a takeover of FAI since at least 1993. In September 1999, HIH's U.K. operations were put into run-off. HIH's ambitious growth strategy had a serious negative impact on its financial position. While its 1998-99 annual report showed a substantial increase in the value of reported assets and liabilities, the commercial business environment was characterized by weak profitability, volatile investments and a series of significant losses in overseas businesses. HIH recorded its first-ever year-end loss in 1999.[6]

During 2000, HIH experienced a significant deterioration in its profitability and capital base. This was a direct result of market difficulties in the U.K. and the U.S. and the acquisition of FAI. HIH soon found itself the subject of unwanted public scrutiny. In late 1999 and into early 2000, APRA released drafts of proposed new prudential regulations. HIH realized that it would have trouble honouring the regulations with its current capital structure. In response, it put its growth strategy on hold and announced a series of transactions with established insurers designed to inject cash and increase its reserves. Unfortunately, this change in approach failed.

The first transaction was a joint venture with Allianz Australia Insurance Limited (Allianz), negotiated in late 2000 and enacted on January 1, 2001. The deal saw HIH transfer a substantial portion of its business (personal lines and compulsory third-party insurance) to an unincorporated joint venture for $200 million. Allianz controlled 51 percent of the joint venture and HIH controlled the remaining 49 percent. The second defensive move occurred in November 2000. HIH entered into a managing general agency agreement with Gerling Australia Insurance Company to benefit from that company's strong credit rating. While the goal was to proceed into a joint venture, negotiations here failed. The market reacted with skepticism, believing that the transaction would provide temporary relief but rob HIH of its profitable lines of business. In late 2000, HIH's principal banker (Westpac) called on HIH to appoint Ernst & Young (E&Y) to review the company's financial position. In a November 2000 draft report, E&Y noted that HIH's financial position was "delicately poised."

From mid-January 2001 onward, public speculation regarding HIH's financial health increased. On February 9, HIH announced that its interim result to December 31, 2000, was likely to be a loss. Standard & Poor's downgraded five of HIH's core operating entities. Trading in HIH shares was temporarily suspended on February 22 and again on March 11 when APRA issued notices requiring HIH to show cause why inspectors should not be appointed under the Insurance Act 1973. HIH was given two weeks to respond. On March 6, a third defensive move saw HIH enter into a joint venture with QBE Insurance Ltd (QBE) wherein QBE obtained 60 percent of all of HIH's corporate insurance. HIH also appointed KPMG to undertake a review of its financial position. The next day, HIH sold off its former lines of retail business (from the Allianz joint venture). In light of the disturbing results of HIH's financial review, APRA appointed a provisional liquidator (KPMG) on March 15. Similar measures were taken in the following weeks for HIH's overseas operations. On August 27, 2001, a further court order put HIH and 17 companies in the group into liquidation.

The regulatory environment

Responsibility for the supervision of authorized P&C insurers under the *Insurance Act 1973* was vested in the Insurance and Superannuation Commission (ISC) until July 1998. Since then, it has been vested in APRA, a body responsible for prudential regulation. State regulators, including the Motor Accidents Authority of New South Wales (MAA) and the Motor Accident Insurance Commission of Queensland (MAIC), rely upon APRA as the lead regulator.

In March 1997, the government received the Report of the Financial System Inquiry (known as the Wallis Report). The Wallis Report recommended that 11 Commonwealth and state regulators be combined to create an integrated regulator for the prudential supervision of all financial institutions, including banks, building societies, credit unions, superannuation funds (private pension funds), friendly societies, life insurers and P&C insurers. On July 1, 1998, APRA was created through a merger of the Reserve Bank of Australia (previously the supervisor of banks), the ISC (previously the supervisor of insurance companies and superannuation funds) and a network of state regulatory bodies known as the Financial Institutions Scheme (previously the supervisors of credit unions and building societies). This was a complex management challenge.

A key objective of the reform exercise was a reduction in the overall cost of financial regulation. During the first two years of its existence, much of the focus of the APRA board and senior management was devoted to organizational and transitional issues. APRA was not given any explicit powers other than those embedded in current legislation. As it transitioned, APRA lost some corporate memory and industry expertise. Its budget was reduced to less than the combined budgets of its predecessor agencies and its staff count declined from 550 in 1998 to about 400 under the new structure introduced in mid-1999. There were delays in reacquiring much-needed industry knowledge. APRA was newly created and facing challenges, and HIH was in need of greater scrutiny – which APRA could not provide.

The new structure contained two new supervisory divisions, Diversified Institutions Division (DID) and Specialized Institutions Division (SID), in addition to a Policy, Research, and Consulting Division and a group of corporate service departments. Each of the two front-line supervisory Divisions was given responsibility for a full range of institutions, including banks, life and P&C insurers and superannuation funds. DID was responsible for conglomerates with business activities in more than one financial services industry and groups with significant foreign operations or foreign connections. SID was responsible for institutions and groups operating within one financial services industry. Generally, SID-governed institutions were smaller and less complex.

Under the new structure, supervision of the HIH group of companies was assigned to a branch within DID. The branch was responsible for supervising approximately 30 financial groups, including four identified by APRA as systemically significant. HIH was not considered to be systemically important at that time and was expected to take less supervisory effort than the other conglomerates.

APRA received one-page handover documents from the General Insurance Division that rated most HIH companies as “low priority” on the regulatory watch list. While FAI was given a “high priority” classification, no supervisory actions were planned or pending. APRA made two big decisions as it received the ISC files and responsibilities. The first was to adopt an integrated model so that a branch or group would have responsibility for a number of institutions allocated to it on the basis of size and complexity, rather than along industry lines. APRA would not have the same degree of institutional specialization in supervisory activities as its predecessor. It was expected to develop a uniform, risk-based approach to supervision across all entities for which it was responsible. APRA’s second decision was to locate its operations in Sydney rather than Canberra, where the ISC had been headquartered.

APRA’s move to full integration and relocation to Sydney created many distractions for senior managers. High levels of staff attrition led to the loss of specialist P&C insurance skills. APRA was in varying degrees of transition between July 1, 1998, and March 15, 2001. It was slow to recognize a need to recruit and develop extensive insurance expertise. A significant recommendation of the Royal Commission was an overhaul of APRA, including the replacement of its part-time non-executive board with a small full-time executive group appointed by the government. This would bring greater clarity regarding responsibilities and accountabilities. Given the size and complexity of the organizations it was assigned to supervise, APRA believed that it was dealing with sophisticated, well-managed and well-controlled institutions. Consequently, it felt that it could rely upon a less intrusive, consultative and decentralized supervisory regime. APRA also focused on individual organizations, rather than the corporate groups to which they belonged.

The cornerstone of APRA's supervisory approach was the solvency test. The approach it adopted in 1998 and 1999 was largely a continuation of ISC's earlier approach. Supervision of insurers was not risk-based but, rather, was based primarily on a review and analysis of statutory returns, including:

- Quarterly returns – Statements of assets, liabilities, profitability, changes in net tangible assets and premiums;
- Annual returns (Audited by an APRA-approved auditor) – Underwriting experience, assets, liabilities, claims, outstanding claims provision (OCP), premiums and expenses in various categories;
- Annual insurer application for approval of reinsurance arrangements; and
- Applications for approval of related-party assets to be included in the solvency calculation.

APRA assumed it could:

- Use minimum solvency targets plus an informal margin or buffer (or the company's internal minimum capital target, if higher) as an early warning sign to detect financial weaknesses to be remedied through access to additional capital;
- Leverage the company's internal control systems and APRA's knowledge of those systems to confirm that adequate controls were in place; and
- Assume that the institution was not relying on APRA to detect breaches of key prudential requirements, provide guidance on appropriate work and risk management practices, or perform an audit role.

At the time of the HIH insolvency in March 2001, minimum solvency standards required P&C insurers to have total assets exceeding total liabilities by not less than $2 million, 20 percent of net premium income, or 15 percent of net outstanding claims – whichever was the greatest. In addition, reinsurance arrangements had to be approved by APRA. These tests had to be met both inside Australia and on a global basis. Corporate regulation in Australia was designed to clarify problem situations and promote the financial health and longevity of commercial entities. At that time, Australia's solvency standards were less stringent than those of Canada's federal regulator, the Office of the Superintendent of Financial Institutions (OSFI). A decade earlier, OSFI was developing and implementing a range of procedures and approaches to detect early signs of trouble in federally regulated financial institutions and pension plans. This included stronger regulatory capital rules, development and application of rigorous and sound accounting rules, enhancement of OSFI's relationship with regulators at the provincial and international levels and the development of a more risk-based focus for OSFI's examination framework.

The Royal Commission recommended "as a matter of high priority" that APRA develop a minimum capital requirement at a group level as well as at the authorized entity level. The Royal Commission noted that APRA did not cause or contribute to the collapse of HIH, and could not have taken steps to prevent the failure of HIH. It was clear, however, that the manner in which it exercised its powers and discharged its responsibilities under the *Insurance Act* fell far short of what policyholders could have expected from the insurance industry's prudential regulator. APRA missed several early warning signs of financial difficulties with HIH, was slow to act and made errors in judgement regarding some important issues.

The unexpected collapse

As in other countries, P&C insurance in Australia is a cyclical business. Although the late 1990s were a period of poor global market conditions for commercial insurance, most P&C insurers were profitable (although premium rates were inadequate). Some wrote business at cheaper rates in local markets. Others sought to compete in complex international markets. HIH failed because it was unable to cope with soft rates, increasing claims and disappointing returns on investment.

The P&C insurance cycle was close to its peak in the mid-1990s. P&C insurers' total after-tax profit in the year ended June 30, 1996, was 80 percent higher than in the preceding year. On the stock market, the insurance index outperformed the all ordinaries index and the banking index in 1996. HIH's move to rapid growth and diversification came at exactly the point when the market was turning. Industry profits fell sharply as a result of low interest rates, a reduction in investment returns and falling premium rates due to strong competition. In December 1998, the industry reported its highest-ever underwriting loss – nearly 40 percent higher than any result over the past 20 years.

In December 2000, there were 161 insurers and reinsurers licensed by APRA to write P&C insurance in Australia. The top 20 insurers accounted for 88 percent of gross industry premium. The top five insurers (including HIH) accounted for 44 percent of the P&C insurance market. In 2000, gross premium revenue totaled $19.6 billion (a 6.8 percent increase on the 1999 total of $18.4 billion). Claims fell from $20.6 billion in 1999 to $18.3 billion in 2000 (11.2 percent improvement). Industry losses fell from $2.9 billion to $1.5 billion in 2000.

HIH maintained a strategy of international growth and diversification that began in 1995, as Table 1 shows. Its insurance operations grew rapidly from 1995 onward as it made numerous acquisitions both locally and abroad. HIH had three main operating arms:

- HIH Casualty and General Insurance Limited (C&G);
- CIC Insurance Limited (CIC); and
- FAI General Insurance Company Limited (FAI)

Table 1: HIH Insurance reported contributions to total assets, A$ Millions

Area	Filed by HIH Year to December				Compiled by liquidators 18 Months to June	Year to June
	1994	1995	1996	1997	1999	2000
Australia	1,016.5	2,340.8	2,647.7	2,861.4	6,034.8	6,008.3
United Kingdon	62.8	111.3	132.4	377.9	625.0	949.0
United States	17.7	39.1	106.3	502.6	733.9	762.5
New Zealand	68.3	125.1	135.0	153.7	205.6	310.3
Asia	35.7	49.0	95.0	78.0	92.2	246.8
Argentina	-	-	10.5	13.1	33.9	50.2
TOTAL	**1,201.0**	**2,665.3**	**3,126.9**	**3,986.7**	**7,725.4**	**8,327.1**

Source: HIH Royal Commission Report, Volume 1

The Royal Commission encountered serious problems as it sought to reconstruct the affairs of HIH. The businesses were administered on a portfolio-by-portfolio, rather than company-by-company basis, and were overseen by a separate subsidiary.[7] The Royal Commission was unable to obtain from any source a complete set of HIH's board papers and minutes. Critical records were fragmented. Given that the Royal Commission was an Australian undertaking, it could not compel the supply of documents or co-operation from abroad (U.S., U.K. and Hong Kong). Consolidated company information was reconstructed for the following periods: the 12-month periods ending December 31 of 1994, 1995, 1996 and 1997; the 18-month period ending June 30, 1999; and the 12-month period ending June 30, 2000. HIH ceased operation just eight and a half months later, on March 15, 2001.

HIH's growth strategy was never subjected to rigorous analysis to assess its appropriateness in a rapidly changing business environment. HIH management never formally submitted a long-term strategy or plan to the board for review and approval. Its expansion overseas stemmed from bad decision-making that was management driven and from a lack of business judgement in adverse market conditions. HIH failed to respond when losses started to flow from international operations and continued to write new business despite these losses.

[7] Ibid., Volume 3, pg. 44.

HIH managed its insurance business through separate divisions broadly corresponding to various classes and portfolios of business, rather than through subsidiary companies:

- Professional indemnity insurance – written by C&G, FAI and CIC;
- Liability insurance – written by C&G, FAI and CIC;
- Workers' compensation insurance – written by C&G, FAI and CIC;
- Compulsory third-party insurance – written by FAI and CIC (C&G exited this line);
- Salary continuance insurance – written by C&G;
- Short-tail lines of insurance – including motor, household, pleasure craft, commercial property, travel, engineering, trade credit and contingencies (bloodstock and livestock);
- Marine insurance – five distinct areas of business including: U.S. (C&G run-off), marine Australia (C&G), Hong Kong marine, FAI Australian marine and marine group stop loss;
- HIH U.K. operations – U.K. branch and Cotesworth;
- HIH U.S. operations – HIH America (HIH America Compensation and Liability Insurance Company) and Great States Insurance Company;
- HIH Asia operations – written by FAI and C&G; and
- HIH Re – a division within HIH providing reinsurance for the various underwriting divisions.[8]

There was some overlap in the personnel involved in the management of each of the divisions. HIH tracked its financial position by dividing the group's OCP on a portfolio-by-portfolio basis for required reporting dates between December 1997 and December 2000. It stumbled through the late 1990s with a series of poor business decisions. Its re-entry into the U.S. market in 1996 (after having exited the market with a profit in 1994) was a disaster, as Table 3 shows. It expanded its U.K. operations in 1997 into uncharted territory. HIH also made a costly purchase of FAI in 1998. Its U.S., U.K. and FAI operations (before and after being acquired by HIH) suffered from chronic under-reserving. HIH sold its most profitable lines of business in a joint venture with Allianz in September 2000. Cash flow implications from that last venture sped HIH toward financial ruin and led directly to the decision to place the company in provisional liquidation.

[8] Ibid., Volume 2, pg. 291

Table 2: HIH Insurance contributions to consolidated revenue, A$ Millions

	Filed by HIH				Compiled by liquidators	
Area	Year to December				18 Months to June	Year to June
	1994	**1995**	**1996**	**1997**	**1999**	**2000**
Australia	633.9	1,015.8	1,501.3	1,676.3	3,197.3	2,441.1
United Kingdon	30.1	90.4	113.5	266.2	664.2	1,016.9
United States	79.8	83.7	114.4	244.9	736.4	488.8
New Zealand	25.9	51.7	68.1	88.0	187.7	286.0
Asia	12.3	27.3	46.8	59.9	150.3	197.8
Argentina	-	-	4.2	7.8	42.0	45.7
TOTAL	**782.0**	**1,268.9**	**1,848.3**	**2,343.1**	**4,977.9**	**4,476.3**

Source: HIH Royal Commission Report, Volume 1

HIH's greatest losses were in the U.K. A post-collapse (December 2002) examination of HIH financial information showed an estimated asset deficiency for the U.K. operations on a net, undiscounted central-estimate basis totaled $1.7 billion, which included $1.077 billion for Cotesworth Capital Limited, $660 million for the U.K. branch of HIH C&G, and $48.5 million for FAI Underwriting Limited. The nature of its long-tail business in the U.K. meant that losses were not revealed until years later. HIH continued to expand its U.K. branch despite majority shareholder Winterthur's expressions of concern. Gross earned premium was $228.2 million at year-end 1997 – 125 percent higher than the previous year.[9] Revenue grew from $90.4 million in 1995 and $113.5 million in 1996 to $266.2 million in 1997. Much of this growth came from acquisitions.

The financial fortunes of HIH were in serious decline from at least January 1, 1998, onward. At the end of 1995, 1996 and 1997, it reported an operating profit after extraordinary items and income tax that was higher than in the preceding year. The figure was $61.8 million as at December 31, 1997. For the next 18 months (to June 30, 1999), there was a $21.2 million loss. HIH showed a profit of $18.4 million over the next year (to June 30, 2000). If not for some questionable accounting treatments for some transactions, the 1999 loss would have been greater and the small profit in 2000 would actually have been a loss. HIH declared dividends in 1999 and 2000 which exhausted its buffer of retained earnings.

[9] Ibid., Volume 2, pg. 35

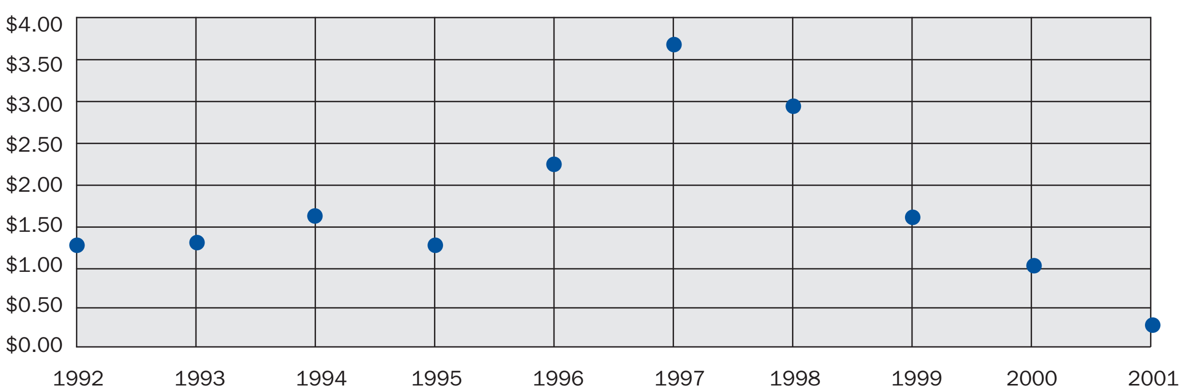
Table 3: HIH Insurance reported contributions to operating profit, A$ Millions

Area	Filed by HIH: Year to December 1994	1995	1996	1997	Compiled by liquidators: 18 Months to June 1999	Year to June 2000
Australia	11.5	57.6	77.3	67.9	78.4	152.5
United Kingdon	1.5	7.5	7.2	7.2	(21.7)	(48.7)
United States	7.9	(2.6)	(5.9)	9.4	(20.5)	(45.4)
New Zealand	(0.7)	9.0	8.8	9.5	17.4	7.2
Asia	(1.4)	1.6	4.8	(2.4)	(5.4)	(11.9)
Argentina	-	-	(1.1)	(1.1)	3.8	2.2
TOTAL	**18.8**	**73.1**	**91.1**	**90.5**	**52.0**	**55.9**

Source: HIH Royal Commission Report, Volume 1

The September 1998 release of its relatively poor first-half results and purchase of FAI just three weeks later polarized market opinion of HIH. Concerns emerged about the company's profit for 1998-99. From May 2000 onward, HIH's generally favourable media coverage ceased, coinciding with a sharp fall in its share price. Except for three brief occasions, HIH's share prices fell steadily from a peak in July 1997. It continued to pay dividends through the last years of its operation: 13 cents in 1996; 15 cents in 1997; 16 cents in 1998; 12 cents in 1999; and 6 cents in 2000. HIH shareholders lost (on a compounded basis) 20 percent of their investment in 1997-98, 20 percent in 1998-99, 40 percent in 1999-2000 and the remainder when the company collapsed.

Graph 2: HIH Share Price, June 1992 to June 2000 and February 2001



Source: HIH Royal Commission Report, Volume 1

HIH's underwriting performance in the late 1990s was poor. On December 31, 1997, it reported an underwriting loss of $33.8 million on earned net premium of $1.233 billion. On June 30, 1999 (using a pro-rated adjustment to reduce it notionally to a 12-month period), HIH reported an underwriting loss of $73 million on a net earned premium of $1.55 billion. On June 30, 2000, HIH's underwriting loss was $103.5 million on a net earned premium of $1.995 billion. Taken together, between 1997 and 1999, the company's underwriting losses more than doubled while its net earned premium rose by 25 percent. Between 1997 and 2000, its underwriting losses tripled while its net earned premium rose by 61 percent.[10]

"Creative accounting" (including increments to goodwill and reinsurance recoveries) was used to hide the true extent of HIH's financial trouble. In 1999, one-off adjustments reduced its underwriting loss by $157 million. In 2000, its underwriting loss was similarly reduced by $360 million. In the absence of the one-off entries, HIH's underwriting losses were much higher. The company's state of affairs was clearly bad and getting worse. If the financial position of HIH entities had been reported accurately, they would likely have failed the prudential requirements set out in the Act. This would have happened well before HIH's eventual collapse.

HIH used goodwill as a crutch to support poor business decisions. On December 31, 1997, total shareholders' equity was $560 million, of which 23 percent was intangibles (goodwill, future income tax benefits and deferred IT costs). On June 30, 1999, intangibles increased to 60 percent of total shareholders' equity. On June 30, 2000, total shareholders' equity was $939 million, of which a full 75 percent ($703 million) was intangible assets. Goodwill alone represented 50 percent of this figure. The company was underperforming at a level that was unsustainable. However, instead of taking responsibility and addressing the underlying causes of its poor performance, management sought to disguise the seriousness of the situation and avoid the consequences of leaving matters unchecked. It opted for business transactions that led to questionable accounting entries. The process was fatally flawed from the outset.

[10] Lai, Iris, "Lessons From HIH Collapse Helped Australia's Insurers Through Current Financial Crisis", Insurancenewsnet.com, A.M. Best Company, Inc., December 22, 2009, pg. 4

Private internal reports began to indicate that the company's debt leverage and insurance liabilities were so high that there was a real risk of insolvency. A final internal audit review of HIH's U.S. operations was performed on February 29, 2000. HIH America continued to experience core earning and underwriting losses, which in turn decreased its capital and shareholder funds. U.S. management failed to book adequate reserves. For a few years, HIH was able to prop up the bottom line of its U.S. operation through the release of prudential margins (generated through acquisition accounting) and the purchase of retrospective reinsurance coverage. It was only in 2000 that market observers began to seriously question the company's financial position. Despite its poor performance, HIH maintained a brave face with regulators. In early March 2000, HIH made a presentation to APRA expressing optimism about its U.K. operations, asserting that the U.K. market was at the bottom of the cycle and recovery was evident. However, poor financial results continued there and elsewhere.

By March 2001, the pressures on HIH that had been building for years could no longer be contained. When the Allianz joint venture caused serious cash flow problems for HIH, a decision was made to delay payments to and on behalf of HIH policyholders. Policyholders and general creditors suffered long delays in receiving funds. Many never received the payments that were due. APRA became involved after successive policyholder complaints about delayed payments. APRA liaised with HIH throughout January and February 2001. HIH shares were temporarily suspended from trading, twice.

On March 1, 2001, APRA called on HIH to show cause why an inspector should not be appointed under Section 52 of the *Insurance Act 1973*. Under the Corporations Law, a group does not become insolvent; rather, companies do. Insolvency carries the meaning in Section 95A of the *Corporations Law* – that the company is unable to pay its debts as and when they become due and payable (or commercial insolvency). The financial health of the entire group is relevant to the status of individual companies within it – there is mutual reliance. On March 15, 2001, all relevant companies in HIH were declared insolvent. HIH ceased writing new business. The end came quickly. Following the notice from APRA, HIH directors took prompt action to have the company placed in provisional liquidation. Formal winding-up orders were issued on August 27, 2001. The five-month window provided temporary administration of HIH while provisional liquidation reviewed HIH's operations and assessed it's financial position.

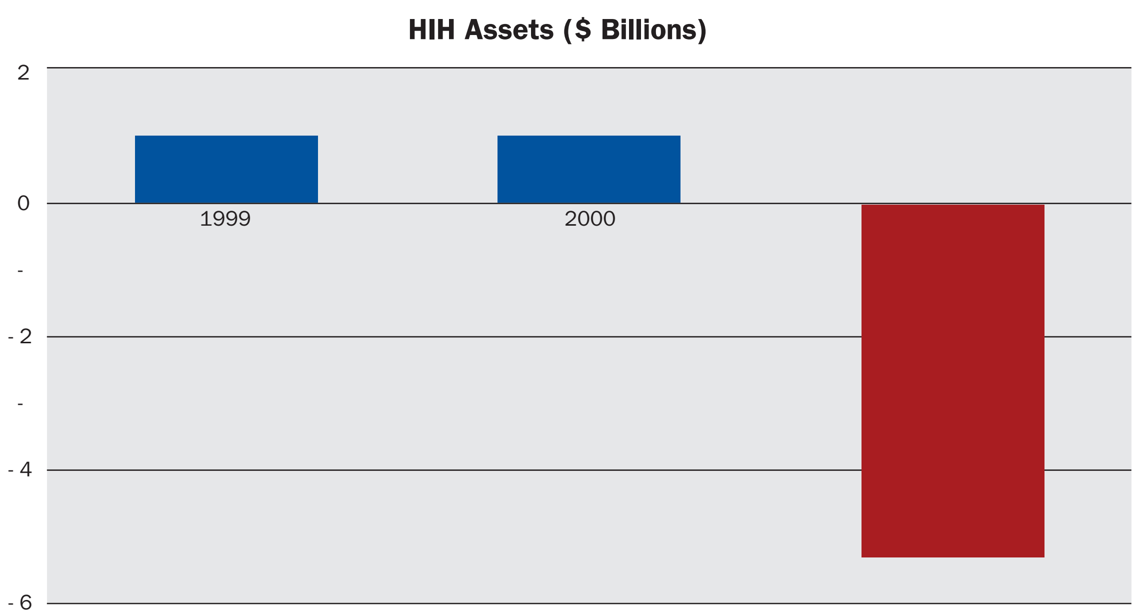
On May 10, 2001, at the request of liquidators, KPMG provided an assessment of HIH's outstanding claims reserves as at December 31, 2000 (Phase I Review; break-up estimate). A second review was completed on July 5, 2001, which provided an assessment of HIH's outstanding claims reserves as at March 15, 2001 (Phase II Review; break-up and going concern estimates). The Phase II Report noted the following points:

- HIH's OCL was undervalued by $1.9 billion on a discounted (going-concern) basis and $2.6 billion on an undiscounted (break-up) basis as at March 15, 2001. The company should have had a prudential margin of $1.7 billion. Its estimated net asset deficiency at March 15, 2001, was between $3.6 billion (central estimate) and $5.3 billion (applying a prudential margin).
- HIH's liability provision at March 15, 2001, should have been $1.001 billion (undiscounted, plus prudential margin of $250 million) or $864 million (discounted). Its liability provision at December 31, 2000 was only $375 million (discounted). This provision was inadequate by some $489 million on a discounted basis.
- A personal indemnity provision at March 15, 2001, should have been $1.020 billion (undiscounted, plus prudential margin of $255 million) or $860 million (discounted). HIH's December 31, 2000 personal indemnity provision was inadequate by $531 million on a discounted basis.
- HIH's U.K. operations provision at March 15, 2001, should have been $921 million (net discounted – $497 million for the U.K. branch and $424 for Cotesworth). Its U.K. operations provision at December 31, 2000 was only $218 million (net discounted and before any prudential margin). Taking into account the timing difference between the two valuations (the U.K. operations were in run-off by the end of 2000) and the growing losses of the U.K. operations, HIH's U.K. operations provision was inadequate by $700 million.
- HIH's U.S. operations provision at March 15, 2001, should have been $565 million (net discounted). Its U.S. operations provision at December 31, 2000, was only $387 million (net discounted). This provision was inadequate by $178 million (net discounted and before any prudential margin).

- FAI accounted for 13.7 percent ($261.1 million) of HIH's total reserves shortfall on March 15, 2001. When added together with FAI's adverse reserve development of $532 million, the total cost to HIH was at least $705 million. This was a conservative estimate, as it did not take into account the value of payments made by HIH on under-reserved claims in FAI's portfolios after January 1, 1999.[11]

The deficiency of all HIH operations was estimated to be between $3.6 billion and $5.3 billion. Observers were shocked that such a large entity with reported premium revenue of $2.8 billion and net assets of $900 million in June 2000 could be found to have an asset deficiency of between $3.6 billion and $5.3 billion just one year later, in March of 2001. One question was on everyone's mind – *Where did the money go?* The abrupt turnaround in HIH's reportedly strong financial position sent shockwaves through Australia's business community and beyond. The HIH insolvency was not a case of fraud or embezzlement. Rather, the deficiency of several billion dollars stemmed directly from claims arising from insured events in previous years that were far greater than the company had estimated. Key industry stakeholders were caught completely off-guard as HIH imploded in spectacular fashion.

Graph 3: HIH Asset Deficiency



Source: HIH Royal Commission Report, Volume 3

[11] Owen, Volume 2, pg. 243

HIH's management and board showed a lack of attention to detail, little accountability for performance and a lack of concern for the company's internal processes and systems. Many of the company's problems related directly to flawed business strategies. It entered highly competitive markets in the U.S. by offering lower insurance premiums (at a low point in the cycle) and expanded into risky lines of business in the U.K. that it did not fully understand.

Causes of the insolvency

Following is a list of causes and factors that led to the insolvency of HIH Insurance.

Primary causes of the insolvency:

1. Reserving

Estimating the size of its OCP is a critical activity for any P&C insurer. In most instances, it is the single largest item on the liabilities side of the balance sheet. This is fundamentally important for a company's financial well-being and the protection of policyholders. For HIH, outstanding claims provisions represented about 50 percent of liabilities. This was significant because the level of reserves plays an important role in the pricing of risk. The casual manner in which HIH estimated and accounted for its OCP was one of the primary reasons for its failure.

The actual value of outstanding claims is not known. OCP is the amount set aside in the accounts to cover the liability – it is an estimate at best, as the actual value is unknown. Insurers must make a number of estimations when preparing their OCP, including:

- Reported outstanding losses – Claims that have been reported to the insurer but have not yet been finalized by the reporting date;
- Incurred but not reported claims (IBNR) – An event has occurred but the claim has not yet been notified or reported to the insurer by the reporting date;
- Incurred but not enough reported losses (IBNER) – Initial case estimates are not sufficient; and
- Claims-administration expenses – Unallocated or indirect costs in settling the claim.[12]

Under-provisioning can overstate solvency on the balance sheet. If OCL has not been developed with reasonable accuracy, any underpricing may not become apparent until the under-provisioning is identified. This will not occur until estimates are revised. Estimates are often made based on technical knowledge, experience and legal advice. For HIH, this came too late in the process for corrective action (meaningful changes to the pricing structure) to be taken. HIH was found to be under-reserving for years. It under-estimated future claims-handling costs, aggressively discounted claims liabilities, excluded a prudential margin and under-estimated claims inflation. Said Justice Owen in his Royal Commission Report, "*It is beyond doubt that the biggest single cause of HIH's collapse was, as I have said, the failure to provide properly for future claims.*"[13]

[12] Ibid., Volume 1, pg. 80

[13] Ibid., Volume 1, pg. xxviii

HIH's OCP was deficient by $382.5 million as at June 30, 1999, as follows: FAI ($190.7 million), HIH C&G ($163.8 million), CMG ($15 million) and HIH America ($13 million). The OCP deficiency for the group grew to $444 million as at June 30, 2000. HIH's OCP (going-concern basis) was estimated to be $4.4 billion on June 30, 2000. On December 31, 2000, it was $3.1 billion. When HIH was declared insolvent on March 15, 2001, liquidators pegged the value of HIH's outstanding claims to be $5.0 billion, meaning it had undervalued claims by some $1.9 billion. That large shortfall increased to $2.6 billion when the estimate was performed on a break-up basis (not allowing for any discounting of the estimate). The figures rose even further, to $4.3 billion when a prudential margin was added. At dissolution, liquidators estimated HIH's net asset deficiency to be between $3.6 billion and $5.3 billion. HIH's significant under-reserving (noted above) contributed significantly to that deficiency.

From 1998 onward, HIH required its consulting actuary to prepare the valuation of liabilities using an allowance across the board of just 2 percent for future claims handling costs. HIH did not make an appropriate allowance for its future claims handling costs because no analysis had been carried out regarding what the actual costs of handling the claims were. This was a lower percentage than the actuary had previously adopted. HIH did not justify the lower percentage through an analysis of its actual claims-handling expenses. This approach resulted in substantial under-provisioning for claims liabilities. An allowance of 2 percent of gross liabilities for claims-handling costs was inadequate. It tended to understate HIH's OCP as at December 31, 1997, and each subsequent balance date. The effect of this under-reserving intensified and became cumulative. An allowance of 5 percent of gross liabilities would have been more appropriate. HIH's consolidated accounts for the periods ending June 30, 1999, included gross OCL of $3.69 billion. For periods ending June 30, 2000, the gross OCL was $4.453 billion. The 3 percent difference on these amounts alone equaled $111 million and $133 million respectively.

The HIH board relied heavily on reports by independent actuaries in setting figures for its reserves. Actuaries set reserves using assumptions for factors such as discount rates and claims-handling costs. At no time were the actuaries' reports (or even summaries of them) tabled at meetings of the audit committee or the board. Actuaries were never asked to attend these meetings to explain their report or to answer questions. It was the practice of the HIH actuary to use a single rate to discount OCP figures, regardless of the jurisdiction.

Prior to July 1, 2002, a P&C insurer in Australia could choose to calculate its OCP using a central estimate (mean of the distribution of possible outcomes) or by applying a prudential margin. Central estimates have a 50 percent chance of being right or wrong. The prudential margin is the difference between a higher percentage used and the central estimate. It is the more cautious approach of the two and has an effect on both the company's balance sheet (higher OCP reduces net assets) and profit-and-loss statement (delaying recognition of profit and the availability of funds to pay a dividend). It was a matter of judgement whether and to what extent a prudential margin should be applied. That was a decision for the directors of HIH (not the actuary) regarding the size of the provision and whether to reserve to the central estimate or adopt a prudential margin. A lack of clear guidelines on reserve adequacy enabled HIH to reserve to the central estimate rather than adopting a prudential margin.

Except in rare situations, HIH (and FAI before it) reserved to the central estimate and did not apply a prudential margin. Valuing insurance liabilities on a central estimate does not truly and fairly represent the financial position of a P&C insurer. Some value must be estimated for risk and uncertainty. It was common practice in Australia for OCP to include a prudential margin. Where prudential margins were used with HIH, they were released in the years leading up to its collapse. Releasing the margin in whole or in part reduced HIH's liabilities on the balance sheet and increased its profit or decreased its loss in revenue statements.

The ultimate decision as to whether a prudential margin should be incorporated was a director responsibility. The function of a prudential margin is to protect the company against the risks inherent in the estimate of its OCL.[14] Any decision on whether it was appropriate to incorporate a prudential margin should have involved consideration of the nature and extent of the risks. A proper review of HIH's actuarial reports would have suggested a high degree of uncertainty and a need for caution. Best practice suggested that the HIH directors should have included a prudential margin in the OCP. In its December 31, 1997, accounts and for every period thereafter, HIH did not include a prudential margin in its OCP. Directors believed HIH's reinsurance program served as a justification for the policy of not including a prudential margin in its OCP. They viewed it as duplicative. However, given the extent to which cover was being provided through future premiums, it was clear that this should not have been viewed as a good substitute for a prudential margin.

[14] Ibid., Volume 2, pg. 317

Assumptions must be made about various items when estimating the OCP, including: the inflation rate, discount rate and future claims-handling costs. Small variations in the assumptions can have a significant impact on the estimate. In calculating its OCP, a company must be mindful of superimposed (social) inflation, which is added to economic inflation and applies to the liabilities of a P&C insurer – especially for long-tail claims where there might be a delay of many years between the occurrence of an event, its notification and the settlement of the claim. Superimposed inflation takes into account an evolving business environment and changing circumstances, such as awards becoming more generous, changes to the law and medical or other recoverable costs increasing at a rate in excess of economic inflation. This adds to the cost to settle the claim.

From 1998 to 2000, HIH's board was advised every quarter that its U.S. operation was losing money. The losses stemmed from claims arising from past business that were continually underestimated. There was a pressing need to increase provisions for those claims. The HIH board failed to recognize the obvious fact that there was a systemic flaw in the assessment of claims arising from past business.[15] The board also failed to direct that steps be taken to ensure that adequate provision was made, once and for all, for future claims arising from past business. Instead, the board allowed the U.S. operations to die a slow death. The shortfall became more and more pronounced with the passing of each quarter.

HIH was criticized for over-reliance on selective judgement (e.g., in determining an appropriate allowance for future claims inflation) at the expense of relying on properly constructed probabilistic models and analysis of the trends and variability found in historical experience. Its rates for superimposed inflation were inconsistent with historical experience. There were also selective judgements made about the impact of particular changes in the type of business being written.

[15] Ibid., Volume 2, pg. 77

2. Pricing

Deficient loss reserves and inadequate pricing together often lead to an insurer insolvency. Past PACICC studies in 2007 (T*he dynamics of property and casualty insurance insolvency in Canada*), 2010 (*Lessons learned from the failure of Advocate General Insurance Company*) and 2012 (*Lessons learned from the failure of Markham General Insurance Company*) have illustrated this point. Insurers that engage in aggressive growth, particularly through new lines of business, typically experience a deterioration in loss reserves and diminished capital.

HIH priced products aggressively to support an international growth strategy, particularly in the U.S. market. This proved to be disastrous, given HIH's volume of business there with long-tail claims where the true costs would only became apparent years later. On January 1, 1995, open rating was introduced in California, removing most of the pricing regulation in the Californian workers' compensation industry. The effect was a dramatic increase in competition, which caused a significant reduction in premium prices and in the profitability of insurers writing this class of business. HIH believed that the Californian workers' compensation market had bottomed out after two years of deregulation and that the timing was good to re-enter the market.

HIH's decision to reacquire CareAmerica in June 1997 was based on simplistic reasoning. HIH had made a profit from the company prior to its sale in 1994 and it thought this could be done again. It was helpful that CareAmerica had retained a number of staff when it bought the company from HIH in 1994. Also, using market history as a guide, HIH believed the market would stabilize and return to profit two years following deregulation. Upon re-entering the market, however, HIH soon realized it would be subjected to low prices for a sustained period. An internal audit report of HIH America as at July 31, 1999, showed that losses from the U.S. operations were continuing and the company's liquidity was deteriorating. The reinsurance mechanism introduced to protect the 1997 and 1998 years of account had been substantially used up. Underwriting expenses increased and underwriting results were below budget. Inadequate pricing contributed to deficient reserves.

Under-provisioning can overstate solvency on a company's balance sheet. If OCL has not been developed with reasonable accuracy, any underpricing may not become apparent until the under-provisioning has been identified. This will not occur until estimates are revised. Estimates are often based on technical knowledge, market experience and legal advice. For HIH, identification of its underpricing came far too late for corrective action (adjustments to its pricing structure) to be taken. Without reliable data on its liability for claims, HIH found out too late that its products were underpriced and that the company had been operating unprofitably for years.

Australian Accounting Standards Board (AASB) 1023 requires a deferral and matching approach to the recognition and measurement of premium revenue and claims liabilities. This approach requires insurers to raise an unearned premium provision as a liability for the amount of premium they have received but not yet earned at the reporting date. An important consequence of this is that if an insurer prices its policies below cost, the unearned premium provision, by definition, will underestimate the claims liabilities arising from events that occur after the reporting date under existing policies. This was a significant issue for HIH.

Contributing factors to the insolvency:

1. Business strategy

a) Entering new markets

HIH incurred significant losses from its ill-advised expansion into the U.K., U.S., Hong Kong and Asia markets. Its entry into and expansion in overseas markets was unwise and proved costly. There was a consistent pattern to HIH's international growth. The company expanded into markets with little regard for financial consequences, exercised bad business judgement, experienced adverse market conditions and failed to react quickly to contain and minimize the resulting losses. HIH grew its business rapidly and expanded into markets that failed to harden. The board was complacent – there was no evidence that it contributed to the development of an overall business plan. For example, HIH established its U.K. branch in mid-1993. The U.K. operations consisted of public liability and professional indemnity and some inwards treaty business. While the operations were a success in their first year, business was expanded in 1995 into areas where HIH underwriters had little experience or expertise. At that point, losses began. The U.K. branch did not develop adequate underwriting guidelines or controls.

HIH entered the Californian market assuming it would be successful, without fully exploring the risks involved. This approach proved disastrous. A court decision in California in 1997 expanded the authority of primary treating physicians, who were given virtually unilateral authority to determine levels of disability. The courts applied the decision to claims before the date the legislation took effect, which caused claims costs to rise retroactively. HIH soon found out that it had underpriced workers' compensation risks. Given that this was long-tail business, the losses flowing from contracts signed earlier on took years to materialize and, by the time they did, the extent of competition in the marketplace, and the consequent inability to recoup past losses via higher premiums on new business, meant that little could be done to improve HIH's financial situation.

HIH's U.K. and U.S. operations generated combined estimated losses of about $2.4 billion. Its U.K. operations, initially underwriting public liability and professional indemnity insurance, branched out into areas where HIH had little experience, not addressed, due to inadequate reporting systems that impaired Australian management's ability to effectively control the U.K. operations. In the U.S., management's ability to effectively control the U.K. operations. In the U.S., deteriorating market conditions and significant mispricing of risk led to similar substantial losses.

The performance of HIH's Asia operations was another example of the dangers of expansion into unfamiliar markets and untested lines of business. HIH's Asia operations were expanded between 1998 and late 2000. The Hong Kong office was committed to expansion in an extremely difficult business environment. The focus was on growth without apparent regard to profitability. There was insufficient back-office infrastructure to support the business's growth, little adherence to underwriting strategies and a need for management controls to ensure future self-sufficiency.

Inadequate attention was paid to problems encountered and there was a lack of reaction to losses incurred. HIH thought its Hong Kong operations would give it a platform to expand into Asia. Audit reports on its Asia operations were consistently critical. They focused on HIH's lack of internal controls and the unreliability of reported results. HIH's Hong Kong operations (acquired in 1986) consisted of business spread over Thailand, Malaysia and the Philippines. HIH was seeking to sell its Asian operations prior to its collapse, but Hong Kong investment banks were reluctant to solicit prospective bidders. Business shortcomings made the investment too risky.
In 2002, liquidators noted that HIH's Asia operations had an asset deficiency of $235 million.

b) Entering new lines of business

HIH placed itself at great financial risk when it entered new lines of business where it had no history. Underwriting experience assists actuaries in developing case estimates. Past experience in lines of business gives actuaries greater ability to find a consistent run-off pattern that has applied in the past.

Problems in the U.K. stemmed from HIH's expansion into the marine excess-of-loss whole-account line of business (a market in which the U.K. branch had no experience) and, in particular, its involvement with John Charman (an active underwriter for Syndicate 488 at Lloyd's). Large losses were incurred here in the writing of marine excess-of-loss contracts. There was no reporting structure that allowed others in HIH to know what the U.K. branch was writing. The U.K. branch was willing to underwrite lines of business in which it had little or no experience. Two glaring and costly mistakes were the provision of personal accident cover to members of the Taiwan army (whether on military duties or otherwise) and covering physical damage to or loss of Israeli motor vehicles (without terrorism exclusions). These two initiatives had costly implications for HIH in 1997 and 1998. The U.K. branch failed to adopt adequate underwriting guidelines and controls that would limit underwriting activities to less risky lines of business.

The main losses for the U.K. branch occurred in underwriting whole-of-account excess-of-loss marine reinsurance and film financing. Film finance coverage proved particularly problematic for HIH. It wrote this business for a short period of time, from 1997 to July 1998. Assessing risk for the film finance business was difficult. There was a complete lack of any independent risk analysis by HIH in this novel line of coverage. HIH's lack of underwriting controls, relevant experience and familiarity in particular lines of business proved to be a formula for financial disaster. With no reporting structure to routinely flag emerging issues, HIH had no process to address concerns and mitigate the losses. It expanded into the U.K. with poor-quality management information and inadequate accounting systems. Management could not monitor and control the operations effectively. Losses in the U.K. were estimated at $1.7 billion.

c) Acquisitions and joint ventures

HIH did not ensure that business purchase and joint venture activities were carefully researched to determine whether they supported its strategic objectives. The purchase of FAI in Australia and the joint venture with Allianz are examples of this. HIH's decision to acquire FAI (at a cost of $295 million) was impulsive and based on inadequate information. In September of 1998, HIH announced a takeover for the issued share capital of FAI. It had been interested in acquiring a strategic shareholding or possibly taking over this company since at least early 1993. Acquisition of the company's retail lines was attractive. It would allow HIH to broaden its base of short-tail insurance lines and help to balance its existing and substantial long-tail lines.[16] FAI would help HIH to expand its distribution channels and rationalize its IT resources. It would also help to raise HIH's public profile and size and generate economies of scale. FAI refused HIH's attempts to perform a due diligence investigation. HIH proceeded with the takeover based solely on an assessment of publicly available information. FAI became a wholly-owned subsidiary. Only later would HIH learn that FAI had some long-tail business where there was significant under-reserving. The public information did not make this clear, which proved problematic for HIH.

FAI management looked to reinsurance to offset any increase in reserves on the balance sheet with a corresponding recovery under a reinsurance contract. Arrangements were structured to allow FAI to defer to later years expensing the premium paid to obtain the recoveries. It was thought that increases in reserves could be staged over a number of years. There was a big problem with this approach – FAI negotiated arrangements with reinsurers that gave the appearance of a transfer of risk where in fact there was no transfer. The problem was concealed through a series of fraudulent initiatives: the use of side letters (setting out creative arrangements to negate the transfer of risk), document backdating, inclusion of sections of coverage not intended to be called upon and the use of triggers for additional coverage that were unrealistic. The Royal Commission referred a number of matters to the Director of Public Prosecutions and ASIC for consideration of whether to commence proceedings against certain individuals.

[16] Ibid., Volume 2, pg. 200

When HIH announced its offer to acquire FAI, the company was under-reserved by almost $200 million. Had this shortfall been reflected in the June 30, 1998, FAI accounts, it would have had a serious impact on reported profit. It could have also placed FAI in breach of the solvency requirements of the Australian *Insurance Act* and raised questions about its solvency. FAI failed to address systemic provisioning problems which had a direct effect on the financial health of the company and the way its financial health was reported. HIH had similar problems. Its under-provisioning problems and the practices of FAI interacted with and compounded those it was already experiencing. The results were catastrophic.

It was later learned that FAI reserves for business written before 1991 were inadequate by perhaps $50 million to $60 million. APRA had considered FAI to be under-provisioned by at least $40 million from at least June 3, 1997, onward. The takeover proceeded with little consideration in a very short time frame and insufficient preparatory and investigative work on the part of HIH. The cost to HIH from the FAI acquisition (deteriorating reserves) was estimated to be $590 million.

HIH's joint venture with Allianz was negotiated in late 2000 and came into effect on January 1, 2001. This involved the sale of HIH's profitable retail lines (most of which had come from the FAI acquisition). The joint venture was attractive to HIH as it offered a form of restructuring. The proportion of intangibles on HIH's balance sheet was high. Proposed reforms to insurance regulations would effectively require HIH to convert a significant amount of its intangible assets into tangible assets. The deal would also provide HIH with a $200 million cash injection – the upfront cost to Allianz for the purchase of HIH's retail lines. The venture called for the establishment of a trust to ensure that the joint venture had sufficient funds to cover claims.

Premium income to which HIH was entitled was to be paid directly into the trust. Profits would be distributed from the trust on a quarterly basis, but only after an actuarial assessment confirmed that the trust funds were sufficient. A joint venture of HIH's retail insurance business was not a matter which had been raised or canvassed at board level. Also, the board did not approve the contents of the joint venture information memorandum or its distribution. The Allianz transaction represented a profound change in the strategic direction of HIH. It was shocking that management would pursue such a radical change in direction without even informing the board.

This highlighted a serious governance deficiency at HIH – the ineffectiveness of its board in controlling management activities. The board was passive and management took advantage of this. The way that the transaction was handled demonstrated the narrow view that management had of the board's oversight role.

After the venture came into effect, HIH was still burdened with growing claims costs from the portfolios it had retained. It would not receive funds from the trust until May of 2001. HIH's access to its main income source (about $1 billion per year) was cut off until after the completion of the first actuarial assessment, which would have been five months after the start of the joint venture. HIH was required to contribute a significant amount of assets and cash ($500 million) to the trust at the outset. However, it did not have assets worth $500 million to contribute to the claims reserve trust as required and therefore had to use the $200 million received from Allianz for this purpose. The sale resulted in severe cash flow problems for HIH. The cash flow crisis this created in early 2001 proved insurmountable and had a direct bearing on the timing of the HIH collapse. Within 10 weeks of the start of the joint venture, HIH was forced into liquidation.[17]

[17] Ibid., Volume 2, pg. 554

2. Financial reporting

a) Financial statements

Accurate financial statements are critical in cases of long-tail insurance where the payment of claims may occur many years after premium income has been received. In the absence of such information, it is possible that a P&C insurer dealing in long-tail classes of business could be technically insolvent (true liabilities exceeding its assets) but remain operational for a significant period of time because of the timing of receipts and payments in the business. This was the situation with HIH.[18] Its financial statements did not give a true and fair view of the group's position. Management used aggressive accounting practices (reserving to the central estimate and not applying a prudential margin) and creative transactions to mask mounting costs from long-tail claims. This approach proved to be unsustainable.

In 1999 and 2000, HIH's financial statements were distorted by questionable entries, heavy reliance on one-off end-of-year transactions and aggressive accounting practices (e.g. recognizing future income tax benefits in the face of losses being incurred). Those aggressive accounting practices strained the spirit of accounting standards as far as possible and were at odds with the policy intent underlying the standard. From 1997 to 2000, auditors noted the use of one-off end-of-year transactions that had an effect on profits. HIH incurred significant income tax losses for the years ending June 30, 1999, and June 30, 2000. Despite this, the company recorded as an asset in its financial statements the full value of the future income tax benefits associated with the income tax losses, as well as future income tax benefits associated with the timing differences.

For the financial statements ending June 30, 1999, future income tax benefits resulting from tax losses totaled $27 million and those associated with timing differences totaled $145 million, for a total of $172 million. For the financial statements ending June 30, 2000, the figures were $137 million and $91 million respectively, for a total of $228 million. Australian accounting standard AASB 1020 makes it clear that, where a company incurs a tax loss, significant doubt arises about its ability to realize the related future income tax benefit in subsequent periods. It would be imprudent to carry as an asset the future income tax benefit attributed to the tax loss.

[18] Ibid., Volume 1, pg. 141

It was later learned that HIH misled APRA with its quarterly return dated September 30, 1999. The documents filed with APRA did not reflect information in the general ledgers, trial balances and other accounting records of the companies involved. Adjustments were made to reduce its OCL and create a notional transfer of semi-government bonds and unit trusts between companies in the group. Without these adjustments, two of the three licensed insurers in the HIH group would have failed their solvency tests. The returns to APRA did not reflect what was in the general ledgers, trial balances and other accounting records of the entities concerned. APRA failed to take a skeptical professional approach with questions, analysis and review of information that was filed. For example, earlier APRA intervention here might have prevented the November 2000 Allianz joint venture that proved fatal to HIH.

b) Reinsurance arrangements

Reinsurance is widely used by P&C insurers to manage underwriting and financial risk. It is a legitimate and effective means for an insurer to supplement its capital base. A key function of reinsurance is to transfer the risk of future adverse developments in relation to claims. It is very important when the level of OCP and other factors affecting an insurer's financial statements are being considered. Traditional reinsurance centres on the transfer of risk. HIH employed financial insurance (pg. 43-44), which was essentially a deposit arrangement that was not accompanied by a risk transfer.

Accounting standard AASB 1023 required insurers to account for both their OCP and reinsurance recoveries on a gross basis. They were not permitted to set off the recovery under the reinsurance arrangement (an asset) against the OCP (a liability) and thereby reflect in the balance sheet a lower level of liabilities (even though the effect on the bottom line would be the same). HIH used questionable reinsurance arrangements to produce false and misleading financial statements. It was able to understate its OCL, claims and underwriting expenses and overstate its liabilities to reinsurers, reinsurance premium expenses and its operating profit before tax.[19] A key difference between insurance and the financing transactions that HIH engaged in is the issue of risk transfer.

[19] Ibid., Volume 2, pg. 488

There were several examples of reinsurance arrangements that led the Royal Commission to conclude that this was finite reinsurance, which obfuscated a lack of risk transfer and inflated HIH's financial statements:

- HIH entered into a reinsurance arrangement with Hannover Re and two of its subsidiaries on August 25, 1999. The arrangements were documented in two reinsurance binders and in separate agreements relating to some letters of credit and a trust. It was agreed that companies within HIH would pay $200 million and five annual instalments of $11 million each into a fund. HIH could make claims up to a maximum of $550 million, but the reinsurer did not have to pay out until September 2009 at the earliest. HIH was to be responsible for the costs and expenses of the fund's investment and for managing the investments within guidelines agreed to by the reinsurer. However, payment of claims was to come from the fund, rather than the reinsurer. HIH was obligated to top up the fund to ensure that it was always sufficient to meet the claims. The reinsurance binders gave the impression that the reinsurer was responsible for establishing, maintaining and reporting on the managed fund and that the reinsurer carried the risk that the fund might not grow at a sufficient rate to meet HIH claims costs. In reality, however, a letter-of-credit agreement showed that the risk was in fact borne solely by HIH. While this allowed HIH to book a profit of $92.4 million from reinsurance arrangements on June 30, 1999, the agreement was not entered into until August 25, 1999. This arrangement was not true reinsurance, but was presented to APRA as such. Key features of the arrangement (particularly the letter of credit agreement) were not disclosed to the HIH board or to Andersen. HIH was able to report an operating profit before tax and extraordinary items of $52 million, when in fact it should have been faced with a loss of $40 million. This loss situation would have deteriorated by a further $50 million when losses on extraordinary items were taken into account.[20]
- HIH entered into a financial reinsurance contract with Swiss Re on January 21, 2000, to smooth HIH earnings. The arrangements provided HIH with multi-year aggregate excess of loss reinsurance cover for a five-year term to June 30, 2004. It received protection against both deterioration in prior year losses and its loss ratios for future years. For the six months to December 31, 1999, HIH booked a recovery of $84 million and a net profit of $31 million. For the 12 months to June 30, 2000, it booked recoveries of $220 million and a premium expense of $100 million, resulting in an after-tax profit of $84 million.

[20] Ibid., Volume 2, pg. 468

- HIH's U.K. branch was involved in questionable reinsurance arrangements as well. Luxembourg European Reinsurance SA (Lureco) was a financial reinsurer that issued policies to HIH's U.K. branch for years. The Lureco policies were back-to-back policies with a fellow subsidiary of the HIH group (CIC), on exactly the same terms in a "mirror image deal." The U.K. branch of HIH C&G bought reinsurance from Lureco, which bought exactly the same reinsurance from CIC. The reason for involving Lureco as an independent reinsurer was that related-party reinsurance would not qualify as an asset for the U.K. branch for its solvency margin with the U.K.'s Financial Services Authority. The substance of the transaction was a transfer of risk from the U.K. branch to CIC. Had this been done openly without an intermediary, the reinsurance policy could not have been counted as an eligible asset in the U.K. regulator's assessment of the solvency of the U.K. branch. It had the effect of allowing HIH C&G to report lower taxable income in the U.K. and also allowed CIC to report higher income in Australia.[21]
- In 1998, HIH America entered into three retroactive reinsurance contracts that were used to reduce losses by $33 million. It failed to account for the contracts in the manner prescribed by the National Association of Insurance Commissioners Accounting Practices and Procedures. HIH should have accounted for these as deposit transactions and not reinsurance contracts.

HIH clearly used questionable reinsurance arrangements to produce false and misleading financial statements, as the growth in reinsurance recoveries in Table 4 shows. The arrangements enabled the company to understate its OCL and overstate its reinsurance liabilities, premium expenses and operating profit before tax.

[21] Ibid., Volume 2, pg. 55

Table 4: Outstanding Claims Provisions, December 1995 to June 2000

	Discounted			Undiscounted		
Date	OCP ($M)	Reinsurance recoveries receivable ($M)	OCP (net of reinsurance) ($M)	OCP ($M)	Reinsurance recoveries receivable ($M)	OCP (net of reinsurance ($M)
Dec. 31, 1995	1,153.4	250.7	902.7	1,430.9	318.5	1,112.4
Dec. 31, 1996	1,359.1	317.9	1,041.2	1,678.8	373.5	1,305.3
Dec. 31, 1997	1,956.6	446.1	1,510.5	2,377.3	527.4	1,849.9
June 30, 1999	3,699.5	1,050.2	2,649.3	4,246.7	1,198.9	3,047.8
June 30, 2000	4,430.9	1,819.9	2,611.0	4,922.9	1,991.6	2.931.3

Source: HIH Royal Commission Report, Volume 2

c) Reporting systems

Deficiencies within HIH's information systems prevented the flow of timely and reliable information as a basis for management decisions. This negatively affected decisions made by directors regarding the financial health of HIH. The problems were amplified by the group's complex corporate structure and its ever-expanding operations. Flaws in accounting, budget and ledger systems slowed the flow of information and undermined the credibility of prepared statements.

There were flaws in the accuracy and flow of provisioning information within HIH to management (e.g. FAI reinsurance problems), the HIH actuary (e.g. out-of-date data on the Asia operations, the builders warranty business, unknown liability exposure and FAI liability) and the board (e.g. HIH actuarial reports and warnings, unbooked liability exposures and March 2000 information regarding troubles with the U.S. operations). These flaws tended to undermine the accuracy of HIH's OCL for both HIH management its actuary. The inadequacies contributed significantly to under-provisioning within HIH.

As a result of numerous acquisitions, HIH was saddled with a number of different financial reporting platforms that added to the confusion in interpreting the integrity of its financial reporting. These included:

- Oracle system – This was purchased after the CIC takeover and was the general ledger system used by HIH to record financial data for both the Australian and overseas operations;
- Aegis system – This was acquired during the takeover of FAI, storing policy details and claims histories for FAI business;
- Liability and indemnity recording system – This contained data for numerous HIH portfolios, including professional indemnity, public liability, trade credit and builders warranty; and
- GEN+ system – This software was developed by HIH to merge existing systems in order to provide greater functionality and to meet Year 2000 (Y2K) compliance requirements. Throughout 1999, ongoing problems with this system resulted in a lack of financial information or faulty financial information for HIH subsidiaries

The GEN+ system was plagued with serious and ongoing problems, including: inability to produce debtors' statements, process correct premiums for financial endorsements and produce sufficient management reports. A significant backlog of historical transactions developed. The integrity of the financial data produced by this software was questionable, for both accuracy and completeness. The ability of HIH's management and board to operate and oversee its businesses was seriously compromised. The credibility of information recorded in the company's general ledger was compromised by problems with reconciliations extending over a long period of time. There was no formal process of regular, comprehensive reconciliation of all of HIH's accounts. A number of unreconciled accounts remained at the time of dissolution in March 2001 – some transactions dating as far back as 1995.

The budget process is an important tool for managing expenditures and assessing company performance. HIH failed to meet its budgetary targets from 1997 onward. This represented a serious breakdown in HIH's financial controls. There was no process whereby serious deviations from budget could be clearly identified and addressed. The board failed to monitor expenditures of the executive directors. Budgetary control as a strategic planning tool was not properly employed.

Table 5: Comparison of HIH Budget Figures (Budget/Actual) for Financial Years

Financial Year	Gross Written Premium	Gross Earned Premium	Net Premium Earned	Core Underwriting (loss)/profit	Operating Profit/(loss) Before Tax	Operating Profit/(loss) After Tax
1996 Budget	1367.0	1310.0	940.0	-3.0	93.0	61.0
1996 Actual	1407.3	1345.8	931.5	-18.1	91.1	61.1
1997 Budget	1789.0	1690.0	1287.0	-12.0	109.0	72.0
1997 Actual	1725.1	1708.5	1233.5	-33.8	90.5	61.8
1998 Budget	1868.7	1824.6	1410.7	-24.1	125.9	84.4
1998 Actual	2079.8	2030.9	1410.7	-73.4	61.8	37.6
1999 Budget	1486.3	1418.6	1009.3	-80.0	67.8	45.4
1999 Actual	1455.1	1408.3	913.9	-100.3	40.1	-58.8
2000 Budget	2824.9	2579.6	1965.5	-	126.4	85.4
2000 Actual	2887.6	2862.6	1995.4	-103.5	37.2	18.4

Source: HIH Royal Commission Report, Volume 3

Table 5 reveals the fact that HIH never recorded an underwriting profit in the five years prior to insolvency. The principal source of information about HIH's performance was a quarterly financial report. The board received little information on broader business issues. The financial reports presented to the board emphasized current performance by describing the amount of premium written and earned, current underwriting losses, core earnings and core earnings ratios. The reports did not focus on the reliability of the provisions, which would have a direct effect on those earnings and ratios. It was extraordinary that HIH was not able to carry out a comprehensive reconciliation of all of its balance sheet ledger accounts between late 1996 and March 2000.

The HIH board was not in possession of sufficient information to enable directors to properly discharge their obligation to consider the adequacy of the company's OCP. None of the directors read or received HIH's audit reports, or had any communication with the company's internal auditor. He was never asked to attend board or audit committee meetings. Board members were not aware of the auditor's warning regarding the need for a prudential margin and the consequences associated with the failure to maintain one. The directors seemed to expect that any warnings or risks would be brought to their attention by management.

3. Corporate governance

Corporate governance refers to the control of corporations and to systems of oversight and the accountability of those in control as they seek to comply with external legal and regulatory obligations. This includes the framework of rules (laws and internal rules), relationships (between shareholders, directors, management and regulators), systems and processes (formal and informal) within and by which authority is exercised and controlled in corporations. The focus of corporate governance is on accountability and stewardship.

a) Director responsibilities

Primary governance responsibility within a corporation lies with the board of directors. It is the responsibility of the board to set the company's strategic aims, provide leadership to put them into effect, supervise management and report to shareholders on their stewardship. Directors have an obligation to take action to address problems that could adversely affect the solvency of their organization. They must inform regulators and the public of the company's true financial position.

HIH's board failed in its stewardship of the organization in three key areas:

- Decisions on major transactions and acquisitions – These were made without due deliberation or analysis. There was an absence of strategic discussion at the board level. The board's processes were driven by the timetable for approval of financial reports, as if that were its principal function. It appeared that the sole purpose of the quarterly half-day board meetings was to discuss the draft quarterly financial reports.
- Processes of the audit committee – The committee did not give separate, closer consideration to audit issues.
- OCL – The board failed to appreciate the importance of HIH's single biggest liability.[22]

[22] Ibid., Volume 3, pg. 260

HIH's board was highly ineffective, relying heavily upon information from management and external advisers without independent verification. The board had such a degree of respect for management that the recommendations of management were assumed to have been carefully thought out and therefore must be correct. The board was heavily dependent upon the advice of senior management. It placed implicit trust in management to highlight significant matters for the board's attention.

HIH had an ineffective board chair (Geoffrey Cohen) for all of the several years leading up to the insolvency. He should have controlled the board agenda and rigorously analyzed all information provided. His roles and responsibilities were different from and often greater than those of other directors. He had an obligation to ensure that the board kept its own role and performance under review and did not end up rubber-stamping management decisions. The views of all directors should have been included. The chair ignored the written concerns of a board member regarding the quality, amount and relevance of material provided to the board to make decisions. He also failed to address a situation when the chief executive bypassed the board and distributed an information memorandum offering HIH's personal lines for sale in the marketplace.

HIH's board did not pay attention to the adequacy of information being supplied by management. Risks were not being properly identified and managed. There were problems for years with accounting information being made readily available to the board. Management said the complexity of the group's operational structure was the reason for the delay. Board reports were not circulated as early as they should have been. A key board responsibility is to analyze, test and endorse the company's business strategy. The HIH board failed to do this. Unfavourable business information was being hidden from the board, filtered or repositioned before release. Directors failed to take a skeptical approach when it mattered most. The board reviewed management reports but did not regularly review reports on strategy, identification and management of risk, corporate governance, performance and succession planning. There was little, if any, analysis of the future of the organization.

HIH experienced poor leadership and inept management. It did not have a system whereby the board would periodically assess the practical effectiveness of its governance model. HIH failed to make the transition from an entrepreneurially run company directed by senior management to that of an ASX company run primarily in the interests of shareholders. Good corporate governance requires independent and proactive oversight.[23]

There are several examples of poor stewardship by the HIH board:

- HIH directors failed to respond appropriately and effectively to the deteriorating results that were so evident in the U.K. operations. Losses kept mounting. Board members failed to ensure that there were systems in place to address the problems and that they were in fact effective. The problem was more acute for executive directors (versus non-executive directors) as they were privy to internal audit reports and other correspondence on matters relating to the U.K. operations. They attended various meetings of the board and audit committee meetings in the U.K. and were generally more aware of the status of the U.K. operations than the other directors.
- The board acted rashly in approving the FAI acquisition. The board should have demanded evidence of the synergies and economies of scale the takeover appeared to promise. There was no analytical justification. Only cursory attention was given to the bid in a hastily called board meeting on September 22, 1998, attended in person by only three directors. Four directors joined by teleconference. The remaining five directors were overseas and did not receive notice of the meeting.
- Decisions on significant proposals were often made by the board on short notice with insufficient information and without adequate analysis of the impact of the decisions being made. This was often a result of the board accepting the views of management uncritically. Examples include the opening of the U.K. branch, the reacquisition of CareAmerica, the FAI acquisition and the Allianz joint venture.

[23] Ibid., Volume 2, pg. 5

b) Board committees

HIH failed to make effective use of its board committees.

- Audit committee
  - The audit committee operated as an extension of a board meeting and did not provide in-depth examination of audit and financial issues. The board delegated decision-making over financial matters to the audit committee. The audit committee was focused on the accounts and numbers – not risk identification and assessment.
  - An audit committee should comprise non-executive directors. This was not the case with HIH.
  - The committee rarely met in the absence of management and failed to detect deficiencies in the ways that the accounts were prepared.
  - There was no effective authority under which the audit committee operated. Its charter was short and its terms of reference were couched in general language. The role and responsibilities of the committee and its relationship to the board were not well defined. The terms of reference were not reviewed annually to ensure that the committee and its role was relevant to the needs of HIH.
  - The audit committee had an inadequate basis upon which to discharge its function. It had inadequate time to prepare for meetings and virtually no access to the auditors in the absence of management. There was no opportunity to independently debate and consider the relevant issues. These deficiencies seriously undermined its effectiveness as a corporate governance mechanism.
- Nomination committee
  - There was no nomination committee for new directors. The board did not play any part in the nomination of new board members. Rather, it merely ratified the candidates proposed by the chief executive.
  - There were no guidelines in place to enable the board to assess whether proposed candidates were genuinely independent. The board chair should have taken primary responsibility for this process.

- Human resources
  - In March of 1996, the committee retroactively approved sizeable adjustments to the salary package of three HIH executives, back to April 1, 1995. A lack of transparency regarding factors considered here was a departure from appropriate standards of corporate governance.

  - In March 1998, the human resources committee requested that the requirement to review senior officers against key position objectives be deleted from its terms of reference. This was an abrogation of one of its key responsibilities. The move ensured that the chief executive held the balance of power regarding performance evaluations of senior officers. By March 1999, the review of senior management staff remuneration and bonuses was at the sole discretion of the chief executive. No guidelines existed to ensure that the salary level increases or bonuses were appropriate.

  - Rather than demanding that the chief executive demonstrate how his achievements measured up against the corporate objective of value for shareholders, human resources committee members were content to continually increase his salary without appropriate justification. There was an absence of performance indicators against which the chief executive's performance was measured.

  - On February 26, 2001, the committee approved a new fee structure for directors with retroactive application, back to January 1, 2001. It was incredible that such a decision could be made at a time when HIH was beset with cash flow difficulties.

  - Over the years, senior executives consistently received salary increases exceeding those given to staff. The increases were approved by the human resources committee without seeking any independent advice. When the chief executive resigned from the board and as chief executive in December 2000, the human resources committee recommended to the board that he receive a payment equal to three times his annual salary plus statutory entitlements, totaling approximately $5 million. Given that he voluntarily resigned, the chief executive was not entitled to anything beyond accrued leave.

c) Audit function

Auditors play a vital role in the financial reporting process. Their work allows users of a company's financial report to rely on the accounts with a degree of confidence. An audit provides independent assurance of the integrity of the manner in which a company has reported financial results. The audit process provides stakeholders with early notice of potential risks affecting the company's short- or long-term viability. Auditors have an obligation to detect at an early stage any problems that might adversely affect the solvency of a commercial entity. An audit opinion serves as an assurance mechanism.

While there was no reason to conclude that Andersen's independence from HIH was compromised, there was an appearance that it was not independent of HIH. In the context of an audit, matters affecting the appearance of independence can undermine the confidence that users of the accounts may place on the audit opinion. There were a number of deficiencies in the quality of the audit work performed by Andersen that were not helpful to HIH:

- Three former Andersen partners were on the HIH board, including the chair, who was a recipient of continuing benefits from Andersen (fees from a consultancy arrangement). One party was appointed chair of the board and appointed to the audit committee. Another joined HIH as the chief financial officer the day after he resigned from Andersen, where he had been the engagement partner on the HIH audit. A third former Andersen partner was appointed to the HIH board after playing a significant role in HIH audits for 25 years. This "familiarity threat" had implications for the perceived credibility and reliability of HIH's published financial statements.
- Andersen had been HIH's auditor of record since 1971. HIH had become one of Andersen`s most important clients. The long-standing appointment of an auditor can adversely affect the perception of an audit firm's independence.
- Only selected matters were taken to HIH's audit committee. Many issues were resolved between Andersen and HIH management before audit committee meetings.

- There was pressure on the Andersen partners to maximize their fees from non-audit work that created a potential conflict with their audit obligations. Andersen provided tax advice to HIH. The provision of non-audit services for audit clients raises two significant issues related to independence – the impact upon independence when, as a necessary part of a statutory audit, the auditor must review non-audit work performed by the auditor (or the auditor's firm); and the pressure on audit personnel to secure non-audit work by maintaining a strong relationship with management.

Table 6: Fees Received from HIH by Andersen

Financial Year Ending	Audit Fees	Non-Audit Fees	Total
December 31, 1997	$980,000	$436,000	**$1,416,000**
June 30, 1999	$2,417,000	$757,000	**$3,174,000**
June 30, 2000	$1,700,000	$1,631,000	**$3,331,000**

Source: HIH Royal Commission Report, Volume 3

- The circumstances of HIH from at least 1999 onward warranted meetings between Andersen and the non-executive directors in the absence of management in the ordinary course of the audit. Such meetings are highly desirable and standard audit practice. Andersen's long-standing engagement partner was removed from the HIH audit following his decision to meet with some of the non-executive directors of HIH in the absence of HIH management on March 12, 1999. Management was intimidating the independent directors. This sent the clear message that Andersen personnel who displeased HIH management, particularly by meeting with non-executive directors, might be removed from the audit. This gave the perception that Andersen's independent audit of HIH was or could be compromised.

- Andersen relied on the valuations of HIH's consulting actuary in the conduct of its audit. The largest single item of the balance sheet of a P&C insurer is the provision it sets aside for payment of future claims (whether known or unknown). This item is based on actuarial valuations. Andersen did not have or retain any actuarial expertise. It relied on HIH's consulting actuary to confirm the credibility of the provision for outstanding claims. Andersen should have taken steps to confirm the competence, integrity and objectivity of HIH's consulting actuary. Andersen relied on extracts of monthly actuarial reports. The complete reports were not delivered to Andersen usually until after the audit was completed.

- Andersen did not obtain sufficient appropriate audit evidence concerning the assessment of the recoverable amount of deferred acquisition costs as at June 30, 1999, or June 30, 2000, as required by audit standard AUS 502. It required that, when obtaining audit evidence from substantive procedures, the auditor should consider the sufficiency and appropriateness of audit evidence from such procedures, together with any evidence from tests of control to support the financial report assertions. One of those financial report assertions required to be supported was that an asset or liability was recorded at an appropriate carrying value.
- Andersen's audit work focused mainly on those areas which Andersen determined to be of high significance and risk – the major long-tail classes of business such as liability, personal indemnity and personal injury resulting from a motor vehicle accident. The estimation of the OCL in respect of long-tail business requires the professional expertise of an actuary. Auditors do not have this expertise. The audit work performed in respect of OCL was therefore corroborative in nature rather than determinative. HIH's actuary said he had no personal contact with anyone from Andersen from 1996 to 2000. It is not clear that Andersen took adequate steps to gain an understanding of the assumptions and methods used by HIH's actuary, and to consider the reasonableness of those assumptions and methods.
- Andersen failed to obtain sufficient appropriate audit evidence to substantiate the carrying value of goodwill arising from the FAI acquisition as at June 30, 1999 (which was booked at $275 million).
- By February 2001, HIH had become Andersen's most valued risk client in Australia. There was little evidence that senior Andersen personnel took any effective action regarding the risks identified in auditing HIH. The audit team did not formulate a formal risk management plan. This was surprising, given the clear risk that HIH posed to Andersen and its reputation.
- Andersen relied upon the work of HIH's internal audit division without evaluating or testing to confirm its adequacy in the conduct of the 1999 and 2000 HIH audits.

- Andersen should have approached the recoverability of goodwill arising from the acquisition of FAI with a heightened degree of professional skepticism. There was a significant deterioration in the value of the net assets of the FAI group in the six months between its last audited statements (as at June 30, 1998) and the date of acquisition. Much of this was a result of trading losses and increased claims liabilities for the FAI group. There was practically no due diligence undertaken by HIH regarding FAI's earnings prior to HIH's acquisition.

- The Allianz transaction represented a fundamental change to the manner in which HIH derived its cash flows. Following the Allianz transaction, instead of receiving $1 billion per annum of premium income directly, HIH would be entitled to 49 percent of premium income, estimated to be $1.4 billion (approximately $700 million per annum), and a payment of $200 million. The adverse effects of these features of the Allianz transaction on HIH's cash flow should have been recognized by Andersen.

HIH's internal auditors were criticized for focusing too heavily on the organization's accounts and not enough on the poor risk management frameworks it employed. HIH's external auditors (Andersen) were criticized for not being rigorous enough in questioning the organization's financial position and accounting treatments and for relying too heavily on HIH's internal audit documents.

d)Internal controls

HIH had a number of clearly defined policies and procedures in place, but they did not deal with areas essential to the operation of such a large organization. They dealt largely with underwriting and administrative matters. HIH lacked guidelines and processes to hold staff, management and executives accountable. This enabled management to exert undue influence over business decisions, ignore conflict of interest and personal benefit situations and withhold valuable information from the board. The board had an obligation to ensure that the corporation had in place the necessary controls over its activities and to ensure that those controls were working. It was akin to having laws on the books without any enforcement personnel in place to ensure compliance. Controls should have been established to guide HIH's rapid business expansion and they should have been reviewed periodically to ensure they remained relevant to the company's changing business environment.

Following are examples of problem situations (large and small) with HIH's internal controls:

- There were no clearly defined statements of duties or limits on the authority of the chief executive in areas such as investments, corporate donations, gifts or staff benefits.
- The level of authority held by executive directors was not defined. Management said the demarcation of responsibilities, accountability and areas of discretion did not need to be codified, as people understood what needed to be done.
- There was never an independent review performed on the efficiency of HIH's organizational structure or the adequacy of reporting lines the company had in place.
- Key performance indicators for executives were not defined. There was no formal process in place for reviewing the performance of HIH's executive directors.
- The board did not have procedures in place governing conflict of interest situations. The board chair was passive and ineffective here, believing it was the responsibility of each director to declare any conflict of interest.
- The board failed to exercise appropriate supervision over expenses incurred by executive directors and management over a lengthy period of time.

- Salary increases generally followed the recommendation of the chief executive. He was given complete discretion as to who would be the beneficiary of $3 million in options available for allocation. Surprisingly, a number of bonus payments were made to HIH staff in February and March 2001 at the height of the company's financial difficulties.
- HIH lacked controls over donations made by the company. The amounts were significant and were made for many years. This money came from shareholder funds. From 1996 to 2000, HIH made over $21 million in donations, averaging about $4 million per year. This was a noticeable portion of the company's reported net profits. The chief executive had the sole power to determine which organizations were to receive donations and the amount of those donations. No steps were taken to review the level of donations as the company's financial position deteriorated. The process should have been transparent and justifiable. There were no guidelines in place for donations made to charitable, philanthropic, political or discretionary causes along with a statement of the rationale for those donations – or any board review mechanism.
- There were many instances of misuse of company assets. Some involved larger sums of money than others. When considered together, they revealed a systemic failure in the stewardship of the group's assets. There was a consistent pattern of the group's resources being inappropriately applied for the personal benefit of senior executives, including executive directors. This included remuneration paid to executive directors, termination payments and travel expenses as well as other examples of inappropriate corporate excess. The 1999 staff Christmas party was extraordinarily lavish – at an average cost of $920 per person for the 799 people in attendance. This was surprising given that HIH reported a loss at year-end 1999. Also, HIH expended $670,000 on the provision of personal tax advice to certain senior executives that year.
- There was no formal policy in place for the issue of corporate credit cards.
- HIH lacked formal guidelines governing travel expenditures that could properly be incurred by the spouse of an executive who was required to travel on company business. There were no discernible limits on spouse travel expenditures. Even as the company's financial position worsened, HIH continued to pay for the travel expenses of spouses.

- There were several blatant conflict of interest situations that were not addressed:
  - When CE Heath's parent company CE Heath plc sold its entire shareholding in CE Heath to Winterthur Australia (making Winterthur Australia the majority shareholder of CE Heath), the deal was negotiated between two parties who had director obligations to CE Heath (the vendor) and fiduciary obligations to Winterthur Australia (the buyer).
  - When CE Heath plc sold its HIH shares to Winterthur Australia, the party negotiating the sale on behalf of CE Heath sold his personal shares to Winterthur at a higher price than CE Heath, resulting in a $3 million personal profit. Information on this private deal with Winterthur was not disclosed to the HIH board or shareholders.
  - There was a series of development proposals involving HIH wherein a director had a related party interest in the financial transaction. HIH did not have a mechanism to identify and resolve these conflict situations.

The above points clearly show that HIH failed to hold executives to account in the interests of the company and its shareholders. The board failed to ensure that management was always acting in the best interests of the corporation. The board itself failed in this respect - its core fiduciary responsibility.

4. Regulatory supervision

a) Regulatory approach

There was no evidence that APRA caused the collapse of HIH. However, it missed a number of warning signs that HIH was heading for statutory and commercial insolvency and could have taken steps to counter this. Issues included: adequacy of OCP, effectiveness of reinsurance and netting-off issues, statutory solvency position, reporting delays, accuracy of information, letters of credit and the integrity of HIH management.

APRA's main supervisory powers under the *Insurance Act* in the period up to March 15, 2001, included the power to:

- Approve the appointment of an external auditor;
- Require an authorized insurer to appoint an independent actuary to investigate OCP;
- Require an insurer to produce books required by or under this Act to be kept by the body corporate;
- Carry out an investigation and appoint an inspector where it appeared to APRA that the insurer was, or was about to become, unable to meet its liabilities or had contravened or failed to comply with a provision of the *Insurance Act* or a condition or direction applicable to it under the Act; and
- Issue directions against an insurer in certain limited circumstances.[24]

Where an entity authorized to carry on insurance business was incorporated in Australia, its authority to do so was subject to the minimum solvency condition, which required that the value of assets should at all times exceed the amount of its liabilities by not less than the greater of:

- $2 million;
- 20 percent of its premium income during its last financial year; or
- 15 percent of its OCP as at the end of its last financial year.

[24] Ibid., Volume 3, pg. 363

Section 30(1) of the *Insurance Act* prohibited some assets being counted for the purpose of the minimum solvency calculation. This included an asset "charged for the benefit of a person other than the body corporate to the extent that it is so charged." Under Section 30, related body assets were not permitted to be included in the minimum solvency calculation unless they were approved by APRA. By setting off related company liabilities and receivables, HIH companies understated their non-approved related body assets, with the result that net assets were overstated by the same amount.

APRA missed several key opportunities for regulatory intervention:

- HIH had three authorized insurers: C&G, CIC and FAI. All three were below the minimum solvency requirements at one or more balance dates before March 2001. APRA took no action in relation to these solvency breaches.
- In 1998, HIH acquired Cotesworth Capital Limited in order to gain entry to the Lloyd's market in the U.K. Following the acquisition, arrangements were made for letters of credit to be issued to support the obligations of the Lloyd's syndicates. Those assets were not excluded from the available assets in any of the returns lodged with APRA after that date. Had they been excluded, at least two of the authorized insurers would have failed the minimum solvency requirements. Related body assets were permitted to be included in the minimum solvency calculation only if they were approved by APRA.
- The annual APRA return for CIC for the period ending June 30, 1999, showed that CIC had net assets of $116.2 million ($17.1 million above its minimum solvency requirement). Although HIH advised APRA that it had no liabilities to related trusts or bodies corporate, it actually had liabilities of $33.9 million to related bodies corporate. If this was not netted off for the purposes of the minimum solvency calculation, the return would have showed that CIC had failed to satisfy its minimum solvency requirements as at June 30, 1999. The ultimate effect of the arrangement was to deprive creditors in Australia of the benefit of assets which might have assisted HIH in meeting its offshore liabilities.

- The annual return for C&G for the period ending June 30, 2000, showed total net assets (less statutory exclusions) of $227.5 million and net assets inside Australia of $190 million. The return stated that C&G had no liabilities to related trusts and bodies corporate. If the $429.5 million of liabilities to related bodies corporate disclosed in the financial statements had been disclosed as a liability in the APRA return and not netted off for the purposes of the minimum solvency calculation, the return would have showed that C&G failed to satisfy its minimum solvency requirements as at June 30, 2000.
- The Winterthur sell-down was an unheeded warning sign. APRA accepted Wintherthur's assertion that it was selling off its shares in HIH because the strategy of its new owner (Credit Suisse) was to divest. A closer analysis might have revealed problems with HIH's strategic and managerial approaches.
- HIH was evasive with APRA in disclosing details of the Hannover arrangement. APRA should have pursued this issue to gain a deeper understanding of HIH's financial position and the strategy behind its reinsurance program. Inadequate attention was given to analyzing HIH's recent underwriting and earnings performance and to understanding the reasons underlying the contract. APRA did not analyze the motivation behind the Swiss Re contract. This should have put APRA on notice of deeper problems concerning HIH's profitability and OCP.
- When HIH decided to sell its personal lines in the Allianz deal in September 2000, APRA should have realized that the company was in serious difficulty. This should have prompted greater regulatory scrutiny.

At that time, APRA was not functioning with a risk-based supervisory framework. It lacked the tools to proactively address crucial governance and risk management weaknesses. It also lacked legislative authority to proactively intervene and an early stage. APRA focused on statutory returns (the equivalent of a P&C-1 in Canada). There were no appropriate guidelines dealing with asset quality or the sufficiency of provisioning. Returns were mechanically reviewed to ensure compliance with guidelines. APRA was operating under the assumption that it was dealing with sophisticated, well-managed and well-controlled institutions. It considered the shortcomings of individual authorized insurers as less significant because those insurers were part of a larger group.

It reached this conclusion without undertaking a critical analysis of the financial health of the group as a whole. APRA did not anticipate problems in HIH's U.S. and U.K. operations, in spite of the fact that it had information in its possession which should have caused concern here. It was maintaining a narrow focus on authorized entities and failed to consider the commercial realities of the corporate group. Its consultative approach made it difficult to recognize an institution whose characteristics were not consistent with this premise. A detailed analysis of the adequacy of OCP had all but disappeared from the supervisory approach. The manner in which APRA exercised its powers and discharged its responsibilities under the *Insurance Act* fell short of that which the community was entitled to expect from the prudential regulator of the insurance industry.[25]

[25] Ibid., Volume 3, pg. 442

b) Accounting standards

Accounting standards in Australia are set by the AASB. This entity seeks to improve the quality of general purpose financial reports in Australia. HIH showed that the interpretation of key accounting standards was not straightforward. It was able to manipulate the meaning and requirement of rules governing the recognition of insurance premiums and reinsurance expense costs in order to produce misleading financial statements. The standards included AASB 1013 (accounting for goodwill) and AASB 1023 (financial reporting of general insurance activities).

Accounting standards require that accounting treatments reflect the substance and economic effect of a transaction. HIH seemed to feel that standards were open to interpretation. The misinterpretation of the standards allowed HIH to publish financial statements that did not truly or fairly represent the financial position or performance of the HIH group.[26]

- AASB 1023 (Financial reporting of general insurance activities)
  - AASB 1023 requires insurers to recognize premium revenue (and reinsurance expenses) in accordance with the pattern of the incidence of risk under relevant contract. The clause "in accordance with the pattern of the incidence of risk" enables companies to manipulate the timing of the recognition of premiums. If a company considers that an insurance (or reinsurance) policy permits it to recognizeall premiums (or reinsurance recoveries), yet delay the recognition of liabilities (or reinsurance premium expenses), then this could result in the recognition of profit being brought forward artificially in the early period of a contract. HIH sought to utilize reinsurance to deal with under-reserving, offsetting any increasing reserves on the balance sheet with a corresponding recovery under a reinsurance contract. It believed that premiums could be expensed over the period for which benefits might be properly regarded as remaining available under the arrangement. So long as there was life in the contract, the premium could be expensed over that life.[27]

[26] Ibid., Volume 1, pg. 138

[27] Ibid., Volume 1, pg. 152

- AASB 1023 requires that insurance liabilities be discounted at a market-determined risk-adjusted rate of return. This encourages discounting at a rate of return that the insurer might expect to earn on its assets. HIH booked lower amounts for OCL. Its actuary was asked to discount at rates in excess of the rate of return on risk-free securities. Accounting standards provide for the discounting of a P&C insurer's OCL using a market-determined risk-adjusted rate of return appropriate to the insurer. The discount rates adopted by HIH were consistently higher than yields available on Commonwealth Government bonds with a three-year maturity. HIH took a relatively optimistic and aggressive approach to discounting its OCL.

- AASB 1013 (Accounting for goodwill)

  According to this standard, goodwill means the future benefits from unidentifiable assets. Goodwill purchased by the entity must be recognized as a non-current asset at acquisition. Goodwill is only recognized as an asset when it is probable that the future benefits embodied in the unidentifiable assets will eventuate, and when it possesses a cost or other value that can be measured reliably. The unamortized balance of goodwill must be reviewed at each reporting date and recognized as an expense in the profit and loss account to the extent that future benefits are no longer probable. Purchase goodwill must not be revalued

  - Regarding the FAI takeover, HIH management set out a calculation of goodwill on the acquisition of $275 million on the basis of an acquisition cost of $300 million and adjusted net assets at acquisition of $25 million.
  - There was no specific guidance regarding the assessment – establishing that the excess cost of acquisition over net assets represented future benefits from unidentifiable assets.
  - There tended to be an increased emphasis upon the measurement of the residual amount said to represent goodwill and a decreased emphasis upon a consideration of the manner in which the future benefits from unidentifiable assets may be realized.
  - Additional pre-acquisition claims deterioration that was identified as a result of management or actuarial reviews resulted in a substantial increase in the amount of goodwill brought to account in respect of the acquisition of FAI on June 30, 2000. This treatment was said to be in accordance with mandatory accounting standards. The deterioration should have been recognized as an expense for the year ended June 30, 2000, which would have resulted in HIH reporting a substantial operating loss.

The HIH collapse highlighted weaknesses in the Insurance Act in the relevant period:

- The Act focused on OCP and net premium in calculating statutory solvency. Assets had to exceed liabilities by not less than the greater of: $2 million; 20 percent of premium income over the last year; or 15 percent of OCP at the end of the last fiscal year. This placed undue emphasis on only one factor relevant to financial strength and provided incentives to manipulate OCP.
- There were few limitations on asset concentration and composition other than with respect to related party investments and loans.
- The Act focused on the company (not the corporate group) which skewed the regulatory focus.
- The supervisory regime was principally off-site and based upon the review of special purpose financial returns. APRA was to a large extent reliant upon the accuracy of the returns and had few formal powers to seek independent verification of this information.
- The scheme imposed a requirement that the corporate entity be authorized, but there was little capacity to scrutinize the personnel engaged by the insurer.
- There was no capacity to change licence requirements when ownership changed.
- APRA had little responsibility for setting requirements for corporate governance.
- The *Insurance Act* did not confer any power to supervise the foreign operations of an Australian insurer where foreign incorporated entities were carrying out the business.

These weaknesses created a simple and non-interventionist regulatory and supervisory regime. Many observers felt that the *Insurance Act* was limiting rather than empowering. Disputes between auditors and management over the correct interpretation and application of accounting standards are usually resolved between the auditors and management directly. With HIH, disputes were typically resolved by adopting the view of management, which sometimes led to an incorrect accounting treatment. An important contributing factor to the failure of HIH was inaccurate reporting of financial information – particularly the valuation of OCP. This inaccurate reporting was caused partly by HIH management and auditors misinterpreting the requirements and application of current accounting standards. Deficiencies in those standards were partly to blame as well.[28]

[28] Ibid., Volume 1, pg. 142

The aftermath

With the collapse of HIH, the Commonwealth, state and territory governments in Australia immediately came under pressure to provide financial assistance to affected policyholders. This was forthcoming within weeks. The states and territories undertook to meet outstanding HIH builders warranty and compulsory third-party claims at a combined cost of $1.4 billion. The Commonwealth announced its own aid program to help in cases of genuine economic hardship. A non-profit industry-run company (HIH Claims Support Pty Ltd) was established to distribute $640 million allocated to meet claims for workers' compensation and builders' warranty. Most claims from household, property, commercial and motor vehicle policies were paid. The majority of outstanding claims were from long-tail policies, including public liability and professional indemnity.

On July 1, 2002, a new regime for the prudential regulation of P&C insurers came into effect in Australia. APRA was given credit for its role in the development and introduction of new prudential standards. New legislation and new prudential standards were introduced, including:

- An increase from $2 million to $5 million in the minimum capital requirement for P&C insurers;
- The introduction of risk-weighted capital solvency requirements such that high-risk activities would need to be supported by more capital;
- The imposition of a conservative insurance liability valuation standard, including the requirement for a prudential margin;
- P&C insurers must use the services of an approved actuary, unless granted an exemption by APRA;
- A requirement that the board of each insurer approve a formal reinsurance-management strategy;
- A general tightening of corporate governance and other management requirements (e.g., adoption of formal risk and other management strategies and more stringent "fit and proper person" tests for directors, senior managers, auditors and actuaries); and
- The imposition of greater controls and requirements for auditors and actuaries.[29]

[29] Ibid., Volume 1, pg. 74

It is interesting to note that APRA retained former OSFI Superintendent John Palmer to assist with its representation to the Royal Commission and to prepare a report on the supervisory approaches of APRA and ISC. The 183-page Palmer report (published July 15, 2002) set out 22 recommendations for change in supervisory approaches. The report noted that the Insurance Act was based largely on arithmetic tests which created a narrow and mechanical mindset of simply checking reported numbers rather than considering substance. This, it said, may have contributed to a reluctance on the part of APRA to go beyond discussion and persuasion when faced with a serious problem. The report also noted shortcomings in oversight that focused on a company rather than the corporate group to which it belonged – this served to exclude from solvency calculations loans and investments made by companies to and in related bodies. The report found that the supervisory approach of ISC was relatively light by modern supervisory standards.

On January 1, 2005, Australia adopted international accounting standards for entities subject to the *Corporations Act 2001* in order to address the possible misinterpretation of key accounting standards. The decision to adopt international standards necessarily meant that Australia would have less flexibility to develop standards that apply domestically. It did, however, increase comparability of financial reports across countries and served to make Australia more attractive to international capital investment. Following the collapse of HIH, the industry proposed an industry levy for a guarantee fund. The levy would be imposed based on a proportion of the gross or net premium income of each insurer covered by the scheme. The guarantee fund ultimately adopted by government, which was designed to protect policyholders when an insurer fails, was taxpayer funded. Until the failure of HIH, Australia did not have a guarantee fund in place to protect policyholders.

Following the Royal Commission, ASIC brought forward civil penalty actions against HIH's chief executive Ray Williams, director Rodney Adler and chief financial officer Dominic Fodera for 197 alleged (officers' duties) breaches and contraventions of the *Corporations Act*. Adler was fined $900,000 and was disqualified from being a director for 20 years. Williams was fined $250,000 and received a 10-year disqualification. Adler and Williams were jointly ordered to pay $8 million to HIH Insurance Ltd. Fodera received a $5,000 fine. Criminal charges related to stock market manipulation were then brought against Williams, Adler and a number of other HIH executives. Williams was sentenced to four-and-a-half years imprisonment, with a non-parole period of two years. Adler was sentenced to four-and-a-half years in jail, with a non-parole period of two-and-a-half years.

Could a similar failure could occur in Canada? It is unlikely given the rules governing regulatory capital (e.g. goodwill cannot be counted as capital for reserve calculations) as well as the layers of review in place regarding reserving practices (e.g. peer review by other actuaries, annual regulatory review and independent audit review). Failures are rare, but some Canadian insurers have failed. There is always the risk of a major catastrophe, failure of a foreign parent or chronic underperformance. Large insurers typically have more diverse operations, and may be subject to greater regulatory and shareholder scrutiny than smaller insurers. Nevertheless, HIH provides a specific example that it is possible – unlikely, but possible – for insurance companies to fail, even large companies.

Lessons learned from the HIH insolvency

Following is a list of lessons learned from the HIH Insurance insolvency.

- **Reserving –** Adequate, provisions for outstanding claims are critical to the financial health of any insurance company. Senior management, the board of directors, independent auditors and solvency supervisors must ensure a fair and honest statement of reserve adequacy.
- **Pricing –** Assessing and properly pricing risks is vital to an insurance company's long-term success. Sustained aggressive pricing to support ambitious growth is often a fatal strategy for insurers.
- **Entering new markets and new lines of business –** Companies must exercise caution and carefully manage uncertainties when expanding into unfamiliar markets and new lines of business where they have no past experience. HIH took great risks entering new lines of business and new markets, without clear evidence of the prospects for success.
- **Acquisitions and joint ventures –** Companies must ensure that planned acquisitions and joint ventures are carefully researched and support the strategic objectives of the organization. HIH's gambles with acquisitions and joint ventures cost the organization dearly, hastening its demise.
- **Financial statements –** A company's financial statements must accurately reflect its true financial position. HIH used aggressive accounting practices and creative transactions to mask mounting costs from long-tail claims. This approach was misleading and unsustainable.
- **Reporting systems –** Fully functioning reporting systems are crucial to the timely production of accurate financial statements. Problems with HIH's accounting, budgets and ledger systems undermined the quality and timeliness of critical business information being supplied to the board.
- **Reinsurance arrangements –** When used properly, reinsurance is a legitimate and effective means for an insurer to augment its capital base. Questionable use of finite reinsurance arrangements allowed HIH to produce false and misleading financial statements and thereby overstate its financial position.

- **Director responsibilities –** Boards of financial institutions have an obligation to act on behalf of the corporation and its shareholders and policyholders, and demonstrate independent judgement regarding the company's strategy, performance, resources and standard of conduct. HIH's board was ineffective in this respect.
- **Management oversight –** Boards must exercise effective oversight of management. HIH's board played a passive role in overseeing management operations and financial reporting.
- **Audit function –** An effective audit function requires an external auditor to be rigorous in its work and independent, both in fact and appearance. HIH's external audit function was flawed.
- **Internal controls –** Internal controls help to ensure accountability and encourage the proper use of a company's assets and resources. HIH executive directors' authority was not clearly defined. An independent review of the corporation's organizational structure was never undertaken. HIH lacked a sound internal audit function.
- **Accounting standards –** Accounting standards must be clearly worded to avoid interpretation or abuse by regulated parties. HIH was able to manipulate the meaning and requirement of rules governing the recognition of insurance premiums and reinsurance expenses. This resulted in misleading financial statements.
- **Insurance supervision –** Regulators must ensure that the intensity of their supervision efforts is in relation to the systemic importance of the institution, and be prepared to escalate their intervention activities when they encounter growing evidence of poor governance, weak risk management or financial weakness. APRA missed several early warning signs that HIH was in financial trouble.
- **Consumer protection** – In 1945, Australia set up protection for consumers if a bank fails, however protection for insurance consumers was not introduced until after HIH failed. Financial protection for consumers, like that offered by PACICC, is critical to maintain consumer confidence in the insurance industry.

Causes of the insolvency

Following is a list of causes and factors that led to the insolvency of HIH Insurance.

Primary causes of the insolvency:

1.Reserving

HIH was found to be under-reserving for years. It under-estimated future claims costs, aggressively discounted claims liabilities, excluded a prudential margin and under-estimated claims inflation.

2.Pricing

HIH priced products aggressively to support its international growth strategy. This was problematic, given HIH's volume of business in markets with long-tail claims, where the true costs only became apparent years later.

Contributing factors to the insolvency:

1.Business strategy

a) Entering new markets – HIH incurred significant losses from its ill-advised expansion into the U.K., U.S., Hong Kong and Asia.

b) Entering new lines of business – HIH placed itself at great financial risk when it undertook to write lines of business where it had no past experience, such as excess-of-loss marine reinsurance and film financing in the UK.

c) Acquisitions and joint ventures – HIH did not ensure that the purchases of FAI and CareAmerica, and the joint venture with Allianz, were carefully researched and supported its strategic objectives.

2.Financial reporting

a) Financial statements – HIH used aggressive accounting practices and creative transactions to mask mounting costs from long-tail claims. This approach proved to be unsustainable.

b) Reinsurance arrangements – HIH's questionable use of finite reinsurance arrangements produced false and misleading financial statements. It was able to understate its OCL and overstate its reinsurance liabilities, premium expenses and operating profit before tax.

c) Reporting systems – Flaws in HIH's accounting, budget and ledger systems slowed the flow of information and undermined the credibility of its prepared statements. This negatively affected decisions made by directors regarding the financial health of HIH.

3.Corporate governance

a) Director responsibilities – HIH's board was ineffective, relying heavily upon information from management and external advisers without independent verification.

b) Board committees – HIH did not make effective use of board committees. The audit committee operated as an extension of the board meeting and did not provide closer examination of audit and financial issues. There was no nomination committee for new directors.

c) Audit function – There were deficiencies in the quality of the audit work performed by Andersen. In addition, Andersen was not totally independent of HIH.

d) Internal controls – HIH's lack of established guidelines, protocols and processes enabled management to exert undue influence over business decisions, ignore conflicts of interest and personal benefit situations and to withhold key information from the board.

4.Regulatory supervision

a) Regulatory approach – APRA missed several early warning signs that HIH was in financial trouble. Issues included adequacy of OCP, effectiveness of reinsurance and netting-off issues, statutory solvency position, reporting delays, accuracy of information, letters of credit and the integrity of HIH management.

b) Accounting standards – HIH was able to manipulate the meaning and requirement of rules governing the recognition of insurance premiums and reinsurance expense costs in order to produce misleading financial statements.

Timeline of key events

1968	MW Payne Liability Agencies Pty Ltd. incorporated to write insurance business in Australia
1971	MW Payne Liability Agencies Pty Ltd. acquired by CE Heath plc and renamed CE Heath Underwriting Agencies Pty Ltd.; becomes CE Heath International Holdings Ltd. (CE Heath)
1986	CE Heath begins to expand operations into the U.K., U.S., Hong Kong and Asia
1987	CE Heath acquires Falcon Insurance Company – renamed CE Heath Compensation and Liability Insurance Company (Heath Cal) – sold in 1994
April 6, 1992	CE Heath is listed on the Australian Stock Exchange
May 18,1995	Ernst & Young's financial due diligence report on CE Heath is finalized
June 1995	CE Heath acquires CIC Insurance from CIC Holdings; CIC Holdings later becomes Winterthur Holdings Australia Limited (Winterthur Australia)
June 13, 1995	Winterthur Australia becomes majority shareholder of CE Heath
May 1996	CE Heath becomes HIH Winterthur International Holdings Limited (HIH Winterthur)
July 1996	HIH Winterthur auditors express concern about U.K. operations (provisioning data, underwriting approach, business philosophy and quality of financial information)
June 12, 1997	HIH Winterthur reacquires CareAmerica Compensation and Liability Insurance Company (formerly Heath Cal) – renamed HIH America
March 18, 1997	Australian Government receives the Financial System Inquiry Report (Wallis Report) recommending an integrated regulator for prudential supervision of all financial institutions

December 31, 1997	HIH Winterthur reports an operating profit after extraordinary items and income tax of $61.8M; Underwriting loss of $33.8M on earned net premium of $1.233B; Intangible assets equal 23% of shareholders' equity
Early 1998	Winterthur Australia merges with Credit Suisse
July 1, 1998	APRA is created through a merger of the ISC and Reserve Bank
July 13, 1998	Winterthur Australia memorandum indicates inadequate provisioning at HIH Winterthur.
September 22, 1998	HIH Winterthur launches takeover bid for FAI; completed in January 1999
October 1998	HIH Winterthur becomes HIH Insurance Ltd. (HIH)
October 31, 1998	HIH acquires Great States Insurance Company
December 1998	HIH acquires the Cotesworth Group Limited
February 25, 1999	Andersen presentation to HIH audit committee notes that HIH's reserves at December 31, 1998 were at the very low end of tolerable limits
March 12, 1999	Andersen meets with two non-executive HIH directors
June 30, 1999	HIH reports an operating loss after extraordinary items and income tax of $21.2 M; Underwriting loss of $73M on earned net premium of $1.550B; Intangible assets equal 60% of shareholders' equity
August 25, 1999	HIH enters into reinsurance arrangement with Hannover
September 1999	HIH (UK) put into run-off
January 21, 2000	HIH enters into reinsurance arrangement with Swiss RE
March 9, 2000	APRA holds first of a series of prudential consultation meetings with HIH and is misled about the financial health of HIH's U.K. and U.S. operations.

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June 30, 2000	HIH Insurance reports an operating profit after extraordinary items and income tax of $18.4 million; Inderwriting loss of $103.5M on earned net premium of $1.99B; Intangible assets equal to 75% of shareholders' equity.
April 10, 2000	APRA hold prudential consultation with HIH to discuss its reinsurance program.
September 13, 2000	HIH enters into joint-venture agreement with Allianz
October 12, 2000	Williams exits as CEO of HIH; remains on teh board until December 15, 2000
October 31, 2000	APRA completes updated assessment of HIH
December 4, 2000	Ernst & Young present its report to HIH
December 31, 2000	HIH reports (going-concern) OCL of $3.1B (under-valued by &1.9B - $2.6B on the break-up basis and $4.3B with prudential margin)
January 1, 2001	Joint venture with Allianz - $200M purchase price and $500M of assets locked into a trust
February 9, 2001	HIH announces that its interim results to December 31, 2000 will likely show a loss
February 22, 2001	Trading in HIH shares is temporarily suspended (and again on March 1, 2001)
March 1, 2001	APRA calls on HIH to show cause why an Inspector should not be appointed
March 15, 2001	All major companies in HIH are placed into provisional liquidation – Going-concern OCL estimates total $5B – net asset deficiency of between $3.6B and $5.3B
May 10, 2001	First assessment of HIH's OCL (Phase I Review) – as at December 31, 2000
July 5, 2001	Second assessment of HIH's OCL (Phase II Review) – as at March 15, 2001

August 27, 2001	Court order places HIH in official liquidation; KPMG is appointed as Liquidator
August 29, 2001	$39.7M HIH Royal Commission is established to examine the reasons for and circumstances surrounding HIH's failure, and to restore public confidence in Australia's financial system and general insurance sector – Examination period covers January 1, 1995 to March 15, 2001.
July 1, 2002	*General Insurance Reform Act 2001* introduced – new prudential standards for P&C insurers in Australia
April 4, 2003	HIH Royal Commission Report is published – Three volumes; 1,457 pages

Abbreviations

AASB	Australian Accounting Standards Board
AFIC	Australian Financial Institutions Commission
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ASX	Australian Stock Exchange
AUS	auditing standard
C&G	HIH Casualty and General Insurance Limited
CIC	CIC Insurance Limited
CLERP	Corporate Law Economic Reform Program
DID	Diversified Institutions Division
DPP	Director of Public Prosecutions
E&Y	Ernst & Young
FAI	FAI Insurance Limited
HIH	HIH Insurance Limited
IBNER	incurred but not enough reported
IBNR	incurred but not reported
ISC	Insurance and Superannuation Commission (now APRA)
MAA	Motor Accidents Authority (NSW)
MAIC	Motor Accident Insurance Commission (Queensland)
OCL	outstanding claims liability (liabilities)
OCP	outstanding claims provision(s)
OSFI	Office of the Superintendent of Financial Institutions
P&C	Property and Casualty
PACICC	Property and Casualty Insurance Compensation Corporation
QBE	QBE Insurance Limited
plc	public listed company (UK)
SID	Specialized Institutions Division
Y2K	Year 2000

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