Session 1 – Case
HIH Insurance Group

IAIS-ASSAL Training Seminar

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Agenda

1. Background
   – Failure of HIH Insurance Group
2. Governance Structure & Operations
   – Strategy
   – Board, Chair & Committee
   – Information Provided to Board
   – External Auditor
   – Conflict of Interest
3. Significant Business Decisions
   – UK Entry & Expansion
   – US Re-entry
   – FAI Acquisition
   – Allianz Joint Venture

The case is based on the report of the HIH Royal Commission.

Background

- HIH Insurance Group failed in 2001
  - Second largest non-life insurer in Australia
  - Largest corporate failure
  - Significant adverse impact on policyholders
- Australian government appointed Royal Commission to look into events surrounding HIH's collapse
- Report in April 2003
  - Poor corporate governance
  - Lack of integrity of information provided to board, auditors & regulators
  - Under-provisioning
  - Inadequate & inappropriate asset valuations
  - Abuses of reinsurance
- Please read handout for brief corporate history

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Dominant Figure

- Williams was dominant figure over entire period until HIH collapses in 2001
  - No one rivaled him in terms of authority or influence
  - All major decisions were driven by Williams
- Strong entrepreneurship & leadership are not necessary bad thing
- But must be subject to close review, question & challenge

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Strategy

- “If a director could not articulate the strategy of the company, he or she should not be on the board”
- At board level, there was little analysis of future strategy
  - Discussed only in context of annual budget meeting
  - Generally about numbers & not analysis of direction in which HIH was heading
  - Just broad statement
  - No re-assessment
- Williams might have had one in mind but never clearly expressed to board

Board & Chair

- Board failed to check dominant CEO
  - Review, question & challenge management decisions
  - No clearly defined duties & limits on authority of CEO
  - CEO had many discretions
- Lack of independent critical analysis
  - Board was too ready to accept what management was saying without appropriate analysis
- Chair (Geoffrey Cohen) was reluctant to act on matter, especially if CEO support is not likely
  - e.g. In May 1995, two directors raised concerns on governance but chair did not take matter any further because Williams did not welcome idea
  - e.g. he did not bring Williams to account when he bypassed board in distributing memorandum (Allianz Joint Venture)

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Human Resource Committee

- Board's human resource committee met annually for remuneration reviews
- But decisions were principally made by CEO
  - CEO, whilst not committee member, attended all meetings by invitation
- By March 1998, committee deleted requirement to review senior officers against key potions objectives
  - Rationale: CEO individually communicated expectation
  - From this time, no benchmarks to measure performance of senior officers
  - Review became at sole discretion of CEO

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Information Provided to Board

- Breakdown in system by which information was furnished to board
  - Received little information on broader business matters (mostly quarterly financial reviews + individual transactions)
  - Although presented, it was not in such way as to indicate significance
  - Instances of manipulation of financial information (not only to board but also to auditor and regulator)
- Board did not have any major involvement in process for determining what information would be presented to board

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External Auditor

- Independence might have been compromised
  - Appointment of ex-Andersen partners to board & senior management
  - Absence of meetings between Andersen & non-executive directors without management presence
  - Incentives Andersen had to attract non-audit consulting fees
- Did not have any actuarial expertise
  - Relied heavily on David Slee (HIH's consulting actuary) for valuation of technical provisions
  - No attempt to obtain full understanding of Slee's work

Conflict of Interest

- Following acquisition of FAI, Rodney Adler (major shareholder of FAI) became director of HIH
- Number of related-party transactions
  - He himself worked as consultant to HIH (A$40,000/month)
  - Abacus, & Pacific Mentor (he was director)
  - Pacific Capital (he was director & major shareholders)
- HIH did not have effective mechanism to address conflict of interest
  - Some members remained present when private interests were clearly at issue
  - Some did not even disclose
  - Some disclosed but too little to judge

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Significant Business Decisions

- Business decisions poorly conceived & executed
  - Afflicted by under-reserving, destroying entity value
- Williams promoted, despite Winterthur opposition
  - Winterthur, owning 51% shares, did not have board control
  - It believed it had an understanding with Williams that HIH would concentrate operations in Australia & Asia
- Winterthur withdrew
  - Initially sought for trade sale (i.e. sale to single entity)
  - Under pressure from Williams, changed to sell shares through public offering, allowing Williams to maintain dominance

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UK Entry & Expansion

- For initial entry, board minutes disclose
  - No consideration of whether UK entry fit with strategy
  - No attempt to develop business plan
- Expanding into unfamiliar territory with little experience or expertise
  - Unsuitable underwriting guidelines & controls
- Outcome
  - Huge loss due to inadequate risk identification & management

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US Re-entry

- Decision was made largely based on
  - Anecdotal reports from some executives of CareAmerica (acquired insurer) that bottom of market had been reached
- Limited due diligence
  - No attempt to obtain results of empirical research
  - No comprehensive analysis on actuarial(reserve adequacy etc) or assumptions' reasonableness
  - Review of mathematical accuracy only.
- Board simply accepted management's assertions
- Outcome
  - Anticipated profits never emerged
  - Market conditions deteriorated

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FAI Acquisition

- Possible acquisition consideration was suspended
  - Difficulty in conducting any satisfactory due diligence
  - Reluctance to sell on part of Rodney Adler, a major shareholder of FAI
- Later, Adler changed mind
- Negotiation was brief & board proceeded in very short time frame
  - Board met on evening of 22 September 1998 & decided to proceed
- Outcome
  - Unexpected losses from serious (& undisclosed) under-reserving

FAI Acquisition

- Inappropriate procedures
  - Notice of meeting was circulated earlier that day
  - Only 3 out of 12 were present in person
  - 4 participated by video (but did not receive copies of relevant documents)
  - 5 did (could) not participate
- Insufficient preparatory & investigative work
  - Without any due diligence, board decided to proceed
- Not-balanced information
  - It was told that there were other parties interested & meeting proceeded urgently to consider the acquisition

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Allianz Joint Venture

- Background
  - Proportion of intangible assets was high
  - APRA regulation change effectively required to convert significant amount of intangibles into tangible assets
  - Allianz joint venture offered opportunity
- Chronology
  - Proposal first came to board on 5 September 2000
  - (But, without board approval, information memorandum was already distributed in July to many parties)
  - Board met again on 12 September & resolved to proceed in only 75 minutes

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Allianz Joint Venture

- Information presented to board lacked any careful analysis
- No one at board requested full & accurate analysis
  - Board's focus was on short-term benefits of restructure
  - Keen to announce to market what it considered "value-enhancing strategy" right before announcement of HIH's disappointing financial results
- Outcome
  - Soon became apparent that A$ 500 million contribution to trust fund to cover claims seemed impossible without utilising A$ 200 million paid by Allianz
  - Lost profitable line of business
  - Severe cash flow problem, triggering liquidation

The case is based on the report of the HIH Royal Commission.

Royal Commission Report (2003) can be found at:

http://www.hihroyalcom.gov.au/

¡Muchas gracias!

www.iaisweb.org

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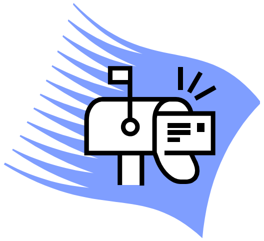

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