GIRO XXX
2003 Convention

14-17 October 2003
City Hall, Cardiff

The HIH Royal Commission
Lessons from down under

Alex Marcuson
15 October 2003

"ELIZABETH THE SECOND, by the Grace of God Queen of Australia and Her other Realms and Territories, Head of the Commonwealth:

TO the Honourable Justice Neville John Owen

WHEREAS it is desired to have an inquiry into certain matters relating to the failure of HIH Insurance Group ("HIH")

BY these Letters Patent issue in Our name by Our Governor-General of the Commonwealth of Australia on the advice of the Federal Executive Council and pursuant to the Constitution of the Commonwealth of Australia and the Royal Commissions Act 1902 ..."

Introduction

- What happened?
- Why a Royal Commission?
- How the HIH Royal Commission operated
- Policy recommendations
- Topics for discussion
  1. Insiders vs. outsiders
  2. The $5bn question
  3. Dealing with auditors
  4. Lies, damned lies and reinsurance contracts
What happened?

- 1992 - Listed on ASX
- 1995 – 1998 (June)
  Winterthur the majority shareholder
- Sept 1998
  - Purchase of FAI
- Late 1999 / early 2000
  - APRA release drafts of new prudential standards
- Sept 2000
  - Allianz joint venture
- Dec 2000 – Williams (CEO) resigns from board
- 6 March 2001 – QBE joint venture
- 15 March 2001 – provisional liquidation
- 27 August 2001 – official liquidation

Why a Royal Commission?

- Sudden demise
- 2nd largest insurer
- “Shouldn’t happen in a modern economy”
- Public suffering
- Ensure new APRA standards work
- General election …
Royal Commissions:
What are they?
• Royal Commissions Act 1902
• Letters patent
• Nature of commission
• Evidence gathering

Royal Commissions:
How did this one work?
• Hearings
• Web-site
  www.hihroyalcom.gov.au
• Parties and witnesses
• Technology

Recommendation Extracts
4 Support for IAS participation
8 Accounting standards amended to reflect new APRA standards
15 Mandatory certification of completeness and accuracy
16 Approved actuary cannot belong to same organisation as approved auditor
17 More detailed disclosure requirement from approved actuary of the “exercise, incidence and impact of subjective judgement and departure from historical experience”
35 Publication of “Schedule P” loss-development data …
35 Publication of a summary of the approved actuary’s valuation, including methodologies and assumptions
42 Insurance Act 1973 extend prudential regulation to cover all discretionary insurance-like products – to extent possible within constitutional limits
60 Tax relief to catastrophe reserves
61 Introduction of policyholder support scheme
Topics for discussion

- Insiders vs. outsiders
- Dealing with auditors
- The $5m question
- Lies, damned lies and reinsurance contracts

Insiders vs. Outsiders

Situation:
- Internal actuary raises concern that external actuaries are underestimating reserves because they are not receiving complete or accurate data
- Receives instructions not to take matter further / assurances that others will take matters further

Issues:
- Management interest vs. public interest
- What additional reliance do you place on data if there is an internal actuary involved?
- When could / should / must you whistle-blow?
- What protection do you have?

The $5bn question

How can a listed company with a BBB rating (or better), big-five auditors, internal and external actuaries … “suddenly” have a $5bn shortfall?
Dealing with auditors

• Who is responsible for data accuracy?
• Should an auditor’s firm have any involvement in the actuarial estimation of reserves?
• What place have actuaries in an audit?
• How can the actuary and the auditor work together to avoid “dodgy data”?

Lies, damned lies and reinsurance

A. Reinsurance in place of prudential margins
B. Side letters negating the transfer of risk
C. Backdating of documentation
D. Inclusion of sections of cover not intended to be used
E. Uses of unrealistic “triggers” for unrealistic cover
F. Uses of letters of credit to transfer risk from reinsurer back to insurer
G. Back-to-back reinsurance to make an ineligible parental guarantee “eligible” for UK solvency

Why did HIH fail?

• Systematic under-provisioning
• Weak governance / no clear strategy
• Conflicts of interest at board level
• Disastrous misadventures
• Dominant senior executive directors
• Poor management information
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