THE FAILURE OF HIH INSURANCE

Volume I

A corporate collapse and its lessons

April 2003

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National Library of Australia Cataloguing-in-Publication data:

Australia. HIH Royal Commission.
The failure of HIH Insurance.

ISBN 0 9750678 0 X (volume I)
ISBN 0 9750678 5 0 (set)
1. HIH Insurance. 2. Insurance companies—Australia.
3. Insurance—Australia. 4. Business failures—Australia.

I. Title.

368.006594

Printed by National Capital Printing, Canberra
Canberra Publishing and Printing

The HIH Royal Commission

The Hon Justice Owen

Commissioner

4 April 2003

His Excellency the Right Reverend Dr Peter Hollingworth AC OBE
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Your Excellency

In accordance with the Letters Patent issued to me on 29 August 2001, as amended by Letters Patent issued on 6 February 2002, 2 May 2002 and 23 January 2003, I have inquired into and prepared a report on the reasons for and the circumstances surrounding the failure of the HIH insurance group.

I now present to you my report and return the Letters Patent.

Yours faithfully

The Hon Justice Owen

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Explanatory notes

The report consists of three volumes.

This first volume 'tells the story' of the failure of HIH in order to answer the question: why did HIH collapse? It also canvasses changes that are desirable if we are to minimise the risk of another failure of a large insurance company. Discussion of the evidence is kept to a minimum in this volume, but this does not mean that I have proceeded without a close analysis of the evidence on which my findings are based.

Volumes II and III provide a detailed recitation and critical examination of the evidence.

The following notes clarify practices adopted for the preparation of the report.

References to people

As a general rule, after the first mention people are referred to simply by their family name. This has been done in the interest of efficiency: no disrespect is intended.

Companies and firms

As a general rule, companies' corporate denominators—such as Limited, Pty Ltd, plc and Inc.—are omitted after the first use.

Depending on the context, a reference to 'HIH' can be to the ultimate holding company, HIH Insurance Limited, or to the entire group, meaning HIH Insurance Limited and its subsidiaries. Where it is important to distinguish and deal with the activities of a particular entity within the group, the entity is identified.

The accounting firm Arthur Andersen, which provided services to both FAI and HIH, changed its name to Andersen in March 2001. Unless the context otherwise requires, the firm is referred to simply as Andersen.

Endnotes

The notes at the end of each chapter refer to source material used in the preparation of the chapter. Many of the references are to the transcript of proceedings or to documents tendered as exhibits. A reference such as 'T3034' is to the page number of the transcript, and a reference such as 'T3034/15' is to line 15 of page 3034 of the transcript. References such as 'AND.1360.0155' and 'WITS.0162.001 at 024 par. 4.2.1' are to material tendered as exhibits; the first one here is to a document produced by Andersen and the second to paragraph 4.2.1 on the 24th page of a witness statement.

The transcript of proceedings and the exhibits are on an electronic database that was available to all parties before the Commission. They now form part of the records of the Commission, which are held in accordance with directions issued by the Minister responsible for administering the *Royal Commissions Act 1902*.

Legislation

Unless otherwise noted, references to legislation are to Commonwealth legislation.

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The failure of HIH: a critical assessment

'Beware the ides of March.' The soothsayer's words have become synonymous with unheeded warnings since they were penned by Shakespeare some 400 years ago. Caesar's response—`He is a dreamer; let us leave him: pass'—is less well known but equally apposite. These words sum up the life and times of HIH, and they resonated eerily throughout the inquiries I made.

On 15 March 2001 the major companies in the HIH Insurance group were placed in provisional liquidation. The provisional liquidators were appointed, the magnitude of the HIH group's

obligations began to emerge, and the journey towards oblivion proceeded. Formal winding-up orders were made on 27 August 2001—the corporate equivalent of death. By then the deficiency of the group was estimated to be between $3.6 billion and $5.3 billion. If the ultimate shortfall is anywhere near the upper end of that range, the collapse of HIH will be the largest corporate failure Australia has endured to date.

But the shambling journey towards oblivion began a long time before March 2001.

A corporate context

Corporate regulation in Australia in the late 1990s and into the present decade was replete with mechanisms designed to detect danger signs and promote the financial health and longevity of commercial entities. The law imposes duties and responsibilities on corporate officers and others such as auditors to ensure that problems that may adversely affect the solvency of a commercial entity are detected at an early stage. When problems of this nature are detected, corporate officers have a responsibility to take action. In the case of a company such as HIH, the corporate officers must inform the regulators and the public of the company's true financial position. The law also confers on regulators significant powers to act on the information that is provided and to obtain other information to protect the public interest.

Despite these mechanisms, the corporate officers, auditors and regulators of HIH failed to see, remedy or report what should have been obvious. And some of those who were in or close to the management of the group ignored or, worse, concealed the true state of the group's steadily deteriorating financial position.

The governance of a public company should be about stewardship. Those in control have a duty to act in the best interests of the company. They must use the company's resources productively. They must understand that those resources are not personal property. The last years of HIH were marked by poor leadership and inept management. Indeed, an attitude of apparent indifference to, or deliberate disregard of, the company's underlying problems pervades the affairs of the group.

Those responsible for the stewardship of HIH ignored the warning signs at their own, the group's and the public's peril. The culture of apparent indifference or deliberate disregard on the part of those responsible for the well-being of the company set in train a series of events that culminated in a calamity of monumental proportions.

A far-reaching calamity

Insurance is a vital element of modern society. It is one of the means whereby the consequences of injury to person or property and the risk of incurring liability to others can be spread. The object is to lighten the burden of loss to individuals and groups in the community. When an insurer fails, the loss lies where it falls. The collapse of HIH has reverberated throughout the community, with consequences of the most serious kind.

Harm to individuals

Individual cases of personal hardship emerged almost immediately after the collapse and continue to emerge. They will probably keep emerging well into the future.

A 50-year-old school principal who had contributed a portion of his weekly earnings to an income protection insurance policy developed a brain tumour in 1996. Unable to work, he and his family survived on the monthly cheques that came from HIH under the policy. In February 2001 the monthly cheque was dishonoured on presentation; his policy is now worthless. His spouse was forced to approach Centrelink in an effort to obtain a disability support pension.

About 200 permanently disabled people no longer receive their regular payments from HIH. These people have joined other unsecured creditors and policyholders, and they all face a wait of up to 10 years before receiving what the liquidator has predicted will be a 'very poor' payment.

Retirees who invested their superannuation or life savings in HIH shares to fund their retirement have been left with nothing. A person who owned a small business and was insured with HIH became embroiled in a legal dispute. Just weeks before its liquidation, HIH encouraged him to settle the claim out of court for $90 000. The subsequent collapse of the insurer left the business owner liable for the payout.

Thousands of holders of professional indemnity, public liability, home warranty and travel insurance policies have found themselves uninsured for claims made by or against them. A family whose HIH-insured home was destroyed in a fire was forced to live in the burnt shell of the house after HIH defaulted on their caravan rental payments.

As with most corporate collapses, the employees of HIH were also dealt a bitter blow: one morning in March 2001 about 1000 of them woke to find themselves unemployed; hundreds of others lost their jobs in the ensuing months.

Some of those people will by now have received compensation under the government funded HIH Claims Support Scheme, however that scheme was necessarily limited in scope and operation. These are just a few examples of the personal hardship the failure of HIH has wrought[HiH1].

Community distress

The general community has been caught up in the aftermath. The ramifications of the failure have been felt throughout many local industries. The same can be said of organisations in the arts and entertainment and in sport and recreation. Some non-profit organisations have been forced to shut down businesses as a result of the collapse.

A local theatre had to close its doors, with the loss of 70 jobs, because it did not receive sponsorship funds that had been promised by HIH. Sport and recreation centres, including local festivals and amusement parks, have been forced out of business, either because they have been unable to find alternative insurance or because they are no longer able to afford the spiralling costs of premiums.

The annual St Patrick's Day parade through the streets of Fremantle—a fixture in the Western Australian calendar for decades—was almost abandoned in 2002 because the public liability insurance premium was prohibitive. At the last minute a local agency stepped in to fund the cover. In an era of scarce resources, those funds will be sorely missed in the furtherance of welfare and social justice.

As a result of a court judgment, a rural local authority in Western Australia has been left exposed to a liability estimated at $6 million because of a fire that started in its rubbish tip and devastated surrounding farms. The local authority's lead insurer at the time was HIH. Those who suffered loss or damage to property and all ratepayers in the district are victims of the collapse. Other local authorities are similarly vulnerable.

Consequences for the public

HIH was one of Australia's biggest home-building market insurers. Its collapse left the building industry in turmoil. Home owners were left without compulsory home warranty insurance; the owners of residential dwellings have found that cover for defective building work has vanished; builders are unable to operate because they cannot obtain builders' warranty insurance. The cost to the building and construction industry alone has forced state governments to spend millions of dollars of public money to prevent further damage to the industry.

There are thousands of other cases of personal and community hardship, each one no less devastating for those affected by it. Such have been the losses to the community that by the end of February 2003 the Commonwealth Government had already paid out $195 million through the government-funded HIH Claims Support Scheme. By that time 11 400 applications had been received; of these, some 5850 had been approved, wholly or in part. The full cost of this scheme is yet to be determined.

There are other ramifications that, although less direct, are nonetheless real. Whether it is characterised as a symptom or a cause, the failure of HIH has contributed to what has become known as the 'public liability insurance crisis'. This has brought about proposals for legislative reform of tort law, which—without entering the debate about the overall desirability of the proposals—must inevitably bring about pain, inconvenience and perhaps injustice to some individuals. The process of change is tortuous, and the states and territories have differing views about how change should be implemented. Caps on damages awards, contraction of limitation periods, and moves towards proportionate liability have either been implemented or are imminent in some jurisdictions. There is a strong argument that the public interest calls for change. But this does not lessen the impact of the changes on individuals who are denied full (or any) recompense for a loss they have suffered.

A collapse of this magnitude must inevitably shake public confidence in the insurance industry and in the regulatory system's ability to carry out its protective role properly. The Australian general insurance market is not particularly large by global standards. It needs stability, and it assumes that supervisory and regulatory functions will operate to that end. There will always be corporate failures but, in terms of their consequences, most are relatively self-contained. Some

collapses, though, cause the public to question the integrity of the market system itself. The failure of HIH was an event of that nature.

Reasons for the failure: a broad perspective

How did it happen? The insurance market is undoubtedly cyclical. The second half of the 1990s was a period of poor global market conditions for commercial insurance, and HIH was not the only insurer to collapse.[1] Nevertheless, market conditions provide neither an excuse nor an explanation for HIH's predicament: most insurers weathered the storm.

In a collapse of this type it would not be unnatural for an outside observer to suspect that the central players must have been fraudsters. They might also suspect that large sums of money must have been spirited away to the dungeons of financial institutions, in so-called safe havens.

HIH is not a case where wholesale fraud or embezzlement abounded. Most of the instances of possible malfeasance were borne of a misconceived desire to paper over the ever-widening cracks that were appearing in the edifice that was HIH.

Where did the money go? Some of it was wasted by extravagance, largesse, paying too much for businesses acquired, and questionable transactions. There were some trading losses. But in the main the money was never there. The deficiency of several billion dollars has arisen because claims arising from insured events in previous years were far greater than the company had provided for. Past claims on policies that had not been properly priced had to be met out of present income. This was a spiral that could not continue indefinitely. In the language of the industry, the failure to provide adequately for future claims is called 'under-reserving' or 'under-provisioning'. This, in my view, is the primary reason for HIH failing—and not only failing but doing so in such an egregious way.

Why was there such serious under-reserving and why were the risks not properly priced? The answer here is that HIH was mismanaged. The factors contributing to the mismanagement of the group—and hence the reasons for the failure—are many, varied and complex. They are also interrelated. They are epitomised by a lack of attention to detail, a lack of accountability for performance, and a lack of integrity in the company's internal processes and systems. Combined, these features led to a series of business decisions that were poorly conceived and even more poorly executed.

Among such decisions were the ill-fated commitment in 1996 to re-enter the US market (HIH having extricated itself at a profit in 1994); the expansion of the UK operations in about 1997 into previously 'uncharted territory'; and the unwise acquisition of FAI Insurances Ltd in 1998. Not surprisingly, the US and UK operations—as well as FAI, both before and after its acquisition by HIH—were afflicted by chronic under-reserving that all but destroyed the entities or branches concerned.

The poor decision making continued until the very end. It culminated in September 2000, when HIH sold most of its profitable lines of business to a joint venture with Allianz Australia

Limited. The negative cash flow aspects of this venture hastened the rate of HIH's decline and led directly to the decision on 15 March 2001 to place the company in provisional liquidation.

A cause for serious concern arises from the group's corporate culture. By 'corporate culture' I mean the charism or personality—sometimes overt but often unstated—that guides the decision-making process at all levels of an organisation. In the case of HIH, the culture that developed was inimical to sound management practices. It resulted in decision making that fell well short of the required standards.

The problematic aspects of the corporate culture of HIH—which led directly to the poor decision making—can be summarised succinctly. There was blind faith in a leadership that was ill-equipped for the task. There was insufficient ability and independence of mind in and associated with the organisation to see what had to be done and what had to be stopped or avoided. Risks were not properly identified and managed. Unpleasant information was hidden, filtered or sanitised. And there was a lack of sceptical questioning and analysis when and where it mattered.

A brief financial perspective

Before I elaborate on my concerns about corporate culture, the financial position and performance of the group warrants mention. By 15 March 2001 the group could not pay its debts as they fell due; in other words, it was insolvent. This may sound trite, but a commercial entity such as HIH—which existed primarily to offer financial services to the public and to generate a return for its shareholders—must remain solvent or it cannot trade. If it does not trade it cannot fulfil either of those objectives.

The financial fortunes of the group were in serious decline from at least 1 January 1998, although the accounting techniques the group used served to disguise to some extent the full import of the decline. It was not until 2000 that the market began to express serious disquiet about the group's fortunes. From mid-2000 some journalists were writing stories generally critical of HIH. Unlike the soothsayers of Caesar's time, they did not have to consult the oracles to ascertain the bad news; it came from a source inside the company—possibly at board level. This is a small indication of just how dysfunctional the management of the company was. Nevertheless, even during that period some brokers and analysts were looking on the group with favour.

Time has permitted an in-depth analysis only of the HIH group's accounts as at 30 June 1999 and 30 June 2000. Despite this limitation, analysis of the group suggests that serious problems existed in the years preceding 1999. The analysis in the following paragraphs takes as its base the accounts as at 31 December 1997. Moving forward from that date, there are several measures, admittedly simplistic, that demonstrate starkly the deterioration in the financial fortunes of the group during the last three or so years of its existence.

Profits and losses

In each of the years ending 31 December from 1995 to 1997 the group reported an operating profit after extraordinary items and income tax that was higher than in the preceding year. For 31 December 1997 the figure was $61.8 million. For the 18 months to 30 June 1999 there was a loss of $21.2 million. In the year ending 30 June 2000 the group returned to profit, but only to the extent of $18.4 million. It is my opinion that, were it not for questionable accounting treatment of some transactions, the loss in 1999 would have been greater and the profit in 2000 would have been a loss. In both 1999 and 2000 the company declared a dividend but in doing so exhausted its store of retained profits.

Underwriting performance

It is not unusual for a general insurer to make a loss on underwriting. This is not fatal if returns on other aspects of the business, such as investment of policyholders' and shareholders' funds, are positive. But underwriting is the core aspect of a general insurer's operations and its performance requires close scrutiny.

An analysis of the performance of HIH's underwriting business shows a similar pattern of deterioration.

In the year ending 31 December 1997 HIH made an underwriting loss of $33.8 million on net premium earned of $1233.5 million. In the 18 months to 30 June 1999 (making a pro rata adjustment to reduce it notionally to a 12-month period) the underwriting loss was $73 million against a net earned premium of $1550 million. The comparative figures for the year ending 30 June 2000 are $103.5 million and $1995.4 million respectively. In other words, between 1997 and 1999 (notionally adjusting the latter to reduce it to a 12-month period) the underwriting loss more than doubled while the net earned premium rose by 25 per cent. If the comparison is made between 1997 and 2000 the underwriting loss increased threefold and yet net earned premium increased by 61 per cent.

On 12 September 2000 Andersen, HIH's auditor, made a presentation to the HIH audit committee. Included in the presentation was a schedule showing trends in core underwriting performance in the various accounting periods between December 1998 and June 2000. The schedule provides a telling demonstration of the extent to which the reported core underwriting loss was diminished by increasing use of one-off entries such as increments to goodwill and recoveries under reinsurance contracts. In the 12 months to December 1999, one-off adjustments reduced the underwriting loss by $157 million; in the year ending 30 June 2000 they reduced the loss by $360 million. In other words, without those one-off entries the underwriting loss would have been much worse, and the situation was deteriorating.

Reliance on intangibles

Another feature of the financial trend was the increasing reliance on intangible assets to support shareholders' equity. The net tangible asset backing per share, as reported in the published accounts of HIH, was $1.39 at 31 December 1997; it had declined to 33 cents by 30 June 2000. Somewhat curiously, the net tangible asset backing was calculated by treating only goodwill and

management rights as intangibles. It also reflects the position before diluting for the effect of convertible and converting notes.

In addition to goodwill and management rights, HIH had in its balance sheet future income tax benefits and deferred information technology costs and deferred acquisition costs. I do not think there can be any real argument that future income tax benefits and deferred information technology costs are tangibles. There is, however, doubt whether deferred acquisition costs—while answering the euphemistic description 'soft assets'—fall into the same category. They are omitted from the calculation that follows.

As at 31 December 1997 total shareholders' equity stood at $560 million, of which 23 per cent was represented by goodwill, future income tax benefits and deferred IT costs. By 30 June 1999 intangibles had increased to 60 per cent of total shareholders' equity. In the accounts to 30 June 2000 the total shareholders' equity was $939 million, but this relied on intangible assets of $703 million, or 75 per cent of total shareholders' equity. Goodwill represented 50 per cent of HIH's shareholders funds as at 30 June 2000. By way of comparison, QBE and NRMA (two comparable Australian insurance companies) had a ratio of goodwill to shareholders funds of 4.9 per cent and 0.4 per cent respectively.

This is not to say that reliance on intangibles is illegitimate. But the trend is disturbing for at least two reasons. First, the value to be attributed to intangibles is often a matter of judgment and is particularly susceptible to error—witting or unwitting; in the accounting practices of HIH goodwill became something of a repository for the unpleasant and unwanted consequences of poor business judgment. Second, when times get tough it is difficult to convert intangibles to cash; as other sources of cash disappear, the intrinsic value of intangibles is seriously called into question.

Mismanagement: a failure of culture

I move now to consider the corporate culture of the group and how it fits with the broad statement that HIH was mismanaged. There is probably no better example of what I mean than failure of risk identification and risk management within the group.

Risk identification and risk management

An experienced Australian company director recently commented that if a director could not articulate the strategy of the company he or she should not be on the board.[2] I share that view, and I consider that this is an area in which the governance of HIH was deficient.

Strategy and the board

At board level, there was little, if any, analysis of the future strategy of the company. Indeed, the company's strategy was not documented and it is quite apparent to me that a member of the board would have had difficulty identifying any grand design. If the HIH board discussed strategy at all, it was in the context of an annual budget meeting. But budget sessions are

generally about numbers, and there is no indication that the board seriously grasped the opportunity to analyse the direction in which the company was heading.

Generally speaking, it is for management, rather than the board, to propose strategy. This is not an impediment to the board taking the initiative in an appropriate case. But management is best able to dedicate time to strategic thinking and is likely to have greater industry knowledge and experience. Nevertheless, it is the board's responsibility to understand, test and endorse the company's strategy. In monitoring performance, the board needs to measure management proposals by reference to the endorsed strategy, with any deviation in practice being challenged and explained. This is what the HIH board failed to do.

A plan may have existed in the mind of the chief executive. In his evidence Williams said that all of Australia's commercial insurers were under enormous pressure throughout the 1990s. The pressure was primarily a consequence of weak global market conditions for commercial insurance, which translated into inadequate premium rates locally. Each local insurer responded differently. Some wrote business locally at cheaper rates. Others sought to compete in complex and difficult international reinsurance markets. Williams said that HIH responded with a strategy based on seeking greater exposure to the more profitable domestic personal lines and also with some diversification offshore, principally in the United Kingdom and the United States. He also said that, without a massive capital base to withstand the cyclical downturns, insurers need consistent profitability to maintain strong balance sheets and to deliver a satisfactory return on capital.

I accept that it was a difficult commercial environment. I accept most of the other things that Williams said in that part of his evidence. Where I take a different view from that which is implicit in Williams's evidence is whether the 'strategy' was properly analysed and thought through, whether it was tested and understood by the board, and whether it was put into effect with adequate and proper attention to detail. The problem is Williams's perspective was never clearly expressed to the board. As one director conceded, if he had been asked to commit to writing what the long-term strategy was he would have had difficulty doing so; the other directors struggled when asked to identify strategic directions. The chairman of the board maintained that HIH's strategy was international growth and diversification. But the formulation of strategy requires more than just a broad statement of the intended result. Further, the board must regularly review and test the strategy's appropriateness, and it must monitor and assess whether the strategy is being achieved and, if so, to what extent. According to the chairman of the board, it appears the same 'strategy' existed from at least 1995 and was never subjected to rigorous analysis to gauge its continuing suitability in a changing environment.

A long-term strategy or plan was never submitted formally to the board for critical analysis. Nor did one emerge or evolve informally. In the absence of a framework within which investment and other decisions could be evaluated, the growth of the group was opportunistic and lacking in direction.

There is a related problem. A board that does not understand the strategy may not appreciate the risks. And if it does not appreciate the risks it will probably not ask the right questions to ensure that the strategy is properly executed. This occurred in the governance of HIH. Sometimes

questions simply were not posed; on other occasions the right questions were asked but the assessment of the responses was flawed. The absence of a well-understood strategy compounds the difficulties that arise in opportunistic development. The failure of operations in the United Kingdom and the United States and the acquisition of FAI provide ample evidence of this.

The way the group managed its entry into and expansion in overseas markets was extremely imprudent and ultimately very costly. It involved bad decision making and a lack of business judgment in circumstances of adverse insurance market conditions. Similarly, the decision to acquire FAI was impetuous and based on completely inadequate information.

A failure: the UK operations

HIH's UK branch was established in mid-1993 and began underwriting in September of that year. The HIH board minutes for the first half of 1993 do not disclose any consideration by the board of whether the opening of a branch in the United Kingdom was compatible with HIH's broader strategy. And there is no evidence that the board contributed to the development of a business plan for the new branch. This apparent complacency about the group entering unfamiliar territory—the UK insurance market—is worrying.

Initially, the business written by the UK operations consisted of public liability and professional indemnity and some inwards treaty business. The operations were a success in their first year. These lines of business were expanded in 1995: the UK chief executive decided to move into areas of business in which the underwriters had little experience or expertise. From that time on, the losses began to flow.

The main losses occurred in the underwriting of whole-of-account excess-of-loss marine reinsurance and film financing. Among other instances of dismal outcomes were the provision of personal accident cover to members of the Taiwanese military and of motor vehicle physical damage cover—without terrorism exclusions—to an Israeli insurer.

It would appear that the UK branch failed to institute suitable underwriting guidelines and controls. The controls that did exist were inadequate to limit underwriting activity to less risky lines of business. The writing of the four lines of business just noted demonstrates the UK branch's willingness to underwrite cover in areas where the underwriters had insufficient, or no, experience. The combination of a lack of underwriting controls and a lack of relevant experience and familiarity in those particular lines of business was a formula for financial disaster.

It seems there was no appreciation of the risks associated with expanding the lines of business written by the UK operations beyond the expertise of the underwriters. The situation was exacerbated by the lack of a reporting structure that would allow others in the organisation to know what business was being written and the risks being assumed. Further, once problems emerged, there was no process for redressing them and stemming the consequent losses. Poor-quality management information and inadequate accounting systems impaired the Australian management's ability to monitor and control the UK operations effectively.

This is a different aspect of the risk-identification and -management problem because it occurs at the operational level, rather than the governance level. It nevertheless demonstrates systemic failure. The losses in the United Kingdom may amount to as much as $1.7 billion.

A second failure: the US operations

The story of the US operations is not dissimilar to that of the UK operations. In 1994—in anticipation of legislative changes that it was thought would cause premium rates to fall—HIH sold its workers compensation business in California on favourable terms. In late 1996 it began negotiating to reacquire the business, by then known as CareAmerica.

The decision to consider re-entering the US market was made largely on the basis of anecdotal evidence and reports from some of the CareAmerica executives that, two years after deregulation, the bottom of the market had been reached. The prognosis of the market was the fundamental consideration for HIH in determining whether to proceed with the repurchase. By 13 December 1996, when the board decided to proceed with the transaction, no attempt had been made to obtain the results of empirical research on that subject or otherwise to verify the assertions made.

The reacquisition was subject to limited due diligence. No comprehensive actuarial analysis was sought by HIH, so the adequacy of CareAmerica's reserves was not assessed. The review of CareAmerica's profit forecast involved no more than testing the mathematical accuracy of the model on which it was based. The assumptions on which the model relied—for example, the expectation of improved market conditions—were not tested for reasonableness.

The board finalised the reacquisition on 3 January 1997. Full due diligence had not been performed—contrary to the advice of HIH's financial adviser—and no indemnity was sought against any potential deterioration in CareAmerica's level of reserves. The board simply accepted, without analysis, management's assertions that re-entry into the US market would prove profitable and resolved to proceed with the transaction. There was a complete failure to appreciate the level of risk involved.

As it turned out, the re-entry into the US market was a debacle: the anticipated profits never emerged and market conditions deteriorated. In October 2000 the US operation was placed in run-off. It is estimated that the foray cost the group about $620 million.

A third failure: the FAI acquisition

In September 1998 HIH announced a takeover offer for the issued share capital of FAI. The group had been interested in acquiring a strategic shareholding in, or possibly taking over, FAI since at least early 1993. From 1995 HIH and its financial advisers kept FAI and the possibility of an acquisition under regular review. The advice to HIH always was that there would need to be a due diligence investigation of FAI before any acquisition could proceed. But all attempts to carry out such an investigation were rebuffed by FAI's chief executive officer, Rodney Adler. In February 1998 discussions lapsed.

In September 1998 negotiations were renewed. The HIH board met to discuss the acquisition on the evening of 22 September. It was ultimately resolved that the takeover bid should proceed. The notice of meeting had been circulated earlier that day and, because of the lateness of the notice, five of the 12 directors were not present at the meeting. They were overseas and had no notice of the meeting at all. In fact, only three directors were present in person; the remaining four participated by video. Those participating by video may not have had copies of all relevant documentation—including the report prepared by HIH's financial advisers. The meeting was told that there were other parties interested in acquiring a shareholding in FAI, and it was in that context that the meeting proceeded urgently to consider the acquisition.

There remained substantial financial uncertainties for HIH in contemplating the takeover. There was a dearth of information available to HIH at the time, and when the matter was raised with Adler he refused to allow due diligence. The directors decided to proceed in any event. A careful and considered assessment of the true worth and future prospects of FAI, or any combined entity, was not possible in the circumstances. HIH proceeded with the takeover solely on the basis of its assessment of publicly available information. What was not apparent from that public information was the excessive under-reserving of FAI's long-tail business. HIH itself had provisioning problems: the compounding effect of the FAI shortfall would prove disastrous.

Against this background, the HIH directors' decision to approve the takeover—reached after scant consideration, in a very short time frame, and with insufficient preparatory and investigative work—was unwise. The directors failed to consider fully the risks that the takeover posed to HIH. There had been a suggestion of competition with another potential bidder, but this was not a justification for ignoring due process. I say this recognising the difficulty of persuading a takeover target to open its books to a suitor who is also a competitor.

The acquisition of the FAI retail lines was beneficial to HIH and, on balance, HIH achieved reasonable results from the realisation of non-insurance assets acquired from FAI. But the group was not equipped to handle the unexpected losses that arose from serious—and undisclosed—under-reserving in FAI's long-tail portfolios. As at 30 June 2000 HIH had recognised more than $530 million of these losses. They were either taken to goodwill or purportedly covered by reinsurance.

On the available evidence, my estimate is that the cost to HIH of the FAI acquisition was about $590 million.

The harbinger of doom: the Allianz joint venture

The transaction that, in retrospect, hastened the inevitable demise of the HIH group was the Allianz joint venture, which was negotiated in the second half of 2000 and came into effect on 1 January 2001. It involved the sale of HIH's profitable retail lines—most of which had come from the FAI acquisition—into a joint venture with Allianz Australia Limited. The arrangements agreed between HIH and Allianz ultimately caused HIH to experience an insurmountable cash flow crisis in early 2001 and largely dictated the timing of HIH's collapse.

Somewhat bewilderingly, no one in management or at board level called for or did a full and accurate analysis of the likely cash flow implications of the transaction before HIH entered into the joint venture in September 2000.

I can see why the joint-venture proposal might have appeared attractive to HIH. It was seen as providing the group with a form of restructure that would resolve a number of concerns that had arisen during 2000. The proportion of intangibles in the group's balance sheet was high—including a large carrying value of goodwill as a result of the FAI acquisition. Proposed reforms to insurance licensing regulations would effectively require HIH to convert a significant amount of its intangible assets into tangible assets. The Allianz joint venture offered HIH that opportunity. It would also provide HIH with a $200 million cash injection, that being the sum payable by Allianz 'up front' for the purchase of HIH's retail lines.

A closer examination of the joint-venture arrangements reveals, however, that the benefits to HIH would be outweighed by the severe cash flow consequences it would experience. The arrangements envisaged that a trust would be set up 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 and profits would be distributed from the trust on a quarterly basis—but only after an actuarial assessment confirmed that the trust funds were sufficient.

The impact on HIH's cash flow was twofold. First, the group was required to contribute a significant amount of assets and cash—about $500 million—to the trust at the outset. As it turned out, the group was unable to cobble together that amount, and the $200 million payable by Allianz to HIH as part of the purchase price had to be used. Second, HIH was cut off from its main premium income flow—about $1 billion a year—until the completion of the first actuarial assessment, which would probably be five months or so after the start of the joint venture.

The Allianz proposal first came before the board on 5 September 2000. A joint venture of HIH's retail insurance business was not something that had previously been raised or canvassed at board level. Yet by this time, quite extraordinarily, management had been pursuing several restructuring options for some months; various offers had been received and negotiations with interested parties were well under way. Incredibly, without board approval an information memorandum had already been distributed, in July 2000, to a number of parties. Indeed, the existence of the information memorandum was not made known to some board members until the meeting of 5 September 2000. It is strange that most members of the board appeared unconcerned by management's pursuit of such a profound change in HIH's strategic direction without first having been informed.

The Allianz joint venture was presented to the board as one of four restructure proposals. A basic overview was provided in respect of each of the four options. A week later, on 12 September 2000, the board met again and—in a mere 75 minutes—resolved to proceed with the Allianz proposal. This was wholly inadequate for the proper ventilation of the complex affairs associated with the transaction. The information before the board lacked any careful analysis of the joint venture and its implications for the future operations of HIH. The trust provisions and their potential adverse effect on cash flow were either completely overlooked or not properly appreciated. The board's focus appears to have been on the short-term benefits of the restructure.

They were also keen to announce to the market what it considered a 'value-enhancing strategy' on presentation of HIH's very poor end-of-year results the following day.

The board's lack of understanding of the transaction—as a result of inadequate information and the oppressive time constraints—meant that the directors were incapable of fully understanding the risks involved. This failure to identify and understand the risks meant that the right questions were not asked. And so the ruinous cash flow consequences were not properly appreciated until it was too late.

In the months immediately following the signing of the joint-venture documents, HIH's management started examining in detail the trust arrangements that were to be in operation by 1 January 2001. It emerged that HIH would be required to contribute about $500 million to the trust. By November 2000, management realised that the $200 million purchase price—initially envisaged as an 'up front' payment by Allianz—would have to be used as part of the trust funds. In turn, management began to realise that cash flow difficulties would result from the transaction because HIH would be deprived of its main premium income. These matters appear to have been raised at board level at about this time, albeit with little emphasis on their significance. So it was, then, that most of the non-executive directors, and some of the executive directors, did not have a clear understanding of these matters until early January 2001.

After the joint venture came into effect, HIH remained saddled with a deteriorating claims experience from the portfolios it had retained. At the same time it was deprived of the cash flow from premiums from the retail lines committed to the joint venture and about $500 million of its assets and cash were 'locked' in the trust. And it could not expect to receive a distribution from the trust until at least May 2001.

Thus it was that HIH was unable to gain access to the capital injection it needed to survive in the short term. The result was predictable: it ran out of cash. Within 10 weeks of the start of the joint venture, HIH was placed in provisional liquidation.

Mismanagement: a particular outlook

Problems of corporate culture and deficiencies in management extend well beyond risk identification and control. They manifest themselves in the very heart of an organisation and the way it is run.

A private company approach

As early as 1995 an independent due diligence report described HIH as a 'company which has not yet made a complete transition from an entrepreneurially run company influenced strongly by senior management, and from which senior management benefits significantly, to that of an ASX listed company run primarily in the interests of shareholders'. In my view, this remained true for the remainder of the company's life.

For example, company funds were used to pay for personal taxation advice to certain senior executives, including executive directors. The cost of the advice was not a recognised element of

the salaries provided to the recipients of the advice. In addition, the fact that the company was paying for it was not disclosed to the board or to the shareholders.

Another example is that from time to time the chief executive's personal funds were transferred into HIH UK's bank account. He would subsequently receive equivalent funds from HIH in Australia. The reason for using the corporate banking facilities remains largely unexplained. Intermingling of personal and company funds is undesirable. Furthermore, it was not disclosed to the board.

These are not, in themselves, particularly serious matters. I mention them only as illustrations of an approach that I perceive to have existed within HIH.

Dominant personalities

The business was established by Raymond Williams and Michael Payne in 1968. George Sturesteps and Terence Cassidy joined the company in 1969 and 1970 respectively. Payne was the chief executive of the UK operations until ill-health curtailed his activities in late 1997. He became chairman of the main UK entity in 1999; he was an executive director of the holding company from 1992 until June 1998 and a non-executive director from July 1998 until September 2000. Sturesteps and Cassidy remained in very senior management positions until September 2000 and March 2001 respectively. They both left the board in September 2000.

Williams was, in reality, chief executive from the inception of the business until he stepped aside in October 2000. No one rivalled him in terms of authority or influence. Even as his business judgment faltered in the second half of the 1990s he remained unchallenged. No one else in senior management was equipped to grasp what was happening and to bring about a change of direction for the group. There was a lack of accountability among senior management and the board of directors, and there was a singular failure to assess performance in the context of deteriorating financial results.

The hand and influence of Williams were paramount. In itself, there is nothing inherently wrong with a strong and forceful influence guiding the affairs of a corporation. Indeed, in Australian corporate life there have been many examples of successful businesses built in such a way. But in the modern commercial context such influence must be subject to the countervailing effect of close review, debate and questioning. This appears to have been a commodity in short supply at HIH.

I gained the impression that the general approach of the board and of senior management was unduly deferential. No doubt it was in most cases subconscious, and it would come as a surprise to some of those involved that an outside observer would hold such a view.

I have no doubt that Payne, Sturesteps and Cassidy were competent insurance managers and that they had earned the respect and loyalty of Williams over a long period. Between them, they had an immense store of knowledge about the business. They should have been in a position to act as a counterfoil to Williams, but I am not convinced they did so. They were, after all, directors and

executives of a public listed company that was embarking on rapid growth in a volatile market. Williams's loyalty to them was readily apparent.

Winterthur: in and out

Williams's influence can be seen in two aspects of the dealings with Winterthur Swiss Insurance Company, a giant in the global insurance market and a company with a strong reputation and credit rating.

HIH perceived that there would be advantages in forging links with an entity such as Winterthur. In 1995, as a result of the merger between HIH and Winterthur's Australian subsidiary, Winterthur came to hold 50 per cent of the ordinary shares in HIH but did not have board control. Winterthur believed it had an understanding with Williams that HIH would concentrate its operations in Australia and Asia and not expand in areas such as the United States (where Winterthur was active) or the United Kingdom (a market Winterthur regarded as commercially unattractive). Williams did not accept that the arrangement was as clear as the Swiss considered it to be. In any event, despite Winterthur's protestations, HIH expanded its operations in the United States and the United Kingdom. These were ventures in which Williams's influence was material. They were disasters.

In 1998 Winterthur decided to quit its holding in HIH. It would have preferred to do so by a trade sale—that is, a sale to a single entity, but Williams was opposed to such a move and did little to assist. A trade sale would have required the approval of shareholders other than Winterthur, and that approval was not likely to be forthcoming without board support. The sale was effected by a public offer following an institutional book-build. The result for HIH was a share register without a financially strong shareholder similar to Winterthur. The change was to the detriment of HIH because the market no longer had the confidence engendered by the association with a financially strong shareholder of global repute.

Mismanagement: under-provisioning

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.

The provision for outstanding claims is the biggest single item on the liabilities side of a general insurer's balance sheet and is of particular significance because the level of reserves plays an important role in the pricing of risk. For HIH, the provision for outstanding claims represented about 50 per cent of liabilities: I think the inability to price risk properly was a serious problem.

Time permitted the Commission a close examination only of the accounts for 1999 and 2000. But it is very apparent that under-provisioning and the causes of it had existed for many years.

Under-provisioning: systemic problems

Outstanding claims provisions are of fundamental importance to the financial well-being of a general insurer and hence to its policyholders. The directors said they were aware of the

importance of the provisions, but I am not convinced they understood their full significance. In terms of stewardship, this was a particularly important function vested in the directors.

Both the directors and management were been found wanting in this regard. By their failure to come to grips with what I regard as the most critical aspect of HIH's financial statements, the directors passed up an opportunity to identify and deal with looming problems that proved, in the end, to be the company's undoing. Geoffrey Cohen, Charles Abbott, Rodney Adler, Justin Gardener, Alexander Gorrie, Neville Head and Robert Stitt, all of whom were non-executive directors from time to time during the period 1997 to 2001, must share some responsibility for this situation. So too must the executive directors—Williams, Cassidy, Payne, Sturesteps, Dominic Fodera and Randolph Wein.

In setting the figure for reserves, the board relied on reports by independent actuaries and on the assessment of those reports by the auditors. The actuarially based reserves were set using assumptions for factors such as discount rates and claims-handling costs. Small changes in the assumptions could have made a major difference to the bottom-line result. Yet at no time were the actuaries' reports, or even a summary of them, tabled at meetings of the audit committee or the board. Nor was an actuary ever asked to attend a meeting to explain his or her report or answer questions. Any significant discussion of the assumptions on which the actuaries' recommendations were based was uncommon. There was no real understanding of the way the auditors dealt with the actuaries' reports or of the extent to which, if at all, the auditors reached an independent opinion as to the appropriate level of reserves.

Another aspect of the way in which claims reserves were set is, I think, illustrative of systemic failure. Between 1997 and 2000 (and perhaps before) the auditors did what they described as an 'analytical review' and came up with 'high', 'low' and 'likely' reserves figures. The purpose was to see whether the figure proposed by management was within the auditors' materiality tolerance (3 per cent) of the 'likely' estimate. In the presentations to the audit committee (and thus to the board) the auditors included the 'low' and 'high' figures but not the 'likely' figure.

The explanation for not including the 'likely' figure was that the auditors' testing process did not engender sufficient confidence for it to be put forward as a point estimate. There was a similar lack of confidence in the reliability of the 'low' figure, but it was included—even though the auditors knew that the directors would place reliance on the 'low' figure to see where the reserves management proposed to book sat in the range. There is no evidence that the directors ever asked what the 'likely' figure was. Nor were they ever told. Nor did they ask how the 'low' figure measured up to the point estimate. In fact, there were occasions when the 'low' figure was more than 3 per cent below the point estimate, but this was not disclosed to the directors.

The level of under-provisioning

Lest it be thought I have placed too much emphasis on under-provisioning, it is worth describing briefly what I found about the level of shortfalls. It is, of course, not an exact science, and the figures will change over time as experience turns estimates into reality. But on the basis of work done by Richard Wilkinson (an actuary engaged by the liquidators) and expert actuarial advice obtained by the Commission I believe the position to be as follows.

As at 31 December 2000 HIH estimated its provisions for outstanding claims (on a going-concern basis) as $3.1 billion. Wilkinson opined that as at 15 March 2001, assessed on a going-concern basis, the value of the outstanding claims liabilities was $5 billion. It follows—disregarding any discrepancy that may be attributable to the different dates of valuation used by HIH and Wilkinson—that the HIH group's outstanding claims were undervalued by $1.9 billion. If a different approach is taken and the estimate is made on a break-up basis, which assumes the company is no longer a going concern and thus does not allow for any discounting of the estimate, the figure rises to $2.6 billion. If a prudential margin (which for present purposes can be described as a safety margin) is added, the figure rises to $4.3 billion.

I make two points about this. First, the provision for outstanding claims disclosed in the accounts to 30 June 2000 was $4.4 billion; this is without a prudential margin. Even allowing for the time difference between 30 June 2000 and 15 March 2001, a difference of $1.9 billion in a base figure of $4.4 billion is conspicuous. Second, the liquidators have estimated the net asset deficiency of the HIH group as between $3.6 billion and $5.3 billion. Quite obviously, under-provisioning of between $2.6 billion and $4.3 billion has made a material contribution to that deficiency.

The use and abuse of reinsurance

Reinsurance, as traditionally understood, is a mechanism whereby an insurer transfers part of the risk it has assumed on behalf of its policyholders. It is widely used by general insurers to manage underwriting and financial risk. One purpose of reinsurance is to transfer the risk of future adverse developments in relation to claims. It is thus important when the level of outstanding claims provisions and other factors affecting an insurer's financial statements are being considered.

During the inquiry, questions emerged about the use of alternative risk-transfer products—often called financial reinsurance. Traditional reinsurance is primarily directed at the transfer of risk. On the other hand, financial insurance (of the type employed by FAI and HIH) is more like a deposit arrangement, which, whether or not it is accompanied by risk transfer, is primarily directed at the appearance of the balance sheet. Reinsurance is a legitimate and, when properly used, effective mechanism for insurers to augment their capital base. There is, however, a place for financial reinsurance, properly used, as well as for traditional reinsurance: nothing in this report should be taken as indicating the contrary. I do, however, have real concerns about the use—or, more accurately, the abuse—of reinsurance and its susceptibility to manipulation.

Two troublesome FAI contracts

HIH was not alone when it came to severe under-reserving problems. As I noted, FAI also suffered from a seriously deficient level of reserves in relation to a number of its lines of business. Few individuals within FAI had been aware of this when the problem emerged in late 1997. Management looked to reinsurance as a means of solving—or at least deferring—the problem. The objective was to use reinsurance to offset any increase in reserves on the balance sheet with a corresponding recovery under a reinsurance contract. The arrangements were structured so as to achieve an accounting treatment that would allow the company to defer to

later years expensing the premium paid to obtain the recoveries. Thus it was thought that increases in reserves could be staged over a number of years.

There is a problem with this approach. It would be possible under the accounting standards only if the reinsurance contract provided for a 'transfer of risk' from the reinsured to the reinsurer. In 1998 FAI negotiated with reinsurers arrangements that were structured in such a way as to give the appearance of a transfer of risk when in fact there was none.

A wide array of practices was employed to achieve these ends, among them the use of side letters setting out arrangements that negated the transfer of risk, the backdating of documents, the inclusion of sections of cover not intended to be called upon, and the use of 'triggers' for additional cover that were unrealistic. The word 'audacious' springs to mind.

The effect of these arrangements was that the extent of FAI's under-reserving problems was concealed. The contracts were also vehicles for the overstatement of FAI's reported operating profit before tax for the year ending 30 June 1998. FAI reported an $8 million pre-tax operating profit instead of a significant loss. That undoubtedly made it a more attractive takeover prospect for HIH. It also left HIH with a severe financial headache after the acquisition. Partly to cure this malady but also to counteract its own under-provisioning ills, HIH negotiated other financial reinsurance.

An HIH reinsurance case study

A reinsurance arrangement entered into between HIH and a reinsurer in August 1999 provides a unique case study that reveals much about what went wrong with this company.

On 25 August 1999 HIH entered into so-called reinsurance arrangements with the reinsurer. The arrangements were documented in two reinsurance binders and in separate agreements relating to some letters of credit and a trust. In addition, there were between the parties understandings that were recorded in correspondence but not included in any of the formal documents.

The substance of the arrangements was that companies within the HIH group 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 responsible for the costs and expenses of the fund's investment and for managing the investments within guidelines agreed with the reinsurer. But payment of claims under the binders was to come from the fund, not from the reinsurer. HIH was obliged to top up the fund to ensure that it was sufficient to meet the claims.

Considered alone, the reinsurance binders created the impression that the reinsurer was responsible for establishing, maintaining and reporting on the managed fund. They also created the impression that the reinsurer carried the risk that the managed fund would not grow at a sufficient rate to meet claims by HIH. Under the letter-of-credit agreement, however, the risk that appeared on the face of the slips to be borne by the reinsurer was transferred to HIH.

In its accounts for 30 June 1999 HIH booked a profit of some $92.4 million in relation to these reinsurance arrangements. But the contract was not entered into until 25 August 1999. For accounting purposes, it was treated as a true reinsurance arrangement. It was not true reinsurance. In any event, the booking of recoveries under it as at 30 June 1999 was not justified under the relevant accounting standard.

Management and the executive directors were aware of the circumstances surrounding this arrangement. When the auditors came to make their presentation to the audit committee there was reference to the arrangement and to the profit booked under it. But neither the contracts nor the additional documents affecting them were tabled, and none of the non-executive directors who gave evidence could recall any specific discussion about it.

Accordingly, neither the characterisation of the arrangement as true reinsurance nor the problems raised by the date the contract was entered into were addressed by the audit committee or the board. Had the transaction not been accounted for as true reinsurance, HIH's reported operating profit before tax and extraordinary items of $52 million would have become a loss of $40 million. This would have deteriorated by a further $50 million when losses on extraordinary items were taken into account.

Management accounted for recoveries and premiums under the contract on the basis that it was true reinsurance. The auditors concurred with this approach. The auditors were not shown or told about the additional arrangements. Had they been, it is unlikely that they would have approved the accounting treatment advocated by management. The auditors were, however, aware that the arrangements had not been entered into before 30 June 1999.

Other reinsurance arrangements

Reinsurance arrangements were to serve a similar purpose in the profit-and-loss account as at 30 June 2000. During that year the company had entered into a contract with another reinsurer. I do not cavil with the characterisation of this arrangement as true reinsurance. But the treatment afforded it in the 30 June 2000 accounts was predicated on the assumption that the contract would continue to exist for a long time. There is evidence that at one stage management believed the contract would be commuted within two to five years and that the external actuary had serious doubts about its long-term efficacy. None of this was disclosed to the auditors. Had it been, they might not have approved the booking of an after-tax profit of $84 million under the contract. In that event the reported profit of $18.4 million would have been a loss of $66 million or thereabouts.

Another problematic reinsurance arrangement involved HIH's UK branch. Over a number of years it bought reinsurance policies from a European reinsurer. At the same time a subsidiary of the HIH group, CIC Insurance Limited, issued policies to the reinsurer on identical terms. In relation to the 1993, 1994 and 1995 underwriting years, the arrangement had the effect of allowing the UK branch to report lower taxable income in the United Kingdom and CIC to report higher income in Australia. In later years the arrangement had the effect of allowing the UK branch to improve its balance sheet solvency for regulatory purposes in the UK.

The substance of the transaction is that risk was transferred from the UK branch to CIC. Had that been done openly—without an intermediary—the reinsurance policy could not have been counted as an eligible asset in the UK regulator's assessment of the solvency of the UK branch. The risks associated with such an arrangement were borne out when the reinsurer disputed liability under the policies following the collapse of the HIH group.

Corporate governance: a poor role model

I am becoming less and less comfortable with the phrase 'corporate governance'—not because of its content but because it has been so widely used that it may become meaningless. There is a danger it will be recited as a mantra, without regard to its real import. If that happens, the tendency will be for those who have to pay regard to it to develop a 'tick the box' mentality. The attitude might be, 'Yes, we have a state-of-the-art corporate governance model; yes, it is committed to writing; and, yes, the company secretary has checked that each item is in place and has included a statement to that effect in the annual report. Therefore there could be no problem in the corporation'.

Corporate governance—as properly understood—describes the framework of rules, relationships, systems and processes within and by which authority is exercised and controlled in corporations. Understood in this way, the expression 'corporate governance' embraces not only the models or systems themselves but also the practices by which that exercise and control of authority is in fact effected.

HIH had a corporate governance model. The directors said so in the annual reports. But there is little, if any, evidence that the board periodically assessed the company's corporate governance practices to ensure that they were, and continued to be, suited to the changing environment in which the company operated. For example, what might have been adequate for a group that was primarily Australian-based, as it was in 1996, might not have been so as the overseas operations burgeoned in subsequent years. The danger of this practice is that, among other things, it can lead to the 'tick the box' approach just mentioned. There is little point in having a corporate governance model if the directors fail to examine periodically its practical effectiveness.

Earlier I have made some broad comments about the HIH board's failure to understand long-term strategy. That went to the heart of corporate governance. Apart from that general observation, however, some specific matters arose during the inquiry that do not reflect well on the way HIH was managed.

A lack of process

An odd feature of the way HIH was organised was the relative dearth of clearly defined and recorded policies or guidelines. There may have been some, but they did not deal with areas essential to the proper running of such a large organisation In any case, where they did exist they were often ignored.

In some instances there were guidelines, such as those applying to underwriting practices. The presence of written instructions does not guarantee there will not be departures, and the system

of checks and balances HIH had in operation failed to detect and stop what might be termed 'rogue underwriting'. For example, the HIH procedures prohibited 'fronting' without with high-level management approval. Fronting is a practice whereby a company issues policies under an arrangement where another company accepts 100 per cent of the risk and the issuer acts solely for a fee. Through its Adelaide office, HIH issued policies underwriting film finance in circumstances where it was fronting for a reinsurer not licensed to write business of that type. The practice went unchecked for some time and substantial losses are likely to flow from it.

There is another illustration of serious disregard of published guidelines. In August 2000 APRA conducted a credit–risk management visit at HIH. After the visit it wrote to Williams to inform him of its main observations. The letter noted that HIH's investment strategy was 'based on the premise that the group's business risk arising from underwriting performance and its reinsurance policies should not be compounded by the investment risk'. It then referred to HIH's investment guidelines and expressed this conclusion:

The investment guidelines include various limits and exclusions imposed on the main asset classes including authorisation for any new acquisitions.

…

It is clear from our visit that following the acquisition of FAI, many investments exceed Board approved guidelines and limits and have done so continuously.

APRA expressed the opinion that HIH's investment- and credit–risk management processes were inadequate in terms of identification, analysis and evaluation of the risks arising from the investment portfolio. I saw no evidence to persuade me that APRA was mistaken in this aspect of its assessment of HIH's activities.

Limits of authority

There were no clearly defined limits on the authority of the chief executive in areas such as investments, corporate donations, gifts, and staff emoluments. In some of these areas the system was out of control but the board did not appreciate it. Nor did the board have a well-understood policy on matters that would be reserved to itself. Apart from obvious things—such as financial statements and approvals for large transactions—matters seem to have come forward at the discretion of the chief executive.

Within HIH management there does not appear to have been any clearly defined statement of duties or limits on authority. The chief executive had many discretions—for example, in connection with corporate donations—that were practically unfettered.

The confusion of roles was most marked as the company lurched towards its demise. Top management was restructured from 12 October 2000. Williams stepped aside as chief executive but remained on the board until 15 December 2000. Dominic Fodera, who had been chief financial officer and a member of the board, resigned as a director and became chief operating officer. In essence, he was to fill the gap pending the appointment of a new chief executive. This

occurred on 15 December 2000, when Randolph Wein took up the position. Yet no one thought to define the roles that Williams and Fodera were to play. In effect, Williams continued on with much the same authority, ill-defined as it was, as he had always had.

A lack of independent critical analysis

I formed the view that 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 to be correct. The board was heavily dependent on the advice of senior management: there were very few occasions when the board either rejected or materially changed a proposal put forward by management.

The board's independence was compromised by the influence of management in relation to its deliberations. I do not doubt that from time to time things were debated. There was at least one instance—the Allianz transaction—where a director asked that management carry out further analysis of proposals that had been put before the board. But the fact that debate occurred does not necessarily mean the independence and rigour of analysis that is required of a board was practised. Generally speaking, the board was too ready to accept what management was saying without testing the matter by appropriate analysis.

A small but telling example concerns the way the board approached remuneration reviews for senior executives. The board's human resources committee met annually. Its terms of reference required it to review, among other things, the remuneration of various officers and employees. Decisions about the performance and remuneration of senior officers were principally made by the chief executive, who, whilst not a committee member, attended all meetings by invitation. It appears that the committee did not make proposals on its own initiative, nor did it ever reject a proposal made by the chief executive.

By March 1998 the human resources committee had resolved to recommend to the board that the requirement to review senior officers against key position objectives be deleted from its terms of reference. The recorded rationale for this resolution was that the chief executive had made it known to senior officers what was expected of them. The board complied, and from that time there were no benchmarks against which the committee could measure the performance of senior officers. This ensured that the chief executive held the balance of power in relation to performance evaluation of senior officers.

By March 1999 the review of staff remuneration and allocation of bonuses among senior management was at the sole discretion of the chief executive. No guidelines existed to ensure that the levels of salary increases or bonuses were appropriate. This abrogation by the human resources committee of one of its central functions was inappropriate and rendered the committee of little practical use or importance.

There was only the most perfunctory review of the performance of the chief executive. It was carried out by the chairman, without any proper process. The human resources committee approved increases in the chief executive's salary, either without external advice or without heeding advice that had been obtained. The committee never demanded that the chief executive

demonstrate how his achievements had measured up to the corporate objective of achieving value for shareholders.

Recognition and resolution of conflicts of interest

I was left wondering whether the board as a whole really understood what was involved in the concept of a conflict of interest and the critical importance it holds in corporate governance. Some members may have grasped the theory, but when the activities of the board are examined in detail the position is not at all clear. It seems that from time to time there were disputes even about whether a board member should absent himself during discussion of a particular matter. Some members remained present when, on any objective view, their private interests were clearly at issue in a way that might be quite different from the interests of the company.

There were similar problems associated with related-party transactions. One director considered his personal interests were so well known that in some instances he did not have to declare an interest in a transaction to which the company was also a party. In the case of another director, the fact of the interest was disclosed but the paucity of the information provided would have made it very difficult for the other members of the board to decide whether it was in the interests of the company to permit the transaction in question to proceed.

How did these problems arise? The answer is that the board did not focus on this critical subject and did not have procedures to enable it readily to identify and resolve such issues. A chair has primary responsibility in this area. But Geoffrey Cohen, the chairman of HIH, said that he did not have any particular role to play in identifying circumstances that posed a conflict of interest. He did say, however, that he knew the secretary was receiving from directors reports about their other interests and tabling them. He thought it was the responsibility of each of the directors to declare any conflict of interest they may have had.

The absence of disclosure by board members did not in itself permit the chairman to assume there was no conflict of interest in a transaction. Nor is disclosure a matter exclusively for the director concerned. The situation just described illustrates the chairman's abdication of responsibility for taking the lead in securing full disclosure by all directors. Avoidance of conflicts goes directly to the integrity of the board's processes.

Cohen is not solely to blame. The board should have recognised it as a problem and moved on its own initiative to install a proper system. Related-party transactions were common in the life of HIH, and HIH was not immune to the problems that almost always attend them. The board should have ensured that proper procedures had been implemented for identifying and resolving problems related to conflict of interest. It did not do so.

The role of the chair

Overall, my conclusion is that Cohen was an ineffective chairman. His lack of attention to identifying conflicts of interest has just been discussed. There are other matters that lead to this conclusion.

Failure to bring the chief executive to account

Cohen seemed reluctant to act on matters that should have caused him concern, especially if he knew he would not have the support of the chief executive. For example, he did not bring Williams to account when Williams bypassed the board in distributing the information memorandum in what was to become the Allianz transaction. He also took no steps to ensure that non-executive directors' concerns about governance were dealt with in a proper manner at board level.

Dealing with concerns

Concerns about the governance of HIH were raised separately by two directors, Gardener and Head, in May 1999.

Gardener was concerned that the board was not dealing appropriately with a number of important strategic considerations and was dealing only with issues brought to its attention by management.He prepared, for discussion with Williams,an analysis of matters that covered the desired attitudes of the board; matters to be reviewed with management, including HIH's vision, purpose and strategy; oversight of management performance; and accountability. He met Williams to discuss his concerns, but it was apparent to him that Williams did not intend to take action in response to his concerns.

Headwrote to Cohen to express his unease about HIH's corporate governance procedures. He questioned whether critical issues were being fully discussed and whether the board was being provided with all the information necessary for informed debate.

In June 1999 Williams called a meeting of non-executive directors to see if directors other than Gardener and Head were similarly concerned. Cohen was present at the meeting. Later in June, Head met Cohen and Williams to discuss his letter. Cohen was surprised to receive the letter from Head. The problems Head raised were never considered at a full board meeting. Cohen suggested to Williams that one way of allaying Head's concern might be to hold strategy meetings, at which strategic matters could be presented to the board. Williams did not embrace that idea and it lapsed.

Head's concerns were astute and well-reasoned, and Cohen should have acted on them. On the basis of what was then known, Cohen should have realised the emerging difficulties were serious. But he was not prepared to raise at board level matters that did not have Williams's imprimatur. Indeed his evidence was that, although he believed strategy meetings were appropriate, he did not take the matter any further because Williams did not welcome the idea. That attitude displays a misconception of his role and duties as chairman of the board.

The reaction to Head's letter and the subsequent meeting was at least part of the reason why Head resigned from the board in August 1999. As for Gardener, I gained the impression that he concluded that his suggestions were not going to be acted on and he did not pursue them or raise them again. This was an opportunity lost to HIH, which should have grasped it and reviewed its

entire management and directorial philosophy. The chairman should have seen to it that the opportunity was grasped.

Control of the agenda

As chairman, Cohen had a general responsibility to oversee the functioning of the board and to ensure that all matters properly to be considered by the board were in fact brought before it. Crucial to this responsibility was control of the agenda.

The agenda for each meeting was prepared by the company secretary, according to a standard form, and forwarded to Cohen for approval. Occasionally, Cohen would contact the company secretary and ask him to include a particular item or items. The agenda would then be forwarded to Williams for comment; it appears that other board members did not contribute. The agenda became pro forma and was not a living tool for organising and shaping consideration and review.

Some directors conceded in evidence that the agendas were not adequate to canvass the matters that should have been dealt with at board meetings. They tended to be formulaic and procedural in nature, bringing forward items of concern to management but little from outside that source. As chairman, Cohen should have ensured that all important matters were put on the agenda, so that board members had ample opportunity to contribute their views.

The agenda for the board was controlled by management and not by the board. This does not properly reflect the true nature and scope of a board's role; nor is it consistent with a board's responsibilities. That is undesirable.

Provision of information to the board

During the inquiry there arose many instances that caused me great concern about the information flow to the board. There were occasions when there were material omissions from information given to the board, to the point where the information provided was misleading. Directors can do little if they are misled. But the question that arises is whether appropriate checks and balances were in place to minimise both the risk of that happening and its effect if it did occur.

In any event, management is part of the overall corporate governance structure. To the extent that there was a breakdown in the systems by which information was furnished to the board, it reflects on the corporate governance of the company.

The principal source of information about the group's performance was a quarterly financial report. That report was prepared by the financial services division after it had obtained information from 15 divisional managing directors in Australia and internationally. It contained a summary of the quarter's results and any issues to be brought to the board's attention. Bill Howard (general manager of the financial services division) was responsible for producing the draft. The first review of the draft was made by Dominic Fodera (initially chief finance officer and later finance director). Following that, the report would be circulated to Williams, Cassidy

and John Clarke for their comment. Once Williams had finished the final review, the report would be finalised and sent to the board about a week before the board meeting.

Clarke was HIH's public affairs manager. I am surprised that he should have had a role in reviewing the financial report to be provided to the directors. My surprise is not assuaged by the explanation given in evidence that Clarke was involved because he helped the executive directors prepare material to be presented to insurance analysts and major shareholders after the group announced its results. There is nothing exceptional in that, but it does not explain why there would be public relations input to the source material that went before the board.

As noted, it does not seem that Cohen had any major involvement in the process for determining what information would be presented to the board. To a large extent, the non-executive directors were dependent on management for what they were told. The failure to present to the board the full arrangements concerning the reinsurance transactions described earlier and the fronting of high-risk film finance business are but two of many examples.

In a normal year there were four board meetings plus an annual budget meeting. Other meetings were held to approve individual transactions. My impression is that the board focused on the quarterly financial reviews and on the results from the perspective of financial performance. Apart from individual transactions, the board received little information about broader business matters.

On other occasions, although some information was presented to the board, it was not presented in such a way as to indicate its significance. Again, there are many examples, but two suffice here. One is the failure to advise the board that the due diligence that was expected to be carried out before the reacquisition of the US operations had not in fact been carried out to the extent anticipated. The other concerns the cash flow consequences of the Allianz transaction and the fact that the $200 million sale price was to go into trust.

It seems that the board placed implicit faith in management's ability to highlight significant matters for the board's attention. The financial reports were not excessively long documents. They emphasised current performance by describing the amount of premium written and earned, current underwriting losses, core earnings and core earnings ratios. They did not focus upon the reliability of the provisions, which of course would have a direct effect on those earnings and ratios.

These are good illustrations of how the process of information provision broke down. Some of them also illustrate a failure of process by the main board members. To the extent that the board papers summarised the affairs of subsidiaries, the main board members could have called for the board papers of those subsidiaries. In particular, if he were to have conducted a rigorous review of the information provided to the board, the chairman should have performed at least periodic reviews of the board papers (or other materials) of the subsidiaries to be satisfied that the summaries provided to the main board were adequate.

From the directors' perspective, this highlights the need for the chair to consider how to satisfy himself or herself that the supply of information to the board is appropriate and for the board itself to consider whether the process is optimal.

Whilst the board, and in particular the chairman, should have done more to focus on the adequacy of the information provided, management, too, should have done more to bring matters of concern to the board's attention. It did not.

Another aspect of the passing of information within HIH warrants mention. There were instances of manipulation of financial information. At various times this contributed to the board, the auditors or the Australian Prudential Regulation Authority being misled. On some occasions HIH employees who might be described as 'middle management' were involved, to varying degrees, in the manipulation. It was a frustration during the inquiry that many witnesses played down their own responsibility in these events—for reasons that are perhaps obvious. The point that needs to be made is that if these employees assumed as little responsibility as they asserted for the incidents in which they were involved, that was wrong. People in middle management who are charged with the primary practical responsibility for regulatory disclosure should not approach their task as mere functionaries. They should not prepare for others documents that they would not, if required, be prepared to sign themselves.

Towards the finishing line

The life and times of HIH in its last three-and-half months provides some interesting insights into the group's governance.

In late November 2000 Ernst & Young, at the behest of Westpac, delivered to the HIH directors a draft report that included comments on HIH's parlous cash flow position. The directors were told that the group's position was 'delicately poised'. They were also told that Ernst & Young had not concluded that the HIH group or any company within the group was insolvent. Such a statement should, nevertheless, have given no real comfort to the directors. It was clear from the terms of the draft report that Ernst & Young had serious doubts about the solvency of the companies within the group but that further work was necessary before any meaningful conclusions could be expressed on that subject. The board failed to direct that such work be done urgently.

During November, December and January work continued on cash flow projections. Some of the projections showed there would be a cash deficit by the end of March 2001. The Allianz joint venture's implications for cash flow became more widely appreciated: HIH simply could not afford to allocate the $500 million it was required to place in the trust without severe consequences for its operating cash flow.

In order to alleviate the cash flow problems a decision was taken to delay payments to or on behalf of HIH policyholders. From then on policyholders and general creditors suffered long delays in receiving their dues; many never received payment. APRA became involved when a policyholder complained about the delay. Talks continued throughout January and February 2001. Work on the half-year results to 31 December 2000 was continuing. It was becoming clear

the loss would be very large. Because the company could not tell the market what the loss would be, HIH shares were suspended from trading. The cash flow problems showed no sign of abating. Indeed, they were escalating.

Against that background there occurred an incident that I find quite startling. At a meeting of the board's human resources committee on 26 February 2001 it was resolved to recommend to the board retrospective increases in directors' fees. The board approved the recommendation on that day. As it turned out, there were no adverse consequences from the decision because no payments were made under the new arrangements. But, given what the directors knew about the cash flow difficulties the company was experiencing, quite how the question of fee increases came to be considered at all—let alone approved—is a mystery to me.

On 1 March 2001 APRA served notices calling on HIH to show cause why an inspector should not be appointed to the three authorised insurers under s. 52 of the *Insurance Act 1973*. HIH engaged KPMG to carry out a solvency review. At an audit committee meeting held on 13 March 2001 the auditor reported that 'going concern was an issue' and that the half-year accounts might have to be qualified. On 14 March 2001 KPMG advised Wein and Abbott that HIH was at best marginally solvent and that they would recommend to the directors the following day that the company be placed in provisional liquidation. That happened.

The dash for cash

The lack of control and direction and the failure to appreciate the basic responsibilities of those concerned with the governance of the corporation are epitomised by the unseemly 'dash for cash' that occurred in the days leading up to 15 March 2001. In the dying days of the corporation, millions of dollars flowed to a favoured few, some of whom—directors, senior managers, advisers, and so on—were in privileged positions.

The accounts of HIH: substance or gloss?

This brings me squarely to the accounts of HIH and the way in which the corporate culture contributed to the preparation and presentation of accounting statements that did not accurately reflect the financial condition of the group.

The accounts of HIH

It is a truism that a company prospers in the market only if it is financially viable and likely to attract support. The market can assess the financial well-being of a company only by using the information the company publishes. The integrity of financial reporting is fundamental to the system. So how did HIH fare in this regard?

The accounting function

At the outset I need to say something about how I view the accounting process.

Why do corporations prepare accounts at all? Leaving to one side taxation considerations, accounts are prepared so that those with an interest in the financial affairs and condition of the entity—whether that interest be proprietorial, regulatory or transactional—are truly and fairly informed as to the entity's financial state. The process by which accounts come to be finalised is relatively simple. Management assembles the information and prepares the accounts. The auditors opine as to their truth, fairness and compliance with relevant accounting standards. But they are the accounts of the company, and the final decision on whether they accurately reflect the financial state of the organisation rests with the directors, not with management or the auditors.

This is not to downplay the role of management or the auditors. It would be facile to suggest that in a company as large as HIH the directors were not entitled to expect that management would assemble, analyse and present the information in a way that complied with statutory and ethical obligations. Of course, the board was entitled to rely on the professional competence and standing of the auditors and to give due weight to the report they provided. But, the board—the ultimate decision maker—could rely on management and the auditors only if it was satisfied that the accounts had been derived from systems that were likely to produce accurate returns after diligent search and inquiry into relevant and material matters.

The integrity of information sources

It goes without saying that the reliability of the accounts depends on the integrity of the information on which they are based. I doubt the accuracy of much of HIH's accounting and other records. Some of the systems the company had for collecting and reporting management information left much to be desired. The lack of reliable information meant that those who directed and managed the company's affairs were often flying blind. Worse, there was a filtering of information such that, on occasions, bad news reached the board only if it could not be avoided. I have already commented that there were occasions on which the board was misled.

Accurate information systems are a vital part of a viable insurance business. Without reliable financial data on liability for claims, an insurer faces the danger of underpricing its products and so trading unprofitably over an extended period. Similarly, information systems must be capable of producing material that will allow the board and management to assess properly the company's financial position and performance and to detect any deterioration on a regular basis.

The HIH accounting systems

I am far from satisfied that the accounting systems and procedures adopted by HIH were appropriate to the circumstances of the organisation. HIH was a complex group and its accounting systems focused attention at a group level. But the licences to operate the insurance businesses were conferred on individual subsidiary entities, not on the parent company or the group. No management accounts were prepared for the licensed entities. Instead, the accounting information was prepared according to divisions of business type, rather than by reference to entities, and was then consolidated at group level.

There was then a process of disaggregation back to entities. Time and time again this process failed. The result was that the returns of licensed entities prepared for submission to the regulator were often wrong—sometimes materially so. Management should have recognised the deficiencies and moved to remedy them. But the board was also at fault: it should have satisfied itself that the systems were appropriate for the type of operation that HIH was conducting.

A problem: GEN+

In 1997 HIH developed a new electronic financial system called GEN+. At first GEN+ was introduced to the Queensland operations; it was later implemented in New South Wales and Victoria. The new system was plagued by serious and continuing problems, among them an inability to produce debtors' statements, to process correct premiums for financial endorsements, and to produce sufficient management reports for the business. Difficulties were also experienced in the processing of data, so that a significant backlog of historical transactions soon developed. The integrity of the financial data produced by GEN+ was accordingly questionable, in terms of both accuracy and completeness. As a consequence the ability of management and the board to operate HIH's businesses was significantly impaired.

Another problem: reconciliations

Similarly, the credibility of the information recorded in HIH's general ledger was compromised by problems with HIH's reconciliations extending over a long period. A project aimed at rectifying these problems was embarked upon in September 1996 and most balance sheet reconciliations were brought up to date. Yet the problems persisted because there was simply no formal process for regular, comprehensive reconciliation of all HIH's accounts. Following pressure from HIH's auditors, considerable efforts were again expended in early 2000 to complete outstanding reconciliations. But a number of unreconciled accounts remained at the date of provisional liquidation, some containing transactions dating back to 1995.

A third problem: budgets

Meanwhile, HIH consistently failed to meet its budgetary targets from 1997 onwards. The budget process is an important tool for managing expenditure and assessing performance. The continuing failure to meet budget targets represented a serious breakdown in HIH's internal financial controls. It also suggested that senior management was setting aggressive or overly optimistic budget forecasts for HIH's operating divisions. Surprisingly, it seems there was no process whereby deviations from budget were clearly identified and reflected on. The substantial departure of expenditure from budget suggests that the board failed to monitor the expenditure of the executive directors and failed to ensure that proper controls existed in relation to such expenditure.

There is no evidence, for example, that at the annual budget meetings, or at any other time, the directors considered the performance of 'actual to budget' in preceding account periods in order to assess the efficacy of the budgets or the budgetary processes. Nor did they seek explanations for the over-runs in executive office expenditure.

Budgetary control as a strategic planning tool was thus rendered completely ineffective. And the board members' reliance on budgets to exercise financial control over the actions of executive management was entirely misplaced.

The audit committee

In modern corporate governance models, great emphasis is placed on the role of the audit committee. Within the HIH structure the decision-making process in relation to financial matters was effectively delegated by the board to the audit committee. The terms of reference of the audit committee and the minutes of its meetings suggest that the committee concentrated almost entirely on matters bearing directly on the accounts and the numbers contained in them. In some companies the audit committee fulfils an allied and equally important function—that of risk identification and assessment. Other companies have a separate committee for that purpose. Either mechanism seems to have been absent altogether from the HIH governance structures.

The way the committee was constituted

In my view, the way the HIH audit committee was constituted detracted from its ability to function effectively. An audit committee should operate independently of management. In other words, it should, where possible, be the domain of the non-executive directors. This is not how the audit committee of HIH operated. Regardless of the committee's appointed membership, all directors were invited to attend the committee meetings and customarily did so. In the last few years of the company's existence there were four executive directors and two other directors who were or had recently been in senior management roles in overseas branches.

Interaction between management and auditors

The auditors and management met before audit committee meetings to discuss contentious matters. That is not objectionable. But there were very few occasions when the non-executive directors met the auditors in the absence of management. I think the ability to meet in this way is a necessary part of the process whereby the board ascertains whether it can safely rely on what management is telling it. The non-executive directors are likely to learn more about what the auditors really think and about 'line-ball' judgments if management is not present.

This is not to advocate clandestine meetings at which personal grievances and prejudices can be aired with impunity. I think, however, HIH would have been better served had organised, regular discussions between the auditors and the non-executive directors been entrenched in the deliberative processes. As I said, this did not happen. On one celebrated occasion, early in 1999, the auditors did meet with two of the non-executive directors because they were not satisfied that the audit committee properly understood messages they were trying to impart. The chief executive took umbrage. There was no similar contact thereafter.

The evidence suggests that the audit committee rarely, if ever, preferred the auditors over management when the two differed in relation to something. Cohen had been an auditor before retiring from private practice and was a member of the audit committee throughout his time on the board and its chairman from August 1999. He testified that he did not read the auditors'

presentations to the committee in their entirety. He said he perused them and read parts. His main concern was whether the auditors had satisfied themselves sufficiently to give an unqualified audit certificate. But the audit certificate is simply a by-product of the audit process. It does not obviate the need for the board to probe the issues carefully and thoroughly.

I have already mentioned the directors' approach to the setting of reserves for future claims. The audit committee was the first 'port of call' in the process by which the directors approved the level of provisions for future claims. The failings of the board, as already canvassed, apply equally to the audit committee. It simply did not ask the right questions.

All in all, it seems that management and the board failed in their primary responsibilities in relation to the accounts of the company. The auditors failed to detect the manifest deficiencies in the way the accounts were prepared and presented. They, too, must accept some of the responsibility.

Aggressive accounting practices

Users of HIH's accounts may not have understood it at the time but in 1999 and 2000—the years to which primary attention was given in the inquiry—the financial statements were distorted by questionable entries, heavy reliance on one-off end-of-year transactions, and aggressive accounting practices.

Indeed, on more than one occasion independent commentators observed that the management of HIH was apt to use 'aggressive' accounting practices. This is a euphemism for accounting treatment that strains the letter of an accounting standard as far as possible and that may or may not comply with the policy underlying that standard.

In each year from 1997 to 2000 the auditors noted that HIH management tended to rely on one-off year-end transactions that affected profit. They also consistently regarded HIH as a maximum-risk audit client. Leaving to one side for the moment the role of the auditors, there was in my view a failure of the board properly to consider and redress the consequences of management's use of aggressive accounting practices and one-off entries. What follows is an example of what I regard as an aggressive accounting practice.

The HIH group had incurred significant income tax losses for the years ending 30 June 1999 and 30 June 2000. Despite those losses, the group continued to record as an asset in its financial statements the full value of the future income tax benefits associated with those income tax losses, as well as future income tax benefits associated with timing differences. The financial statements as at 30 June 1999 showed future income tax benefits resulting from timing differences at $145 million and those resulting from tax losses at $27 million, a total of $172 million. The comparative figures for 30 June 2000 are $91 million, $137 million and $228 million respectively.

The relevant Australian accounting standard is AASB 1020 'Accounting for income tax (tax-effect accounting)'. The commentary to the standard makes it clear that, where a company incurs a tax loss, significant doubts must arise about the company's ability to realise the related future

income tax benefit in subsequent periods. It goes on to say that in those circumstances—and unless realisation of the benefit is virtually certain—it is imprudent to bring to account as an asset the future income tax benefit attributable to the tax loss. The commentary also notes that in such a case the test of 'virtual certainty' will be met only in rare and exceptional cases.

In the light of that accounting regime, HIH's recognition of future income tax benefits in the face of the losses it was incurring can only be described as 'aggressive'.

Put bluntly, HIH management recognised that the group was underperforming at a level that could not be sustained. But it failed adequately to respond to the underlying causes of poor performance. Instead, it used and relied on questionable transactions giving rise to doubtful accounting entries, which disguised the seriousness of the situation and the consequences of leaving it unchecked. The process was fatally flawed.

Questions of solvency

Many who have been affected by the collapse of HIH will be asking three questions: For how long before March 2001 had the company been insolvent? Who knew about it? And why did they not do anything to stop HIH trading? These are questions I cannot answer. But there are several points I can deal with and they may be instructive.

Commercial solvency

Assuming that reference to 'HIH' is to the HIH group, to ask when HIH first became insolvent is to ask the wrong question. This is because insolvency has a particular meaning under the Corporations Law and a 'group' does not become insolvent: individual companies do. Certainly, the financial health of the entire group is relevant to the status of individual companies within it because, in normal circumstances, there would be mutual reliance, so that one member of the group would expect others to provide support in times of travail. But attention must still be paid to the individual entities, not just to the conglomerate.

Insolvency must be assessed according to the definition in s. 95A of the Corporations Law—namely, that the company is unable to pay all its debts as and when they become due and payable. In this inquiry that test has been referred to as 'commercial insolvency', to distinguish it from the question of whether, as an authorised entity, the company met the solvency ratios under the *Insurance Act 1973*.

Assessment of the commercial insolvency of an insurance company under the Corporations Law can be complex and difficult for a number of reasons, among them the uncertain nature of an insurer's liabilities. These liabilities often relate to future events and are subject to contingencies, including the outcome of future litigation. Nonetheless they are booked as liabilities. The concept of insolvency under the Corporations Law and its application to general insurers is discussed in detail in the Commission's Background Paper no. 14 'The assessment of the insolvency of a general insurer'. I do not propose to repeat what is said there.

One thing is clear. The companies in the HIH group are being wound up in insolvency. It is safe to assume that as at 15 March 2001 all relevant companies in the group were insolvent: no one contended to the contrary. But, in the light of the difficulties just referred to, I have made no definite findings as to a particular date or dates before 15 March 2001 at which HIH became insolvent. Having said that, if the accounts had included the adjustments I believe should have been made, the state of HIH's shareholders' funds at 30 June 1999 was parlous and there was a deficiency of shareholders' funds as at 30 June 2000. I am not able to conclude whether that translates to commercial insolvency at any particular date.

Insolvent trading

Each of the HIH directors was subject to the insolvent trading provisions of the Corporations Law, which impose civil penalty and, in some circumstances, criminal liability on directors of companies that incur debts while the company is insolvent.

For a director to be held liable for insolvent trading, it must first be established that the company was insolvent at the time the debt was incurred. It must then be established that the director had reasonable grounds to suspect that the company was insolvent.

In deciding whether a director had engaged in insolvent trading, the first step would be to identify the corporate entity that incurred the debt or debts in question; in the case of HIH, that entity is very likely to have been a subsidiary rather than the holding company. Next, it would be necessary to identify the directors of the entity concerned; in the HIH structure many of the subsidiaries had on their boards a combination of some holding company directors and some members of management. It would then be necessary to decide whether that subsidiary was insolvent.

If the debt were incurred by a subsidiary whose solvency (as a stand-alone entity) was suspect, the directors would very probably claim they relied on, and were entitled to rely on, support from other companies in the group. This, in turn, would necessitate an examination of the state of knowledge of each director of that subsidiary as to the financial state of the group. That state of knowledge would then determine the reasonableness of the reliance the director placed on the likelihood of support from other members of the group.

In the absence of evidence about specific debts incurred by specific entities, and without evidence of the state of knowledge of the directors of the entity concerned, no such finding could be made.

These difficulties became apparent at an early stage in the inquiry, so the question of the timing of the insolvency was not a focus of attention. With that in mind, little evidence was elicited that would enable any meaningful consideration to be given to the question whether particular directors had, at particular dates, reasonable grounds to suspect the insolvency of particular companies. As appears from Chapter 17, the preponderance of evidence (so far as it went) is that, although solvency had been raised as a concern in December 2000, the question of insolvency did not come to a head until 14 March 2001. The directors then took prompt action to have the company placed in provisional liquidation: they did so on 15 March 2001.

Regulatory solvency

Another type of solvency is relevant in the context of HIH. For prudential purposes, authorised insurers are required to comply with the conditions imposed by s. 29 of the *Insurance Act 1973*. This includes the requirement to maintain a prescribed excess of assets over liabilities—called the 'minimum solvency requirement'. It requires that the value of the insurer's assets at all times exceed the amount of its liabilities by not less than the greater of $2 million, 20 per cent of annual premium income, or 15 per cent of outstanding claims provisions.

Prudential insolvency does not equate to commercial insolvency. In the normal course, it is to be expected that a company would fall below the minimum solvency requirement before it would become commercially insolvent.

An authorised insurer is required to lodge quarterly returns and yearly accounts with APRA, and the yearly accounts must be audited. Among the required information is a statement of assets and liabilities, having regard to the minimum solvency requirement.

Section 30(1) of the Act provides that some assets may not be counted for the purpose of the minimum solvency calculation—including an asset 'charged for the benefit of a person other than the body corporate to the extent that it is so charged'.

HIH had three authorised insurers: HIH Casualty and General Insurance Ltd, CIC Insurance Ltd and FAI General Insurance Co. Ltd. On the evidence tendered to the Commission, all three companies were, on the face of the quarterly returns, below the minimum solvency requirements at one or more balance dates before March 2001. The regulator took no action in relation to these breaches.

For at least some of the returns the position was actually worse than had been disclosed. HIH had failed to disclose accurately and adequately in the returns the true financial position of the entities concerned. Two examples demonstrate this.

Pledged assets

In 1998 HIH acquired Cotesworth Capital Limited in order to gain entry to the Lloyd's market in the United Kingdom. Following the acquisition, arrangements were made for letters of credit to be issued to support the obligations of the Cotesworth syndicates. The letters of credit were secured by indemnities from companies within the HIH group, including the authorised insurers, supported to an extent by cash deposits or securities owned by the authorised insurers. The effect of those arrangements was that the cash deposits or securities were 'charged for the benefit of a person other than the body corporate' within the meaning of s. 30(1)(c) of the Insurance Act, with the result that the authorised insurers were not entitled to count those assets for the purposes of the minimum solvency calculation.

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 authorised insurers concerned would have failed the minimum solvency requirements.

Netting-off related company balances

When the returns lodged with APRA by the authorised insurers are compared with the statutory financial reports lodged with the Australian Securities and Investments Commission in 1999 and 2000, it is clear that in some instances related company liabilities and receivables have been set off against one another in the APRA returns. Under s. 30 of the Insurance Act related body assets are permitted to be included in the minimum solvency calculation only if they are approved by APRA. By setting off related company liabilities and receivables, the authorised insurers understated their non-approved related body assets, with the result that net assets were overstated by the same amount.

The effect of the set-off was that on the face of the returns lodged with APRA the authorised insurers appeared to meet the minimum solvency requirement. According to the information in the statutory financial report, however, there had been no set-off.

An explanation proffered in evidence as to how this situation might have come about is that journal entries may have been passed to give effect to the set-off. There was no evidence that the journal entries were passed before balance date (the explanation went on), so they must, if they existed, have been done after the statutory financial statements had been prepared and lodged but before the APRA returns were compiled.

That explanation—which I did not accept—causes me to add a comment about netting-off generally. Inter-company indebtedness is not merely notional, and it should not be treated as such in the preparation of financial statements and statutory returns. The law does not permit debtor and creditor balances to be set off against one another in the absence of a legally recognised right of set-off. If, as I suspect, there evolved within HIH a practice which disregarded that fundamental proposition, that practice is to be condemned.

This matter probably extends beyond general insurers. There is more to netting-off within a group than merely 'tidying up' the balance sheet. The problems may not be as evident where there are class orders or cross-guarantees within a group but, as a general rule, third parties deal with particular entities, not with a group. In the process of netting-off, regard must be had to the effect, if any, that the assumption or discharge of liabilities—which is a concomitant of the process—could have on the interests of third parties.

The regulators

APRA

Responsibility for the supervision of authorised general insurers under the *Insurance Act 1973* was vested in the Insurance and Superannuation Commission until July 1998; since then it has been vested in the Australian Prudential Regulatory Authority.

In March 1997 government received the report of the Financial System Inquiry (known as the Wallis report). It recommended that an integrated regulator be created for the prudential supervision of all financial institutions, including banks, building societies, credit unions,

superannuation funds, friendly societies, life insurers and general insurers. This recommendation was accepted and implemented. On 1 July 1998 APRA was created through a merger of the ISC and that part of the Reserve Bank that had been responsible for supervision of the banking industry.

In relation to general insurance, the ISC handed over files and responsibilities to APRA. There was a 'settling-in phase' while the board and executives of APRA considered a suitable organisational and operational structure. In the course of these considerations APRA took at least two significant decisions. First, it decided 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. The second decision—which seems to have been taken by government rather than APRA—was to establish operations in Sydney, rather than Canberra, where the ISC had been centred. It took until August 1999 for these arrangements to be implemented, whereupon what has become known as 'new APRA' came into being.

APRA's performance in supervising HIH was not good. It missed many warning signs, was slow to act, and made misjudgments about some vital matters. But two things need to be said.

First, APRA did not cause or contribute to the collapse of HIH; nor could it have taken steps to prevent the failure of the company. A regulator cannot be expected to provide a guarantee that no company under its supervision will ever fail.

Second, APRA faced several handicaps in its supervision of the HIH group as a direct result of the implementation of the new regime. In particular, in APRA's early days, the move to full integration and its relocation from Canberra to Sydney created many managerial distractions for senior executives. The move also resulted in high levels of staff attrition and led to the loss of specialist general insurance skills. As a result of the far-reaching and fundamental nature of the reforms, the supervisory regime was in varying degrees of transition throughout the period from 1 July 1998 to 15 March 2001.

During 2001 APRA commissioned an internationally recognised regulator, John Palmer, to assess its performance in the supervision of HIH. Palmer prepared a report and it was tendered in evidence to the Commission. I have placed great weight on that report and I acknowledge the candid and open way that APRA has dealt with both it and the Commission. In giving oral evidence, Palmer said that, given the handicaps APRA faced, it would have been a miracle if it had managed quickly to identify and act on the problems confronting HIH. But Palmer was also critical of many aspects of APRA's approach, both generally and in specific instances. I have formed much the same view.

The systemic hindrances with which APRA was burdened go some way to explaining how and why it failed to supervise HIH adequately. But numerous questions are left unanswered. In many instances—even taking account of the constraints it was under—APRA did not react appropriately. In late 1999 it was aware that HIH was spending a great deal of money on its reinsurance programme. By early 2000 it suspected that the underlying motivation for that programme was 'profit smoothing'. As the year went on, HIH's share price continued to decline and negative media speculation about the group's financial well-being intensified. In mid-July

2000 APRA received a damning document entitled ‘HIH Insurance due diligence’ from an anonymous former employee of HIH. Later that month APRA met with a number of HIH officers: the meeting brought to light some troubling signs in connection with HIH’s capital adequacy.

By 20 September 2000 APRA was on notice that HIH was potentially overstating its statutory solvency position by including pledged assets in the solvency calculation of its licensed insurers. Within weeks APRA had realised that HIH was also overstating its statutory solvency by means of a netting-off process and incorrect reporting of its related body assets. At around this time APRA also learnt of the serious deterioration in HIH’s UK and US businesses. But, in spite of the mounting evidence of HIH’s problems, APRA did comparatively little in response. It grappled poorly with the information in its possession, either failing to recognise its significance or failing to analyse it thoroughly. It lacked commitment in enforcing in its requests for further information and explanations from HIH. It did not recognise the seriousness of the situation until it was too late for effective intervention.

Early in December 2000 APRA received a copy of the Ernst & Young report that was mentioned earlier. Later in December the officer to whom the report was delivered perused it. He passed it to his superior. That officer did not read it until late February 2001. He immediately recognised its significance but by then it was too late.

It must also be noted that HIH’s disclosure of information to APRA was not what it should have been. I have already described the prudential solvency regime. The returns to APRA for the quarter ending 30 September 1999 were prepared on what the author described as a ‘back of the envelope’ basis. Adjustments were made to reduce outstanding claims liabilities and to effect a ‘notional transfer’ of semi-government bonds and unit trusts between companies in the group. These adjustments were made because it was realised that without them two of the three licensed insurers concerned would have failed the solvency tests. The returns to APRA, as compiled and lodged, did not reflect what was in the general ledgers, trial balances and other accounting records of the entities concerned. In other words, APRA was misled.

There were other instances of APRA being given incorrect or misleading information. The matter of the pledged assets is an example. The failure of a regulated entity to deal in a frank and open way with the regulator is to be regretted and it must make the supervisory task very difficult. On the other hand, that is one of the reasons for having a system of regulation. The regulator must develop a regulatory culture that will enable it to cope.

An APRA officer proffered the view that it would have been necessary to intervene as early as mid-1999 to have made any meaningful difference to the outcome for policyholders of HIH. I can see the force in that argument. I acknowledge, too, that it would be speculative to talk of what would have happened had intervention occurred in, say, November 2000. It would certainly have placed in jeopardy the Allianz joint venture. Policyholders whose business was transferred to the joint venture may therefore be better off. But the fact remains that HIH was still writing business in the months following November 2000. People who took out policies in that period paid good money for cover of doubtful, if any, value.

In July 2002 a new regime for the prudential supervision of general insurers came into force. It is a marked improvement on the system that was in place during the life of HIH. APRA is to be given credit for the development and implementation both of the legislation and of the prudential standards under which the new regime operates. More will be needed, though. If it is to engender in the public confidence that it is well placed to rectify the shortcomings that were identified during the inquiry, APRA will have to demonstrate that the requisite change has occurred in its operational structures, its understanding of its powers under the legislation, and its basic approach to prudential supervision.

Other regulatory bodies

The general insurance industry is subject to regulation at a number of levels, administered by a number of bodies. As explained, APRA, which is a Commonwealth body, bears responsibility for prudential regulation. In addition, there is some state and territory regulation in specialised areas of general insurance such as compulsory third party insurance, workers compensation and builders warranty insurance. At a broader level, ASIC administers those provisions of the Corporations Law dealing with the conduct and disclosure obligations of financial service providers, including general insurers.

State regulators

Of the state regulators, only the Motor Accidents Authority of New South Wales and the Motor Accident Insurance Commission of Queensland had significant contact with HIH. In the months preceding its collapse they engaged in detailed consideration of matters arising from the HIH–Allianz joint venture. Of particular concern to the two bodies, respectively, was the sale of HIH's New South Wales and Queensland compulsory third party lines of business. The conditions of sale posed a direct and substantial risk to MAA and MAIC if the HIH group became insolvent.

In contrast to APRA, MAA and MAIC were quick to realise that the Allianz joint venture threatened HIH's ongoing financial viability. Indeed, by November 2000 MAA and MAIC were each contemplating the possibility of appointing an inspector (which they did on 6 March 2001). Ultimately, however, they were heavily reliant on APRA as the 'lead regulator', in terms of both access to information and implementation of initiatives. As it turned out, MAA and MAIC were hindered by APRA's inaction.

ASIC

Similarly, ASIC limited its involvement in HIH's affairs because of a perception that APRA was responsible for and was in fact closely and effectively monitoring the situation. ASIC considered it had little direct responsibility in relation to prudential regulation of insurers: that was APRA's role. I am not sure that I agree with this view of the allocation of functions between ASIC and APRA, but I cannot fault ASIC for assuming that position. It was a view that APRA shared.

ASIC gave attention to negative media commentary in the latter half of 2000 and acted on persistent concerns about the adequacy of HIH's market disclosure by starting a formal

investigation on 26 February 2001. It pursued various further actions in the days leading up to HIH's provisional liquidation.

External advisers

In an environment of this kind the task of external advisers such as auditors, accountants, lawyers, investment bankers and other financial consultants is not easy. This is especially so when the advisers cannot rely on full and frank disclosure of necessary information.

Those to whom HIH owed obligations—shareholders, policyholders, creditors, regulators, and so on—were entitled to expect that the external advisers would demonstrate independence from management and exercise their professional skill in a way best suited to helping the company act as it should. There are areas in which the conduct of individual external advisers fell short of what was required in the circumstances.

But what they and the other external advisers did or failed to do can properly be described as a factor that influenced the course of events. Generally speaking, the community is entitled to be disappointed that in at least some respects the external advisers and the key regulator failed to use their professional skills and statutory powers to better effect.

The auditors

Auditors play a vital role in the financial reporting process. This is particularly so with companies such as HIH because their true financial position and performance is a matter of national economic significance. A properly conducted audit should allow users of the company's financial report—including regulators, shareholders, policyholders, lenders and other creditors—to rely on the accounts with a degree of confidence. The audit process should be designed to provide the company and users of its accounts with early notice of potential risks affecting the company's short- or long-term viability.

It is sometimes suggested that whenever a company fails its auditor must have been at fault. I do not subscribe to that theory. It is correct neither in principle nor practice. The work performed by the auditor must be carefully analysed, having regard to all the circumstances of the audit process. In the case of Andersen, those circumstances include the fact that on some occasions and in relation to material matters they were misled.

During the course of the inquiry, a select number of specific accounting matters dealt with by Andersen in the course of the 1999 and 2000 audits were examined in detail. In relation to some of them I found that Andersen did not obtain sufficient audit evidence to support its conclusions. In many instances I found that adjustments ought to have been made to the accounts in relation to matters that were the subject of inquiry.

I then had to try to find out why these defects occurred. Two specific questions arose: Was Andersen's independence compromised? And was Andersen's methodology fundamentally flawed?

Independence

That an auditor must be independent both in fact and in appearance is fundamental to an effective audit. The concept of 'appearance' of independence is similar to the well-known adage that justice must not only be done but be seen to be done. If the appearance of independence is affected this can undermine the confidence that a user of the accounts may attach to the audit opinion.

One such matter in the case of HIH was the presence of three former Andersen partners on its board. One of them was the chairman and the recipient of continuing benefits from Andersen, including fees from a consultancy arrangement. Another noteworthy matter was the removal from the HIH audit of the long-standing engagement partner in 1999, following his decision to meet with some of the non-executive directors of HIH in the absence of management. The pressure on the Andersen partners to maximise their fees from non-audit work—giving rise to a potential conflict with their audit obligations—was also a cause for concern. In my view, the combined effect of these features of the relationship between Andersen and HIH gave rise (or would give rise to those aware of the relevant facts) to a perception that Andersen was not independent of HIH. Nevertheless, a close analysis of the conduct of the 1999 and 2000 audits reveals no reason to conclude that Andersen's independence was in fact compromised.

The audit methodology

Andersen had in operation a formal system of quality control and procedures that governed its audit work. It required conformity with standards and policies that were consistent with authoritative auditing standards. On the whole, its general approach to the HIH audit in 1999 and 2000 complied with that system. There were, however, a few aspects of Andersen's methodology that troubled me.

One area of concern was the manner in which Andersen relied on the valuations of HIH's consulting actuary, David Slee, in the conduct of its audit. As noted, the largest single item on the balance sheet of a general insurer is the provision it sets aside for payment of future claims. That item is based on actuarial valuations. Andersen did not have any actuarial expertise, and nor did it retain such expertise to assist it as part of the audit process. It therefore relied heavily on Slee's work to confirm the credibility of the provision for outstanding claims.

In these circumstances it was incumbent on Andersen to take steps to satisfy itself as to Slee's competence, integrity and objectivity. It also needed to obtain an understanding of the assumptions and methods Slee used and to consider whether they were reasonable, based on Andersen's knowledge of the business and the results of other procedures performed. This is not to suggest that Slee's work was questionable; it is to say that Andersen was required to satisfy itself that Slee's work was beyond reproach before relying on it so heavily.

Andersen and Slee had no direct meetings or contact during either the 1999 audit or the 2000 audit. Andersen never sought to obtain a full understanding of the extent and nature of all the work carried out by Slee for HIH and of Slee's relationship and dealings with the various management personnel in HIH. Andersen generally relied on extracts from six-monthly reports Slee prepared in respect of individual portfolios and the group outstanding claims provision,

which it received before the finalisation of the year-end accounts. In most instances the complete reports were not delivered until after the completion of the audit. Generally speaking, the extracts provided scant detail as to Slee's methodology and assumptions.

The new prudential regulations that came into force on 1 July 2002 have codified some aspects of the relationship between auditor and actuary, and greater communication than occurred between Andersen and Slee is now likely to occur. Given the importance of outstanding claims provisions, that is a good thing.

The efficacy of the audits

Users of financial statements have varying expectations of the audit certificate. In my view, Andersen's approach to the audit in 1999 and 2000 was insufficiently rigorous to engender in users confidence as to the reliability of HIH's financial statements. This detracted from the users' ability to appreciate fully HIH's true financial position.

Other advisers

The consulting actuary

As with any general insurer, the role of the consulting actuary was vital. The board and management of HIH placed considerable reliance on Slee's work. So, too, did the auditors, to varying degrees, as mentioned. In relation to the estimates of claims reserves in particular portfolios, there were individual instances of work carried out by Slee (and his employees) producing results that were less than optimal. In some instances, Slee's use of data and choice of methodologies was not conducive to bringing about—and did not bring about—a satisfactory result.

During the course of the Commission's inquiry questions were raised as to whether Slee's independence had been (unwittingly) compromised by his relationship with HIH, so that he could not properly carry out his functions. Individual errors do not, of themselves, connote a lack of independence. Overall, I was not convinced that Slee was so compromised.

The lawyers

HIH approached various legal advisers from time to time to provide guidance on particular matters. There were occasions when the legal advice given fell short of what one would expect in the circumstances. One such occasion involved the provision of advice in a situation where the potential for a conflict of interest was obvious. Another entailed advice that sought to explain how to effect an arrangement in a way that would 'get around' certain provisions of the Corporations Law that otherwise prohibited the arrangement. It is also disappointing that lawyers were among those involved in what I call the 'dash for cash' in the days leading up to 15 March 2001.

Investment bankers and other financial consultants

HIH sought ongoing advice and support from investment bankers and other financial consultants. In particular, these advisers were consulted about decisions involving acquisitions, sales and restructuring. They would often explore a range of options for effecting a certain transaction. On occasion, the level of fees they were entitled to charge varied according to the option. It seemed to me that this had the potential to compromise the advice they were required to give about the merits of each option. Nevertheless, I was not able to conclude that, in relation to any particular transaction, the advice had actually been compromised.

In some instances the fees charged to HIH were very high in relation to transactions that in the end proved not to be beneficial to the group. In one instance the financial adviser sought to downplay the significance of its role by describing it as 'purely executionary'. I am not sure what that means. If it means no more than ensuring that all of 'paperwork' was in order then the amount of fees levelled in respect of the transaction seems difficult to justify.

Individual conduct

The terms of reference directed me to inquire into and report on the reasons for and the circumstances surrounding the failure of HIH. This is what I have referred to as the 'core instruction'. I regarded this as by far the most important aspect of the inquiry. Most of the findings I have made go to the core instruction and, in particular, to the circumstances surrounding the failure.

In identifying the reasons for and circumstances surrounding the failure I have come across acts and omissions that might amount to a contravention of the law. The terms of reference directed me, if that should occur, to report on it and recommend whether or not the possible contravention should be referred to an agency. I have complied with that direction, but I regard it as subordinate to the core instruction.

I conducted this inquiry in a manner that was as open and transparent as possible. I did so for two reasons. The first concerns the principle of open justice. The other is because this Commission was established at least in part to help restore public confidence in an important sector of industry and in the market generally. I felt that an open and transparent inquiry was the best way to make that contribution. But open inquiries come at a cost—the potential to affect reputation. The competing interests are not always easy to balance.

During the course of the inquiry aspects of the proceedings were given widespread publicity. Matters were raised that had potential to affect the reputation of individuals, sometimes in a serious way. I made it clear that what occurred during the hearings had nothing to do with findings. Only I could make findings and I have now done so. They are presented in the body of this report.

It has not been possible to deal with every one of the myriad matters that arose during the hearings and that could affect the reputation of individuals.

Had I analysed each such matter and ruled formally on it, this report would have become so long that it would very probably have lost its utility. In addition, I might have overlooked some

matters and thereby possibly compounded the hurt by leaving some, and not others, apparently unresolved. There are two reasons for this. First, the sheer number of matters that accumulated over the 14 months of the hearings meant that, even by careful search, it was extremely difficult to identify all contentious matters. Second, there may have been some matters that I considered to be benign without appreciating the depth of feeling harboured by the individual concerned.

The findings presented in this report represent the entirety of the findings that are, or could be regarded as, adverse to the interests or reputations of an individual or entity. If, during the course of the hearings, publicity was given to an allegation against or about a person or company and there is no express finding against that individual or entity in the report, then it is to be taken that I have made no such finding. This is the case regardless of what may have been written or said about the person or company, in evidence, in submissions or in publicity about the proceedings. Where there is no finding in this report against the person or company, the reputation of that person or company emerges entirely free of any adverse implications. It must be seen and judged accordingly.

What of the future?

A vital part of the work of this Commission has been its deliberations on the future. Everything that can be done should be done to minimise the risk of a collapse of the severity of the HIH failure happening again.

A number of recommendations are made to that end. The changes proposed are not particularly radical but in my opinion they are important and will make a meaningful contribution to the restoration of public confidence in the market. They build on changes that have already been made or are in progress. I can draw out some broad themes that have guided my thinking.

The regulation of insurers

General insurance is a complex product beset by uncertainties. Because of the vagaries, it is a minefield for the uninitiated. Strong and efficient external regulation is both justified and necessary. Much has been done to effect change in the prudential regulation of general insurers through the introduction in July 2002 of the *General Insurance Reform Act 2001* and the prudential standards promulgated by APRA under it. They are a vast improvement on the system that applied while HIH existed. But there is a great deal more to be done to minimise the risks.

Strangely, there is no fixed definition of the term ‘insurance’ and thus of suppliers of ‘insurance-type’ products who are amenable to supervision. For example, some medical indemnity arrangements are discretionary in nature and do not fit within the current understanding of the term ‘insurance’ under the *Insurance Act 1973*. This is the subject of proposed legislation. Foreign underwriters, who are not subject to regulation by APRA, can offer products to Australian consumers through intermediaries such as agents and brokers who are situated here. But the purchasers of those products do not have the protection the regulatory system provides. In my opinion, the definition of ‘insurance’ should be as wide as the constitutional limits will allow, so that, so far as is possible, suppliers of insurance-type products and foreign underwriters come within the purview of APRA.

Because of the complexity of the industry—especially in relation to the estimation of its outstanding claims liabilities—it is very difficult for consumers to make informed decisions about the financial strength of insurers. One way to limit these difficulties is to require greater disclosure of information. This is not just disclosure for disclosure's sake. It will be a catalyst for the regulator, analysts and others with experience to understand better the import of the information and so inform the public and detect weaknesses at an earlier stage.

Many overseas countries have policyholder protection schemes that are designed to lessen the impact on individuals of the collapse of an insurer. The Commonwealth Government established a scheme of that nature in the wake of HIH's failure. This may increase the expectation among consumers that, were the situation to recur, the government would step in again. Some fundamental questions have to be answered and, in my view, now is the time to do it. Is there a moral hazard in allowing consumers to make decisions (perhaps based solely on price) safe in the knowledge that if the insurer were to fail they would not suffer? Should the taxpayer bear the risk of another failure or should it be borne by the industry? I believe that the competing interest can be balanced and that a permanent scheme should be introduced. The policy questions will then have been resolved. If a collapse were to happen in the future, the effects could be mitigated relatively quickly.

APRA's governance structures are not optimal for an organisation of its type. It has a board that is in some respect similar to the boards of commercial entities. I do not think this is necessary. Control—and with it responsibility—should rest with a small full-time executive. This would make APRA more efficient and better able to discharge the responsibilities it has.

Structural reform affecting the industry

Some general insurance activities are subject to regulation purely by APRA. Other insurance—for example, workers compensation and compulsory third party motor vehicle—is the province of the states and territories. There is a degree of overlap in regulation; this is inefficient and adds to the cost of insurance. Individual state and territory levies and imposts also add to the cost. These inefficiencies can and should be reduced.

Accounting considerations

Users of financial statements expect the accounts to give a true and fair view of the state of the company in question. After all, that is the prescription of the Corporations Act. HIH's accounts did not give a true and fair view of the group's situation.

Australia has joined the move to develop and adopt international accounting standards. I have no difficulty with that as a principle. Matters disclosed during the inquiry led me to conclude, however, that there were serious deficiencies in some of the accounting standards applicable to general insurers. I do not think remedying these deficiencies can await the adoption of international standards.

Once again, disclosure looms large in relation to accounting matters. There are many respects in which the confidence users of financial statements can have in accounts would be increased by

greater disclosure. An example is the scope of audit. Audit is required by statute, but not all audits are conducted according to the same methodology and with the same depth of inquiry. The financial statements are those of the company, not the auditors. The directors need to understand that the audit opinion is not a commodity to be bought at the cheapest possible price. It is an assurance mechanism. It is in the interests of the directors, as much as anyone else, to get the most from the audit process.

There is a related issue. The scope of audit ought to be disclosed in plain English, so that the consumer can assess the degree of reliance to be placed on the audit opinion.

The government has before it recommendations to change the audit regime in the Corporation Act, in the form of the rather oddly named 'CLERP 9' proposals, which deal with matters such as auditor independence and the relationship between directors, management and auditors through, for example, audit committees of the board. In my view, there are ways the CLERP 9 proposals can be refined to afford better protection to all participants. Once again, disclosure is the key, so that there is a process that is both open and accountable.

Management and control of corporations

That brings me once again to the subject of the governance of companies—a topic of intense debate in the commercial community and, for that matter, the wider community. Among the areas that I think warrant attention are the need for truly independent judgment at board level, periodic testing of the practical effectiveness of a company's governance models, and greater disclosure of information about the way a company is run.

There is also an allied matter. The directors are accountable for their actions. Those at other levels of the decision-making process within companies and on whom the directors rely should also be accountable. The law may have to be changed to achieve that.

The Royal Commission: a personal perspective

I have been working solidly on this inquiry for more than 18 months. I hope no one will begrudge me a few personal observations.

The two most important questions I had to consider were what I have called the 'core instruction' in the terms of reference ('the reasons for and the circumstances surrounding the failure of HIH') and paragraph (e) (recommendations for change so as to improve the system of regulation). The terms of reference also required me to give attention to what might loosely be described as finger pointing and the apportionment of blame.

At first glance, it may seem that a far greater proportion of the report is devoted to blame than to dealing with the core instruction and paragraph (e). But much of what is contained in Volumes II and III—for example, the chapters dealing with provisioning, reinsurance and the overseas operations—is essential for a full understanding of the conclusions reached in relation to the core instruction. Matters of blame flow from those findings; they do not precede them.

I found that in relation to specific incidents there might have been a contravention of the law. I did this without enthusiasm. It is not for me to judge whether this Commission has faithfully served the public interest and whether it has fulfilled the expectations the public had of it. To the extent that I am permitted to form a view, it will not be influenced in the slightest by the number of prosecutions (if any) that flow and the severity of the penalties (if any) that are imposed. If this report is seen to provide a plausible explanation for the collapse of HIH and to offer sound guidance as to ways of lessening the chances of another such event occurring, I will be content.

I hope that readers of the report will not become preoccupied with blame and that attention will not be diverted from the primary messages. How the failure of HIH came about and what should be done to diminish the likelihood of such a calamity occurring in the future are at the heart of this report.

From time to time as I listened to the evidence about specific transactions or decisions, I found myself asking rhetorically: did anyone stand back and ask themselves the simple question—is this right? This was by no means the first time I have been prone to similar musings. But I think the question gives rise to serious thoughts.

We live in a dirigiste age. Each year there is a dramatic increase in the size of the statute books. Almost every facet of life is governed by rules, regulations, proclamations, orders, guidance notes, codes of conduct, and so on, prescribed by governments or recognised agencies. The courts, through the common law, add to the plethora of rules to which we must have regard.

There is no doubt that regulation is necessary: peace, order and good government could not be achieved without it. But it would be a shame if the prescription of corporate governance models and standards of conduct for corporate officers became the beginning, the middle and the end of the decision-making process.

Right and wrong are moral concepts, and morality does not exist in a vacuum. I think all those who participate in the direction and management of public companies, as well as their professional advisers, need to identify and examine what they regard as the basic moral underpinning of their system of values. They must then apply those tenets in the decision-making process. The education system—particularly at tertiary level—should take seriously the responsibility it has to inculcate in students a sense of ethical method.

In an ideal world the protagonists would begin the process by asking: is this right? That would be the first question, rather than: how far can the prescriptive dictates be stretched? The end of the process must, of course, be in accord with the prescriptive dictates, but it will have been informed by a consideration of whether it is morally right. In corporate decision making, as elsewhere, we should at least aim for an ideal world.

As I have said, 'corporate governance' is becoming something of a mantra. Unless care is taken, the word 'ethics' will follow suit.

I note the sad passing, during the course of the inquiry, of Brian Woodley, a respected journalist who was covering the Commission at the time of his death. It was also sad that in October 2002,

after he had given evidence, Randolph Wein died in an accident. I am uncomfortable about the criticisms I have made of Wein in this report, but the story of HIH would not have been complete without them.

I am very grateful to the Commission staff and counsel and solicitors assisting for their tireless and expert help during the term of the inquiry. It is trite to say that without their contribution this report would never have been completed, but their willingness and dedication went beyond what I had a right to expect. I am also grateful to the legal practitioners and other representatives of witnesses and parties who, in often difficult circumstances, acted professionally and with patience.

A final comment

By March 2001 the pressures on HIH that had been building over the years could no longer be contained or controlled. There was a huge implosion. The end, when it came, was sudden and spectacular. The fact that the principal players were not prepared for it compounded the gravity of the consequences. But that is the end of the story: I return now to the beginning.

Policy recommendations

In Part Three I deal with important matters affecting the regulation and prudential supervision of the general insurance industry. I have made recommendations that have implications for business activity and for the community generally. What follows is a list of the recommendations.

Corporate governance

1 I recommend that the disclosure and other requirements of the *Corporations Act 2001*, the relevant accounting standards and the Australian Stock Exchange Listing Rules that relate to directors' remuneration be reviewed as a matter of priority, to ensure that together they achieve clear and comprehensive disclosure of all remuneration or other benefits paid to directors in whatever form.

2 I recommend that the *Corporations Act 2001* be amended to repeal the existing legislative provisions relating to the definition of the extended classes of personnel upon whom duties are imposed by the Act and to substitute instead a definition that is clear, simple and certain of application.

The definition would focus on the function performed by the relevant person—not the classification of their legal relationship to the corporate entity—and avoid expressions such as 'employee' in favour of a functional orientation.

The definition would then form the basis of a regime having the following features:

- All the general duties imposed by Chapter 2D of the Corporations Act should be imposed on directors, secretaries and the wider class of personnel encompassed within the functional definition.

- The duties imposed by ss. 182(1), 183(1) and 184(2) of the Act should be imposed on all persons performing functions for and on behalf of corporations, whether employees or suppliers of services under contract.

- The liabilities created by s. 1309 of the Act should be imposed on all persons and not be restricted to a limited class of management personnel.

- The classes of personnel prohibited from acting dishonestly in connection with the performance or satisfaction of any obligation imposed on the company by any written law should be extended.

Financial reporting and assurance

3 I recommend that the Commonwealth Government broaden the membership of the Australian Accounting Standards Board to include people with business or professional backgrounds beyond the accounting profession.

4 I recommend that Australia participate fully in the development of international accounting standards and pursue the adoption of high-quality, consistent and readily understood accounting standards.

5 I recommend that, in adopting international standards, Australia reserve the right to require more stringent standards that are not inconsistent with the relevant international standards. These would generally relate to disclosure requirements.

6 I recommend that the Australian Accounting Standards Board alter the Urgent Issues Group or create a separate group that is able promptly to issue binding rulings on important and urgent matters concerning the interpretation and application of the accounting standards.

The board should extend the constitution of the Urgent Issues Group or the separate group beyond accounting professionals and include lawyers and users of financial statements.

7 I recommend that the professional accounting bodies develop guidelines to encourage their members to consult independent third parties or the Urgent Issues Group when there is disagreement with the management of companies concerning the interpretation or application of accounting standards.

8 I recommend that the Australian Accounting Standards Board amend accounting standard AASB 1023 to include the following:

- a definition of insurance that includes the requirement for a material transfer of insurance risk
- a requirement that insurance liabilities be valued at a level of sufficiency of at least 75 per cent, as required by APRA's prudential standards. Companies should be explicitly permitted to set prudential margins in excess of 75 per cent if the company's board considers that appropriately reflects a true and fair view of the financial position of the insurer
- a requirement that entities disclose in their financial statements
  - the valuation of their insurance liabilities at a central estimate
  - a 75 per cent level of sufficiency
  - the margin ultimately adopted by the entity
- a requirement that premium revenue and insurance liabilities be recognised on the commencement of a contract of insurance. This will require the recognition of premium liabilities
- a requirement that, in estimating the present value of liabilities, future cash flows be discounted using a risk-free rate similar to that required by the prudential standards
- a requirement that companies subject to the standard disclose a 10-year claims-development table that includes past estimates of claims on an undiscounted basis as well as the actual costs of settling claims. This information should be provided both net and gross of reinsurance.

9 I recommend that all standards of independence of auditors in Australia, including those contained in legislation and professional standards such as Professional Statement F1, be consistent with the standard of independence defined as follows:

- An auditor is not independent with respect to an audit client if the auditor might be impaired—or a reasonable person with full knowledge of all relevant facts and circumstances might apprehend that the auditor might be impaired—in the auditor's exercise of objective and impartial judgment on all matters arising out of the auditor's engagement.
- A reference to an auditor includes both an individual auditor and an audit firm. In determining whether an auditor or an audit firm is independent, all relevant circumstances should be considered, including all pre-existing relationships between

the auditor, the audit firm and the audit client, including its management and directors.

10 I recommend that the *Corporations Act 2001* should be amended to require the board to provide a statement in the annual report that identifies all non-audit services provided by the audit firm and the fees applicable to each item of work and explains why those non-audit services do not compromise audit independence.

11 I recommend that, in implementing the CLERP 9 proposal for restrictions on employment relationships between an auditor and the audit client, the amendments provide for the following:

- a mandatory period of four years following resignation from an audit firm before a former partner who was directly involved in the audit of a client can become a director of the client or take a senior management position with the client. This restriction should be extended to include key senior audit personnel

- an extension of the restriction to a former partner who was not directly involved in the audit of a client. In my opinion, the current proposed period of two years would be appropriate for such a partner

- a prohibition on any more than one former partner of an audit firm, at any time, being a director of or taking a senior management position with the client

These restrictions should be enforceable against both the audit firm and the relevant former partner or senior audit team member.

12 I recommend that, in implementing the CLERP 9 proposal for rotation of audit personnel, the requirement for rotation of the lead engagement partner and review partner be extended to key senior audit personnel.

13 I recommend that the *Corporations Act 2001* be amended to require the disclosure in audit reports of the following:

- the impact of the position taken by the reporting entity where alternative accounting treatments are reasonably open from the reading of an accounting standard and the difference between those accounting treatments is material

- the significant matters arising in the audit process.

The Corporations Act should be amended to require audit reports to be presented in plain English and to require the inclusion of an operating and financial review as part of an annual report, which would be the subject of audit.

14 I recommend that the *Corporations Act 2001* be amended to require public listed companies to include a brief, plain English summary of the nature and scope of the audit services provided by their auditor each year.

15 I recommend that both the Australian Prudential Regulation Authority and the Institute of Actuaries of Australia introduce compulsory certification of the completeness and accuracy of data.

16 I recommend that the Institute of Actuaries of Australia and the Australian Prudential Regulation Authority introduce a requirement for more detailed disclosure of the exercise, incidence and impact of subjective judgment and departure from historical experience.

17 I recommend that the Australian Prudential Regulation Authority extend the qualifications of the approved actuary to require that they not be an employee or partner of the organisation to which the approved auditor belongs.

Regulation of general insurance

18 I recommend that the *Australian Prudential Regulation Authority Act 1998* be amended to replace APRA's non-executive board with an executive group. This group would comprise the chief executive officer and two or three executive commissioners and would carry the responsibility, and account to government, for the operation and performance of APRA.

19 I recommend that the *Australian Prudential Regulation Authority Act 1998* be amended to provide the chief executive with the power to establish an advisory board.

20 I recommend that the direct involvement of representatives of the Australian Securities and Investments Commission and the Reserve Bank of Australia in the governance of the Australian Prudential Regulation Authority be discontinued. This will require amendment of the *Australian Prudential Regulation Authority Act 1998*.

21 I recommend that the Australian Prudential Regulation Authority chief executive instigate, as a matter of urgency, a review of APRA's organisational structure. The object of the review should be to achieve a workable and effective balance between accountability for and knowledge of particular financial services on one hand and cross-sectoral functional skills and perspective on the other. In particular, the review should consider the creation of a specialist team to take primary responsibility for the supervision of general insurers.

The review should report to APRA's board with recommendations on APRA's appropriate internal structure, given its responsibilities across the deposit-taking, insurance and superannuation sectors. The board should publicly respond to its recommendations.

22 I recommend that the Commonwealth Government consider removing the requirement for the Treasurer's agreement to operational decisions involving APRA's prudential oversight of general insurers.

23 I recommend that, given the inconsistencies between the *Insurance Act 1973* and the *Banking Act 1959*, the Commonwealth Government review the current legislative provisions for merit review of APRA's decisions for the purposes of ensuring consistency.

24 I recommend that the Australian Prudential Regulation Authority implement a programme to build the skills of staff involved in the supervision of general insurers. This should involve a review of its human resource management policies to assess APRA's competitiveness in the financial services sector labour market. The review should take account of the adequacy of remuneration, training and career structures as well as other steps to increase APRA's attractiveness as an employer.

25 I recommend that the Commonwealth Government adopt a three-year rolling funding arrangement to set the Australian Prudential Regulation Authority's budget.

26 I recommend that the Australian Prudential Regulation Authority develop a more sceptical, questioning and, where necessary, aggressive approach to its prudential supervision of general insurers. Consultation, inquiry and constructive dialogue should be balanced by firmness in its requirements and a preparedness to enforce compliance with applicable standards. In particular, APRA should take a firm approach to ensuring regulated entities' timely compliance in the lodging of returns and the provision of information.

27 I recommend that the Australian Prudential Regulation Authority continue to develop and review processes, guidelines and training to assist its staff in considering the appropriate approach to take towards supervised entities in different situations.

28 I recommend that the Australian Prudential Regulation Authority develop systems to encourage its staff and management continually to question their assumptions, views and conclusions about the financial viability of supervised entities, particularly on the receipt of new information about an entity.

29 I recommend that the Australian Prudential Regulation Authority develop an internal system for tracking all relevant information concerning regulated entities.

30 I recommend that the Australian Prudential Regulation Authority develop mechanisms for investigating the reinsurance arrangements of authorised general insurers on a random but frequent basis.

31 I recommend that the effectiveness of the current memorandum of understanding between the Australian Prudential Regulation Authority and the Australian Securities and Investments Commission be reviewed.

The processes for liaison, coordination and exchange of information between APRA and ASIC should be reviewed on a regular basis. To facilitate the exchange of information, the Commonwealth Government should make a regulation specifying ASIC for the purposes of s. 56(5)(a) the *Australian Prudential Regulation Authority Act 1998*.

32 I recommend that matters relating to the coordination of Commonwealth regulation affecting the insurance industry be the province of the Commonwealth Treasury.

33 I recommend that coordination of the matters related to the regulation of the insurance industry be addressed through the proposed ministerial council.

34 I recommend that authorised insurers be required to make greater disclosure of information about their financial position. In particular, all financial and statistical information general insurers currently provide to the Australian Prudential Regulation Authority in their regular returns should be made public.

35 I recommend that information that enables external users to make an informed assessment of an insurer's outstanding claims provisions and reinsurance arrangements be published by the insurer or the Australian Prudential Regulation Authority. APRA should develop reporting returns for insurers that would enable this to occur if existing returns are insufficient.

In particular, general insurers should publish:

- material equivalent to the 'schedule P' loss-development data published in the United States

- a summary of the approved actuary's valuation of the outstanding claims liabilities, including the methodologies and assumptions underlying that valuation.

36 I recommend that insurers be required to make greater disclosure of qualitative information relating to their risk- and reinsurance-management strategies. Other qualitative information—where the prospect of disclosure may affect the quality of information provided to companies—need not be disclosed.

37 I recommend that the Australian Prudential Regulation Authority identify and make known the kinds of regulatory activities that in its view should be disclosed publicly (whether or not the insurer in question is a listed company) and should specify the process by which such disclosure should occur.

38 I recommend that, as a matter of high priority, the Australian Prudential Regulation Authority develop and promulgate a standard for the effective regulation of authorised insurers that operate as part of a corporate group.

The proposed prudential standard on corporate groups should include a minimum capital requirement at the group level as well as the authorised entity level.

39 I recommend that the Australian Prudential Regulation Authority monitor the financial condition of corporate groups, including those with foreign operations. Pending the development of the proposed prudential standard on supervision of corporate groups, APRA should use existing powers to require groups to provide any information it considers necessary to perform this role.

40 I recommend that the Australian Prudential Regulation Authority take steps to ensure that it effectively exchanges with relevant foreign regulators information and intelligence on the operations of Australian insurers with international operations.

41 I recommend that the Australian Prudential Regulation Authority modify the prudential standards to require the annual production by an authorised general insurer's approved actuary of a report on the overall financial condition of the insurer.

42 I recommend that the Commonwealth Government amend the *Insurance Act 1973* to extend prudential regulation to all discretionary insurance-like products—to the extent that it is possible to do so within constitutional limits.

43 I recommend that s. 462(3) of the *Corporations Act 2001* be amended so that the Australian Prudential Regulation Authority may apply to wind up a company that is an authorised insurer if any of the criteria specified in s. 52(1)(aa), (ab) or (a) of the *Insurance Act 1973* are met.

44 I recommend that s. 461 of the *Corporations Act 2001* be amended to specify that the interests of policyholders are interests to which the court should have regard in deciding whether to make a winding-up order.

45 I recommend that the Australian Stock Exchange amend Listing Rule 3.1 to require—or publish a guidance note making it clear—that price-sensitive announcements have the approval of either the board or a delegate of the board subject to ratification by the board.

46 I recommend that the Australian Stock Exchange amend the Listing Rules to prohibit 'blacklisting'—defined as exclusion of a person or organisation from briefings by a company or a pattern of such exclusion in the face of negative reports on the company by those analysts over a specific period.

47 I recommend that the Australian Stock Exchange clarify Listing Rule 11.1, so that it applies to any significant change in the business or assets of a listed company, whether it be by acquisition, disposal, amalgamation or otherwise. I further recommend that the ASX amend the Listing Rules to define 'significant change', so that it encompasses financial and geographic factors as well as the nature and scale of the company's business.

48 I recommend that the Australian Stock Exchange amend Listing Rule 11.2, so that it applies to any disposal of the whole or substantially the whole of the assets or operations of a listed company.

State and territory regulation

49 I recommend that the states and territories not undertake any prudential regulation of general insurance. The Australian Prudential Regulation Authority should be the sole prudential regulator in this field.

If such regulation is to continue, state and territory governments should ensure that it is consistent with the requirements of the *Insurance Act 1973*. This is a matter that might properly be referred to the proposed ministerial council.

50 I recommend that, to the extent that states and territories continue to involve themselves in prudential regulation, the Australian Prudential Regulation Authority should share all information relating to the prudential regulation of relevant general insurers with relevant state and territory bodies.

The states and territories should provide APRA with all relevant information that may concern the financial condition of relevant general insurers. This exchange of information should proceed through memorandums of understanding between APRA and each relevant state and territory body.

APRA and the state and territory instrumentalities should review applicable secrecy provisions and where necessary seek legislative action to ensure they do not inhibit the free flow of information between APRA and the instrumentalities relevant to the prudential regulation of general insurers.

51 I recommend that the states and territories implement a process designed to reduce inconsistencies in their statutory schemes. This is a task that would appropriately be overseen by the proposed ministerial council.

52 I recommend that state and territory governments apply relevant prudential requirements to government insurers and statutory fund schemes. This is a matter that would appropriately be overseen by the proposed ministerial council.

53 I recommend that the states and territories consider allowing greater price flexibility in their statutory schemes. This is a matter that would be appropriate for consideration by the proposed ministerial council.

54 I recommend that the Commonwealth Government move to identify or establish a ministerial council or like arrangement to provide a ready and regular forum for the discussion and resolution by the Commonwealth and the states and territories of matters relevant to general insurance—and perhaps to other financial services.

The ministerial council (or other similar body) should consider measures to:

- avoid duplication in the prudential regulation of general insurers
- remove regulatory inconsistencies
- achieve a consistent approach to the prudent management of state and territory monopolies.

It could also play a part in:

- moves to introduce greater price flexibility in statutory schemes
- the introduction of a policyholder support scheme
- the removal of anomalies in the taxation arrangements applicable to general insurers.

Taxation and general insurance

55 I recommend that state and territory governments abolish stamp duty on general insurance products. It would be appropriate for this process to be coordinated through the proposed ministerial council with responsibility for general insurance.

56 I recommend that those states that have not already done so abolish fire services levies on insurers.

57 I recommend that state and territory governments exclude the cost of the GST for the purposes of calculating stamp duties or any other state or territory levies that are imposed on insurance premiums.

58 I recommend that governments avoid imposing on insurers levies and other taxes that cannot be passed on to policyholders.

59 I recommend that the Commonwealth Government review the current requirements of the *Income Tax Assessment Act 1936* with a view to changing the Act to bring it into alignment with the modified accounting standards I propose.

60 I recommend that the Commonwealth Government amend the income tax regime to encourage the creation and use of catastrophe reserves. Contributions to catastrophe reserves would be tax deductible. Releases from the reserve would be assessable for tax.

A policyholder support scheme

61 I recommend that the Commonwealth Government introduce a systematic scheme to support the policyholders of insurance companies in the event of the failure of any such company.

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[1] Other examples are Reliance Insurance Company in the United States, Markham General Insurance Company in Canada, and Chester Street Insurance Holdings Ltd in the United Kingdom.

[2] This is a comment by Don Argus, as reported in *The Weekend Australian*, 5–6 October 2002.