Liquidation and Payment of Claims
HIH Insurance Limited (2001)

Australia

Background and context

HIH Insurance Limited (HIH) was a complex corporate group with more than 200 subsidiaries and extensive overseas operations, including seven authorised insurers conducting general or property and casualty insurance business in Australia. The Group's main entities were HIH Casualty & General Insurance Limited, CIC Insurance Limited (CIC) and FAI General Insurance Company Limited (FAI). Collectively, HIH ranked as the second largest general insurer in Australia with 13% market share by premiums and 15% by assets.

> *The collapse of HIH increased awareness of the significance of insurance to the wider economy. Insurance is socially valuable. It promotes financial security and personal responsibility. The insurance market generates price signals, helping to allocate resources to productive uses ... without insurance, a range of essential activities in commerce, trade and community life can simply grind to a halt*
>
> Treasury of the Australian Government

Rapid expansion amid challenging operating environment in the late 1990s

HIH was established in 1968 by Ray Williams and Michael Payne as a workers' compensation underwriter. It was then acquired by a UK insurer in 1971 and expanded into property, commercial and professional liability insurance across Australia, New Zealand, Hong Kong and the US. From mid to the late 1990s, HIH grew rapidly through a series of acquisitions. This includes the purchase of CIC from Swiss owned CIC Insurance Group, Heath Cal in the US (now known as CareAmerica Compensation and Liability Insurance Company), Colonial Mutual General Insurance's operations in Australia and New Zealand, Cotesworth Group Limited in the UK, and FAI. Notably, 1998 saw the exit of HIH's majority shareholder (Winterthur International Holdings Limited) due to concerns over HIH's international expansions. This was conducted through a divestment of Winterthur's 51% stake through a public share offer to investors in Australia, which was over-subscribed.

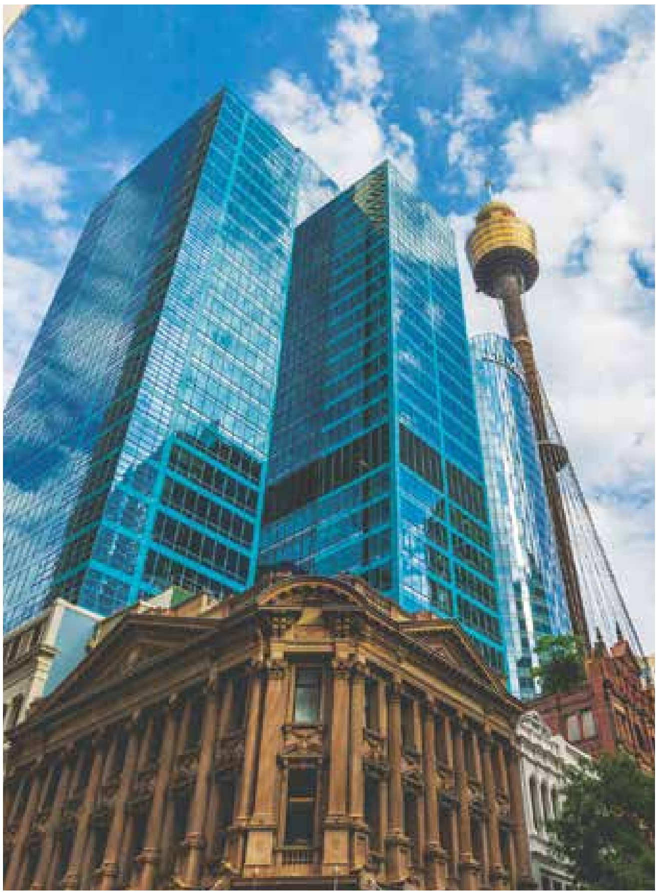
The performance of Australia's general insurance industry began to deteriorate in the mid-1990s, marked by a period of worsening claims experience, poor investment returns, soft premium rates and declining profits. The tough business environment resulted in intense competition, market consolidation, the failure of two small reinsurers and the rescue of a larger company (GIO Australia Holdings Limited) by another insurer (AMP General Insurance) in 1999. During that period, the general insurance industry was both fragmented with close to 160 insurance and reinsurance companies. It was also concentrated with the top five insurers, contributing to about 50% of the industry's business, while the top 20 players accounted for 88% of total gross premiums.

Significant losses and unsuccessful recovery efforts led to HIH being wound-up

In 1999 and 2000, HIH's financial position was dragged down by poor results from its subsidiaries in the UK and US (due to mispricing and deteriorating market conditions).

As part of its recovery efforts, in September 2000, HIH entered into a JV with Allianz Australia Insurance Limited (Allianz). The JV entity – 51% held by Allianz and 49% by HIH - assumed HIH's profitable business lines (majority of personal lines and compulsory third-party insurance business) in exchange for AUD200 million ($127 million) received by HIH. The JV was ceased nine months later when HIH sold off all its 49% stake to Allianz. However, the JV had a negative impact on HIH's cash flows, resulting in delayed payment of claims to policy owners. Subsequently, HIH also sold its workers' compensation business to NRMA Insurance (Australia's biggest general insurer). HIH had also pursued a managing general agency agreement with Gerling Australia Insurance Company (Gerling), which fell through. HIH's strategic intent was to leverage Gerling's strong credit rating, following HIH's rating downgrade, which had constrained its conduct of business with insurance brokers.

In early 2001, the APRA issued a 14-day show cause notice to HIH concerning the appointment of an inspector under the Insurance Act 1973. Markets reacted negatively to speculation about HIH's financial sustainability and viability, and the trading of HIH's shares was twice suspended. On 6 March 2001, HIH's Board of Directors (Board) commissioned KPMG to undertake an independent financial review. After receiving the KPMG review, the Board of HIH took the decision on 15 March 2001 to place the company into provisional liquidation. Pending formal appointment of a liquidator by the Court, the interim caretaker took control of, reviewed and assessed HIH's operations, assets, records, financials as well as the magnitude of losses. HIH was found to be in grave condition with deficient assets ranging from AUD3.6 billion to AUD5.3 billion ($2.3 billion to $3.4 billion). This reflected significant under provisioning of outstanding claims liabilities for HIH as well as for overseas business operations in the UK and US. On 27 August 2001, the Court issued formal winding-up orders to put HIH and 17 subsidiaries into liquidation and appointed KPMG as the liquidator.



Resolution actions

Resolution of HIH – Timeline of Key Events

End 1999/2000
Reported first financial year losses.
Suffered additional substantial operating losses and erosion of capitalisation.

Sep 2000
Entered into joint venture (JV) with Allianz and transferred personal lines and compulsory third party insurance business to the venture.

Early Mar 2001
Australian Prudential Regulation Authority (APRA) issued show-cause letter to HIH and the trading of HIH's shares was suspended.
HIH's Board commissioned KPMG to undertake an independent review.
Sold workmen compensation business to NRMA.

Mid Mar 2001
HIH declared insolvent and was placed under provisional liquidation.
Asset deficiency ranged from AUD3.6 billion to AUD5.3 billion.

Aug 2001
Court issued winding-up order and put HIH and 17 subsidiaries into liquidation.
Liquidator secured short-term limited insurance coverage for builders warranty and transferred travel insurance to QBE.

Apr 2003
Royal Commission tabled report to Parliament on causes of HIH's failure and recommended improvements on prudential regulation and supervision.

Apr 2005
HIH's CEO and a director were fined and sentenced to 4.5 years imprisonment for misleading shareholders, dissemination of false information and acting dishonestly.

Impact of failure and setup of HIH Scheme

HIH was the largest corporate failure in Australian history. Its liquidation in 2001 was profound and caused major disruptions to the economy and businesses, as well as livelihoods. HIH's two million policy owners faced significant hardships following the termination of various classes of insurance policies comprising motor, fire, home warranty, workers' compensation, professional indemnity, public liability, personal accident and travel insurance. Apart from the thousands of HIH employees who had lost their jobs, thousands of professionals – including doctors and surgeons – were unable to perform their work without insurance protection. The lack of substitutability for certain insurance coverage and HIH's under-pricing of risk, also triggered significant increases in premiums and caused, among others, rail and tram societies, sports centres and amusement parks, to cease operations. In addition, HIH was one of the largest home-building market underwriters and its failure affected many homeowners and builders, left without home warranty insurance and defective building work coverage.

To close these protection gaps, HIH's liquidator (KPMG) worked with Royal & Sun Alliance Australia Ltd to offer limited, short term insurance for builders' warranty insurance while Dexta Corporation agreed to provide insurance coverage for building works.[93] However, HIH's policy owners bore higher premium rates and were subjected to specific underwriting requirements. KPMG also completed the transfer of HIH's travel insurance, and insurance coverage of the Rugby Union and Rugby League competitions to QBE Insurance Australia (QBE). This included an agreement by QBE to renew HIH's corporate business.

The failure of HIH severely dented consumer confidence in the insurance industry, as well as the ability of regulators to protect and safeguard the interests of policy owners. The protection of financial consumers became a policy imperative. Since there was no IGS or financial claims scheme when HIH failed, the Australian Government implemented a claims support scheme to assist affected policy owners of HIH (HIH Scheme), valued at more than AUD500 million ($318 million).

> ***Ultimately, the success of the HIH Scheme demonstrates that industry and the government can work together to deliver mutually beneficial outcomes***
>
> Treasury of the Australian Government

[93] For works-in-progress and works pending commencement, of which contracts have been signed

Establishment of a Royal Commission (RC) and findings

The RC was set-up to investigate the causes of HIH's failure as well as to recommend improvements on prudential regulation and supervision of general insurance companies. It was headed by Justice Neville Owen and aided by 70 accountants, information technology specialists, lawyers as well as external actuarial and accounting support from Deloitte and Trowbridge Consulting. This endeavour required AUD50 million ($32 million) and 18 months, culminating in a report tabled to the Australian Parliament in April 2003.

The RC's conclusions could be summarised in three points. First, how the combination of improper reserving practice (where future claim costs / liabilities were substantially under-estimated), aggressive pricing (low premiums), and rapid business expansion led to HIH's downfall. The latter saw HIH's international ventures in the UK and US generating massive losses of AUD2.4 billion ($1.5 billion). Domestically, HIH overpaid for the purchase of a troubled insurer (FAI), borrowed heavily to fund the acquisition worth AUD300 million ($191 million), and wrote-off its entire investment.

Other related factors contributing to HIH's failure included the abuse of reinsurance, conglomerate complexity, inappropriate asset valuations as well as lack of integrity in the information submitted by management to the Board, auditors and the regulator.

Second was poor corporate governance. HIH's Board was found to be unduly influenced by the senior management team led by Ray Williams (the CEO and Deputy Chairman). The Board did not pay enough attention to strategic matters, failed to implement robust risk management controls, ignored conflict of interests, and did not reign in excessive expenditures in the form of executive remuneration and benefits.

Thirdly, in terms of regulation, the RC identified areas of improvement. This includes early warning signals of financial difficulties, as well as the implementation of preventive and corrective measures. Since then, APRA has significantly strengthened supervisory practices.

Key takeaways

An IGS is an essential element of the financial safety net to safeguard the interest of policy owners. In the case of HIH, policy owners were left unprotected and the Australian Government had to step in and establish a specific financial support scheme (HIH Scheme). With this intervention, policy owners were compensated for financial losses (payments of 90 or 100 cents on the AUD) compared to lower and prolonged recoveries from being pooled with unsecured creditors under the winding-up process. During that time, the government also lacked the capability and infrastructure for claims management and collaborated with the industry to promptly implement the HIH Scheme.

> ***I recommend that the Government introduce a systematic scheme to support policy owners of insurance companies in the event of a failure of any such company***
>
> Royal Commissioner the Honourable Justice Owen

In the aftermath of HIH's insolvency, an industry funded IGS was proposed by industry. This led to a technical study considering the merits of introducing an explicit guarantee for parts of the financial system, as well as a comprehensive review of Australia's failure and crisis management arrangements by the Council of Financial Regulators. An IGS, known as the Financial Claims Scheme (FCS), was subsequently adopted by the government for general insurers in 2008 at the same as a deposit insurance scheme was introduced. The FCS is funded by a government appropriation and APRA is responsible for administering the FCS, if invoked.

Besides a new financial claims scheme administered by APRA, the failure of HIH also led to the strengthening of the oversight of general insurance companies. A new regime for the prudential regulation of general insurance companies was put in place, including increasing minimum capital requirements, introducing a risk-weighted capital solvency framework, strengthening corporate governance policies as well as imposing tighter controls for auditors and actuaries.

The corporate governance failures of HIH were met by a strong response by the authorities. This included civil actions against two of HIH's ex-Board members, Ray Williams and Rodney Adler. Both persons were jointly ordered to pay AUD8 million ($5.1 million) to HIH, and were individually imprisoned for 4.5 years after pleading guilty to misleading shareholders about HIH's financial position, stock market manipulation, disseminating false information, acting dishonestly, and failing to discharge duties as a director in good faith and the best interests of HIH.

The case of HIH also demonstrates the importance of having in place strong internal capabilities and a robust framework, including comprehensive due diligence before launching a strategy of aggressive business expansion via mergers and acquisitions, proper claims reserving practices and pricing mechanisms, as well as strong internal control, governance and risk management.