

Report of the Royal Commission into HIH Insurance

The HIH Collapse

The major companies in the HIH Insurance Group (HIH) were placed in provisional liquidation on 15 March 2001. The collapse of HIH is likely to be the largest corporate failure in Australia to date. The losses and hardship inflicted on the Australian community by this corporate failure have been significant and have been a major contributing factor to the current insurance crisis. The liquidation process could take up to ten years and the financial return to creditors is expected to be negligible.¹

The Australian community had an expectation that corporate regulation, audit and good corporate governance should have triggered early warnings of any looming crisis. Public confidence has been shaken.

The subsequent suspicions about a serious level of corporate mismanagement within HIH saw the appointment of a Royal Commission in August 2001.² The Royal Commission's report was publicly released on 16 April 2003 together with the Government's response.³

Some Key Findings

The Royal Commission did not find fraud or embezzlement to be behind the collapse. The failure was more the result of attempts to paper over the cracks caused by over-priced acquisitions and too much corporate extravagance based on a misconception that the 'money' was there in the business. The primary reason for the failure was that adequate provision had not been

made for insurance claims. Past claims on policies had not been properly priced. HIH was mismanaged in the area of its core business activity. The ultimate shortfall is likely to be in the billions of dollars.

The acquisition of FAI Insurance Ltd in Australia, combined with re-entry into the US market and the expansion of the UK operations, were poor commercial decisions. All were afflicted with under-reserving. The Royal Commission noted that a culture appeared to have developed within HIH not to question leadership decisions.

HIH had a corporate governance model but the Royal Commission found that HIH had failed to review the model to assess its suitability for changing circumstances in the insurance industry. Under the HIH model, the internal audit committee focused almost exclusively on the accounts rather than taking on an additional function of overall risk identification and assessment. Also, the Royal Commission noted that the audit committee within HIH should have met more often with directors with management absent.

HIH had three authorised insurance arms, including FAI. The Royal Commission found that prior to its provisional liquidation in March 2001 all three companies had operated below the minimum solvency requirements stipulated by the regulator and the *Insurance Act 1973*.⁴ The prudential regulator is the Australian Prudential Regulatory Authority (APRA).

Overall, the Royal Commission referred 56 possible breaches of the

Corporations Law and the NSW *Crimes Act 1900* to the Australian Securities and Investments Commission (ASIC) and to the NSW Director of Public Prosecutions for consideration.

Although the Royal Commission found that APRA did not cause or contribute to HIH's collapse, APRA did not recognise the seriousness of the situation or question the reliability of the information it was receiving from HIH until too late.

A significant recommendation of the Royal Commission was an overhaul of APRA, including the replacement of its non-executive board with an executive group.

Proposed Legislative Response

In his personal perspective, the Royal Commissioner noted that, while regulation is necessary, he thought that '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'.⁵

(a) Corporations Act 2001

One significant legislative issue brought to light by the Royal Commission was an unfortunate effect created by the narrowing of the definition of 'officer' in the *Corporations Act 2001*—a carry-over from the Corporations Law Economic Reform Program (CLERP) revisions of 1999 to simplify the Corporations Law.⁶ The revised definition omitted to include a person 'concerned in'

management issues, i.e. to cover all relevant persons concerned in the management of the company. A legislative response is called for to apply legal responsibility more broadly across the Act as a whole.

Apart from correcting the ambiguities about liability for employees who are concerned in the management of the company, the Royal Commission also recommended that the existing class of persons covered be extended to those who are suppliers of services under contract. Sections of the *Corporations Act 2001* deal with civil obligations (ss.182–183) and criminal offences (s.184), respectively, for improperly gaining an advantage, causing a detriment to the company or a failure to act in good faith (including acting recklessly or being intentionally dishonest).

The extension of expanded responsibility to contract advisers may generate debate and, if implemented, could lead to higher costs for professional indemnity.⁷

In the area of audit services, the Royal Commission recommended a range of measures including some designed to provide greater disclosure of the scope of audit services as well as non-audit services provided by audit firms and the level of fees applicable.

APRA Legislation

The Royal Commission's recommendations on APRA were comprehensive and started with the proposal to replace APRA's non-executive board with an executive group. The reasoning behind this recommendation is that APRA has been constructed in a way that has a governance board rather than an advisory one. APRA has a CEO who is appointed by the Treasurer. The CEO reports to both the Treasurer and the board. The placement of the APRA board between the CEO and the Treasurer is perceived as clouding the lines of communication. A small executive group may offer more direct

accountability to Government, similar to the ASIC model. It is noted, however, that APRA in its existing model has more recently introduced new prudential standards to address under-reserving by insurers, enhanced disclosure by actuaries as to methods used for calculating outstanding claims, and improvements in corporate governance, including APRA's 'fit and proper test' for directors.

The Royal Commission also recommended that APRA's existing powers to apply for winding-up of a company be expanded to enable APRA to apply under the *Corporations Act 2001* without an inspector being appointed first under section 52 of the *Insurance Act 1973*.

Insurance Act 1973, Banking Act 1959 and Income Tax Assessment Act 1936

The Royal Commission also made recommendations concerning consequential amendments and the removal of inconsistencies in a range of other Commonwealth enactments.

Also recommended were amendments to the ASX Listing Rules and the abolition of some State and Territory levies on general insurance to reduce premiums.

Comment

The proposed legislative response is useful and, in the case of the *Corporations Act 2001*, remedial in terms of the significant definitional ambiguity in the meaning of 'officer' of a corporation. Some of those who may have contributed to the collapse of HIH will avoid investigation and responsibility.

In March 2003, the ASX issued its *Principles of Good Governance and Best Practice Recommendations* promoting the need for the majority of a board to be independent directors and identified as such.

One very small practical change in ASIC documents is suggested. ASIC's Form 304 records new

appointments as directors. It could also confirm that the director has sought independent advice as to the duties of a director.

These proposed changes will not prevent future collapses but they may help minimise damage. It is not really possible to legislate against the timidity of company officials to speak out. That is being left to shareholders at AGMs.

1. Juan-Carlo Thomas, 'The shattered lives behind an insurance catastrophe', *Sydney Morning Herald*, 17 April 2003. One estimate of the possible recovery is 20 cents in every dollar. Marcus Priest 'HIH creditors may recover 20pc', *Australian Financial Review*, 28 April 2003.
2. The Royal Commissioner, Hon. Justice Neville John Owen, was appointed to inquire into the reasons for and the circumstances surrounding the failure of HIH prior to the appointment of the provisional liquidators.
3. See Press Release by the Hon. Peter Costello, MP, Treasurer of the Commonwealth of Australia, no. 2003/021 of 16 April 2003.
4. The 'minimum solvency requirement' means that the value of the insurer's assets must exceed 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.
5. *The Failure of HIH Insurance*, The HIH Royal Commission, vol. 1, Canberra, April 2003, p. lxiii.
6. *ibid.*, (para 6.4.2 of volume 1).
7. Leon Gettier, 'More in firing line in post-HIH era', *Sydney Morning Herald*, 18–20 April 2003.

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