

Hih insurance the failure in corporate governance



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In the past few years, the collapse in large public listed companies has raised stakeholders concern about corporate governance, which is a leading issue area for business worldwide. While numerous definitions of the term corporate governance have been suggested, it is generally defined as the framework of processes and structures to control and manage a corporation with the objective of enhancing company and shareholder wealth, whereas at the same time, protecting the interests of other stakeholders. The failure of many corporations resulting from a corporate governance problem caused counterproductive outcomes to shareholders and also the wider community. One of the most well-known business debacles, particularly in Australia, is HIH Insurance Limited (HIH).

As a result of over-optimistic valuations of assets and extensive understatement of liabilities, many of HIH's policyholders and its creditors

encountered a substantial loss. Bailouts can cost Australian taxpayer over a billion-Australian dollar but it did not cover all. It is the fact that not only the scale of the corporate failure is so huge but also its effect is widely, including the community and regulators.

The paper therefore is developed to discuss the HIH corporate governance failure in an aspect of risk management. Both a culture failure and mis-governance/mismanagement can be identified as key risk management issues. The board of directors (from here it will be referred to as the board) and management were unable to act as their own roles and basically on behalf of shareholders' interests. One of fundamental problems is that HIH offered at too high price for merger and acquisition. Besides, the company had not set aside enough capital to cover its future liabilities. It can be argued that HIH's board was subservient to senior management resulting to a poor decision making is critical factor of this crisis. Moreover, the paper will apply some theories and/or the other company's crisis to compare and contrast with the HIH crisis. Ultimately, several lessons which are to improve performance and to enhance accountability will be addressed to continue good corporate governance.

Introduction and aims

Business risk management is generally a variety of activities undertaken by a corporation to control and manage potential adverse effects. On the other hand, the corporation may take such advantages by experiencing from opportunities which are relative to those risks. It therefore plays an important role in a corporation to be continuing growth, enhances success as well as sustainability. As a result of its importance, this paper will stimulate

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all stakeholders especially at the level of senior management and board of directors to be aware of risks and also to attempt to handle uncertain circumstances by learning from a previous case namely, the HIH failure.

A decade ago, HIH was put into liquidation representing one of the largest company collapses in the history of Australian. Many accusations, in particular business analysts, have attributed questionable decision-making processes as one of major factor to this crisis. This paper will examine about causes of HIH failure and substantial unfavorable effects involved in a corporate governance topic.

While there are various reasons resulting in the HIH crisis, this paper will concentrate solely on a business risk management issue associated with the failure in corporate governance. To consider the selected issues, which are a culture problem (a poor role model), and mis-governance/mismanagement (an under-provision), explicit criteria are that the severity of impact on financial performance and its scope.

The purpose of this paper is to analyse the HIH corporate governance issue. The first section will discuss the surrounding facts containing a company background. The second section will evaluate risk management issues: in aspects of an incompetent role model and a provision deficit, in line with compare and contrast with reference materials and other companies. After that, some consequences of this crisis and its implications will be addressed. Lastly, the learned lessons and recommendations: paying more attention to risk management, encouraging more accountability, restructuring the board

as well as appointing proper management, enhancing risk-based decision and setting intensive regulations, will be stated in a conclusion section.

SURROUNDING COMPANY FACTS

MW Payne Liability Agencies Pty Ltd. was established in 1968 by incorporating between Ray Williams and Michael Payne to underwrite insurance business in Australia as an agency for Lloyd's of London syndicates (Owen 2003a). The core business was to write various types of licensed insurance comprising compulsory insurance (such as workers' compensation) and non-compulsory insurance (such as travel insurance) (Owen 2003a).

Over the next two decades, the company expanded and diversified its insurance business geographically in both Australia and overseas, and became an Australian listed company in 1992 (Owen 2003a). At that time, the CE Heath plc was a major shareholder with 44 percent of total equity (Owen 2003a). The company merged with the Swiss based insurer Winterthur Insurance Company established 'HIH-Winterthur' (subsequently HIH Winterthur International Holdings Ltd.) as the second largest general insurance underwriter in the Australian market (Owen 2003a). However, three years later, Winterthur disposed of its HIH holding, which then continued as HIH Insurance Ltd. (HIH) (Owen 2003a). After Winterthur's exit, HIH acquired FAI General Insurance Company Limited (FAI) and entered a joint venture relationship with Allianz (Owen 2003a).

According to Lipton (2003), there are several factors attributed to the collapse in the governance of HIH. Those factors are associated with an

ineffective decision making and a lack of business judgment in circumstances of opposite insurance market conditions. The absence of a well-understood strategy was illustrated by the difficulties in the operations in both the United Kingdom and the United States market. Besides, an inappropriate reinsurance and an improper provision level reflected the understatement of liabilities. Similarly, the entirely inadequacy information of the board led to overvalue acquired company's assets.

The failures of culture and mis-governance/mismanagement are probably the underlying reasons of the Australia's biggest corporate collapse, HIH. Severely, there was a significant fall in share price below an insurance sector average and an insufficiency up to AUD5. 3 billion (Mellahi 2005, p. 266). HIH was placed into provisional liquidation on 15 March 2001 and is still run-off nowadays (Owen 2003a).

Regarding to risk management that is about wealth creation and protection by assisting a corporation to make a decision how to deal with risks, HIH therefore should address material business risks of its company. However, in practice, it does neither identify risks nor implement risk treatments causing a catastrophic event.

A CULTURE FAILURE: A POOR ROLE MODEL

In general, board of directors has responsible to understand, endorse and monitor company's strategies in line with a risk management process, which are proposed by management. Conversely, both the board and management of HIH failed to act on their stewardship. One of the main reasons that the board failed to fulfill its role as monitor is the culture of the boardroom.

Culture refers to the collegiate atmosphere that prevents any member speaking out against the senior management's view (Monks and Minow 2001, p. 189). For example, Chief Executive Officer (CEO) controls the board's agenda, information and compensation without any challenging of board members about his authority and influence. As the existence of this culture, the board thus seems to be accused as "old boys' clubs" (Monks and Minow 2001, p. 189). This paper will discuss how the culture did not suit with the company statements.

While the environment changes overtime, the company strategies had never been considered and revised to reflect its continuing sustainability growth (Owen 2003a). The board was risk-ignorance and did not understand company strategies. Thus, they would have no right questions to ensure whether strategies are properly executed in the right direction or not (Lipton 2003, p. 275). Likewise, an independent due diligence reported that Ray Williams, the HIH's CEO, had strongly influenced on the company and might act on his own interests rather than company's benefits (Lipton 2003, p. 274 and Owen 2003a). A culture problem is therefore one of the major risk management issues.

The acquisition of FAI can be a good instance of the board and management's role problem, caused by and affected on a poor corporate governance culture. General speaking, a corporation is advised to exercise a due diligence in making a decision but the FAI's CEO refused to allow the due diligence process (Owen 2003a). More seriously, the HIH's board and management did nothing to oppose his action, the takeover hence is continuously proceed by only relying on the publicly available information

(Owen 2003a). Moreover, five of 12 directors were not present in the meeting due to the lateness of the notice (Lipton 2003). Of the three directors were present in person and the remaining directors, who might not have enough relevant information, just participated by video conference (Lipton 2003). Importantly, since lack of knowledge about the FAI's financial position, the company did not notice that FAI had a problem about an excessive reserve deficit (Owen 2003a). The compounding impact made HIH facing more difficulties because at that time HIH itself had a reserving problem as well. The overall costs of the FAI acquisition from overpayment have been estimated at AUD590 million (Owen 2003a). It can be seen that the decision to takeover FAI went ahead with insufficient preparation and investigation resulting from a culture problem.

In terms of risk types, strategic risk is defined as the risk to earnings from adverse business decisions or improper implementation of those decisions. Operational risk refers to exposure to loss leading to inadequate or failed internal processes, people and systems or from external events. It is likely to be some overlaps between strategic and operational risks, the risk issue of HIH thus might be classified as both.

A supporting example is that though HIH had a corporate governance model presented in the annual report, there was a little evidence that the board frequently examined the HIH's corporate governance principles to ensure that they were suited to the company and continued practice, Owen (2003a) claimed. Moreover, the board misunderstood long-term as well as relevant business strategies and also was missed opportunities to achieve them. These could go to the heart of corporate governance failure.

Although it can be argued that related-diversification acquisition can generate positive outcomes to an acquirer, it is irrelevant in the FAI case. The HIH's CEO insisted that FAI acquisition would reward the company at reasonable returns, which is apart from enhancement of well-known reputation, removal of a competitor, expansion of distribution channels and synergy (Owen 2003b). The board totally failed to consider the risks: under-estimated provision and mispricing posed by proceeding the FAI takeover. It is probably obvious that the problematic decision making procedure of HIH should be concerned.

MIS-GOVERNANCE AND MISMANAGEMENT: AN UNDER-PROVISION

As a reserve represents future obligations of an insurance corporation, it is one of essential tools to measure a corporation's financial health.

Outstanding Claim Provision (OCP) is a fundamental critical item reported on the liability side of a general insurer's financial statements (balance sheet). For HIH, a key business is a general insurance, OCP thus shown about a half of its liabilities (Owen 2003a). The maintaining of OCP level is to ensure a corporation's abilities to meet every claim from the policyholders occurred in the future. Improper provision either inadequate or excessive can present a false picture of a company's financial conditions and cause serious problems. Thus, the level of a reserve plays an important role in a price risk regarding an increase in number of underwriting policies as well as the size of insurance contracts.

Since 1995 the number of acquisitions increased sharply both local and international business because of the rapid growth in HIH operations (Owen

2003a). However, the company appeared consistently to have an under-provision, which is neglected to provide properly operation growing rapidly for future commitments. Its board and management failed to grasp an opportunity to identify and handle this problem. Findings like this, theoretically, governance involves monitoring and overseeing a corporate direction as strategy-oriented, while management relates to task-oriented associated with administering a corporate operation, both mis-governance and mismanagement hence could be identified as another risk management issue of HIH.

To set a provision figure, the board relied on external specialists' reports. They did not notice the critical assumptions; such as discount rates and claims-handling costs which are used as an actuarial-based reserve (Owen 2003a). It may be questionable why such a huge insurer did not understand and concern about this key issue particularly in its proficient field. Lipton (2003) pointed out the fact that CEO promoted exclusively close person, such as his friends, becoming the board or management of company. It implies that those may do not have enough professionally actuarial knowledge in their background. As a consequence, this was instrumental in a lack of accountability by senior management to the board and a lack of independence within the board. Owing to an inappropriate business decision, this issue can be identified as the strategic and operational risks as well as may create some extent of risks.

On the top of that Devid Slee of David Slee Consulting Pty Ltd was the HIH's consulting actuary and was also Williams and Payne's former colleague in CE Health plc (the majority shareholder of HIH in later) (Owen 2003b).

Obviously, Slee had unusually close relationship with two founders. This possible contributed to a weak independent report. For example, no prudential margin was recognised in Slee's estimation, too high estimating discount rate and assuming fully recoverable of reinsurance in his report (Owen 2003b). These are likely to allow HIH to publish healthier its financial position than it should. The reduction in its distribution to a provision can cause to mislead the use of excessive funds. Besides, the company would anticipate with its higher expected return from investments. Without skepticism of using information, HIH was operated careless of risks incurred from the under-provision setting.

Another risk type that HIH faced is regulation risk, which refers to the potential loss arising from the uncertainty of legal proceedings affecting the corporation change, such as bankruptcy. In 2000, the prudential regulations of the Australian Prudential Regulation Authority (APRA), the principal regulator, enforced the underwriter to increase capital adequacy requirements of insurers (Owen 2003a). As a consequence, it led to the shortfall of HIH's reserve level. The company had not enough capital to cover insurance risks for many years and then might be no longer a going concern of its operation. All in all, risk management was not in progress to resolve the reserve shortfalls in that period.

COMPARE AND CONTRAST

Attempting to define the pattern of HIH culture, it may distinguish as the 'fiefs'. A fief culture refers to a private company culture, which is the leader authority is influential in substantial areas such as investment and acquisition (Birkett 1999). It also infers that the risk orientation of company

is risk ignorance (Birkett 1999). Williams, the founder and CEO of HIH, is probably no better example in this point. The dominant chief executive had no clearly identified limited of his authority in investment, donation, and remuneration (Lipton 2003). More importantly, the policy on reserve matters also came forward the personal-based discretion of CEO compounding too optimistic prospective reports by a dependent advisor, Slee (Owen 2003b). Instead of having skeptical review and approve, the board just accepted Slee's suggestions of provision level without concerning the inherent risks of the estimation (Owen 2003b). This might show unawareness of risks occurred among directors and the influence of William is apparently paramount. Such an influence needs to deliberately review, debate and questioning, but the HIH board had done nothing. It could argue that insufficient accountability and independent happened within the board and senior managements.

Moreover, referring to Augustine (2000 pp. 7-27) model which is to manage risks, such participant roles involved in HIH had done in neither the first two steps of crisis management, as prevention and preparation for the crisis, nor the latter step, recognition. Recognising, in line with resolving, the crisis had come belated to HIH as a result of a catastrophe. The company did not gain any favorable outcomes (profit) from this crisis as well. It also conducted to a deficient recovery claim which brought significant loss to policyholders and made the company's liability to be default. The HIH then went bankruptcy finally.

Furthermore, the financial magnitude of HIH collapse is possibly the Australian's biggest and hence it can be comparable in relative to Enron (the <https://assignbuster.com/hih-insurance-the-failure-in-corporate-governance/>

American energy company) scandal. Similar to Enron, HIH attributed to managerial failures, especially the immediate role of senior management. They seemed to have had an under-involved and under-informed the board. In contrast to Enron, HIH have not been reported a large-scale fraud or insider extractions. HIH still retained characteristics of a private company dominated by its founder and CEO. Williams had an overbearing influence on an expansion decision making, whereas the present board ignored to question and concern about a connection between acquisitions and other strategies of company that is a case in point.

AFTER THE CRISIS

Meanwhile, APRA (2001) revised a new version of prudential standards for general insurance companies in Australia. There were six standards have been released, including ‘Liability Valuation’ – to promote the provision of actuarial advice to the board and management, ‘Capital Adequacy’ – to maintain a minimum level of capital with the risk profile and ‘Risk Management’ – to promote strong corporate governance by accessing to appropriate independent expertise and systems for identifying, managing and monitoring risks.

In a year later, 2002, the Australian Securities Exchange (ASX) Corporate Governance Council was formed to develop a corporate governance practical guideline for the Australian listed companies. Elizabeth (2003) also advocated that a corporation’s risk management strategy is required to include in a report as an essential part of corporate governance. According to ASX (2007, p. 32), the recent corporate governance principles and recommendations suggest that corporations should establish policies to

manage material business risks as well as disclose those policies. Likewise, the board should oversight a management team to effectively manage corporate risks by designing and implementing the risk management system (ASX 2007, p. 33).

Conclusion

Many of HIH's difficulties are attributed to various factors. Owing to huge impacts, in terms of scale and scope, a failure of culture and mis-governance/mismanagement can be addressed as the main risk issues. There was no apparently defined statement of duties or limited on authority for management. The board had inability to understand and monitor HIH's strategies as well as a risk management process, whereas senior management had too influence on directors. Consequently, a lack of preparation resulting in overestimating FAI's value put pressure on its operation. At that time, reserve strategies itself had already been staged HIH a problem. Such ineffective risk identification in turn led the company to ignore a measurement of risk that is in particular essential in an insurance industry. It also neglected to take into account the associated counterproductive effects under on-going assumption. HIH had subsequently large scale of negative outcomes and then collapsed lastly.

LESSONS FROM THE CRISIS

During periods of corporate failure, trends of reformative corporate governance and increased regulations and recommendations occur. The HIH crisis is one of a beneficial case to be learned about corporate governance and risk management issues as following lessons:

Risk management should be considered as the priority of the corporate policies. The culture problem and mis-governance/mismanagement; such as the Hih corporate governance guidelines being not adhere frequently, the bad decision making into expansion, and inadequate of business judgments, are failure in the risk identification and management. The fact that risks are never-ending and critical issue for all corporations, the company therefore should add its value through having risk management priority.

Accountability is vital at all levels of a corporation. With no attention to unfavorable information, the board did not use their skepticism to question senior managers when or where risk matters. This caused a lack of accountability for performance among senior management and the board. Owen (2003a) recommended that the amendment of Corporation Law and establishment of ASX corporate governance principles and recommendation could ensure that responsibility can be held for any employees and experts' actions.

Beware the qualified and experienced boards, it does not guarantee the success. Between 1997 and 2001, Hih board comprised insurance experts, qualified accountants and auditors. With a variety of expertise, the board was still ineptitude and under the control of CEO. They did not question the key issues and also waived rules and guidelines. Owing to the board improperly carrying out its roles, it was unable to monitor management performance and proposal by referencing from approved strategies. Findings like this, it can be suggested that the company should restructure board of directors by changing the proportion of inside/outside directors on board in order to increase independence of the board and to ensure that it can add

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value to the company by governing the business primarily on behalf of shareholders' interests.

A corporation must exercise due diligence before making a decision (Owen 2003a) and also corporate liabilities need to be properly valued and disclosed. Due to insufficient preparatory and investigative works, the board decided to acquire FAI. They entirely failed to consider the risks posed by the takeover. Besides deliberate manipulation of claim estimation by FAI management and HIH itself contributed to understated liabilities which had arisen because HIH was misgoverned as well as mismanaged. Due to excessive under-reserving, HIH had deficiency up to AUD5. 3 billion and no longer survive at the present time.

Regulators need to be more proactive. As mention above, the new regulation established by APRA as well as ASX corporate governance guideline and principle probably have an aggressive enforcement culture to ensure that this crisis will not reoccur.

In conclusion, good corporate governance involves in company value enhancement and risk management. Risk exists at the heart of any business taken in the search for rewards. Corporations therefore should be aware of risks and attempt to deal with them. Failing to do this, such as in the HIH case, it may cause such multi-billion losses. This crisis also contributes a variety of lessons and implications to all stakeholders. To avoid a catastrophe, continued efforts to make corporate governance both improve corporate performance and enhance corporate accountability as well as to

proceed risk management are vital and ongoing in order to mitigate the most damaging outcomes whilst encouraging the most positive.