Trowbridge Deloitte

6th Global Conference of Actuaries

Corporate Governance and Risk Management for General Insurers

Presentation By John Tucci
Senior Manager and Actuary - Asia General Insurance

Programme

- Corporate Governance
  - HIH Insurance - a Case Study to learn from
  - HIH Royal Commission - Key Issues and principles raised
- Risk Management
  - Understanding the background of risk management
  - Establishing a risk management program
  - Making risk management a paying proposition, not a cost
  - Developing a risk management culture

HIH

- General Insurance company launched 1960s
- Listed public company early 1990s
- Dominant CEO - set up the company 30+ years ago and stayed until 6 months before demise
- By late 1990s, HIH becomes one of the largest public listed general insurers in Australia specialising in volatile liability classes
    - $AUD2 billion in premium in 1999
- Reputation in the market for aggressive pricing to win business

HIH – Opening a UK Branch

- Established 1993
- No evidence of commercial rationale as to why UK branch was established
- Wrote volatile classes - public liability, professional indemnity and inward treaty reinsurance
- Profit in year 1, then expansion into other unchartered areas
  - Marine reinsurance
  - Film financing
  - Accident cover of the Taiwanese military
  - Motor vehicle damage to an Israeli insurer with no terrorism exclusion

HIH – California Workers' Compensation

- Expanded into California workers' compensation in 1996 with limited due diligence
- Bought back CareAmerica after selling it in 1994 on favourable terms
  - Purchased on anecdotal evidence that the weak market was about to rebound – no evidence of research to verify assertion
  - No actuarial assessment of liability reserves held by CareAmerica - No indemnities sought if reserves were found to be inadequate

HIH – Purchase of FAI Insurance

- FAI insurance was another public listed Australian general insurance company
- Similarities to HIH
  - Dominant CEO whose father started the business
  - Reputation in the market for aggressive pricing to win business
  - Significant volatile “long tail” liability classes
- No financial due diligence undertaken – relied on public information
- Hasty decision to buy HIH – notice of board meeting circulated on the day of decision and only 3 of 12 directors present

HIH – The Collapse

- Industry rumours that HIH was in trouble
- In 2000 strong indications that the company was under-reserved for liabilities and funded by significant “goodwill” in balance sheet
- In a bid to raise cash, directors sell profitable “short tail” business through a joint venture with Allianz
  - Allianz proposal presented at board meeting and agreed in 75 minutes
- Major cash flow crisis ensued
- Provisional liquidation 15 March 2001

HIH – Where did the money go?

- Liquidation identified deficiency of up to $AUD5.3 billion.
    - Under provisioning of reserves – $2.4 billion
    - UK operation - $1.7 billion loss
    - US Operation- $0.6 billion loss
    - FAI acquisition - $0.6 billion
    - Major under-provisioning on the back of claims on unprofitably written business
    - Dubious reinsurance contracts
    - Quality of assets - 75% of net assets were intangibles – 50% was goodwill

HIH Royal Commission – Report Summary

- Collapse due to chronic under provisioning – with an impact on pricing
- Mismanagement, ineffective board
- Legal action and overhaul of Regulators
- Suggested directors, management and contractors be made legally accountable for their actions
- Conflict of interest – flawed understanding
- Blind faith in leadership of company
- Poor identification of risks and excessive filtering of information – ineffective board.

HIH Royal Commission - Governance

- Risks not identified and managed properly. Unpleasant information hidden, filtered or sanitised
- Lack of sceptical questioning and analysis when and where it mattered
- Little analysis at Board level of the future strategy of the company
  - Boards are responsible for understanding, testing and endorsing the company's strategy
- A Board that does not understand the strategy may not appreciate the risks, will not ask the right questions to ensure the strategy is properly executed

HIH Royal Commission - Governance

- Lack of accountability among senior management and the Board of Directors
  - Singular failure to assess performance in the context of deteriorating financial results
- Board's independence compromised by the influence of management in relation to its deliberations
- Corporate officers, auditors and regulators failed to see, remedy and report what should have been obvious
- Management group ignored or concealed the true state of the group's steadily deteriorating financial position

HIH Royal Commission - Governance

- Actuarial reports or summaries of them never tabled at meetings of the board or the board audit committee
- Financial reinsurance was used to ‘paper over cracks’ and side letters used to negate risk transfer
- Reporting structure not effective – lack of quality management information

HIH Board independence issues

- Core issue was dominance of the non-executive directors, not their quantity
- Of the 8 'independent' directors
  - One had provided legal advice to the company for many years prior to his appointment and had been a director for 10 years
  - Chairman was a former Andersen partner and continued as an Andersen consultant after his retirement. He held the position of chairman of the audit committee while working as a consultant to Andersen
  - 2 directors were receiving consultancy fees in addition to directors fees
  - One joined the Board immediately after leaving Andersen as HIH's audit partner.
  - One had been the managing director of the UK branch for 5 years prior to joining the board.
  - Only 2 could be considered truly independent and they both resigned in 1999

Lack of HIH accountability

- Few guidelines and processes in place to hold staff, management and executives accountable
- Level of authority held by executive directors was not defined
- Key performance indicators of executives were not defined
- No independent review of the organisational structure
- No review of the board's performance

Key Principles of Governance

Founded on Active Board Involvement and Effective Board Insight

- The board to be kept informed and use independent advice as required – this is not a threat to management but a confirmation of managements direction
- The board to assume its responsibility and provide direction and feedback, leadership, and strong relationship with management
- Don’t over regulate or abrogate responsibility by taking a compliance driven approach
- Focus on a best practice framework and compliance will be an outcome
  - Governance in practice
  - Road tests
  - Transparency - Section in Board Reports
  - Standing item for all meetings

Key Principles of Governance

- Independence requirements
  - Eg. Non-executive director, auditor and actuary
  - Avoid conflicts of interest
- Accountability definition
  - Starts at the top with clear responsibilities set out for the Chairman and the CEO in writing and approved by the board
- Culture and behaviour
  - Directive compliance culture is not long term sustainable
- Strong Risk Management Focus
  - Understand the risks of the business – open and transparent reporting
  - Implement sound risk management strategies

Risk management

- What is risk?
  - Any threat or opportunity that can potentially prevent the company from meeting its objectives
  - Objective is not to eliminate all risk to the detriment of profit, it is about managing risk
  - Approach to Risk Management
    - a systematic approach to the linkage of business objectives, risks and controls
  - Risk has two elements to it
    - the likelihood of an event happening; and
    - the consequences if it happened

Objectives → **Risks** → **Controls**

The cornerstones of good risk management

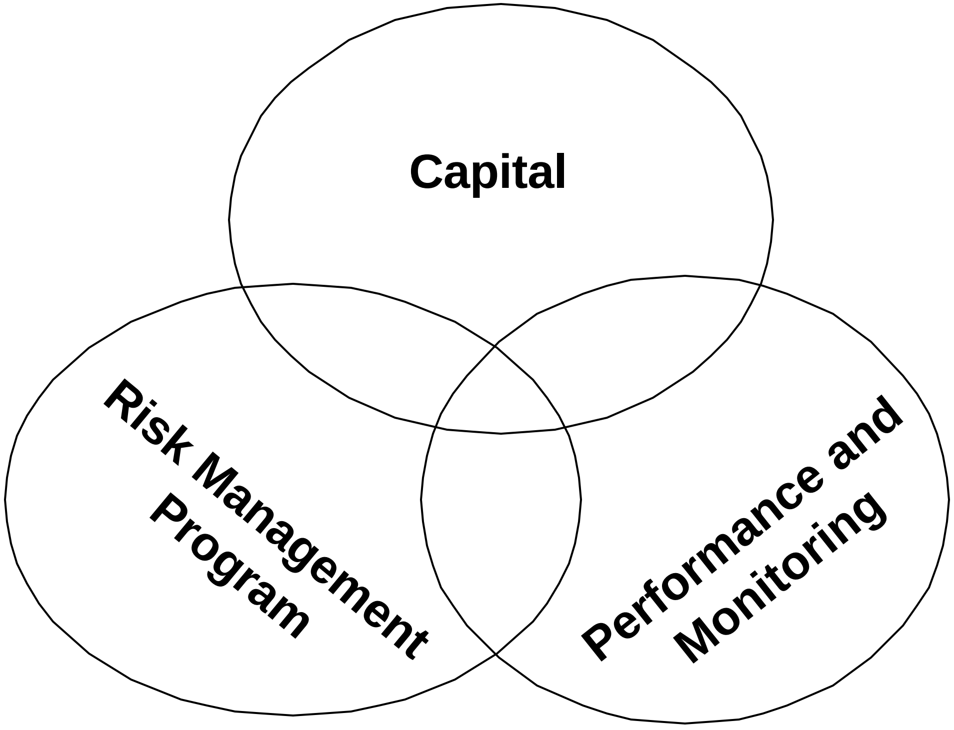
- Culture and behaviour
- Top-down leadership
- Bottom up involvement
- Simplicity
- Transparency

The Changing Face of the FS Industry

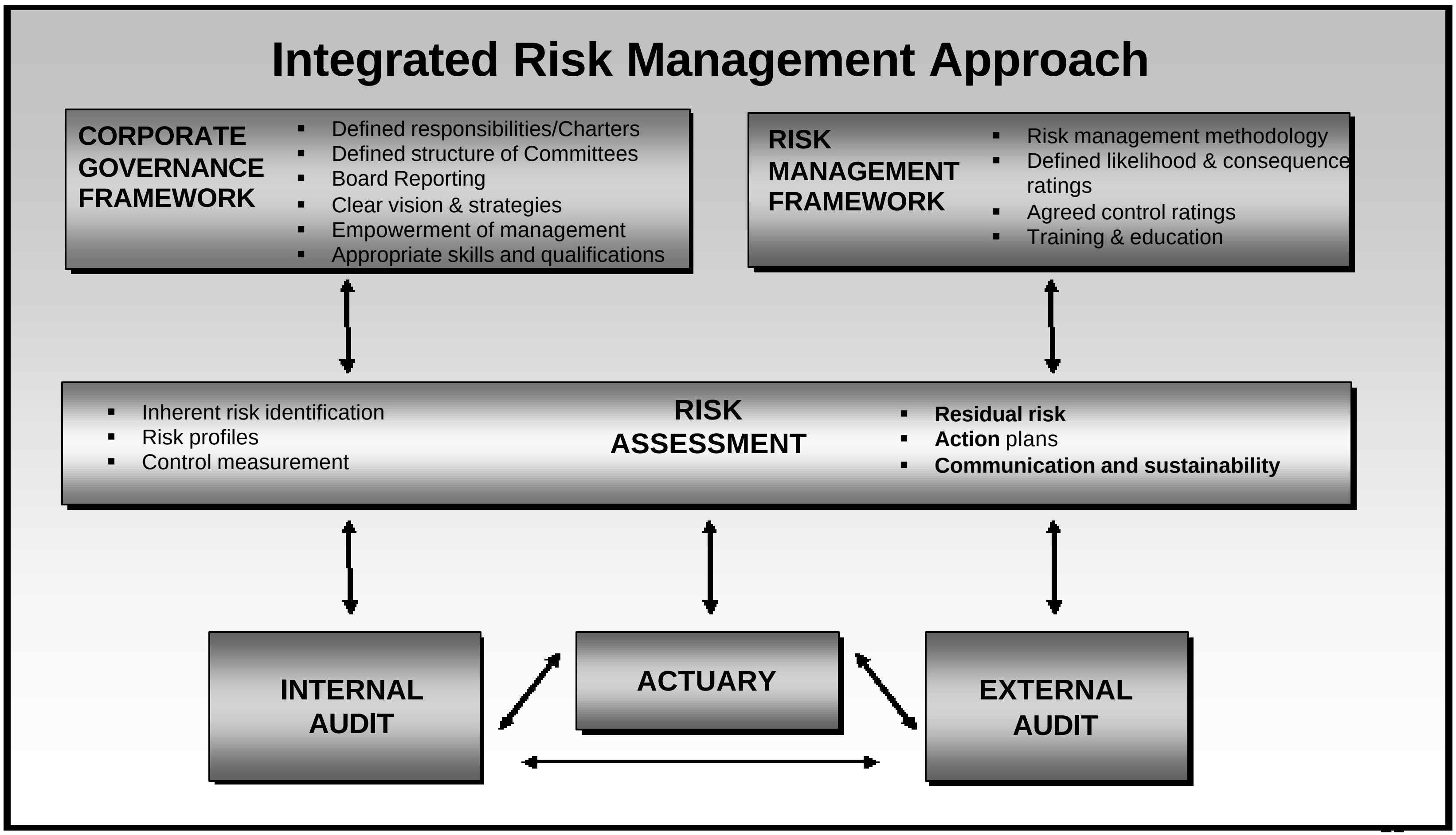
- Risk management has come of age
  - In the financial services industry there is growing urgency for improved risk management. This stems from factors such as
    - Accelerated demand and change
    - Industry failures leading to public/government anger
    - Industry consolidation
    - Industry convergence
    - Globalisation
    - Complex information systems

A Risk Management Program

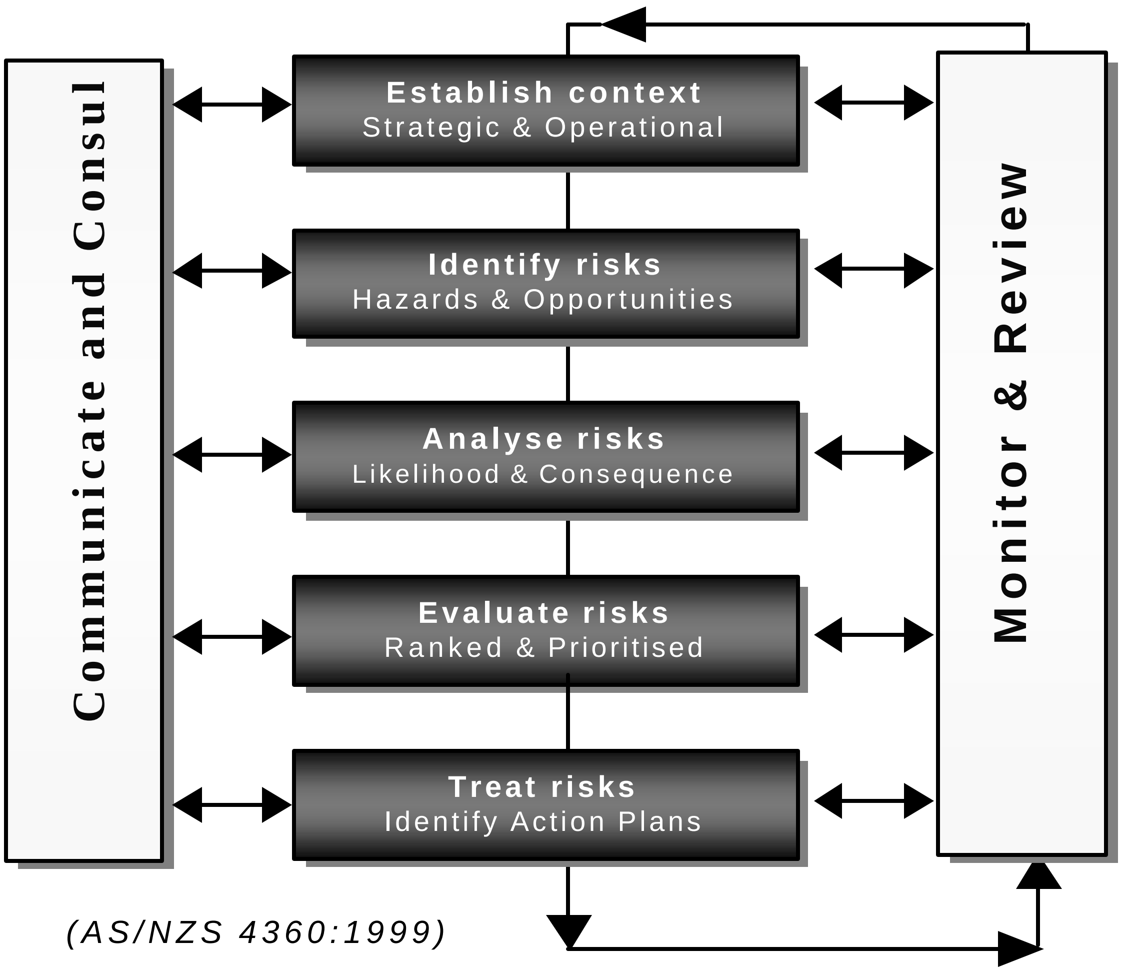
- What must a risk management program take into account?



Risk Management Approach



Risk Management Framework



(AS/NZS 4360:1999)

Inherent Risk Rating Matrix

High Risk

Likelihood					
5	6	7	8	9	10
4	5	6	7	8	9
3	4	5	6	7	8
2	3	4	5	6	7
1	2	3	4	5	6
	1	2	3	4	5
	Consequence				

Low Risk

High risk – Must complete control evaluation. Executive review.

Significant risk – Must complete control evaluation. Management review.

Moderate risk – Management responsibility must be defined. Control evaluation where appropriate.

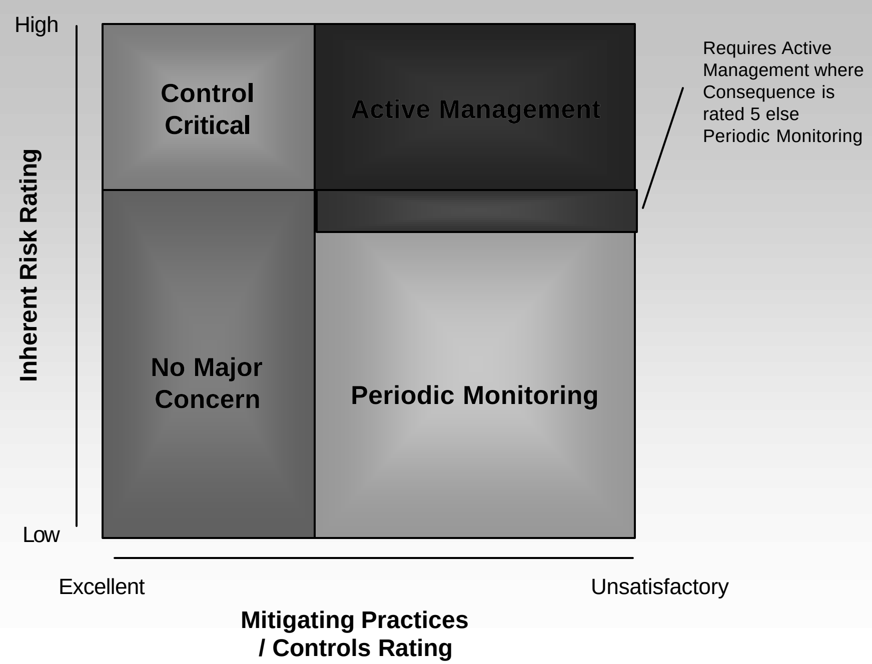
Low risk – Monitor. Examination of controls is not specifically required.

Mitigating Practices / Control Ratings

		RATING	DESCRIPTION
ADEQUATE	Excellent	1 or 2	The system is effective in mitigating the risk. Systems and processes exist to manager the risk and management accountability is assigned. The systems are well documented and regular monitoring and review indicates high compliance with the process.
	Good	3 or 4	Systems and processes exist which manage the risk. Some improvement opportunities have been identified but not yet actioned.
INADEQUATE	Fair	5 or 6	Systems and processes exist which partially mitigates the risk.
	Poor	7 or 8	The system and prices for managing the risk has been subject to major change or is in the process of being implemented and its effectiveness cannot be confirmed.
	Unsatisfactory	9 or 10	No system or process exists to manage the risk.

Trowbridge Deloitte

Risk Action Matrix



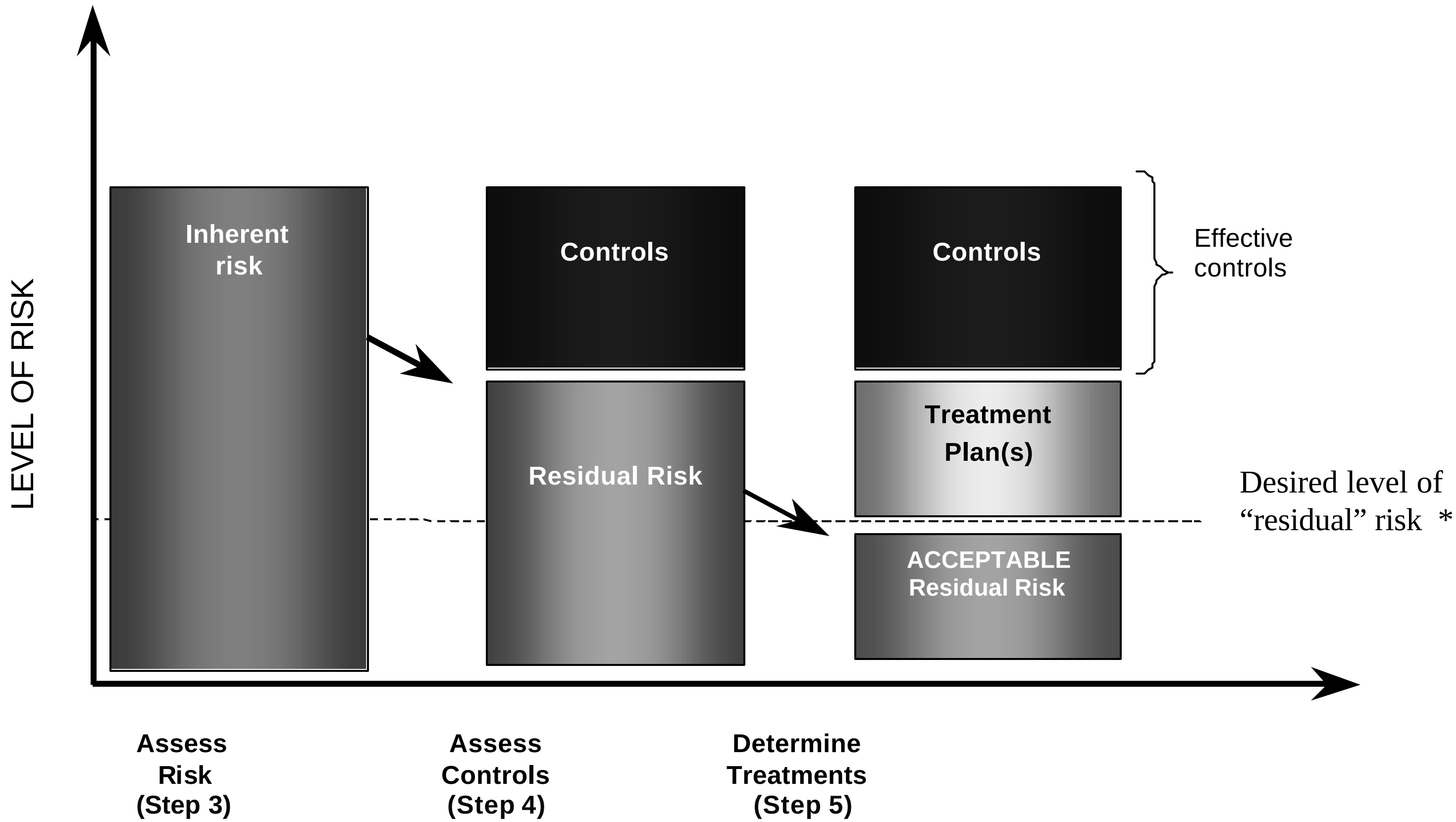
Active Management: Risks where treatment options require preparation, active review and management.

Control Critical: Control is adequate, continued monitoring of controls to confirm this.

Periodic Monitoring: Control is not strong but risk impact is not high. Options include improving control or monitoring risk impact to ensure the residual risk rating does not increase over time.

No Major Concern: Risks where systems and processes managing the risks are adequate. Consider excess or redundant controls.

Bridging the Gap



Benefits of Risk Management

- More effective strategic planning
- Better cost control
- Enhanced shareholder value by minimising losses and maximising opportunities
- Increased knowledge and understanding of exposure to risk
- A systematic, well-informed and thorough method of decision making
- Increased preparation for outside review
- Better utilisation of resources
- Strengthening culture for continued improvement
- Creating a best practice and quality organisation