



The Australian Prudential Regulation Authority, HIH and the NAB (A)

In August 2003, after only a few weeks as the head of the Australian Prudential Regulation Authority (APRA), the body responsible for supervising the deposit-taking, insurance and superannuation sectors, John Laker faced a problem. APRA investigations had indicated shortcomings in some of the risk management controls of one of Australia's largest financial institutions, the National Australia Bank (NAB). The problem had initially come to light in a routine APRA on-site visit to the bank in August 2002, prompting a warning to the NAB board. After another on-site visit in August 2003, NAB management still seemed to be dragging its heels. Laker was now faced with the task of determining APRA's response to the bank's inaction.

Complicating the situation was that the fledgling regulator was still reeling from the most demoralising episode in its brief history: the collapse of Australia's second largest insurer, Heath International Holdings (HIH) in March 2001. A subsequent Royal Commission had found that while APRA could not have prevented the company's failure, it warranted criticism for not recognising the severity of the situation and responding too slowly.

Establishing APRA

The Australian Prudential Regulation Authority (APRA) began life on July 1, 1998. It was an amalgamation of the former Insurance and Superannuation Commission (ISC), the prudential supervision function of the Reserve Bank of Australia plus nine other state

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and Commonwealth regulatory bodies. APRA was created to regulate banks, credit unions, building societies, insurance companies, friendly societies and superannuation funds. The *Australian Prudential Regulation Authority Act 1998* brought the regulator into being; its role was to set and uphold prudential standards in an effort to reduce the likelihood of such entities failing. This new integrated regulator came about as a result of the 1997 Financial System Inquiry, better known as the Wallis Report,¹ which was commissioned by the Federal Government in order to examine the adequacy of the regulatory framework governing the financial services sector. The recommendations included the creation of one body, APRA, to supervise the deposit-taking, insurance and superannuation industry. The *Commonwealth Authorities and Companies Act 1997*, which contains provisions relating to Commonwealth authorities (including reporting, and accountability, banking and investment, and conduct of executive officers) applies to APRA. There was some overlap in roles and functions between APRA and the Australian Securities and Investment Commission (ASIC), which was established in 1991.

All corporate entities in Australia were governed by the *Corporations Act 1989* (later amended in 2001), which ASIC administered. In contrast, APRA's responsibilities were confined to prudential supervision only of insurance companies, superannuation funds and authorised deposit taking institutions such as banks, which were deemed by government to require such supervision as to protect the public. ASIC was primarily concerned with accurate and adequate financial disclosure to the capital markets. APRA however, was concerned with ensuring that companies under its jurisdiction maintained a minimum level of financial system stability and preserve public confidence.

Due to the wide range of organisations APRA was responsible for supervising, there were similarly numerous pieces of legislation to administer including the *Superannuation Industry (Supervision) Act 1993*, *Retirement Savings Accounts Act 1997* and *Life Insurance Act 1995*. General insurers were regulated under the *Insurance Act 1973*. Introduced in response to a number of insurance company collapses, the Act gave APRA the authority, *inter alia*, to:

- grant and revoke authorisation to carry on insurance business
- determine prudential standards that general insurers are required to meet
- require information from an insurer
- order an independent investigation into an insurer.²

Prior to the Act, general insurers were only required to lodge a \$200,000 deposit with the Commonwealth Treasurer. Following the legislation, prudential requirements meant that insurers had to hold a minimum level of capital and have adequate reinsurance cover. The minimum statutory solvency requirement as contained in s. 29 of the *Insurance Act 1973*

¹ Named after the Chair of the Inquiry, Mr Stan Wallis

² Taken from the HIH Final Report, Section 3, Part 8.5: The Prudential Regulator – APRA, p.206.

required “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.”

APRA’s early years

Graeme Thompson was inaugural APRA CEO and an executive director of APRA. He came to the regulator from the Reserve Bank of Australia (RBA) where he had been deputy governor since 1993. The initial APRA board also consisted of seven non-executive directors including Jeffrey Carmichael (Chair), Donald Mercer, Ian MacFarlane, Alan Cameron, John Laker and David Knox. They were later joined by Marian Micalizzi. MacFarlane was also governor of the RBA while Cameron was also the ASIC chairman; their positions on the APRA board, as well as John Laker’s, were *ex officio* positions. The rest were drawn from private enterprise or academia.

The initial phase of APRA’s life was a busy one as the organisation was established. The bulk of the first year was devoted to practical matters: relocating head office, integrating staff from different organisations, establishing new employment terms and conditions, appointing new staff and developing infrastructure, internal processes and policy. Thompson outlined these difficulties in APRA’s first annual report:

“It has been a demanding year for our staff. True, we inherited experienced and professional people from the Insurance and Superannuation Commission and the Reserve Bank. But the transition to the new organisation was not easy for many of them – particularly for people who had enjoyed long and stable careers with their previous employer, and for those whose jobs were to move from the former ISC’s headquarters in Canberra to APRA’s head office in Sydney.”³

In July 1999, the state-based institutions transferred over to APRA and with them came 80 additional staff. However, APRA had lost some experienced employees in the transition, particularly in the area of general insurance. Thompson hoped to fill that gap via training and recruitment. Laker also recalled that it was a challenging time, but one full of promise: “There was no obligation to continue doing things a certain way; there was an excitement amongst staff about developing this agency and its approach. For many people it was a fresh start, offering different career opportunities and broader horizons.”

The new APRA structure was not fully in place until August, 1999 and then consisted of corporate support areas plus three new divisions (*Exhibit 1*): (1) Diversified Institutions; (2) Specialised Institutions; and (3) Policy, Research and Consulting. The Policy, Research and Consulting division existed to drive policy generation, monitor industry developments and provide support to the other divisions. Diversified Institutions was assigned large conglomerate groups comprised mainly of the larger banks and insurance companies and those with international connections. By contrast, Specialised Institutions supervised corporations whose activities were confined to one area only, for example,

³ APRA 1999 Annual Report, p.5.

credit unions and superannuation funds. There was also a Risk Management and Audit Committee.

This structure was quite a radical departure from prudential regulators in other industrialised nations. Instead of organising operations along industry lines (e.g. Banking Division, Insurance Division, Superannuation Division, etc) they were grouped according to the complexity of the institutions supervised. The rationale was that having a division focusing on diversified institutions would help APRA monitor conglomerates more effectively and gain experience to assist in developing practical conglomerate prudential requirements. Although Canada and several Scandinavian countries had integrated regulators, “most of them just put the different sectors together under one roof, but nothing really changed,” said Tom Karp, who headed Diversified Institutions.

During 1999-2000, the Diversified Institutions and Specialised Institutions divisions accounted for approximately 60 percent of APRA staff⁴ and were responsible for day-to-day supervisory activities and enforcement. Diversified Institutions was based in Sydney and comprised three branches, each of which performed financial and risk assessments of institutions. Each branch was assigned at least one large insurance conglomerate and a financial group headed by a major Australian bank. A fourth branch also existed to supply legal and technical support to the three branches. As of 30 June 2000, Diversified Institutions was responsible for 46 of the 50 banks in Australia.

The Specialised Institutions division dealt with a much larger number of smaller institutions (mainly superannuation funds). In addition, these activities were primarily limited to Australia. Specialised Institutions was split into three geographical regions; Central, Northern and Southern.⁵ There was also an additional Coordination, Rehabilitation and Enforcement group to ensure consistency and provide frontline support for each region. The numbers in each category of APRA-regulated institutions are detailed in *Exhibit 2*.

Besides setting up supervisory protocols, cross-skilling staff who previously only had experience with one industry was a high priority. Because of APRA’s structure, analysts could be looking at an insurance company one day, a bank the next. Basically, teams were meant to identify companies at risk, take steps to reduce that risk or help companies exit the industry with minimum disruption to depositors or policy-holders. For the most part, this was done via risk analysis and both formal and informal consultations with the company and relevant experts. During 1999-2000, the Diversified Division had 63 consultations with companies and 33 formal meetings. The Specialised Division conducted 534 on-site visits during the year and conducted 314 reviews of

⁴ APRA 2000 Annual Report, p.13.

⁵ The Central Region was Sydney-based and covered most of New South Wales; the Northern Region was Brisbane-based and took in Queensland plus far-north NSW and the Southern region had Melbourne, Adelaide and Perth offices and encompassed the remaining states plus the Northern Territory and far-west NSW.

superannuation institutions. They also had three auditors disqualified and 23 superannuation funds declared non-compliant.⁶

APRA's operating expenditure for the 1999-2000 financial year was \$52.6 million and funding came predominately from levies imposed on regulated financial institutions.⁷ (However, as John Laker noted, APRA had no discretion to set the fees or charges themselves. They had to be approved by the Federal Government after consultation with industry.) Industry often called for the "Wallis dividend" so APRA was under pressure to reduce overall supervision costs below the total of the previous agencies. In their summation of the year past, Graeme Thompson and Jeffrey Carmichael, the Chair, wrote: "In day-to-day supervision, 1999-2000 was relatively uneventful – given the healthy state of the Australian economy and financial system."⁸ But although APRA had experienced relatively smooth sailing supervision-wise, 2000-2001 was set to change all that.

APRA and the insurance industry

There was a wide range of institutions under the APRA umbrella and each industry group had a different regulatory history pre-APRA. Coming from the RBA, John Laker was well acquainted with the banking industry. During the time that banks were the RBA's responsibility, he observed what was termed the "light touch" approach to regulation. Based on a culture of mutual trust and respect, "one raised eyebrow" from the RBA was usually enough to ensure compliance from an institution. Dubbed the "tea and bikkies" approach, incentives and sanctions were meted out (mostly) in private. But it worked, according to Laker, because the prudential framework developed for banks was extremely strong. "That style of dealing with the banks continued at APRA," Laker recalled, "and that's the way we were used to dealing with institutions of integrity."

Karp, previously of the ISC, observed a broadly similar approach there. "The whole style of supervision was non-intrusive. There were some restrictions... but it was mostly a situation whereby if a company met the basic requirements, the regulator stayed out of the way and simply got financial returns to look at." After the formation of APRA, little changed:

"We came up with a high level of supervision philosophy which wasn't that much different... we were dealing with mostly large and sophisticated institutions who mostly knew what they're doing so we [thought] we shouldn't be getting in their way unless we had good reason to... That works while things are going well; it also works if people are relatively honest with you and come to you with their problems upfront."

However, according to John Laker, general insurance regulation "was, so to speak, back in the Dark Ages compared to banking regulation. The whole approach was based on the 1973 legislation." Outmoded and fragmented legislation proved particularly challenging for Tom Karp as he tried to supervise large conglomerates: "One of the complexities was

⁶ Op. cit., pp. 15-16.

⁷ Ibid., pp. 45-46.

⁸ Ibid., p. 4.

that the legislation we were administering was still industry-based. So all of our powers applied to entities which had a licence under each of those Acts, but we didn't have any powers over the whole group as a whole. The practicality was that groups were managed and run as groups even though they consisted of separate legal entities."

Although APRA had a range of options when it came to enforcement, Laker recalled that "... there was a perception in APRA that there was a huge gap in the range of instruments. The way we understood it at board level was that the only option APRA had to deal with a general insurance company that was troubled was to appoint an inspector. Now once appointing an inspector becomes public, the risks become self-fulfilling because investors won't touch the company." Laker described it as "the thermonuclear option" and given its potential to make perhaps only a minor situation dire, it was used sparingly.

Karp was also aware that a culture of cautiousness had been inherited from predecessor organisations and prior events. He remembered a number of occasions where the ISC or APRA had taken action against companies only to be defeated in the courts or overruled by government. It had a lasting impact:

"There was a bit of hesitancy to use our powers to the full and unfortunately that got inculcated. It was almost a sense of, 'Yeah legally we have the powers but we don't really think we can use them.' All of these things build up a mindset that doesn't really give you a lot of confidence to go out and pursue these actions even though the law says you can."

These problems were also compounded by a lack of appropriately skilled staff. As John Laker noted:

"... some very good staff stayed with APRA, but there was a period when we were losing numbers [and] expertise and quite young people were given quite senior responsibilities. [They would be] peering at the other side of the table at hardened and crusty old general insurers and bankers and would have looked pretty young and raw. I think there was a certain period when we were under-resourced in skills and numbers and savvy."

As such, the newly-formed APRA wasn't seen as particularly threatening. "[C]ertainly in general insurance APRA was not highly respected or feared," Laker said. But while the fledgling regulator was still finding its feet, important developments were occurring at a major insurance company.

HIH

Heath International Holdings Limited, or HIH as it was known, had origins stretching back to 1968 when Ray Williams and Michael Payne established the company. At that time, their core business was the writing of workers' compensation insurance in Victoria. In 1971, the company was acquired by C E Heath, and Ray Williams saw the business diversify into property and commercial insurance plus professional liability. The company also began to venture overseas; first to Hong Kong, then California and the UK.

After listing on the stock exchange in 1992, HIH embarked on an increasingly ambitious expansion programme, locally and internationally. Despite misgivings outlined in due diligence reports, the then ISC approved the sale of the CIC Insurance group to HIH in 1995. By early 1999, HIH had purchased Australian insurer FAI for \$300 million but without performing due diligence. The ISC had encountered problems with FAI in the past. Nonetheless, the transaction proceeded and major FAI shareholder Rodney Alder was appointed to the HIH board.⁹

Signs of trouble

Over the years, the value of reported assets rose steadily (*Exhibit 3*). However the UK operations were foundering and news from the US was little better. These failures began to impact significantly and in the 1998/1999 financial year the company reported its first ever loss - \$21.2 million.¹⁰ Around this time, institutional support of HIH started to diminish with the exit of a major shareholder in 1998. In early 2000, APRA became aware that HIH was investing heavily in reinsurance possibly for the purposes of “profit smoothing”. Many of these reinsurance deals were little more than cleverly disguised loans.

HIH’s troubles were multiplying; by mid-2000 they had performed a \$400 million write-down of FAI assets. At this point, media reports critical of HIH’s business and investment practices started to appear. APRA also received a disturbing report from an anonymous former employee entitled: “HIH Insurance due diligence”. September and October 2000 saw an exodus at the executive level. Four directors resigned and Ray Williams also announced he would step aside once the CEO vacancy was filled.

In September 2000, HIH sold off some of its most profitable insurance lines to Allianz for \$200 million.¹¹ Further lack of performance led Standard and Poor’s to drop their credit rating. The share price continued to fall. From a peak of \$3.70 in 1997, it plummeted to \$0.31 by November 2000.¹²

March/April 2000 was when APRA had its first inkling that all was not well at HIH. APRA then began pushing issues and, in August 2000, began making more detailed inquiries. Some of the company’s figures didn’t quite tally. News of the further deterioration of US and UK assets had also reached APRA. Even so, the situation didn’t look bleak: “It wasn’t as if all of a sudden here’s this big black hole, it was more [a case of] ‘This doesn’t look quite right.’ It wasn’t until quite late in 2000 that we became really concerned,” recalled Karp.

⁹ Adapted from HIH Final Report, Part 2, Section 3.3: The FAI acquisition, p. 56.

¹⁰ HIH Final Report, Vol. 1, Contents: The failure of HIH: A critical assessment, p. xiii.

¹¹ HIH Final Report, part 2, Section 3.5: The final days, p. 59.

¹² Ibid Section 3.6: Share performance in the last years, p.62.

Craig Thorburn was General Manager of Branch 1, the branch responsible for monitoring HIH. After meeting with the company in October 2000, he still was satisfied that HIH would be able to meet their solvency requirements. A report to that effect was sent to the board, quieting their concerns. As Laker remarked: “There were times when the board was picking up market intelligence... when we were hearing and reading about HIH being on the nose. And when we raised those with staff, we were given reassurance that it was just Rodney Adler and his machinations. The board was never given any reason to be seized with concern over HIH.”

According to Karp, the reason for this was twofold; firstly, HIH was simply lying about their position and supplying APRA was appropriately fudged documentation; secondly, some fancy accounting practices ensured that there were too many pieces of the puzzle to assemble: “HIH... had a number of general insurance companies, some of which operated in the UK, US and even South America. We only had regulatory reach over the Australian licensed insurers. In terms of information at the group level, all we could legally get was the public information.”

As APRA started to probe more deeply, a major Australian bank Westpac was already quite concerned about the future of HIH. Worried about outstanding loans, they commissioned an Ernst and Young report in October 2000 and the results weren't promising. It described the company's financial position as “delicately poised.”¹³ In December, Craig Thorburn was delivered a copy of the report. He quickly scanned the executive summary before heading off on a scheduled overseas trip.

HIH Folds

As the end of 2000 approached, the situation at HIH had deteriorated inexorably. Despite efforts to shore up their position, there was a serious cash flow problem and the company decided to delay payments to policy-holders and creditors. In February, HIH shares were suspended from trading by ASIC as the company could not tell the market how large its losses to 31 December, 2000 would be. At the same time ASIC launched an inquiry into HIH. On 1 March, 2001 APRA served notices calling on HIH to show cause why an inspector should not be appointed under s. 52 of the *Insurance Act 1973*. It was only at this point that the severity of the situation became clear to the APRA board, “The board never got a sense of how serious it was until right at the very end,” Laker said.

HIH engaged KPMG to carry out a solvency review and in the meantime directors and senior management siphoned off the last remaining funds until the company was placed in provisional liquidation on 15 March. HIH was Australia's second largest general insurer. That same day, after the legally required 14-day response period to the show cause notice expired, APRA appointed its own inspector to investigate HIH.

With estimated losses in the region of \$3.6-\$5.3 billion, HIH looked likely to snare the title of Australia's largest corporate disaster. As news of the collapse broke, numerous

¹³ Op.cit.

stories of personal hardship emerged; retirees left penniless, families left homeless and businesses ruined. More than 1000 employees now faced the prospect of unemployment.¹⁴ In total, approximately two million policyholders were left exposed,¹⁵ and the consequences were far-reaching. As one of Australia's largest builders' warranty insurers, the failure put a stop to construction work on sites throughout the country. Festivals and local events were cancelled as they now lacked public liability cover.

But from the immediate impact of the collapse, attention soon turned to APRA. Media reports began to question APRA's role in the disaster. Ten days after the first release, APRA responded to articles in the *Australian Financial Review* and the *Sydney Morning Herald* which claimed that Graeme Thompson said APRA did not launch a formal investigation because of fears it would upset the market and damage the company (*Exhibit 4*). A few days later another release outlined proposed reforms to the *Insurance Act 1973* that APRA had been working on since 1999. These amendments to the Act would include:

- more consistent, rigorous and reliable valuation of insurance liabilities, supported by expert actuarial advice;
- capital requirements more sensitive to each general insurer's risk profile;
- increased focus on corporate governance, ensuring that company Boards are well equipped to fulfil their responsibilities to policyholders and other parties.¹⁶

However, this did little to quell suggestions that APRA was too slow to act. On 31 March, APRA issued another statement explaining that there was not legal basis for them to have acted sooner as HIH appeared to be solvent. APRA pointed out that HIH's demise was years in the making, not months.

By 17 May, the State and Federal Governments had approved a \$640 million assistance package for the public,¹⁷ covering outstanding builders' warranties and compulsory third party claims plus other claims in cases of "genuine hardship". But by this stage state Premiers and industry figures alike were demanding a Royal Commission. Graeme Thompson also appeared on ABC Radio lending his support to an inquiry: "The public deserves a full explanation and a full accounting of what's happened here. That clearly involves APRA."¹⁸

¹⁴ 'Union warns of HIH workers' entitlements,' *AAP Newsfeed*, 17 May, 2001.

¹⁵ Kerr, A. and Skelsey, M., 'Renovations go on for Ray – The HIH Collapse', *The Daily Telegraph*, 16 May 2001.

¹⁶ 'APRA's proposals for reform of the prudential supervision framework for general insurance companies', 29 March 2001, APRA Press Release No. 01.07.

¹⁷ HIH Final Report, Part 2, Section 3.7: The response to the collapse, p. 62.

¹⁸ Epstein, R., 'The World Today', ABC Radio Broadcast, 17 May 2001.

The Royal Commission

On 21 May, the Federal Government finally announced that a Royal Commission would be held, and on 18 June, 2001 appointed West Australian Supreme Court Justice Neville Owen to head it. Commencing at the beginning of September, the Commission's final report was due on 30 June, 2002. Its terms of reference (*Exhibit 5*) charged it with identifying the people responsible for the failure of HIH and to what extent they had contributed to the collapse. Justice Owen was also required to examine the regulatory bodies responsible for monitoring HIH. The Royal Commission's investigative team was large, consisting of 70 people at its peak, most with specialised legal and financial expertise. Public hearings began in December 2001, when the Commission started calling the 126 witnesses listed.¹⁹

But before the hearings began, a Senate inquiry into prudential supervision and consumer protection was conducted. Though not specifically focussed on HIH, the findings didn't augur well. APRA was found to be slow to respond to warning signs that financial institutions were in trouble. This problem was compounded by what Senator Nick Sherry described as "spaghetti regulation" – a system that was too complex, messy and confusing.²⁰

APRA takes the stand

Due to the sheer volume of work, APRA representatives weren't called to the stand until late 2002. In the interim, the public heard from some of the key players at HIH, including Ray Williams and Rodney Adler. Details soon emerged about lavish corporate donations, generous remuneration packages, rash decision-making and dubious accounting practices. The media seized upon examples such as \$10,000 watches for employees; corporate credit cards with no spending limits; and the marble and gold bathroom in Ray Williams' Melbourne office.²¹

In November, branch manager Craig Thorburn was one of the first to take the stand for APRA. He had recently left the regulator to take up a position at the World Bank. Through his testimony it became apparent that he spent a great deal of his time (15 weeks in 2000) attending conferences and other work-related meetings overseas. Thorburn admitted he only skimmed the Ernst & Young report detailing HIH's woes. Indeed, he had misinterpreted the phrase "delicately poised" to mean that HIH was on the threshold of a new direction. He had passed on the report to his supervisor Tom Karp, who read it in February, 2001. Thorburn did not read the report in its entirety until August 2002.

It also became apparent that Thorburn had limited personal experience in supervising general insurers. During the October 2000 meetings with HIH, he took company figures at face value. In addition, APRA's serious staffing problems came to light. Most

¹⁹ HIH Royal Commission Final Report Vol. 1, Part 1, Section 2: How the inquiry was conducted, p. 25.

²⁰ Hanna, J, and Hughes, K., 'APRA criticised after HIH, super fund collapses', *AAP*, 21 August 2001.

²¹ Walker, K., 'Gifts and gratuities abounded in last days of HIH: hearing', *AAP*, 7 August 2002.

crucially, from September 2000, the team assigned to HIH only had three of the eight analysts required. Of those three, two were not fully functional. Under cross-examination, Thorburn had little explanation (*Exhibit 6*).

APRA testimony revealed that from the board down, there was the tendency to delegate supervisory matters to subordinates who were assumed to have matters under control. Graeme Thompson revealed that he was largely removed from daily supervisory activity. He admitted under cross-examination that he had been APRA CEO some 18 months before he knew what a prudential margin was. In a witness statement tendered to the court he explained his distance:

“In the latter half of 1998 (and through most of 1999), my focus was almost entirely on organisational and industrial issues connected with the formation and establishment of APRA. It was my judgement, and as I understood it that of APRA’s Chair, Dr Carmichael, and of the APRA board that this was an appropriate and desirable utilisation of my energies and time. It was, and is, my assessment that this judgement was correctly made and that, in those circumstances, it would not have been practicable for me to have paid FAI and HIH (or any other supervised entity) the kind of detailed scrutiny suggested by Mr Martin’s questions.”²²

The Commission also received the Palmer Report as evidence. Commissioned by APRA, it was written by John Palmer, a respected former head of Canada’s integrated regulator (OSFI), who Laker said was given “a warts-and-all” brief to critically examine APRA. Palmer outlined how systemic challenges severely inhibited APRA’s ability to monitor HIH effectively, especially given that APRA was still establishing itself as HIH was beginning to decline. He concluded that APRA couldn’t have intervened much earlier than September 2000 – already too late to have much impact. However, Palmer was still critical of APRA’s failure to adequately recognise or respond to the problems at HIH.

The findings

After 203 days of hearings, the Commission finally wound up in February 2003. In total, the Commission produced 19,500 pages of transcript and cost \$39.7 million.²³ The Royal Commission’s final report was delivered to the Federal Government on 4 April, 2003. Justice Owen found that numerous factors had contributed to the company’s demise. In his summation, he laid the greatest share of the blame with those at 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.

²² HIH Royal Commission, Supplementary Statement of Graeme John Thompson, 8 November 2002, para. 6.

²³ ‘Factbook: Snapshot of the HIH inquiry,’ *AAP*, 7 February 2003.

“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.”²⁴

Unfavourable market conditions for insurers generally, poor auditing and the failure of the HIH board to intervene compounded the effects of mismanagement. With regard to APRA, Justice Owen acknowledged that HIH had been on a collision course with insolvency long before March 2001. He summed up APRA’s role thus:

“APRA’s performance in supervising HIH was not good. It missed many warning signs, was slow to act, and made misjudgements about some vital matters. But... APRA did not cause of 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.”²⁵

Owen went on to acknowledge the specific handicaps faced by APRA which included establishing a new supervisory regime, relocation, high levels of staff attrition and loss of general insurance skills. APRA was still essentially in transition from July 1998 to March 2001.

Justice Owen also recognised that APRA had been misled by HIH on a number of occasions and that the provision of information was sometimes significantly delayed. However, despite the difficulties facing APRA he believed the regulator should have pursued HIH more vigorously, “... 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 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.”²⁶ In addition, 56 possible breaches of the law were referred to ASIC and the Director of Public Prosecutions for investigation. ASIC was spared any significant criticism.

APRA’s response

For APRA, the Royal Commission’s revelations were extremely damaging. John Laker admitted, “It was soul-destroying. And APRA copped it sweet on that. We said ‘yeah we were misled, we were fundamentally misled by HIH but there was enough of an odour and we should have picked it up.’” He acknowledged that although there were supervisory procedures in place, they simply weren’t adequate:

²⁴ HIH Final Report Vol. 1, Contents: The failure of HIH: A critical assessment, p. xiii.

²⁵ Ibid.

²⁶ Ibid.

“Looking at data that might be well over a month or two old doesn’t give you a full sense of how well an institution is going. Sitting down across the table, reviewing risk management plans, talking about bad loans or strategic issues – that interface is quite critical. And we were not engaged enough with HIH. It was not the tradition to be visiting these institutions on a regular basis, working closely with them and breathing down their necks.”

However, though the law and APRA’s protocols weren’t perfect, Laker reflected that, “... there were other options that we didn’t see the need to use up to that point... If we had been sufficiently sceptical about HIH and its prospects we could have asked for an independent actuarial review. But all the way through the staff involved were saying ‘it’s okay’. They were just coned. There was a naïveté there that was exposed startlingly by the Royal Commission.” APRA was forced to re-examine not only the adequacy of its prudential framework but also the premise upon which it was based. As Laker commented: “We put in place a methodology for supervising large complex institutions predicated on the notion that the institutions were ones of honesty and integrity... We had no way in that framework to cope with an institution that was predisposed to lying.”

So predisposed, Karp believed, that, “They (HIH) didn’t realize how bad a situation they’d got themselves into. As they were trying to hide things from us, they were actually conning themselves.”

The recommendations

The HIH Final Report contained a total of 61 recommendations designed to improve regulation of the general insurance industry. The Report also recommended the establishment of a policy-holder support scheme in the event of future collapses. Overall, the report concluded that prudential regulation of general insurance should still be left to APRA. However, significant changes were outlined. The 24 recommendations that related specifically to APRA included:

- Replacing APRA’s non-executive with an executive group. This group would comprise the chief executive officer and two or three executive commissioners who would carry the responsibility for APRA’s performance. (the Report also recommended rescinding the ASIC and the RBA’s places on the APRA board).
- Instigating an urgent review of APRA’s organisational structure and considering the creation of a specialist team to supervise general insurers.
- Implementing a programme to build the skills of staff involved in the supervision of general insurers.
- Developing a more sceptical, questioning and, where necessary, aggressive regulated entities’ timely compliance in the lodging of returns and the provision of information.²⁷

The outcomes

The Federal Government accepted the Commission’s report and announced that it would restructure the APRA board accordingly. Even though the Commission had cleared APRA from having any involvement in the collapse, it was still a public relations

²⁷ Adapted from HIH Final Report Vol.1, Contents: Policy Recommendations, p. lxxv.

disaster. During and after the hearings, headlines such as “Insurance regulator ‘failed’ doomed HIH” and “Heads that were in the sand will now roll” appeared.

The Commonwealth Government had received 11,400 applications for the HIH Claims Support Scheme, with 5850 approved by February 2003. At that point, a total of \$195 million had already been paid out. The HIH collapse had also contributed to a wider public liability crisis. Changes to tort law were proposed in several states in order to limit damages and hopefully bring insurance premiums down. Amendments to the *Insurance Act 1973* which tightened up prudential standards had already been passed and came into effect on 1 July, 2002. In May, the Federal Government announced \$28.2 million in extra funding for ASIC to investigate breaches of the law outlined in the Royal Commission report.

For the main architects of HIH’s demise, charges started to pile up. In July 2003, former HIH director Rodney Alder was committed to stand trial on three charges of manipulating the stockmarket and two charges of making false or misleading statements. He had previously been banned from being a company director for 20 years, was fined \$900,000 and ordered to pay \$7 million in compensation.²⁸ In December 2003, former FAI director Brad Cooper was committed to stand trial on six charges of offering bribes and seven of making false statements for material advantage. As for HIH founder and CEO Ray Williams, he was banned from directorship for 10 years and fined \$250,000 by ASIC. Three charges of breaching the *Corporations Act* were eventually laid, including providing false or misleading information.²⁹

The exit of HIH, a major provider of professional indemnity insurance, from the market saw the number of insurers offering similar cover drop by two-thirds. Premiums rose by 36 percent in 2002, prompting many doctors in high-risk fields such as obstetrics to abandon their practices or retire early. During the same period, public liability insurance premiums had risen by 44 percent.³⁰ This made it increasingly difficult for many councils, schools and community groups to stage activities like workshops, fetes and parades.

Graeme Thompson’s term at APRA expired at the end of June 2003 and he was not reappointed by the Federal Government.³¹ At the end of June, Dr John Laker was announced as the new APRA chairman. Ross Jones, formerly of the Australian Commission and Consumer Commission, was made deputy chairman. Joining them on the new board was Steve Somogyi, previously chief executive of paper company CPI Group but with a long career in insurance. John Laker took up his new position on 1 July.

²⁸ Milligan, L., ‘Adler QC argues for trial stay’, *The Australian*, December 16, 2003.

²⁹ Ray Williams pled guilty to each charge in December 2004, facing a maximum of 5 years imprisonment and \$55,000 fine. ‘Former HIH CEO pleads guilty’, *The Age*, 15 December 2004.

³⁰ Taylor, M., ‘Careful – they might sue you’, *Money Management (Australia)*, September 29, 2003.

³¹ Wright L., ‘APRA boss pays price for HIH debacle’, *Canberra Times*, 6 June 2003.

Moving on from HIH

Laker knew that restoring public confidence would be a challenge. Early into his tenure, he commented publicly that although significant progress had been made already, APRA needed to be better resourced and more active. To this end, he approached the Federal Government for budgetary approval to seek extra funding from industry, which was granted. The Government had agreed to some increases in APRA's funding in the two years after HIH collapsed, but more was needed to begin to bring APRA towards the funding levels of peer regulators elsewhere around the world. But Laker knew that, as always, most of APRA's achievements were likely to go unrecognised: "You don't hear about the successes, just the failures. Our work is mostly based on cooperation with regulated institutions and we're most concerned with the long-term survival of an entity. The danger is that any action we take can be overblown by the market, and that can undermine the objectives we are pursuing." But one of his most important tasks was restoring APRA's confidence in itself:

"My first priority was to steady the ship and be visible as the leader... There had been enough bloodletting. It was very difficult for Graeme Thompson in those latter months not knowing if he was going to be reappointed and being heavily criticised in the Royal Commission, as were other senior staff. It was hard to rebuild morale when you've just taken such a beating. But one thing about a new team is that people give you the benefit of the doubt and a measure of goodwill. What I needed to do was to use that goodwill and continue to do the very good work that APRA had been going across a range of areas. That good work was being overshadowed by HIH."

Tom Karp was still on the regulatory frontline and found HIH a lesson well learnt:

"A number of us had been seriously affected and burnt by the HIH experience. What it did was make us realise that we just have to be far more cynical and less trusting – even though you know the senior management, you meet them regularly and in some cases have known them professionally for years. It brought home strongly that that's all very well but if something starts to smell, your bristles need to go up, you need to be extremely alert and just keep asking questions until you are satisfied. Even though people have always been honest with you in the past, if something goes wrong chances are they'll be under pressure and trying to cover their backsides."

However, there was a new cause for concern at APRA. In August 2002, APRA had made a site visit to the National Australia Bank (NAB), one of Australia's largest financial institutions. As a result, APRA identified some problems with the NAB's risk management controls on its foreign exchange desk. In January 2003 APRA wrote to the Executive General Manager Group, Risk Management and to the chairman of the board of NAB. This letter was not tabled with the board and the Principal Board Audit Committee did not see it until May. But more than six months after the January letter, the problems had still not been addressed as APRA discovered on a later on-site visit in August 2003.

Laker recalled a fairly robust exchange between the parties over the matter. Instead of being eager to comply, NAB risk management was dragging its heels. Tom Karp, who was working on the NAB matter said, "They weren't totally dismissing us; they were making some progress but they weren't taking us as seriously as they should have and

they weren't fixing things up as quickly as they should have." APRA knew that the problems at NAB weren't going to "break the bank". However, some institutions comparable to the NAB had been visited by APRA in the past and told to smarten up their act. It was up to John Laker and his fellow APRA members to decide how to pursue the bank.

Exhibit 1: APRA organization chart, 1999

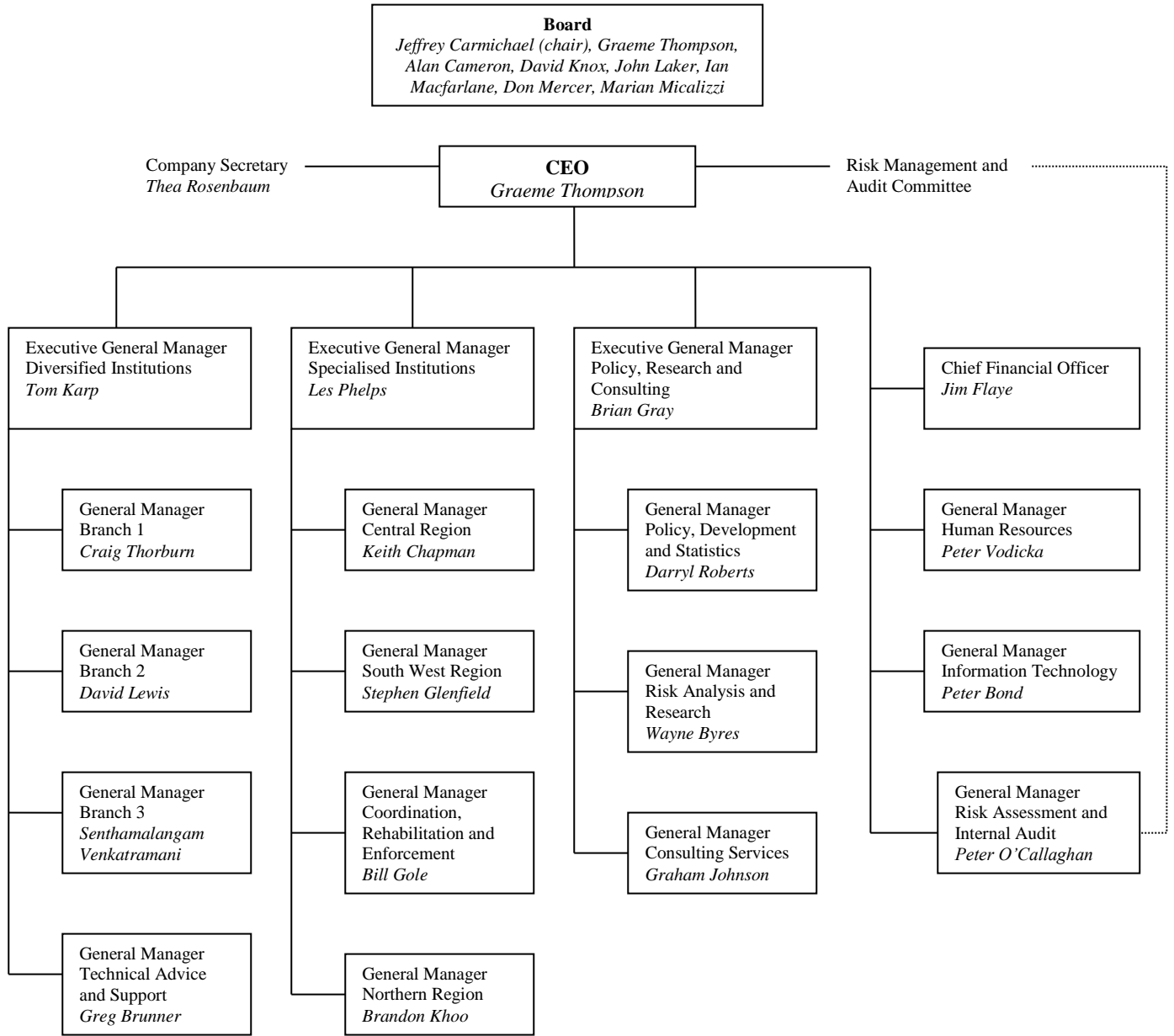


Exhibit 2: APRA – regulated institution³²

Type of Institution	Number of institutions		Total assets (\$billions)	
	Diversified Institutions	Specialised Institutions	Diversified Institutions	Specialised Institutions
Authorised deposit taking institutions	49	241	690	48
Friendly societies	1	53	-	6
General insurers	120	39	59	4
Life insurers	40	3	183	3
Representative offices of foreign banks	-	26	-	0
Superannuation entities	130	2800	181	138
Total	340	3162	1073	200

³² Figures obtained from APRA 2000 Annual Report, p. 14.

Exhibit 3: HIH Insurance: reported contributions to total assets, 1994 to 2000³³
(A\$ Million)

Geographical Area	Year to December				18 months to June 1999	Year to June 2000
	1994	1995	1996	1997		
Australia	1 016.5	2 340.8	2 647.7	2 861.4	6 034.8	6 008.3
United Kingdom	62.8	111.3	132.4	377.9	625.0	949.0
United States	17.7	39.1	106.3	502.6	733.9	762.5
New Zealand	68.3	125.1	135.0	153.7	205.6	310.3
Asia	35.7	49.0	95.0	78.0	92.2	246.8
Argentina	10.5	13.1	33.9	50.2
Total	1 201.0	2 665.3	3 126.7	3 986.7	7 725.4	8 327.1

³³ Take from HIH Final Report, Part 2, section 3: A brief corporate history.

Exhibit 4: APRA Media Release, 26 March 2001

HIH-Insurance

26 March 2001

No: 01_06

Embargo: For Immediate Release

Some comments by the Australian Prudential Regulation Authority's Chief Executive Officer, Graeme Thompson, about the HIH situation were misreported in the Australian Financial Review on 23 March (p. 46) and again in the Sydney Morning Herald on 24 March (p. 26)

Mr Thompson has never said the APRA did not take steps to launch a formal investigation into HIH because of concerns such a move could alarm the market and damage the company.

Mr Thompson has said that it is a big step for a prudential supervisor like APRA to appoint an inspector to a public company – and it needs to have solid grounds to take such a step. In APRA's judgment, it did not have those grounds until very recently.

Apart from needing to observe legal requirements, premature action by a prudential supervisor can make things worse, rather than better. The vast majority of the HIH Group's policyholders are in a better position now, as a result of arrangements made with other insurers, than they would have been if APRA had moved to appoint an inspector three months ago.

APRA staff have worked very hard in recent weeks and months to facilitate those arrangements that not protect most of HIH's policyholders. For further information contact:

Gloria Peterson
Public Affairs Manager
02 9210 3385

Australian Prudential Regulation Authority
www.apra.gov.au

Exhibit 5: ARPA Media Release, 31 May 2001

HIH Insurance – APRA’s Role

Thursday, 31 May 2001

No: 01_08

Embargo: For Immediate Release

In response to continuing suggestions that it should have acted earlier in appointing an inspector to failed insurance company HIH, the Australian Prudential Regulation Authority (APRA) today released the following statement clarifying its role and actions.

1. First, it has been correctly recognised the APRA’s major power under the *Insurance Act 1973* is the appointment of an inspector. This is usually the first step towards liquidation and, rightly, there are some legal protections in the Act to ensure that this power is not used capriciously.

Until recently, APRA did not have solid legal grounds under the Act for exercising that power.

2. Second, there is a perception in some quarters that the earlier appointment of an inspector would somehow have prevented the current situation from arising. The reality is that the problems in HIH go back several years; they did not just happen in the past 6 – 9 months. What did happen in the past month was a reassessment by the company and its auditors of the seriousness of those problems.

Consequently – and notwithstanding that APRA did not believe it had legal standing to do so – appointing an inspector three or more months ago may have been better for APRA’s image as a tough regulator, but it would not have reduced the problems facing HIH. Indeed, it would almost certainly have acted against the interests of policyholders.

3. Third, while appointing an inspector is APRA’s major enforcement weapon, it is not the only action available to it. APRA did act over the past nine months, and it acted, within its powers, in the interests of policyholders.

APRA did not have information suggesting that HIH had a statutory solvency problem. Indeed, on the audited results presented as recently as last September, HIH had close to double the legally required solvency level. These figures were confirmed again in January. While there was no hard evidence of a breach of solvency, APRA did have concerns about HIH. Consistent with these concerns, APRA required HIH to better understand its balance sheet and business risks. APRA required HIH to implement more rigorous risk management systems. Changes to strengthen internal governance were also discussed.

More importantly, APRA helped facilitate arrangements with Allianz, and subsequently with NRMA and QBE, that strengthened the position of many of HIH’s policyholders.

As a result of those arrangements:

- At least one million policyholders have retained current insurance coverage that they would not otherwise have had;
 - Some \$45 million of claims were paid in the first two months of this year that might otherwise have been caught up in the delays of the liquidation process;
 - Around \$1.3 billion worth of outstanding claims are being covered in full and through normal procedures; and
 - As a result of QBE's decision last week, around 750,000 travel policies will remain current and all valid past claims will be met.
4. Fourth, APRA is aware of and concerned for the remaining policyholders caught up in the liquidation process. We recognise that even the prospect of a reasonable recovery rate is small comfort for those who need access to those funds now. We will be pursuing all options available through the liquidators and the financial system to assist these people

For further information contact:

Gloria Peterson

Public Affairs Manager

02 9210 3385 or 0419

Australian Prudential Regulation Authority

www.apra.gov.au

Exhibit 6: HIH Royal Commission Terms of reference

The following is a consolidated version of the Commission's terms of reference, as found in the Letters Patent issued on 29 August 2001 and amended by the Letters Patent issued on 6 February 2002, 2 May 2002 and 23 January 2003.

ELIZABETH THE SECOND, by the Grace of God Queen of Australia and Her other Realms and Territories, Head of the Commonwealth:

TO the Honourable Justice Neville John Owen

WHEREAS it is desired to have an inquiry into certain matters relating to the failure of HIH Insurance Group ('HIH')

BY these Letters Patent issued in Our name by Our Governor-General of the Commonwealth of Australia on the advice of the Federal Executive Council and pursuant to the Constitution of the Commonwealth of Australia and the *Royal Commissions Act 1902* and other enabling powers, We appoint you to be a Commissioner to inquire the reasons for and the circumstances surrounding the failure of HIH prior to the appointment of the provisional liquidators on 15 March 2001.

IN particular, We direct that you inquire into:

- a) Whether, and if so the extent to which, decisions or actions of HIH, or of any of its directors, officers, employees, auditors, actuaries, advisors, agents, or of any other person:
 - i. Contributed to the failure of HIH; or
 - ii. Involved or contributed to undesirable corporate governance practices, including any failure to make desirable disclosures regarding the financial position of HIH;
- b) Whether these decisions or actions might have constituted a breach of any law of the Commonwealth, a State or a Territory and, if so, whether the question of criminal or other legal proceedings should be referred to the relevant Commonwealth, State or Territory agency;
- c) The appropriateness of the matter in which powers were exercised and responsibilities and obligations were discharged under Commonwealth laws;
- d) The appropriateness of the matter in which powers were exercised and responsibilities and obligations were discharged under State or Territory laws; and

- e) The adequacy and appropriateness of arrangements for the regulation and prudential supervision of general insurance at Commonwealth, State and Territory levels, taking into account your findings in relation to the matters referred to in the preceding paragraphs and other relevant matters, including
 - i. Commonwealth arrangements before and after the Financial System Inquiry reforms; and
 - ii. Different State and Territory statutory insurance and tax regimes

AND We declare that, in these Letters Patent:

‘HIH’ Insurance Group’ means HIH Insurance Limited and related bodies corporate and related entities, within the meaning of the *Corporations Act 2001*;

A reference to a director, officer, employee, auditor, actuary, adviser or agent includes a reference to a former director, officer, employee, auditor, actuary, adviser or agent;

A reference to a decision or action includes a failure to make a decision or take an action;

A reference to the exercise of a power includes a failure to exercise a power;

A reference to the discharge of a responsibility or obligation includes a failure to discharge a responsibility or obligation;

A reference to related bodies corporate and related entities includes such bodies irrespective of whether they were so related at the time of the matters being inquired into.

AND, noting that the Australian Securities and Investments Commission (ASIC) is also investigating certain matters relating to the failure of HIH, and without limiting in any way the scope of your inquiry, We declare that you should, to the extent practicable, cooperate with ASIC and conduct your inquiry with a view to avoiding:

- a) Any duplication of ASIC’s investigation; and
- b) Any adverse impact on any civil or criminal proceeding arising out of ASIC’s investigation.

AND you may choose not to inquire into certain matters otherwise within the scope of these Letters Patent, but any such decision must be yours alone.

AND We declare that you are authorised to conduct your inquiry under these Letters Patent in combination with any inquiry into matters referred to in these Letters Patent that you are directed or authorised to make by any Commission issued, or pursuant to any order or appointment made, by any of the Governors of the States.

AND We declare that the Commission established by these Letters Patent:

- a) Is a relevant Commission for the purposes of sections 4 and 5 of the *Royal Commissions Act 1902*; and
- b) Is a Commission to which paragraph 16 (4) (k) of the *Income Tax Assessment Act 1936* applies.

AND We require you to begin your inquiry as soon as practicable, to conduct your inquiry as expeditiously as possible and, not later than 4 April 2003, to furnish to Our Governor-General of the Commonwealth of Australia the report of the results of your inquiry and such recommendations as you consider appropriate.

WITNESS the Right Reverend Dr Peter John Hollingworth, Companion of the Order of Australia, Officer of the Most Excellent Order of the British Empire, Governor-General of the Commonwealth of Australia.