Case Studies on the HIH Insurance Group

Background Note
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Contents

A. Introduction................................................................. 3
B. Regulatory environment.................................................. 5
C. Legislative framework for general insurance........................ 11
D. The state of the economy and the general insurance industry........ 16
E. HIH—the company......................................................... 18
F. References......................................................................... 21

Appendix I. Relevant sections from the Insurance Act 1973.............. 22
Appendix II. Glossary of terms.................................................. 31

Tables

Table 1. HIH assets by geographic area, 1994–2000......................... 19
About the Core Curriculum

A financially sound insurance sector contributes to economic growth and well-being by supporting the management of risk, allocation of resources, and mobilization of long-term savings. The Insurance Core Principles (ICPs), developed by the International Association of Insurance Supervisors (IAIS), are key international standards relevant for sound financial systems.

Effective implementation of the ICPs requires skilled and knowledgeable insurance supervisors. Recognizing this need, the World Bank and the IAIS partnered in 2002 to develop a “core curriculum” for insurance supervisors. The Core Curriculum Project, funded and supported by various sources, accelerates the learning process of both new and experienced supervisors. The ICPs provide the structure for the core curriculum, which consists of a set of modules that summarize the most relevant aspects of each topic, focus on the practical application of supervisory concepts, and cross-reference existing literature.

The core curriculum is designed to help those studying it to:

- Recognize the risks that arise from insurance operations
- Know the techniques and tools used by private and public sector professionals
- Identify, measure, and manage these risks
- Operate effectively within a supervisory organization
- Understand the ICPs and other IAIS principles, standards, and guidance
- Recommend techniques and tools to help a jurisdiction observe the ICPs and other IAIS principles, standards, and guidance
- Identify the constraints and identify and prioritize supervisory techniques and tools to best manage the existing risks in light of these constraints.
A. Introduction

On 1 March 2001, the Australian Prudential Regulation Authority (APRA) served notices calling on HIH to show cause why an inspector should not be appointed under s52 of the Insurance Act 1973. On 15 March, the date of expiry of the “show cause” letter, HIH applied to the courts to be placed into provisional liquidation.

The ensuing investigation revealed that HIH had an estimated deficit of assets over liabilities on the order of A$5 billion in a total balance sheet of about A$7 billion. Although HIH accounted for less than 0.5 percent of the total assets of regulated financial institutions, it was the second largest general insurance (nonlife) company in Australia and Australia's largest corporate failure to that date. The fallout on the Australian economy was significant and, amid pressure from the media and the Opposition, the Australian government appointed a Royal Commission to look into the events surrounding HIH’s collapse.1 The performance of APRA and also of HIH’s auditors (Arthur Andersen) came under close scrutiny in view of the suddenness of HIH’s demise and the extent of the losses involved.

The Royal Commission ran for more than 18 months at a cost of more than A$50 million. In summing up his findings, Justice Neville Owen wrote:

- “Where did the money go? Some of it was wasted by extravagance, largesse, … 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.”2

1. This Background Note draws heavily on HIH Royal Commission (2003) and Palmer (2002).
2. HIH Royal Commission (2003, xvii).
• “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 ... are many, varied, and complex. … They are epitomized 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.”

Justice Owen did not find that HIH failed as a result of “wholesale fraud or embezzlement,” but he did find many breaches of the law by HIH officers and made 53 references for criminal prosecution, many of which have resulted in jail terms, heavy fines, or disbarment from involvement with the finance industry for the offenders.

Particular issues that Justice Owen assessed as contributing to HIH’s failure included the following:

• Poor corporate governance
• Underprovisioning
• Abuses of reinsurance
• Lack of integrity of information provided to the HIH board, to the auditors, and to the regulator
• Conglomerate complexity
• Inadequate and inappropriate asset valuations.

With respect to the regulator, APRA, Justice Owen made the following comments:

• “APRA did not cause or 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 it supervision will ever fail.”

• “However, the manner in which APRA exercised its powers and discharged its responsibilities under the Insurance Act fell short of that which the community was entitled to expect from the prudential regulator of the insurance industry.”

Notwithstanding that the Royal Commission did not find APRA responsible for HIH’s failure, many regulatory lessons can be gleaned from the episode—lessons that APRA has used to greatly strengthen its approach to insurance supervision.

5. HIH Royal Commission (2003, lii).
B. Regulatory environment

Establishment of APRA

APRA was created on 1 July 1998, following a major review of Australia’s regulatory framework. Noting the growing integration taking place within the financial sector, the review recommended that the regulation and supervision of entities in the Australian financial sector be integrated and harmonized, doing away with the separate and often inconsistent rules and supervisory practices applied to different financial industries. APRA was formed to develop prudential regulatory policy and to supervise banks, life insurance companies, general (nonlife) insurance companies, and superannuation funds (private pension funds). As the new prudential regulator, APRA took over responsibilities from the Reserve Bank of Australia (previously the supervisor of banks), the Insurance and Superannuation Commission (previously the supervisor of insurance companies and superannuation funds), and a network of state regulatory bodies known as the Financial Institutions Scheme (previously the supervisors of credit unions and building societies).

Creating APRA was a complex management challenge. The objective was to combine a number of state and commonwealth regulatory organizations into a single regulator, which was to practice a fully integrated approach to the prudential regulation of deposit-taking institutions, life insurance companies, general insurers, and superannuation funds. APRA planned to go further in integrating regulatory and supervisory functions than any significant regulator had gone before, and to do so within an aggressively short time frame. This was a conscious decision taken after balancing the risks of rapid transition against the risks of delaying much-needed reforms to the policies and practices inherited from its predecessor agencies.7 The generally healthy state of the economy and industry were factors in the decision to accelerate the transition. There were many potential benefits from this approach. Most were likely to be realized in the medium to longer term. One short-term consequence, however, was that, during the first two years of APRA’s existence, much of the energy of the Board and senior management was devoted to organizational and transitional issues. Other short-term costs included:

- A loss of some corporate memory and some industry expertise with the departure of many staff from predecessor agencies
- Inevitable delays in reacquiring industry knowledge as new, less experienced people were recruited and asked to supervise more than one type of entity.

While the early focus was largely on transitional matters, policy reforms were also high on APRA’s list of priorities.

APRA faced a significant handicap in its attempts to reform and harmonize its approach to regulatory policy. Although APRA was designed as an integrated regulator and was expected to develop a uniform, risk-based approach to supervision across all entities for which it was responsible, the Act that established APRA gave it no explicit powers other than those embedded in the underlying industry Acts. Thus, for example, the Banking Act gave APRA much broader powers to set prudential standards, to carry out onsite inspections, and to intervene in the affairs of problem institutions than did the Insurance Act (see section C of this Background Note). Consequently, policy reforms required a piecemeal approach, dealing with each piece of legislation individually. They also required a major prioritization of reforms and resources.

Among the weaknesses identified in the regulatory framework, those applying in the area of general insurance were recognized by the APRA board as among the most pressing, and priority was given to a complete overhaul of the regulatory framework for general insurers. Although APRA gave priority to this work, the extent of the reforms required meant that the process took some time. Not only was new legislation required, but APRA also needed to develop a completely new set of risk-based prudential standards, to test them with the industry, and to convince the industry that the reforms were warranted. The industry initially resisted the changes to the status quo. As a consequence, the consultation and testing period was drawn out and confrontational. The draft legislation and prudential standards were completed during 2000, but the legislation was not passed by the Parliament until mid-2001, several months after the collapse of HIH.

**APRA’s internal structure**

Much of the planning for the new organization and decisions about how it would operate took place during the first year of APRA’s existence. While that planning took place, the units that had transferred over to APRA from the Insurance and Superannuation Commission (ISC) and the Reserve Bank (RBA) functioned as they had in their predecessor organizations.

In August 1999 APRA introduced a new internal structure. Unlike most other integrated regulators, which retained some degree of institutional specialization in their supervisory activities, APRA moved to a fully integrated model, under which front-line supervision divisions would be responsible for supervising all types of institutions. The new structure contained two new supervisory divisions, Diversified Institutions Division (DID) and Specialized Institutions Division (SID), in addition to a Policy, Research, and Consulting Division and a group of corporate service departments. Each of the two front-line supervisory divisions was given responsibility for a full range of institutions, including banks, life and general insurers, and superannuation funds. DID was given responsibility for conglomerates with business activities in more than one financial sector industry and groups with significant foreign operations or foreign con-
nections. SID was given responsibility for institutions and groups operating within one financial sector industry. Generally, the SID institutions were smaller and less complex. In response to the government’s decision that the headquarters of APRA would be in Sydney, many of the supervisory functions carried out by the ISC in Canberra were moved to Sydney.

A stated objective of the reforms introduced by the government when it created APRA was a reduction in the overall cost of financial regulation. APRA’s budget was reduced to less than the combined budgets of its predecessor agencies, and the number of staff declined from 550 in 1998 to about 400 under the new structure introduced in mid-1999.

Under the new structure, supervision of the HIH group of companies was assigned to a branch within DID. The branch was responsible for supervising approximately 30 financial groups, including 4 identified by APRA as systemically significant (HIH was not considered to be systemically important at that time and was expected to take less supervisory effort than any of the dozen or so systemically significant institutions). The branch was headed by a general manager, who was supported by two senior managers and another half-dozen staff members with varying levels of experience. A junior analyst had primary responsibility for HIH, with assistance and guidance from his superiors. Expertise in general insurance was also provided through cross-divisional committees and from the expertise resident in the Policy, Research, and Consulting Division.

The final act of the old General Insurance Division in late 1999 was to prepare handover documents for DID and SID for each of the authorized insurers under its supervision. The handover documents were simple, one-page summaries for each company. The handover document for the HIH companies rated them as “low priority,” with the exception of FAI General (one part of a group of companies acquired by HIH in late 1998), which was rated “high priority”—the second highest rating for supervised institutions. However, despite this rating, no supervisory actions were planned or pending for FAI.

**APRA’s approach to supervising general insurers**

The supervisory approach adopted by APRA during 1998 and 1999 was largely a continuation of the approach established by its predecessor agency, the ISC. As contemplated by the Act (see section C), the supervision of authorized insurers was based primarily on a review and analysis of statutory returns. These returns included:

- Quarterly returns, consisting of a statement of assets and liabilities, statements of profitability and changes in net tangible assets, and a statement of premiums
- Annual returns audited by an APRA-approved auditor that contained a great deal of financial information, including detailed information on the insurer’s
underwriting experience, assets, liabilities, claims and outstanding claims provision (OCP), premiums, and expenses in various categories

- An annual application by the insurer for approval of reinsurance arrangements
- Applications for approval of related party assets to be included in the solvency calculation.

The review of this information was supplemented by telephone conversations between APRA analysts and authorized insurers concerning issues arising in the course of the analysis of the returns, and periodic meetings with authorized insurers to discuss future directions.

The cornerstone of APRA's supervisory approach was the solvency test, which was a simple arithmetic calculation intended to create a safety margin beyond the commercial solvency threshold, in order to provide an extra layer of protection for policyholders. As discussed in section 3, the Act defines the minimum solvency test as the greatest of A$2 million, 20 percent of net earned premiums, and 15 percent of net outstanding claims. As required by the Act, APRA supervised the authorized entity, rather than the corporate group of which it was a part, and protected the entity from contagion elsewhere in the group by excluding from the solvency calculation loans and investments made by the authorized insurer to and in related bodies (excluded assets). The Act also gave APRA the power to approve assets of related bodies. Net assets of the authorized insurer, after deducting excluded assets other than those approved by APRA, had to exceed the minimum solvency requirement. The two main rules of thumb inherited from the predecessor agency for assessing statutory solvency were:

- The statutory solvency of an insurer should exceed the minimum requirement by at least 100 percent
- The minimum solvency requirement should be covered by high-quality capital such as share capital and retained earnings—lower quality capital such as subordinated debt was acceptable as backing for the solvency surplus.

The internal restructuring of APRA in August 1999 passed responsibility for the supervision of HIH from the General Insurance Division of the original structure to DID under the new structure. In March 2000 DID introduced a new methodology applying to all institutions that it supervised. The underlying premise of the methodology was that the institutions DID supervised were sophisticated, had access to further capital or solvency support (from either the market or an overseas parent), and had well developed and well documented internal controls and regulatory compliance systems.8

Following this philosophy, APRA assumed it could:

- Use its minimum solvency targets, plus an informal margin or buffer (or the institution's internal minimum capital target, if higher), as an early warning sign

8. It should be noted that the methodology adopted by SID was more structured and interventionist than that adopted by DID, reflecting differences in the size and sophistication of the institutions involved.
to detect financial weaknesses that could be remedied through ready access to additional capital
- Leverage the institution’s internal control systems and APRA’s knowledge of those systems to be reassure itself that an adequate control environment was in place
- Assume that the institution was not relying on APRA to detect breaches of key prudential requirements, provide guidance on appropriate work and risk management practices, or perform an audit role.

On the fundamental premise that it was dealing with sophisticated, well managed, and well controlled institutions, DID concluded that it could adopt a less intrusive, “consultative,” largely offsite supervisory regime. In this regime it would be possible to confirm the effectiveness of control processes through targeted onsite visits and various attestation arrangements, including signoffs by directors and auditors.

Over the 18 months leading up to the failure of HIH, DID enhanced the mechanics of its supervisory approach to general insurers in several areas. Quarterly reviews were extended to include peer group comparisons, to help identify outliers. Annual prudential reviews were introduced as a platform for rating all institutions. Annual prudential consultations were introduced to discuss the findings of the annual prudential review and as a way of establishing better contact between APRA staff members and the institutions they supervised. In addition, APRA introduced a formal onsite inspection program to test risk control mechanisms and the accuracy of the information provided by the institution. These onsite visits were relatively short in duration (averaging about one week for a team of four or five specialists), were targeted to particular issues or risk areas (such as asset risk), and were carried out by a team of experts.

Relative to the legacy methodology left by the ISC, the new APRA methodology developed for DID and rolled out progressively between mid-1999 and mid-2001 made several advances:

- It was less narrowly focused on a review of statutory returns and the solvency test—the prudential review required consideration of strategic issues, risk management, and control matters.
- It directed attention to the financial strength of the group as well as to the authorized entities within the group.
- The onsite visits introduced specialists, benchmarking of practices against other institutions, and the prospect of obtaining more information from which to test the quality of information provided in regulatory returns and assertions by management.
- The proposed risk rating system, while relatively simple, extended the number of risk categories, introduced actions linked to risk category, and introduced ratings for both the corporate group and the authorized entities within that group.
It was nonetheless a high-level, consultative model compared with the more intrusive type of onsite supervision practiced in several other developed countries.
C. Legislative framework for general insurance

The Insurance Act 1973 ("Act") formed the basis for the regulation and supervision of general insurance companies from 1974 until 1 July 2002, when amendments from the General Insurance Reform Act 2001 ("Reform Act") took effect. The Act reflected best practices when it was introduced but was not substantially updated and, over time, it became obsolete and fell behind internationally accepted best practices.

The key provisions of the Act (appendix I reproduces the relevant sections) included:

- A requirement that a company wishing to carry on a general insurance business in Australia be authorized by the commonwealth government and meet certain criteria for that authorisation (s22)
- Regular offsite monitoring based on the submission of special purpose quarterly and annual financial returns (s44)
- The establishment of a statutory solvency test, intended to require that authorized insurers maintain a margin of capital beyond the commercial solvency threshold (s23 and s24)
- The exclusion from the solvency calculation of investments in or loans to related companies unless approved by the regulator and the exclusion of assets encumbered by a charge to a third party (s30)
- A requirement that the regulator approve reinsurance arrangements on an annual basis (s34).

Powers under the Act

To carry out its supervisory responsibilities APRA was given certain powers, including:

- The right to approve the appointment of an external auditor (s46)
- The power to require an authorized insurer to appoint an independent actuary to investigate the OCP (s48)
- The power to require an insurer to furnish information to the regulator in support of any returns lodged with the regulator (s51)
- The power to carry out an investigation of the insurer or appoint an inspector to carry out such an investigation under certain circumstances (s52)
- The power to issue directions to the insurer under certain circumstances (s62).
Features of the Act

During the era in which the Act was introduced, general insurance legislation in many countries tended to be highly prescriptive, with specified limits in such areas as asset concentrations and reinsurance arrangements. In contrast, the Australian Act contained virtually no limits on asset concentration and composition, other than with respect to investments in and loans to related parties, and there were few restrictions on reinsurance arrangements.

The supervisory regime called for in the Act was principally offsite and based on a review of special purpose financial returns. It did not generally contemplate onsite examinations unless an insurer was on the verge of commercial insolvency.

Central to the supervisory regime established by the Act was the reliability of the returns lodged by insurers with APRA. The returns were highly detailed and contained information that APRA could use to assess the adequacy of assets to support liabilities to policyholders, the provision for outstanding claims, and the insurer’s reinsurance arrangements. However, for effective regulation, the information provided needed to be accurate. Except in extreme circumstances, such as where insolvency was imminent, the Act did not give APRA the authority to verify independently the information submitted by an insurer.

Related to the dependence of the regulator on the accuracy of information submitted by insurers, the Act also made APRA dependent on the work of the external auditor, in providing an extra layer of assurance as to the accuracy of the information lodged with the regulator. The importance of this reliance was underscored by the requirement for the auditor to provide to APRA an independent certification of the accuracy of the annual returns submitted by the insurer and the requirement that APRA approve the appointment of the external auditor.

As noted earlier, the primary financial test to be met by general insurers was the statutory solvency test. The supervisory regime contemplated by the Act revolved largely around a check, on a quarterly basis, that insurers met the statutory solvency test, with a more in depth review on an annual basis.

Weaknesses of the Act

The Act had many weaknesses. The powers given to APRA were legalistic and formal and subject to challenge, either by a requirement for the approval of the Treasurer, by the right of the Treasurer to override a decision of the regulator, or by the right of appeal to the Administrative Appeals Tribunal (AAT). The supervisory approach created by the Act was based largely on arithmetic tests and created a narrow and mechanical mindset that inadvertently promoted form over substance.
More generally, the Act failed to meet many of the IAIS Core Principles and met others ambiguously, at best. The more important of these are summarized below.9

*The Regulator must have adequate powers to perform its functions (Core Principle 1: Organization of an insurance supervisor).*10

While the Act provided APRA with powers to intervene, those powers were, for the most part, only able to be exercised when insolvency was imminent. Further, APRA’s ability to use its powers quickly and effectively was handicapped by the Treasurer’s capacity to override them or, in some cases, the AAT’s ability to review them.

*All insurance enterprises should be licensed and, in granting a licence, the regulator should assess the suitability of owners, directors, and/or senior management (Core Principle 2: Licensing).*11

In applying for a licence to carry on a general insurance business in Australia, an applicant was required to satisfy certain financial tests. Convicted felons were disqualified from acting as directors of authorized insurers. However, unlike in many other jurisdictions, there was no requirement that the directors and senior managers possess the necessary knowledge, skills, and integrity to hold their positions. In short, no “fit and proper person” test was contemplated by the Act.

*The regulator should be able to set standards and review company practices and, where appropriate, request strengthening of internal controls (Core Principle 5: Internal controls).*12

The IAIS places particular emphasis on controls in such areas as underwriting risks, the valuation of OCP, reinsurance, qualitative and quantitative standards for investments and liquidity management, the role of the board of directors in providing oversight for these controls, and the role of the regulator/supervisor in being able to impose requirements on boards of directors in this area. Under the Act, APRA had no direct powers to review and require improvements to the system of internal control within an authorized insurer.

*The regulator should establish standards with respect to the liabilities of licensed insurers (Core Principle 7: Liabilities).*13

The Act did not give APRA the power to prescribe standards for the determination of liabilities. The Act did give APRA the power to direct an authorized insurer to change the amount of its provisions for liabilities but, in the absence of standards or standard-setting authority, the exercise of this power was poorly defined. Because this power could also be exercised only with the approval of the Treasurer, there was an im-

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9. This evaluation of the Insurance Act 1973 against the IAIS Core Principles (2000) is a summary of a more comprehensive assessment by Palmer (2001). Note that the ICPs were updated in October 2003.
10. See ICP 3, Supervisory authority, in the 2003 ICPs.
11. See ICP 6, Licensing, in the 2003 ICPs.
12. See ICP 10, Internal control, in the 2003 ICPs.
13. See ICP 20, Liabilities, in the 2003 ICPs.
plicit expectation that it would be utilized only in exceptional circumstances. Further, the Australian accounting standard for insurance liabilities was vague and effectively allowed the use of central estimates without any prudential margin, and without any disclosure that this was done.

Requirements regarding capital to be maintained by licensed insurers should be clearly defined and should address minimum levels of capital (Core Principle 8: Capital Adequacy and Solvency).

The solvency requirements of the Act were clear and easy to calculate. However, because the “net tangible asset” concept in the Act was simply the difference between assets and liabilities, and because the requirements in the Act governing assets and liabilities are deficient, there could be no assurance that the net tangible assets calculated under the formula prescribed by the Act were adequate to satisfy the solvency requirements. Further, the solvency requirements themselves were not driven by the size, complexity, and business risks of the authorized insurer, and the Act gave APRA no power to adjust them to make them so.

The regulator should be able to carry out onsite inspections to review the business and affairs of the licensed insurer (Core Principle 13: Onsite Inspection).

The main provision of the Act dealing with onsite inspections as contemplated by this Core Principle is section 52, which gave APRA the power to investigate the whole or any part of the business of the insurer or to appoint an inspector to carry out such an investigation. However, such an inspection could be carried out only where it appeared to APRA that the insurer was, or was about to become, unable to meet its liabilities or had contravened or failed to comply with a provision of the Act. In short, unless APRA had prima facie evidence of a breach of the Act, an authorized insurer had to be on the brink of commercial insolvency (not just statutory solvency) for a full onsite inspection to be conducted within the legitimacy of the Act.

The regulator must have the power to take remedial action where problems involving licensed insurers are identified (Core Principle 14: Sanctions).

Under the Act, APRA was granted the power to issue directions to an authorized insurer but only when commercial insolvency was imminent.

The regulator should ensure that, through consultation between host and home regulators where necessary, all insurance establishments of international insurance groups are subject to effective supervision and no foreign insurance establishment escapes supervision (Core Principle 15: Cross Border Business Operations).

14. See ICP 23, Capital adequacy and solvency, in the 2003 ICPs.
15. See ICP 13, On-site inspection, in the 2003 ICPs.
16. See ICP 14, Preventive and corrective measures, and ICP 15, Enforcement or sanctions, in the 2003 ICPs.
17. See ICP 5, Supervisory cooperation and information sharing, and ICP 17, Group-wide supervision, in the 2003 ICPs.
The Act provided APRA with the power to regulate the activity of insurance companies operating in Australia. It did not confer on APRA the power to supervise the foreign operations of an Australian authorized insurer where those operations are carried out through foreign-incorporated or licensed affiliates.
D. The state of the economy and the general insurance industry

The Australian economy during the late 1990s

Following a brief but relatively severe recession in the early 1990s, the Australian economy enjoyed an extended period of growth and prosperity—despite the Asian financial crisis in 1997. Unlike some of its Asian neighbors, Australia absorbed the significant fall in its exchange rate in 1997. In part this reflected the extent to which the financial sector provided hedging opportunities for the business community. More generally it reflected the sound macroeconomic policies that were followed throughout the period and also the generally sound condition of financial institutions and financial regulation.

The general insurance industry in the late 1990s

As of December 2000, some 161 private sector insurers and reinsurers were licensed by APRA to write insurance business. The top 20 insurance companies accounted for just under 90 percent of the gross industry premiums written. The top five general insurance companies at the time were:

- NRMA Insurance
- HIH Casualty and General Insurance
- AMP general Insurance
- Suncorp General Insurance
- QBE Insurance.

These five companies accounted for a little over half of industry business. Other major market participants were mostly subsidiaries of foreign insurance companies, including Royal and Sun Alliance, CGU Insurance, ING-Mercantile Mutual, Allianz, and Zurich Australian Insurance.

As in other countries, the insurance business in Australia is cyclical. In terms of performance, the Australian general insurance industry peaked in the mid-1990s. By 2000 it was experiencing a trough that had persisted for several years. Claims experiences had been historically high, rates cyclically soft, and returns on investments low. Profits were down and some companies had begun reporting losses. In 2000 gross premium revenue for the industry was about A$20 billion (a slight rise over 1999). Claims were lower than for 1999 at about A$18 billion, resulting in an overall reduction in the loss on underwriting (after accounting for reinsurance and other recoveries, claims expenses and underwriting expenses) from about A$3 billion in 1999 to A$1.5 billion in 2000.
The extended period of tightness in the industry from the mid-1990s resulted in some consolidation. Insurers merged in an effort to secure market share and economies of scale. Competition from banks and other financial institutions increased as the boundaries between financial institutions continued to erode.

By 1999 a number of warning signals had begun to emerge about the overall state of the industry. Two small reinsurance companies experienced difficulties and failed in this period and a larger company, GIO Australia Holdings Limited, was rescued by another insurer.

Reviews by some commentators pointed to escalating claims in long-tailed insurance classes. Concerns expressed by industry commentators about the adequacy of capital and reserving were shared by the regulator and helped prompt a broad-ranging review of the regulatory framework for general insurance companies. This review culminated in the new capital adequacy and supervisory framework introduced in 2001.

At the time of its collapse, HIH Insurance was the second largest general insurance group in Australia, after NRMA/RACV (in terms of business inside Australia). It had approximately 13 percent market share by gross earned premium and 15 percent market share by total assets.

At the time of HIH’s failure, APRA had prudential supervisory responsibilities for more than 4,000 institutions, with assets under management of more than A$1.5 trillion. Thus, despite its relative size within the general insurance industry, in absolute terms HIH accounted for about 0.33 percent of supervised industry assets and 0.03 percent of supervised institutions. Consequently, at the time, APRA did not consider it to be a systemically significant financial institution.
E. HIH—the company

The structure of the HIH group

By the time the provisional liquidator was appointed in 2001, HIH was a complex corporate group consisting of more than 200 companies, of which the following authorized insurers were authorized to carry on the business of general insurance in Australia:

- HIH Casualty & General Insurance Limited (HIH C&G)
- HIH Underwriting & Insurances (Australia) Pty Limited
- World Marine & General Insurances Pty Limited
- CIC Insurance Limited (CIC)
- FAI General Insurance Company Limited (FAI General)
- FAI Traders Insurance Company Pty Limited
- FAI Reinsurances Pty Limited.

Of these, HIH C&G, CIC, and FAI General were the most significant in terms of size and activity. Before its acquisition by the HIH Group in January 1999, the FAI Group included the last three authorized insurers in this list.

In this case study, references to the “HIH group” refer to all the authorized insurers collectively in the HIH and the FAI Groups. Where relevant, reference is also made to individual authorized insurers within those groups. In general, however, the case study focuses on the consolidated group.

Brief history of the HIH group

In many ways HIH was an Australian success story. It had humble origins: it was begun in 1968 when Ray Williams and Michael Payne incorporated MW Payne Liability Agency Pty Ltd to underwrite insurance business in Australia as an agency for two Lloyd’s syndicates. In 1971 MW Payne was acquired by CE Heath plc, a publicly listed company in the United Kingdom. Over the next 20 or so years, CE Heath expanded from a small company specializing in workers compensation policies in Victoria and Tasmania to become a substantial insurer with business in property, commercial, and professional liability and with operations outside Australia in Hong Kong, New Zealand, and the United States. From the outset the chief executive and driving force in the company was Williams, who held that position until just before HIH’s collapse.

In 1992 the company listed on the Australian Stock Exchange as a specialized liability insurer, sourcing most of its business from local and international insurance brokers. The newly floated company expanded into the United Kingdom, where it focused on public liability and professional indemnity insurance.
Around the mid-1990s the company embarked on a period of growth by acquisition. In June 1995 CE Heath acquired CIC Insurance Limited. The purchase of CIC introduced the Swiss insurer Winterthur as the major shareholder, at the same time that it saw the departure of its original parent company, CE Heath plc. In 1996 the company changed its name to HIH Winterthur International Holdings Limited (HIH). In 1997 HIH acquired Colonial Mutual and General Insurance Limited, and in 1998 it acquired FAI Insurance.

The acquisitions of CIC, Colonial Mutual and General, and FAI substantially changed the group’s business profile, with commercial lines declining to 47 percent of total business by June 1999 (35 percent inside Australia). An indication of the growth in HIH’s business and its changing geographic focus from the mid-1990s is given in table 1.

Table 1. HIH assets by geographic area, 1994–2000

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</thead>
<tbody>
<tr>
<td>Australia</td>
<td>1,016</td>
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<td>United States</td>
<td>18</td>
<td>106</td>
<td>734</td>
<td>763</td>
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<td>New Zealand</td>
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<td>135</td>
<td>206</td>
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<td>Asia</td>
<td>36</td>
<td>95</td>
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<tr>
<td>Argentina</td>
<td>0</td>
<td>10</td>
<td>34</td>
<td>50</td>
</tr>
<tr>
<td>Total</td>
<td>1,201</td>
<td>3,127</td>
<td>7,725</td>
<td>8,327</td>
</tr>
</tbody>
</table>

Following its earlier successful exit from the U.S. market, HIH re-entered the California worker’s compensation market in 1997 by reacquiring its old company, Heath Cal (by then renamed CareAmerica Compensation and Liability Insurance Company). HIH aggressively expanded its operations in the United Kingdom to include reinsurance, marine, property, travel, personal accident, professional indemnity, catastrophe, contingency and political risk insurance, and even underwriting film finance. In 1998 HIH acquired the Cotesworth Group Limited, which was the managing agent of four active Lloyd’s syndicates, three of which wrote marine insurance. The intention was to create HIH’s own corporate syndicate within the Lloyd’s market in the United Kingdom, with the ultimate objective of writing international insurance and reinsurance business through the Lloyd’s licences.

In July 1998 HIH’s majority owner, Winterthur, announced that it would be selling its holding. Although market sentiment about the sale was mixed, the public offering of Winterthur’s shares was oversubscribed. HIH’s release in September 1998 of results that were well below market expectations and its subsequent acquisition of FAI Insurance did little to gain market favor.
By the late 1990s problems had begun to emerge in the U.K. operations. In January 1999, as a result of losses in its U.K. subsidiaries, HIH (U.K.) was put into run-off. The bulk of the U.K. business after that was written through Cotesworth.

On 13 September 2000 HIH announced that it had entered a joint-venture arrangement with Allianz Australia Insurance Limited. The venture was to come into existence on 1 January 2001. Under the arrangement HIH would transfer a substantial part of its business to the venture in return for a payment of A$200 million. The business being transferred was the majority of HIH’s personal lines and compulsory third-party insurance products. In November 2000 HIH announced a further defensive action whereby Gerling Australia Insurance Company would act as its agent for further underwriting (because HIH was downgraded to a level at which brokers would not recommend that commercial clients insure with HIH).

Speculation about HIH’s financial sustainability increased in early 2001, and trading in HIH shares was suspended temporarily on 22 February and again on 1 March. On 1 March APRA issued notices requiring HIH to “show cause” why an inspector should not be appointed under the Insurance Act 1973. On 6 March HIH formally appointed KPMG to undertake a review of its financial position, and on 15 March the HIH board resolved to appoint a provisional liquidator. On 27 August 2001 the court placed the HIH group into official liquidation.
F. References

## Appendix I. Relevant sections from the Insurance Act 1973

### Insurance Act 1973

<table>
<thead>
<tr>
<th>Section</th>
<th>Who can be Authorized</th>
<th>Minimum solvency for authority</th>
<th>Minimum solvency for continuing operations</th>
<th>Treasurer may override regulator’s decision to refuse an authority</th>
<th>Conditions of Authority</th>
</tr>
</thead>
</table>
| S22     | • Australian bodies corporate  
          • Foreign insurers operating as branches (subsidiaries are automatically Australian bodies corporate) | • Minimum paid up share capital of $2 million; or  
          • If incorporated in Australia, assets to exceed liabilities by at least $2 million; or  
          • If incorporated outside Australia, value of assets in Australia to exceed liabilities in Australia by at least $2 million; plus  
          • Must meet reinsurance requirements of s34; and  
          • Must be likely to continue to meet liabilities; and  
          • Must be likely to be able to comply with applicable sections of the Act. | Where an application is made in accordance with section 22 by a body corporate to which section 23 does not apply, APRA may grant to the body corporate an authority to carry on insurance business if APRA is satisfied that:  
(a) where the body corporate has a share capital—the paid up share capital of the body corporate is not less than $2,000,000;  
(b) where the body corporate is incorporated in Australia—the value of the assets of the body corporate exceeds the amount of its liabilities by not less than:  
  (i) $2,000,000; or  
  (ii) 20% of its premium income during its financial year last preceding the financial year in which the application is made; or  
  (iii) 15% of its outstanding claims provision as at the end of its financial year last preceding the financial year in which the application is made; whichever is the greatest;  
(c) the value of the assets in Australia of the body corporate exceeds the amount of its liabilities in Australia by not less than:  
  (i) $2,000,000; or  
  (ii) 20% of its premium income in Australia during its financial year last preceding the financial year in which the application is made; or  
  (iii) 15% of its outstanding claims provision in respect of liabilities in Australia as at the end of its financial year last preceding the financial year in which the application is made; whichever is the greatest;  
(d) the body corporate has arrangements for reinsurance approved by APRA under section 34 or has been granted an exemption under that section; | (1) Where APRA decides not to grant an authority to a body corporate under section 23 or 24 because APRA is not satisfied with respect to the matters referred to in whichever of those sections is applicable, APRA shall inform the Treasurer accordingly and the Treasurer shall, after having considered that information:  
(a) grant the authority; or  
(b) refuse to grant the authority.  
(2) Where the Treasurer decides under subsection (1) to refuse to grant an authority to a body corporate, he or she shall notify the body corporate, in writing, of his or her decision.  
(3) Part VI applies to a refusal of the Treasurer under this section to grant an authority. | • Basically repeats solvency and reinsurance requirements  
• Though note that, under s29.2 APRA may impose further conditions on the authority |

18. Clauses in normal text are from the Act. Clauses in italics are summaries or comments.
Permissible and excluded assets

Assets for solvency exclude (s30.1):

- Loans & investments in related parties
- Future tax benefits
- Guarantees received
- Intangibles including Goodwill

APRA may, if requested, approve such assets for solvency purposes subject to consideration of relevant issues (s30.2, s30.2A, s30.4 and s30.4A).

Expected reinsurance recoveries are an asset (s30.5AA)

(1) In this Part, a reference to assets of a body corporate does not include a reference to:

(a) an amount due from, or a loan to, a person who, when the debt came into existence or the loan was made, was:

   (i) a director of the body corporate;
   (ii) a director of a body corporate that was related to the body corporate;
   (iii) where, by virtue of subsection (7), this section applies in relation to a trust—a trustee in respect of the trust, or, if the trustee is a body corporate, a director of that body corporate; or
   (iv) the spouse of a person referred to in subparagraph (i), (ii) or (iii);

(b) an unsecured loan:

   (i) to a person who, when the loan was made, was an employee of the body corporate; and
   (ii) that exceeded $1,000 when it was made or that was made under an agreement under which the body corporate agreed to lend that person amounts in the aggregate exceeding $1,000;

(c) an asset that is charged for the benefit of a person other than the body corporate to the extent that it is so charged;

(ca) where the whole or part of the undertaking, business or property of the body corporate is subject to a floating charge, that undertaking, business or property to the extent that it is so subject;

(d) an amount due from, or a loan to, another body corporate that is related to the first mentioned body corporate except:

   (i) an amount or loan to the extent that APRA has, under subsection (2), approved the amount or loan as an asset for the purposes of this Part; or
   (ii) if the other body corporate is an ADI, a State bank or another body prescribed by the regulations for the purposes of this subparagraph—an amount due in respect of a deposit with the other body corporate or a loan constituted by such a deposit;

(da) a debenture of, or a share in, a body corporate that is related to the first mentioned body corporate except to the extent that APRA has, under subsection (2), approved the debenture or share as an asset for the purposes of this Part;

(e) an unpaid premium that became due to the body corporate more than 3 months previously;

(f) where the body corporate is registered under the Life Insurance Act 1995, an asset of a statutory fund established under that Act by the body corporate;

(fa) the estimated value of a future benefit to the body corporate that may arise, under a law of the Commonwealth, a State or a Territory, relating to taxation by virtue of a loss or losses incurred by the body corporate;

(g) a guarantee given to or in relation to the body corporate, except to the extent that APRA has, under subsection (4), approved the guarantee as an asset for the purposes of this Part; or

(h) an intangible asset, not being an intangible asset referred to in any of paragraphs (a) to (g), but including expenses of the body corporate in relation to the formation, extension or purchase of its business or the purchase of goodwill.
(2) If a body corporate (the first body corporate) and another body corporate (the second body corporate) that is related to the first body corporate together request APRA in writing to approve as an asset of the first body corporate for the purposes of this Part the whole or a part of an amount due from, a loan to, a debenture of, or a share in, the second body corporate, APRA may, by written notice given to each body corporate, approve the amount, loan, debenture or share, or any part of the amount, loan, debenture or share referred to in the notice.

(2A) In exercising the power of approval under subsection (2) in respect of a relevant asset (the relevant asset concerned) of the first body corporate in relation to the second body corporate, APRA must have regard to all matters that APRA thinks relevant and, in particular, to the following matters:

(a) the proportion that the sum of the values of the relevant asset concerned and of the values of all other relevant assets (whether approved under subsection (2) or not) of the first body corporate in relation to the second body corporate bears to the sum of the values of the assets of the first body corporate (other than the relevant assets of the first body corporate in relation to the second body corporate);

(b) the proportion that the value of the relevant asset concerned bears to the sum of the values of all the assets of the second body corporate;

(c) the nature, and the degree of diversity, of the assets of the first body corporate;

(d) the nature, and the degree of diversity, of the assets of the second body corporate;

(e) the nature of the business carried on by the second body corporate.

(2AA) In subsection (2A):

relevant asset of the first body corporate in relation to the second body corporate, means:

(a) an amount due to the first body corporate by the second body corporate; or

(b) a loan made by the first body corporate to the second body corporate; or

(c) a debenture or share in the second body corporate held by the first body corporate.

(2B) For the purposes of subsection (2A), the value of an amount, loan, debenture or share that is not an asset within the meaning of this Part shall be determined as if it were such an asset.

(4) Where a body corporate requests APRA to approve as an asset for the purposes of this Part the whole or part of a guarantee given to or in relation to the body corporate, APRA may, by notice in writing given to the body corporate, approve the guarantee, or such part of the guarantee as APRA determines, accordingly.

(4A) Without otherwise limiting the discretion of APRA to refuse to approve as an asset for the purposes of this Part the whole or part of a guarantee given to or in relation to a body corporate, APRA shall not give such an approval unless:

(a) the guarantor, or each of the guarantors, is an ADI or a bank constituted by a law of a State;

(b) the guarantee is in accordance with a prescribed form or a form approved by the Treasurer, being a form that includes provision to the effect that, in the event of the winding up of the body corporate, amounts due under the guarantee are to be available to meet the liabilities of the body corporate; and

(c) the guarantee is not revocable without the approval of APRA.

(5) The whole or such part as APRA determines of an amount owed to a body corporate by way of portions of premiums retained under a contract of reinsurance by a person outside Australia shall, for the purposes of this Part, be deemed to be an asset in Australia of the body corporate.
(5AA) If:

(a) a body corporate that is authorised under this Act to carry on insurance business expects to recover an amount under a contract of reinsurance entered into with a person who is outside Australia; and

(b) the amount relates to claims in respect of liabilities to which subsection 31(4) applies, whether or not the claims have been paid by the body corporate; and

(c) under the terms of the contract, payments by way of reinsurance are to be made in Australia;

the amount is taken for the purposes of this Part to be an asset in Australia of the body corporate.

(5A) Where an approval has been given under subsection (2) or (4), or a determination has been made under subsection (2), (4) or (5), and it appears at any time to APRA that the approval or determination is no longer necessary or should be varied, APRA shall, by notice in writing served on the body corporate concerned, revoke or vary the approval or determination, as the case may be.

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**S31 Liabilities**

- *Insurance companies shall make provisions for liabilities (s31.1)*
- *APRA may – with the Treasurer’s agreement – direct an insurance company to make specified provisions (s31.3)*

(1) In this Part, unless the contrary intention appears, a reference to liabilities of a body corporate includes a reference to provision for liabilities made in its accounts, or directed in accordance with this section to be made, but does not include:

(a) a liability in respect of share capital; or

(b) where the body corporate is registered under the *Life Insurance Act 1995*, a liability that is, in accordance with that Act:

(i) referable to a class of life insurance business carried on by the body corporate in respect of which it has established a statutory fund under that Act; or

(ii) charged on any of the assets of such a statutory fund.

(2) For the purposes of this Act, a body corporate carrying on insurance business shall make in its accounts provision in respect of liabilities.

(3) For the purposes of this Act, APRA may, with the Treasurer’s agreement, at any time, if APRA thinks fit, by notice in writing served on a body corporate carrying on insurance business, direct that the body corporate shall, within a specified period, not being less than 21 days, after the giving of the direction, or as at a specified date, make in its accounts provision, or further provision:

(a) of a specified amount; or

(b) of an amount determined in a specified manner;

in respect of liabilities.

(3A) Part VI applies to a decision of APRA under this section.

(3AA) Subsection (3A) does not apply to a decision made within 5 years after the commencement of this subsection.

(3AB) It is not necessary to obtain the agreement of the Treasurer to the making of a decision by APRA under this section after 5 years after the commencement of subsection (3AA).

(3B) Where a direction has been given to a body corporate under subsection (3) and it appears at any time to APRA, and the Treasurer agrees, that the direction is no longer necessary or should be varied, APRA shall, by notice in writing served on the body corporate, revoke or vary the direction.

(3C) Where a body corporate to which a direction has been given under subsection (3) applies to APRA, by notice in writing, for the direction to be revoked or varied, APRA shall:

(a) if it appears to APRA, and the Treasurer agrees, that the direction is no longer necessary or should be varied—revoke or vary the direction; or

(b) in any other case—refuse to revoke or vary the direction; and shall serve on the body corporate notice in writing of the decision.
(3D) The powers of APRA under this section are in addition to, and do not derogate from, the powers of APRA or of the Treasurer under Part V.

(3E) Where a body corporate in respect of which a direction has been given under subsection (3) is commenced to be wound up, the direction ceases to have effect.

(3F) A body corporate that fails to comply with a direction given to it under subsection (3) is, in respect of each day during which it so fails to comply with the direction (including the day of a conviction under this subsection or any subsequent day), guilty of an offence punishable on conviction by a fine not exceeding 100 penalty units.

(4) For the purposes of this Part, where a liability is undertaken by a body corporate under:

(a) a contract of insurance (including reinsurance) made in Australia or in respect of which a proposal was accepted or a policy issued in Australia, not being a contract:

(i) that relates only to a liability contingent upon an event that can happen only outside Australia, not being a liability that the body corporate has undertaken to satisfy in Australia; or

(ii) where the body corporate carries on insurance business both in and outside Australia, that relates only to a liability that the body corporate has undertaken to satisfy outside Australia; or

(b) a contract of insurance (including reinsurance) made outside Australia or in respect of which a proposal was accepted or a policy issued outside Australia where any part of the negotiations or arrangements leading to the making of the contract, to the acceptance of the proposal or to the issue of the policy took place or were made in Australia, being a contract:

(i) that relates to a liability contingent upon an event that can happen only in Australia; or

(ii) where the body corporate carries on insurance business both in and outside Australia, that relates to a liability that the body corporate has undertaken to satisfy in Australia;

that liability is a liability in Australia.

(5) In this section, unless the contrary intention appears, direction includes, where a direction is varied, the direction as varied.

NB the issue of prudential margins is dealt with in Accounting Standards and is left up to the company

<table>
<thead>
<tr>
<th>Table 32 Premium Income</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>S32 Premium Income</strong></td>
<td>Is premiums received or due, minus:</td>
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<tr>
<td>• Amounts relating to earlier years</td>
<td></td>
</tr>
<tr>
<td>• Refunds or refunds due</td>
<td></td>
</tr>
<tr>
<td>• Premiums for reinsurance</td>
<td></td>
</tr>
<tr>
<td>• Other odds and ends</td>
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</table>

<table>
<thead>
<tr>
<th>Table 33 Valuation of Assets</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>S33 Valuation of Assets</strong></td>
<td>• APRA may request information about valuations (s33.2)</td>
</tr>
<tr>
<td>• APRA may – with the Treasurer’s agreement - direct a specific value (s33.3)</td>
<td></td>
</tr>
</tbody>
</table>

(2) APRA may, by notice in writing served on a body corporate, require it to furnish APRA with such information with respect to the value of an asset of the body corporate as APRA specifies in the notice, being a value that is, in APRA opinion, in accordance with those subsections.

(3) Where APRA is not satisfied that the value of an asset of a body corporate as determined by the body corporate in accordance with subsection (4), (6) or (6A), whichever is applicable, APRA may, with the Treasurer’s agreement, by notice in writing served on the body corporate, direct that the value of that asset is the value specified in the notice.

(6) Emphasis is on market value

(6A) Rules for related party valuations of shares
<table>
<thead>
<tr>
<th>Section</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>S34</td>
<td><strong>Reinsurance</strong>&lt;br&gt;Reinsurance arrangements must be approved by APRA each year (s.34.1)</td>
</tr>
<tr>
<td></td>
<td>(1) Subject to this section, a body corporate authorized under this Act to carry on insurance business shall have arrangements, being arrangements approved by APRA on application by the body corporate, for reinsurance of liabilities in respect of risks against which persons are, or are to be, insured by the body corporate in the course of its carrying on insurance business.</td>
</tr>
<tr>
<td></td>
<td>(1C) An application for the approval of arrangements for reinsurance made, or proposed to be made, under an agreement must be lodged with APRA by the start of such period before the agreement comes into force as APRA determines in writing.</td>
</tr>
<tr>
<td></td>
<td>(2) APRA shall not approve arrangements for reinsurance made, or proposed to be made, by a body corporate where the arrangements for reinsurance of liabilities in Australia of the body corporate are made, or proposed to be made, under a contract of reinsurance relating to those liabilities and to other liabilities unless the amount of the premium payable under that contract in respect of the reinsurance of the first mentioned liabilities, or the manner in which the amount of that premium is to be ascertained, is specified in the contract.</td>
</tr>
<tr>
<td></td>
<td>(3) APRA shall, in determining whether to approve arrangements for reinsurance made, or proposed to be made, by a body corporate, have regard to all matters that APRA considers relevant and, in particular to:</td>
</tr>
<tr>
<td></td>
<td>(a) the class or classes of insurance business carried on or proposed to be carried on by the body corporate;</td>
</tr>
<tr>
<td></td>
<td>(b) the amount of premiums received by or due to the body corporate during its last preceding financial year in respect of each class of insurance business carried on by it;</td>
</tr>
<tr>
<td></td>
<td>(c) the nature and value of the assets of the body corporate;</td>
</tr>
<tr>
<td></td>
<td>(d) the places in which liabilities of the body corporate may be incurred; and</td>
</tr>
<tr>
<td></td>
<td>(e) the person or persons by whom the reinsurance is or is proposed to be undertaken.</td>
</tr>
<tr>
<td></td>
<td>(5) APRA, having regard to such matters as APRA considers relevant and, in particular to the matters mentioned in paragraphs (3)(a), (b), (c) and (d) may, by notice in writing given to a body corporate, exempt the body corporate, subject to such terms and conditions and for such period as APRA specifies in the notice, from the requirements of this section.</td>
</tr>
<tr>
<td></td>
<td>(6) A determination under subsection (1C) is a disallowable instrument for the purposes of section 46A of the Acts Interpretation Act 1901.</td>
</tr>
<tr>
<td>S34A</td>
<td><strong>Reinsurance returns</strong>&lt;br&gt;Insurance companies are to lodge with APRA whatever annual reinsurance returns APRA determines it needs</td>
</tr>
<tr>
<td>S35</td>
<td><strong>Treasurer’s exemptions</strong>&lt;br&gt;Treasurer may exempt an insurance company from the ‘net assets in Australia’ test where overseas losses are involved etc.</td>
</tr>
<tr>
<td>S36</td>
<td><strong>Cancellation of Authority</strong>&lt;br&gt;This section covers the mechanical wind-down or withdrawal of a new authority</td>
</tr>
<tr>
<td>S44</td>
<td><strong>Lodgement of Accounts</strong>&lt;br&gt;Insurance companies are to lodge annual accounts and statements as determined by APRA (within 4 months) (s.44.1)&lt;br&gt;All authorized insurers are to lodge quarterly returns as determined by APRA (within 6 weeks) (s.44.4)&lt;br&gt;Statements of Australian incorporated insurers is to include business outside Australia (s.44.5)&lt;br&gt;APRA may determine the form of the returns (s.44.6)</td>
</tr>
<tr>
<td>S46</td>
<td><strong>Appointment of Auditors</strong>&lt;br&gt;APRA is to approve auditors</td>
</tr>
</tbody>
</table>
### ENFORCEMENT

**S48A Actuarial Investigation of OCP**

- APRA may require an insurer to appoint an external actuary to assess its OCP. The insurer may choose the actuary but APRA has the right to approve.
- The report is to be given to APRA within 30 days of the initial notice.

1. This section applies to bodies corporate authorised under this Act to carry on insurance business.
2. APRA may, by notice in writing given to a body corporate, require the body corporate to appoint an actuary to:
   - (a) carry out an investigation of the whole or a specified part of the body corporate’s outstanding claims provision as at a particular time; and
   - (b) make a report on that investigation.
3. The actuary must not be an officer of the body corporate.
4. The body corporate must, within 7 days after the date on which the notice was given, advise APRA, in writing, of the name of the actuary.
5. If APRA notifies the body corporate that the actuary is not acceptable to APRA, the body corporate must, within 7 days after the date on which the notice was given:
   - (a) appoint a different actuary; and
   - (b) advise APRA, in writing, of the name of the actuary so appointed.
6. APRA may, within 7 days after the advice was given under subsection (4) or (5), notify the body corporate, in writing, that the actuary is not acceptable to APRA.
7. The body corporate must cause the actuary’s report to be given to APRA:
   - (a) within 30 days after the date on which the notice was given to the body corporate under subsection (2); or
   - (b) within such further time as APRA, by written notice, allows.
8. The actuary’s report:
   - (a) must be signed by the actuary; and
   - (b) must contain a statement of the actuary’s opinion about each of the following:
     - (i) the adequacy of the amount of the whole or the part, as the case requires, of the outstanding claims provision;
     - (ii) the accuracy of any relevant valuations made by the actuary;
     - (iii) the assumptions used by the actuary in making those valuations;
     - (iv) the relevance and appropriateness of the information on which those valuations were based;
     - (v) the accuracy of the information on which those valuations were based.

### S51 Inquiry

Where it appears to APRA that an authorized entity is—or is likely to become—unable to meet its liabilities, APRA may:

- require information (to be delivered within 7 days)
- direct it not to dispose of assets etc

1. Where it appears to APRA that a body corporate authorized under this Act to carry on insurance business is or is likely to become unable to meet its liabilities, APRA may:
   - (a) by notice in writing served on the body corporate, direct it to furnish to APRA within such period after service of the notice, being not less than 7 days, as APRA specifies in the notice, such information in writing about such matters in relation to the affairs of the body corporate as APRA so specifies; and
   - (b) with the Treasurer’s agreement, by notice in writing served on the body corporate direct:
     - (i) that it not dispose of, or otherwise deal with or remove from Australia, any asset of the body corporate; or
     - (ii) that it not dispose of, or otherwise deal with or remove from Australia, any asset of the body corporate that is, or that is of a kind that is, specified in the notice; or
     - (iii) that it deal with any asset of the body corporate, or any asset of the body corporate that is, or that is of a kind that is, specified in the notice, on such terms and conditions as are specified in the notice;
during such period after service of the notice, not exceeding 6 months, as is specified in the notice.

(2) If APRA has served, or is proposing to serve, a notice under paragraph (1)(a) or (b) on a body corporate, APRA may:

(a) if the notice has been served—at any time; or
(b) otherwise—at or about the time when the notice is served; do either or both of the following in relation to a body corporate that is connected with the first mentioned body corporate:
(c) by written notice served on the connected body corporate, direct it to furnish to APRA in writing, within such period after service of the notice, being not less than 7 days, as is stated in the notice, such information as is stated in the notice about such matters in relation to the affairs of the connected body corporate as are so stated;
(d) with the Treasurer’s agreement, by written notice served on the connected body corporate, direct:
   (i) that it not dispose of, otherwise deal with, or remove from Australia, any of its assets; or
   (ii) that it not dispose of, otherwise deal with, or remove from Australia, any of its assets that is, or is of a kind that is, stated in the notice; or
   (iii) that it deal with any of its assets, or any of its assets that is, or is of a kind that is, stated in the notice, on such terms and conditions as are stated in the notice; during such period after service of the notice, not exceeding 6 months, as is stated in the notice.

S52 Appointment of Inspector

Where it appears to APRA that an authorized entity is - or is likely to become – unable to meet its liabilities, or has contravened a provision of the Act or direction, APRA may:

• require it to show cause within 14 days why an inspector should not be appointed

(1) Where it appears to APRA that a body corporate authorized under this Act to carry on insurance business:

(a) is, or is about to become, unable to meet its liabilities; or
(b) has contravened or failed to comply with a provision of this Act or a condition or direction applicable to it under this Act;

APRA may, by notice in writing served on the body corporate, require it to show cause within such period after service of the notice, being not less than 14 days, as APRA specifies in the notice, why APRA should not, on specified grounds:

(c) investigate the whole or any part of the business of the body corporate; or
(d) appoint a person to make such an investigation and report to APRA the results of his or her investigation.

(1A) If APRA has served, or is proposing to serve, a notice under subsection (1) on a body corporate, APRA may:

(a) if the notice has been served—at any time; or
(b) otherwise—at or about the time when the notice is served;

cause a written notice to be served under subsection (1C) on a body corporate that is connected with the first mentioned body corporate.

(1B) If it appears to APRA that a body corporate that is connected with a body corporate authorized under this Act to carry on insurance business has contravened a provision of this Act or a condition or direction applicable to it under this Act, APRA may cause a written notice to be served under subsection (1C) on the first mentioned body corporate.

(1C) A notice referred to in subsection (1A) or (1B) may require the body corporate on which it is served to show cause, within such period after service of the notice (being not less than 14 days) as is stated in the notice, why APRA should not, on stated grounds:

(a) investigate the whole or any part of the business of the body corporate; or
(b) appoint a person to make such an investigation and report to APRA the results of the investigation.
(2) If:

(a) a body corporate on which a notice is served under subsection (1), (1A) or (1B) fails, within the period stated in the notice, to show cause to APRA satisfaction why an investigation should not be made; and

(b) APRA is satisfied that:

(i) if the notice was served under subsection (1)—in relation to the insurance business carried on by the body corporate; or

(ii) otherwise—in relation to any business carried on by the body corporate;

it is in the public interest that an investigation should be made;

APRA may:

(c) make the investigation itself; or

(d) in writing, appoint a person (in this Part called the inspector) to make the investigation.

(3) If:

(a) APRA has decided that an investigation of a body corporate (in this section called the first body corporate) should be made; and

(b) another body corporate (in this section called the associated body corporate) is, or has at some relevant time been, associated with the first body corporate; and

(c) APRA believes on reasonable grounds that it is necessary for the purposes of the investigation to investigate the whole or a part of the affairs of the associated body corporate;

APRA may:

(d) make an investigation into the whole or that part of the affairs of the associated body corporate; or

(e) authorise the inspector to make such an investigation.

(4) Before commencing an investigation of a body corporate, APRA or the inspector, as the case may be, must serve on the body corporate:

(a) in all cases—a written notice by APRA specifying the matters into which the investigation is to be made, being the whole or some part of affairs of the body corporate; and

(b) in the case of the inspector—a copy of the instrument appointing the inspector.

<table>
<thead>
<tr>
<th>S54 Entry to Premises</th>
<th>APRA (and inspector) can examine books, take possession and copy etc.</th>
</tr>
</thead>
<tbody>
<tr>
<td>S62 Directions</td>
<td>APRA may give directions during an inspection. Refers to disposal of assets etc.</td>
</tr>
</tbody>
</table>
Appendix II. Glossary of terms

AASB
Australian Accounting Standards Board. Responsible for the development and promulgation of accounting standards.

AAT
Administrative Appeals Tribunal. Body which provides independent review of a range of administrative decisions made by the Commonwealth Government and some non-government agencies.

Act
Insurance Act 1973. Formed the basis for the regulation and supervision of general insurance companies from 1974 until 1 July 2002.

AGA
Australian Government Actuary.

AP
Average Provision. Provision discounted by number of reported and outstanding claims.

APRA
Australian Prudential Regulation Authority. Prudential regulator of the Australian financial services industry.

ASC
Average Settlement Cost. Settlement cost during a period divided by number of claims finalized during period.

ASIC
Australian Securities and Investments Commission. ASIC is the Government body responsible under the Corporations Law for regulating companies, the issue and sale of shares, trust units, company borrowings, and investment advisers and dealers. ASIC administers those provisions of the Corporations Law dealing with the conduct and disclosure obligations of financial service providers, including general insurers.

ASX
Australian Stock Exchange. Main Australian marketplace for the trading of equities, government bonds and other fixed interest securities.
AWE
Average Weekly Earnings. This is the index commonly used as a basis for general claims inflation.

Central estimate
Statisticians refer to measures of central tendency of distributions. Such measures include the mode, median and mean. The mean is usually the intended measure of actuaries measuring the central estimate of a liability.

CHE
Claims Handling Expenses. Refer to FCHC.

CMV
Commercial Motor Vehicle. A class of insurance.

Combined Ratio
The ratio of management and general expenses and claims cost to premium. Although a combined ratio in excess of 100% might suggest loss-making business, investment earnings also need to be factored into such considerations.

Corporations Law
A national system of law and regulation for corporations and the securities market (now the Corporations Act 2001).

CPI
Consumer Price Index. A quarterly measurement of movements in the prices of a fixed basket of household goods and services.

CTP
Compulsory Third Party. A compulsory class of insurance covering motor vehicle drivers against injuries to third parties.

DACs
Deferred Acquisition Costs. The portion of acquisition costs not recognized as an expense during the period when incurred but carried forward for the purpose of matching against subsequent revenues that will be bought to account in later financial years.

D&O
Directors and Officers Liability. A class of insurance.
DID
Diversified Institutions Division. Supervisory division of APRA with responsibility for conglomerates with business activities in more than one financial sector industry and groups with significant foreign operations or foreign connections.

DMV
Domestic Motor Vehicle. A class of insurance.

E&O
Errors and Omissions. A class of insurance.

EL
Employer’s Liability. A class of insurance.

FCHC
Future Claims Handling Costs. The provision for the costs to be paid in the future in respect of managing claims in respect of incidents that have already occurred (and have been provided for). The acronym CHE is often used for claims handling expenses and may, depending on context, refer to future CHE.

FITB
Future Income Tax Benefit. Intangible asset representing the estimated amount of future saving in income tax likely to arise as a result of either the reversal of timing differences or the recoupment of carried forward tax losses.

GST

GTPL
General Third Party Liability. A class of insurance

HH
Home and householders. A class of insurance.

HRR
Highest Risk Retention. The largest sum insured retained by a direct insurer.

IATA
Insurance Acquisitions and Takeovers Act. The IATA sets out the rules in relation to control of, and compulsory notification of proposals in relation to:
• the acquisition or leasing of assets of Australian registered insurance companies; and
• the entering into of agreements relating to directors of Australian registered insurance companies.

IBNER
Incurred But Not Enough Reported. The (usually non explicit) component of a claims provision which is the difference between case estimates and the amount provided for all reported claims.

IBNR
Incurred But Not Reported. The (often non explicit) component of a claims provision which allows for the cost of settling claims that have not been reported to the insurer but for which the incident giving rise to a claim has already occurred.

ISC
Insurance and Superannuation Commission. The supervisor of insurance companies and superannuation funds prior to the establishment of APRA.

ISR
Industrial Special Risks. A class of insurance.

JV
Joint Venture.

LOC
Letter of Credit. Contractual agreement to facilitate trade by substituting the credit of a bank for that of the customer.

LOD
Losses Occurring During.

Long tail
Classes of insurance are usually classified as either short tail or long tail depending on what period typically elapses between an incident giving rise to a claim and settlement of the claim. Although there is no specific cut off point for the division, where this delay is typically more than 1 year the class would be long tail where as where it is less than 6 months it would be short tail.

LR
Loss Ratio. Ratio of claims expense to premium.
**MER**
Maximum Event Retention. The highest probable loss an insurer is exposed to usually as a result of natural disaster causing many losses (e.g. homes and cars) in a single geographic region on several policies.

**MOU**
Memorandum of Understanding. An MOU is entered into with foreign regulators to encourage cooperation and information sharing about conglomerates which they supervise.

**NCI**
Net Claims Incurred. Claim payments plus increase in claims provision, net of reinsurance and other recoveries.

**NCP**
Net Claims Paid. Claim payments net of reinsurance and other recoveries.

**NMV**
Net Market Value. The amount which could be expected to be received from the disposal of an asset in an orderly market after deducting costs expected to be incurred in realizing the proceeds of such a disposal.

**Normal inflation**
In assessing an appropriate rate of increase for future claims it is usual to start from a base or “normal” level of price increase based on a general economy-wide measure of inflation such as the change in Average Weekly Earnings (AWE) or the change in the Consumer Price Index (CPI). The base is then adjusted to reflect specific inflation in the type of claim (see “Superimposed Inflation” below) relative to the economy-wide measure.

**NPL**
Non-performing Loans. Loans where the borrower has failed to repay on time or in full, but which are not considered to be in default.

**NTA**
Net Tangible Assets. Total assets less total liabilities less intangible assets (such as goodwill).

**OCP**
Outstanding Claims Provision. The provision in an insurer's accounts for claims in respect of incidents that have already occurred (including IBNER and IBNR). For claims
made classes of insurance this provision is only in respect of reported claims, since only these are covered.

**PA**
Personal Accident. A class of insurance.

**PCE**
Projected Case Estimates. A claim projection technique, used for liability estimation based on patterns of development of reported incurred cost (claims paid plus case estimates).

**PI**
Professional Indemnity. A class of insurance.

**PL**
Public Liability. Also often refers to Public and Product Liability. A class of insurance.

**PML**
Probable Maximum Loss.

**PPCF**
Payment Per Claim Finalized. A claim projection technique, used for liability estimation, based on a rate of finalization (claims finalized per period divided by number outstanding at beginning of period) and average finalization size, each segmented by development period. Generally used for long tail classes.

**PPCI**
Payment Per Claim Incurred. A claim projection technique, used for liability estimation, based on a payment amount per development period in respect of all claims incurred for a given accident period. Generally used for short tail classes.

**PRC**
Policy, Research and Consulting. The PRC Division of APRA provides specialized risk management and consulting services to the other divisions of APRA. It also conducts research activities and has primary responsibility for developing prudential policies relevant to all types of institutions supervised by APRA.

**Provision**
The amount set aside in a company accounts to provide for an expected liability.

Note also that in the Australian context, the insurance jargon often uses the expression “reserve”. The more correct expression is “provision” since a provision is an expense item deducted from revenue in the matching process underlying the periodic
measurement of profit, whereas a reserve is an allocation made from profit. Participants should be aware that many references to “reserves” throughout the Case Study material (especially in the provisioning Case Study) should more correctly be termed “provisions”.

Note that “Provisions” can be called by various names in other countries, including: “Reserves”, “Technical Reserves”, “Claims Reserves” and “Actuarial Reserves”.

**Prudential Margin**
The difference between the provision an insurer holds for a liability and the central estimate of the amount needed.

Note that “Prudential Margin” can be called by various names in other countries including “Provision for Adverse Deviations”.

**RBA**
Reserve Bank of Australia. Central bank and prudential supervisor of banks prior to the establishment of APRA.

**RBC**
Related Body Corporate. Assets of a related body may be counted towards solvency upon approval by the regulator under Section 30.

Also used sometimes to refer to Risk-Based Capital.

**Related Body Assets**
Loans to or investments in related companies. “Related” refers to the ability to control or significantly influence the company. For example, subsidiaries, joint ventures and associated companies. Refer to RBC.

**Reserve**
An allocation from profit to provide for contingencies.

**Risk Margin**
See prudential margin. The term “risk margin” has largely replaced “prudential margin”.

**RRA**
Reinsurance Recoverable Asset.

**RSM**
Required Solvency Margin.
Section 30 Approvals
Section 30 of the Act defines a series of assets not allowable for solvency purposes and gives scope for approval of some classes of those assets to be included in the solvency calculation.

Short tail
See long tail.

SID
Specialized Institutions Division. Supervisory division within APRA with responsibility for institutions and groups operating within one financial sector industry.

Solvency Coverage
Usually used as a ratio of net assets (adjusted for S30 assets in the Australian context) to RSM.

Solvency Surplus
Either the dollar amount of adjusted net assets less RSM or the ratio of the two.

Superannuation
A means of setting funds aside during working life for use as retirement income. Similar to pension plans.

Superimposed inflation
When average claims costs rise at a rate faster than normal inflation, the difference between actual (whether measured historic or expected future) is referred to as superimposed inflation. So, for example, if expected future AWE inflation is 4%pa and overall claims inflation of 8.5% is expected, superimposed inflation is 4.5%.

Technical provisions
Provisions for outstanding claims and unearned premium (though in Australia the latter has been replaced by a premium liability for some purposes).

TPL
Motor Third Party Liability. A class of insurance.

UPP
Unearned Premium Provision. Provision established at the time a premium is received (accrued) and run down over the period of insurance coverage so that the net effect is that premium is taken to income only as periods of claims exposure pass.

WCA
Workers’ Compensation. A class of insurance.