Australian government forced to call royal commission into major insurance collapse

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After two months of refusing to take any action on the collapse of insurance group HIH, the Howard government has been forced by public anger to call a royal commission into the crash and how the government's own regulatory agencies permitted it to happen.

HIH Insurance, Australia's second largest general insurance company, suddenly went into liquidation on March 15, leaving an estimated $4 billion in unpaid claims and a trail of personal and financial disaster that is still only fully emerging.

Less than a week ago, Prime Minister John Howard ruled out a royal commission, claiming it would impede an investigation by the Australian Securities and Investments Commission (ASIC). Yesterday, he was so anxious to announce the government's change of heart that he could not say who would head the inquiry, what its terms of reference would be, or even where it would be held.

Howard said he had opted for a royal commission because of legal advice that ASIC head David Knott had a "technical conflict of interest" as a director of the Australian Prudential Regulation Authority (APRA), the agency responsible for monitoring financial institutions. Now the royal commission will somehow proceed side-by-side with the ASIC investigation.

HIH has become the largest corporate collapse in Australian history, surpassing the 1989 liquidation of the Victorian-based Tricontinental investment bank, which left losses of $2.7 billion and the failure of the Pyramid Building Society, which cost small investors nearly $2 billion.

An estimated two million insurance policies have become worthless, affecting one million policy-holders. Within Australia, some 50,000 HIH customers are facing severe financial difficulties. At least 300 seriously ill people who depended on HIH payments under income protection insurance are no longer receiving them. Car accident victims are waiting for $190 million for operations and other medical procedures in Queensland alone. Thousands of home owners have been left with defective or uncompleted houses, and injured sporting players face being denied compensation.

The crash has also had wider economic effects, deepening the impact of a gathering recession. Uninsured construction projects worth $2 billion have been halted, throwing building workers out of work. Small businesses have been bankrupted, and local councils and community organisations endangered by public liability claims. A substantial section of the country's self-employed professionals, such as accountants, doctors, dentists and lawyers, have lost their professional liability coverage.

Internationally, those affected include workers compensation claimants in California, small fleet fishermen in north-western United States and professionals in London and Hong Kong. One-third of the business of HIH and its 200 subsidiary companies was overseas, spanning five continents. The group's activities included superannuation funds, lending, real estate and travel.

Business commentators have warned that the effects will reverberate for at least 10 years. In the words of the *Australian Financial Review*: "Eight weeks after HIH Insurances was placed into the hands of a provisional liquidator, it has become apparent that the economic and social consequences of the collapse will be far greater than any other insurance company collapse in Australia's history."

The meltdown is a further political and economic blow to the Howard government, which already faces deep popular hostility, electoral swings against it and a loss of support from key sections of big business. Having initially refused to consider a financial aid package for the victims, the government has also felt compelled to announce a rescue plan that will cost at least $500 million.

State governments have been similarly affected, having to promise relief packages totalling more than $1 billion, mostly to cover holders of compulsory third party motor vehicle and building insurance policies.

The debacle has provided a revealing glimpse of how the profit system functions. Insurance industry and share market insiders knew for at least three years that HIH was on the skids, but the company's owners and managers hid multi-billion losses from the public until the bitter end; its external auditors publicly endorsed its book-keeping just five months before the collapse; and federal government agencies decided to protect the company from public scrutiny.

Until the beginning of March, if one were to believe the public utterances of APRA and ASIC, the HIH group was fundamentally sound, with reserves of nearly $1 billion. This week, the provisional liquidator reported that unsecured creditors are expected to receive less than 50 cents in the dollar.

Last October, HIH chairman Geoffrey Cohen wrote to shareholders describing the company as "financially strong, profitable and independent". In December—just three months before liquidation—the newly appointed chief executive Randolph Wein told the annual general meeting: "I strongly believe that this company still contains substantial unrealised value."

According to financial journalists, however, the problems at HIH went back as far as 1992, when large institutional investors first became concerned that the company lacked the financial reserves to cover its long-term liabilities and was aggressively seeking new business at cut-price rates to shore up its position.

In that year, key investors pulled out of a share market float of CE Heath International Holdings—as HIH was then known. An analyst's report highlighted the company's reliance on "long-tail" insurance business, such as workers' compensation, that typically takes many years for policy claims to materialise. Heath had already begun to make losses in California, where it entered the highly-competitive workers compensation market in 1987. These losses eventually exceeded $300 million.

In 1994, there were further signs of trouble. The company tried to offset its losses by diversifying from its main expertise, workers' compensation and professional liability insurance. It entered the high-risk reinsurance market, which consists of underwriting other insurance companies' policies.

By 1996, it had incurred losses of some $350 million in London, mainly due to major marine and airline disasters and the worse-than-expected profitability of several Hollywood movies, including *The People v Larry Flynt* and *The Mirror has Two Faces*. Heath's British manager first wrote to the company's founding chief executive Ray Williams in 1995 warning of the extent of these losses, yet the company's public reports continued to paint a rosy picture.

Despite this, Heath expanded into Europe in 1995, when the Swiss insurance group Winterthur acquired a 48 percent stake in the company. On the surface, the HIH Winterthur books looked healthy and, aided by a soaring stock market, its shares reached a peak of $3.44 in 1997. The price soon began to fall, however, prompting Winterthur to sell out in August 1998.

HIH's management then tried to cover its overseas losses by writing new business in Australia, fiercely undercutting its competitors and branching into fields it had not previously entered, such as general insurance.

These efforts included the 1998 purchase of FAI Insurances, a well-known Australian general insurance company that multi-millionaire Rodney Adler had inherited from his father. Without even conducting the standard pre-purchase inspection of FAI's books, HIH paid $300 million for FAI, consisting mostly of $275 million for goodwill. By September 2000, HIH had written off losses on the FAI deal of $405 million—more than the purchase price.

As HIH's fortunes slumped, it formed a close relationship with its auditors, Arthur Andersen & Co, one of Australia's "big six" accounting firms. Geoffrey Cohen, a former senior partner at Arthur Andersen, became HIH chairman in 1991. Dominic Fodera, another former partner, was appointed HIH's chief financial officer in 1995. Yet another, Justin Gardner, became a non-executive director at HIH in December 1998.

On October 16, 2000—just five months before HIH folded—Arthur Andersen signed off, without qualification, on HIH accounts showing total assets of $8.32 billion, a buffer of nearly $1 billion over liabilities of $7.38 billion.

By this time, HIH's demise was already obvious to the financial elite. Insurance brokers had been withholding business from HIH since June. Large investors deserted the company, sending its share price plumetting to 31 cents by the end of October. In the same month, Standard & Poors, the credit ratings firm, downgraded HIH stock to BBB-plus. By the time that the Australian Stock Exchange suspended HIH shares in early March 2001, the price was 17.5 cents.

Those caught by surprise by the HIH crash were small investors and the company's individual policy-holders. For this, the chief responsibility lies with the Howard government and its corporate monitoring agencies.

In 1996, the Howard government commissioned an inquiry into the financial system, headed by leading businessman Stan Wallis. "We're setting up a new prudential framework that will make sure the Pyramids [building society collapses] and whatever can't happen again," Wallis promised.

Two years later, Treasurer Peter Costello heralded the establishment of two new bodies to take over monitoring and regulating the banks, insurance companies, superannuation funds and credit unions. He boasted that the establishment of ASIC and APRA constituted a "landmark in the history of corporate and financial regulation". His "reform package" would help "make Australia a leading business centre in the Asia Pacific region".

Costello's measures significantly lessened the regulation and supervision of the main financial institutions that ordinary people rely upon for their savings and loans, retirement funds and insurance protection. APRA and ASIC replaced the more specialised and interventionist Reserve Bank, Australian Securities Commission and Insurance and Superannuation Commission.

APRA was given less than 400 full-time staff to examine the operations of thousands of organisations, large and small, that handle 85 percent of the assets in the Australian financial system.

Nevertheless, Costello claimed that the new framework would protect the interests of all. "Recent experience in world economies has demonstrated the importance of having a financial system that is sound, where transactions can be undertaken with confidence and where accurate information is available to the market."

HIH has become the fourth insurance company to crash since then. AMP, one of the biggest life insurance firms, wrote off losses of $1.2 billion after it took over GIO, a major retail insurance company, two years ago. The others were Reinsurance Australia Corp and New Cap Re.

For the past two months, APRA chairman Jeffrey Carmichael and chief executive officer Graeme Thompson have defended their agency's role in the HIH collapse. They have admitted that APRA knew of HIH's difficulties in March last year, but decided not to send in an inspector, which would have alerted the public to the situation. "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," APRA said in a media statement.

Instead, APRA worked with the company secretly, trying to help it offload its loss-making ventures onto other companies. In the weeks before HIH went into liquidation, major general insurance firms, including QBE, NRMA and Allianz, profited from its demise by picking up pieces of its business at fire sale prices.

APRA's cover-up continued right to the end. When HIH missed a deadline for filing December quarter financial statistics, APRA gave the company six weeks' grace to March 1.

Writing in the *Financial Review*, journalist Alan Kohler sought to blame "human error" for APRA's failure to act on HIH. But APRA's efforts to shield the company rather than the public flowed directly from the government's underlying program of economic de-regulation. In the words of APRA's 2000 annual report, its approach is designed to be "consultative" with the industry.

Moreover, the Howard government handpicked APRA's management from the cream of the financial establishment. Thompson is a former Reserve Bank deputy governor and Carmichael was chairman of the Australian Financial Institutions Commission. Other APRA board members include Reserve Bank governor Ian Macfarlane, ASIC chairman Knott, former ASIC chairman Alan Cameron, PricewaterhouseCoopers actuarial director David Knox, and former ANZ Bank chief Don Mercer. None have expressed any disagreement with APRA's role.

The two ministers responsible for APRA, Costello and Financial Services Minister Joe Hockey, have also steadfastly defended its conduct. Hockey declared that he had discussed HIH with APRA last October and concurred with its approach.

Initially silent for weeks, Howard sprang to APRA's defence as well, declaring there were "no suggestions the regulator was tardy in acting in response to information provided to it by the insurance company".

Until last week, Hockey refused to commit the government to any rescue package until the provisional liquidator could specify the extent of the losses. "It is completely irresponsible for any government to throw large sums of money—I'm talking hundreds of millions, if not billions, of dollars—at a problem when we can't quantify the size of the problem," he said.

The government was soon forced to retreat. Costello first floated the notion of striking a levy on all insurance premiums, in effect requiring all policy-holders to bear the burden. This suggestion only inflamed public resentment. The government opted for its proposed bailout, limited to compensating those who can prove "genuine hardship".

Under conditions of economic downturn, the HIH collapse puts a question mark over the finance industry, with potentially devastating consequences for millions of working people. Reserve Bank governor

Macfarlane, a member of APRA's board, last week expressed concerns about the liquidity of some 10,000 medium-sized superannuation funds, mostly employer-run. Macfarlane warned that APRA did not have the resources to identify problems.

No faith can be placed in the royal commission or further “reform” of the financial markets. At least five inquiries have examined aspects of their regulation since the late 1980s, when some of Australia's biggest corporate names crashed, including Tricontinental, the State Bank of South Australia, the Pyramid Building Society, Rothwells merchant bank, Adelaide Steamship and the media/investment empires controlled by Alan Bond and Christopher Skase.

Prudential controls have been reformed twice, most recently in 1998. Yet, over the past 15 years, five banking and building society collapses have cost taxpayers and small investors $10 billion, while those running the corporations have largely escaped scot-free. Nor is HIH the first insurance company failure that working people have had to pay for. In 1991, the Hawke government imposed a levy on insurance policies to fund the bailout of policy-holders in the Occidental and Regal Life companies.

HIH's crash speaks volumes about the workings of the capitalist market. Most ordinary people regard insurance—like superannuation—as a means of safeguarding themselves against economic insecurity and potentially calamitous risks. As the HIH affair demonstrates, insurance companies are run purely for private profit and governments will do anything to protect their operations, together with the rest of big business.