HIH INSURANCE DUE DILIGENCE

The review of the underwriting results and financial position of a general insurance company through a due diligence process requires:

- a good understanding of the general insurance markets both in Australia and internationally
- an ability to understand the intricacies of insurance and reinsurance accounting
- linking public information with company factors and market knowledge into the big picture
- specific review and analysis of the full ambit of a company's underwriting, investment and accounting processes concentrating on:
  - underwriting procedures and exposures by class of business and geographically
  - claims reserving for both direct insurance and inwards reinsurance
  - normal reinsurance arrangements
  - one off reinsurance arrangements
  - expenses
  - one off transactions or issues over recent years and accounting thereof
  - investment valuations
  - value of other assets including intangibles and deferred costs
  - technological systems
  - quality of management and staff
  - motivation of executive management in sale
  - consultation with external auditors and actuary and review of workpapers and reports

A potential buyer of an insurance company in Australia would be able to undertake all but the specific review and analysis process with a degree of ease. The specific review and analysis is however an essential and material missing piece of the jigsaw. No buyer could ever be comfortable if it were unable to undertake a complete due diligence of the target company with full cooperation of the seller.

In Australia we have seen the consequences of failure of the buyer to undertake a complete due diligence process. Both AMP on GIO and HIH on FAI are classic cases of the buyer being caught unawares with severe

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consequences to share prices. More recently there is now the case of HIH supposedly refusing two potential suitors the opportunity to undertake a full due diligence. In the cases of GIO and FAI hindsight has shown that the acquisitions would probably not have proceeded if a full due diligence was undertaken, or at least, not at the price paid.

In the case of HIH they have apparently denied other parties the opportunity of performing a due diligence. If one were to do a due diligence on HIH then what would be the main areas of review in order to ensure that the fair value of the net assets of the company could be ascertained with a greater degree of certainty? The following provides a discussion on the possible exposures, which exist are likely to exist in an organisation such as HIH, and addresses the due diligence process that they may be applied in order to arrive at a possible range for a fair net asset value.

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HIH is quite a diverse organisation having been the result of mergers of CE Heath and CIC in 1995, CMG in 1996 and FAI in 1998. Both CIC and FAI had histories, also involving mergers, going back many decades. HIH also has a wide geographical presence through the Americas, UK and Asia. The areas requiring special consideration in a due diligence on HIH would include the following:

- claims reserving
- asset valuations
- accounting policies
- portfolio profitability and likely developments
- run off exposures
- reinsurance arrangements – normal and one off
- management skills and incentives
- capital sufficiency

It is only after having considered each of these matters that an informed view would be able to be taken on the fair value of the net assets of the HIH Group.

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1. Claims reserving practices

The issues here would include:

- level of prudential margins
- run off exposures
- technical adjustments
- actuarial valuations

It is generally accepted that most insurance companies should set claims reserves at a central estimate level and then hold a prudential margin on top of that to achieve a greater degree of confidence that the reserves are adequately stated. The adding of a prudential margin is considered particularly necessary in the case of long tail portfolios. Most insurers would carry a prudential margin of in excess of 10% with some carrying up to 25%.

In the case of HIH its net claims reserves total $2,561m at December 1999.

	$m
Gross	4,065
Reinsurance	1,504
Net	2,561

Of this amount it is estimated, given its portfolio mix, that long tail reserves would constitute around 85% of these reserves. A prudential margin of 10% would add a further $256m to net reserves at December 1999.

The HIH position is possibly worsened with its constant difficulty in generating reasonable profits. This is not conducive to setting conservative reserves even at a central estimate level so it would be necessary to closely review the adequacy of the central estimate base. Ascertaining the external auditor's and actuary's view of the adequacy of reserves would be an essential phase of the due diligence process. If a low end central estimate outcome were used then greater concern would obviously exist.

A conservative increase for a prudential margin would therefore be $260m (10%) and possibly as much as $390m (15%).

The group has inherited from both FAI and CIC a range of historical liability exposures from old group companies in those organisations. These would range from CIC's asbestosis cover through CSR and US inwards reinsurance liability business from FAI. On top these there is still a possibility of exposure to the Heath inward reinsurance liability business written in the US and UK. It would be necessary to quantify the extent of these exposures and what action, if any, has been taken to contain them. ACE, who as CIGNA was lead on the CSR account, are still seeing development of CSR asbestosis claims. Carlingford (part of CIC group) also participated on CSR. With the passing of time the collectibility of reinsurance increases the potential for a greater net exposure. Exposure to latent claims and uncollectible reinsurance needs to be closely examined. On those inwards reinsurance exposures which have already been settled it would be necessary to review the terms of those settlements to ensure that none of the settlement cost is in the form of delayed payments, the expense for which will not be booked until a future period. On the remaining inwards reinsurance liability exposures close care would need to be taken to undertake a full review of any potential exposures. Exposure on this inwards reinsurance business could be in the range of $50m to $100m given the GIO and Reac scenarios.

The level of discounting of HIH reserves at December 1999 was at 6.8% which is at the high end of the range. Inflation at 5.7% is at the low end after allowing for the level of superimposed and economic inflation expected of a long tail dominated claims reserve liability. A small decrease in discount and a small increase in inflation generating a 0.5% decrease in the real rate of return would add $35m to net claims reserves. The basis of claims reserve discounting therefore would need to be closely examined.

The asset/liability matching is an issue as the claims reserve liability is not fully matched by fixed interest investments. It is necessary to bring into the matching process riskier assets such as equities and property. Cash and fixed interest investments at December 1999 totalled $1867m and represented only 73% of net reserves. No risk adjustment would appear to have been made for the risk adjusted rate of return on equities and property investments, which are used to balance the match of reserve liabilities and investments. A 0.5% decrease in discounting to adjust for risk would add another $35m to claims reserves. Again a close examination of discount rates from this perspective would also be necessary.

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HIH has indicated that it has put in place one off reinsurance arrangements to protect the total reserves. The method of discounting recoveries on reinsurance contracts would need to be examined to ascertain if an exposure arose from the method of discount applied to aggregate stop loss reinsurance recoveries. Exposure could be up to $10m if inappropriate discounting methods have been applied to reinsurance recoveries.

The basis of determination of future claims handling provisions needs to be ascertained. If a run off cost basis as opposed the more correct ongoing operation method has been used claims reserves could be artificially decreased. A 1% increase in FCHC (applied to gross discounted reserves) would add $40m to claims reserves.

The HIH actuary, David Slee has been associated with HIH over twenty years. With HIH being his one of his main clients the issue of total independence is a concern. Such a concern is exacerbated with the use of one off reinsurance contracts, run off exposures and absence of prudential margins. As well, the long standing association with Arthur Andersen and the make up of the Audit Committee further the total independence concern scenario as recently expressed in the financial press.

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2. Asset valuation practices

There are several asset categories in the HIH balance sheet which would require close examination in a due diligence. They include:

- intangibles
- other assets
- fixed assets
- properties
- deferred acquisition costs

By far the major asset valuation exposure is that of goodwill. The goodwill is dominated by the FAI acquisition though the level of goodwill held for HIH America should also be examined given recent problems in this area.

In the six months to June 1999 the level of HIH's goodwill increased by $312.5m predominantly due to the acquisition of FAI ($275m). The FAI goodwill would have been arrived at after taking account of such items including:

- overvaluation of the FAI investment assets
- reinsurance exposures
- undervaluation of claims reserves
- underwriting results 30 June 1998 to 31 December 1998
- integration costs

These adverse net asset adjustments could have been offset by a future income tax benefit on them and the partial recognition of unbooked tax losses. The goodwill would have been higher if the loss on Oceanic Coal was not reported as an abnormal item.

The accounting for goodwill needs to be closely examined to ensure that firstly its method of determination is understood and the appropriateness of that method considered.

The $275m goodwill on FAI is being amortised over a period of twenty years. Given the underlying profitability and size of this business then its value is extremely doubtful. The initial market expectation of the goodwill on the acquisition was less than $100m. At $275m it is clearly overvalued. A reduction in net assets of $225m would not be unrealistic.

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The other goodwill build up in the year to June 1999 needs to be understood. If it related to HIH America then the value of this adjustment is particularly questionable given the profitability of this market even with rate increases. Underreserving in HIH America at the date of acquisition could have been partially offset by the booking of discount on reserves as the US does not discount reserves under US GAAP. The practice of providing for policyholder dividends in the US workers compensation market and the extent to which future exposures have been reserved needs to be understood. The end result could well be an abnormally high level of goodwill and an understated policyholder dividend liability. Reinsurance arrangements for HIH America need to be examined with a view to ascertaining if an exposure also exists as regards future reinsurance contracts. Overall net tangible assets could need to be decreased by up to $20m. Any goodwill reduction would be in addition to this.

Other assets consist of:

Future income tax benefits – timing differences
Future income tax benefits – tax losses
Investments in associated companies
Prepayments and deferred expenses

The value of future income tax benefits in the group at $150m plus is questionable. Tax paid by the group in the period 1 January 1997 to 31 December 1999 (3 years) has totalled $16.8m. Given the level of underreserving and low profitability it will be several years before any benefit can be gained from this asset (if ever). The one off reinsurance contracts may assist in utilising the losses to a certain degree but underreserving could well offset this benefit. There remains an exposure to the group if the tax office were to view any one off reinsurance contracts as financial reinsurance as discussed in Ruling TR 96/2. If this were to be the case then there is a possible dividend imputation exposure.

The possible exposure on FITB could be up to $100m.

Investments in associates are dominated by Home Security International, Nam Seng, a listed Thailand motor insurer, and an UK property holding. Valuation methods/basis of these investments are not disclosed. However, consistent with claims reserving, it is possible that they would not be conservative. A due diligence process would closely consider these valuations and independent advice would certainly need to be taken.

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The possible exposure on investments in associates could be up to $25m.

Prepayments and deferred expenses need to be examined for the deferral of computer development expenditure, in particular IS2. The future viability of this system would need to be closely considered given its development problems. The deferral or capitalisation of IS2 expenditure would need to be considered given QBE's rejection of this insurance system. The possible exposure on prepayments and deferred expenses could be up to $15m. This decrease could be offset by a potential surplus, which exists in the superannuation fund of $20m, that is, if the benefit has not already been booked.

Fixed assets are comprised of leasehold improvements and computer and office equipment. The value of IS2 related items again needs to be closely considered.

The possible exposure on fixed assets could be up to $30m.

The valuation of the HIH property portfolio is subject to one's view on the value of St Moritz and the reliability of the valuations on the other property holdings. Properties have been valued at directors' valuation having regard to the valuations carried out by registered valuers. If the same aggressive approach to claims reserving is taken to property valuations then close attention to the valuation of these assets would be required. A due diligence process would closely consider these valuations and independent advice would certainly need to be taken.

The possible exposure on property investments could be up to $25m.

Deferred acquisition costs comprise deferred commission and deferred underwriting costs. The level of deferral of underwriting expenses is at the high end of reasonableness at 27.9% of unearned premiums. Given the net commission ratio is 10% and the total expense ratio is 14.7% then a deferral at 27.9% raises questions as to the overstatement of this asset. Assuming even 75% of underwriting expenses are deferrable then the ratio to unearned premium should be around 21%. The due diligence process would need to closely examine the basis for the calculation of deferred indirect acquisition costs.

A conservative reduction of deferred expenses would be therefore be around $70m. This may be potentially overstated as net earned premium is artificially low due to the impact of smoothing reinsurance contracts.

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3. Accounting policies

The accounting approach to several areas would require close attention including those covering:

- one off reinsurance contracts
- goodwill amortisation
- deferred expenses
- net discount rate adjustment
- superannuation surplus
- reclassification of items within the profit and loss
- cash flow statement

The method of accounting for one off reinsurance contracts as applied by FAI and HIH from June 1998 requires close review. It would be necessary to examine for the possibility of a reinsurance smoothing transaction being interpreted as a transfer of risk.. All documentation relating to the one off reinsurance transactions would need to be reviewed so as to understand their impact on the reported results for each of the reporting periods from June 1998.

Concern in this area arises from the extent of the loss on the reinsurance account for the recent reporting periods. For example the HIH loss ratio on reinsurance for the six months to December 1999 was 125% compared to the gross loss ratio of 90%. The June 1998 FAI accounts depict a similar scenario.

Goodwill arising on the FAI acquisition is being amortised over a period of 20 years. Clearly both the period and quantum are questionable. The fading FAI direct market presence (advertising cut back significantly), potential deregulation of the Queensland CTP market, a disbanded corporate portfolio, deferral of NSW workers privatisation and departure of the entire FAI executive and senior management team significantly reduces the value in the name or business of FAI.

The expense deferral policy as regards underwriting expenses appears to take into account a higher than normal proportion of management costs, which is possibly stretching the definition of indirect acquisition costs to the limit. Again the accounting policy and methodology would need to be closely examined for appropriateness.

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Lloyd's business profitability is usually recognised at the end of three years at the time the underwriting year is closed. The HIH method of accounting would need to be examined to ensure that it is understood and considered for appropriateness. The treatment of discount on reinsurance to close would also need to be examined.

The net discount rate adjustment is a unique reporting line to HIH. Its unclear definition possibly enables adjustments to be made above or below the underwriting line to boost the underwriting result. The basis of calculation of this item in the P&L over recent years needs to be reviewed to consider its appropriateness.

The accounting treatment of the surplus in the superannuation fund needs to be understood.

In an environment of a wide range of one off adjustments the quantum of the benefits of those adjustments needs to be examined in order to ascertain the real trend of the underlying results.

The cash flow statement is one of the truer indicators of the financial direction of HIH. A negative underwriting cash flow is now evident. As with accounting profit it is important to review basis of compilation of the cash flow statement. In particular the treatment of payments under one off reinsurance contracts would need to be closely examined to ensure that the correct cash flows are reflected in the statement.

At June 1999 an abnormal item of $50m was booked in respect of the estimated impact of the GST legislation on pre 30 June 2000 claims. The determination of this adjustment and subsequent appraisal thereof needs to be considered. In particular it would be necessary to consider how any increase or decrease in this adjustment has been reflected through the P&L in subsequent periods.

Annual and quarterly reports to APRA returns need to be examined particularly in regard to the treatment of one off transactions and the allocation of reinsurance and expense costs between the licensed Australian insurers and other companies in the Group.

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The accounting treatment of major disputes/transactions which the Group has encountered in recent years would need to be closely examined. These would include:

US inward liability reinsurance
Charman inwards reinsurance
FAI Life
One-Tel
St Moritz
OCAL

It is noted that Arthur Andersen were the signing auditors on the FAI June 1998 accounts and are the auditors of HIH. Obviously they have been able to be comfortable with the accounting policies adopted by both FAI and HIH over recent years. Given the range and complexity of possible areas of concern then their rationale for agreeing to the treatment of these items would need to be closely considered in the due diligence process.

4. Portfolio overview

The hardening of rates in the corporate area will assist with future profitability and certainly there have been efficiencies achieved with the completion of the FAI integration.

A broad view on each major HIH portfolio is as follows:

Liability	Historically an unprofitable area of the market. Extent of the success of re-underwriting and ability to achieve rate increases would need to be closely examined.
PI	Historically a profitable market - recent market concerns on several major accounts require close review Impact of weakening market influence needs to be considered Market concerns as to claims payment practices - understand real story on Duke claim Security is an issue – what would be impact of a reduction in the current S&P rating
Property	Rates hardening from a base well below what's required
Marine	Portfolio being attacked by several new players
Motor	Some improvement in market but portfolio too small to be a powerful player
Regional	Likely to be a strong performer – a good market niche
Commercial	Likely to have improved recently except in NSW Liability business profitability would be uncertain
Workers	High level of reinsurance on this portfolio. Extent and future profitability of reinsurance arrangements needs to be assessed

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CTP	Still too early to tell if scheme changes will be effective in NSW though encouraging Queensland underpriced – NRMA seeking a significant market share will not help rates
Fin Institutions	Growth of credit union sector will be limited Other mergers/alliances CBA/Colonial and AMP/NAB? will limit future customer reach NRMA listing benefits uncertain Competition on Queensland motor (FAI's major portfolio) will intensify with NRMA in the market and CTP deregulation
New Zealand	History of profitability and strong presence in market. Impact of increased competition needs to be assessed. Renationalisation of Workable impact needs to be assessed
Asia	Too small and diversified to achieve significant profits
UK	Good news is rates are up 7% - bad news is they need to climb 33% to achieve profitability All new business now through Cotesworth Run off exposures still emerging
US	Severe losses since acquired Potential legacy costs – reinsurance contracts and policyholder dividends
Argentina	Underpricing an issue
Europe	Too small

The likelihood of any to these portfolios generating super profits from general insurance business is low. The "recent" new growth areas of UK and America are in run off and unless the cost of this has been fully reserved then they will continue to impact future profits. FAI business was never a profitable portfolio, and its strength, personal lines in Australia, is subject to ever increasing competition and uncertainty. The traditional corporate portfolios and their strong profits are under much greater market pressure.

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5. Run off exposures

Exposures from run off portfolios have historically been a problem within the HIH group. Historical problem run offs would have included:

Heath

US inward liability reinsurance
International aviation
Charman
Councils liability
Liability schemes
Tasmanian workers compensation

CIC

NSW workers top up
WA workers
CSR

Current run off exposures possibly include:

US inward reinsurance liability
Liability schemes
NT workers
UK inwards reinsurance
USA marine
FAI PI
FAI inwards reinsurance
FAI liability
FAI workers
FAI Lloyd's

Close examination of all these exposures needs to be undertaken as part of a due diligence process. The problem will be finding the issues to discuss and ensuring that the information presently available to HIH is sufficient to be able to come to a conclusion as to the exposures.

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6. Reinsurance arrangements

Review of the published accounts of HIH and FAI indicates that there is likely to have been three major reinsurance transactions put in place by the combined group since June 1998 being:

FAI June 1998
HIH June 1999
HIH December 1999

The nature and accounting treatment of these transactions needs to be closely examined and understood as regards

Accounting for transaction
Future costs associated with transactions
Impact of claims reserves valuation
Discounting
Cash flow and future investment income impact

In addition any other smaller one off reinsurance arrangements need to be examined to ensure that the sum of smaller exposures does not add up to another area of major exposure.

The extent of utilising reinsurance contracts to smooth reported results is a major area to examine in the due diligence process of any general insurer in Australia. The number of financial reinsurance arrangements on the market dressed up as risk transfer transactions makes it easier for insurers to smooth the cost of the past over future years in anticipation that future profits will more than cover these costs. There is a very grey line between profit smoothing and true risk transfer. The extent to which HIH has used, if at all, such contracts needs to be ascertained in order to establish a realistic underlying level of profitability of its underwriting business.

Management skills and incentives

The senior HIH executive has been largely unchanged for three decades.

Ray Williams as chief executive is clearly in charge of his fellow executives and the board. A most positive outlook is always pursued.

Terry Cassidy as Australian Managing Director has presided over the slow and onerous tasks associated with the CIC and FAI mergers and changes in underwriting and operational approaches. They certainly have not been model mergers.

Dominic Fodera as Finance Director appears to be very effective in holding together the Group's reported financial position. An ex Arthur Andersen partner he has been associated with HIH for twenty years. He would certainly play a vital role in achieving Arthur Andersen and actuarial sign off of the accounts. His involvement in any due diligence process would be essential in order to understand the complexities of the Group.

George Sturesteps has presided over the poor HIH America performance. The Group has struggled for success in Asia.

Randolph Wein has taken control of Asia. It will take time to become a force in this area.

There is little new blood in the next level of management. The success of the FAI asset disposals under Bill Howard is one bright spot.

The extent to which golden parachutes have been provided to the senior executives needs to be ascertained. Given the current value of the executive options the best financial outcome for them is a takeover and the golden handshake, if one exists. The FAI executives certainly appear to have benefited from significant golden handshakes in the merger process. If now in place at HIH the value of the contracts could be around $20m.

The non executive board members have been close to the company for many years. Two are ex Arthur Andersen partners, Justin Gardiner and Geoffrey Cohen, Rodney Adler is ex FAI and Michael Payne and Robert Stitt have been associated with company since day 1. The extent of independence and questioning of the financial performance, especially

with the dominance of Ray Williams, has been questioned in the market place. The due diligence process would certainly involve a review of the corporate governance processes in the sign off of the financial information provided to the market.

It is noted that the directors have been provided with an indemnity for up to seven years after resignation as a director.

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8. Capital sufficiency

Australian insurance regulators currently apply several solvency tests to insurance companies. The ratio of net outstanding claims to net assets must be greater than 15% and the ratio of net assets to net written premium must be greater than20%.

Net tangible assets in the case of HIH excludes goodwill ($330m) but includes subordinated bond debt ($160m). At December 1999 the net tangible assets of HIH were thus determined as follows:

	$m
Reported net assets	962
Less goodwill	(330)
Add subordinated debt	160
Net tangible assets	792
Net outstanding claims	2,561
Claims solvency ratio	31%
Solvency margin (claims)	408
Net written premium	1,885
NWP solvency	42%
Solvency margin (premium)	415

The above indicates if the net tangible assets of HIH were to be decreased by more than $400m then the group would be below the current solvency requirements of APRA.

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The possible adjustments to net tangible assets outlined herein are summarised as follows:

	Best $m	**Worst $m**
Claims reserves prudential margin	260	390
Claims historical exposures	50	100
Discounting	35	50
Asset risk adjustment	35	50
Reinsurance discounting	10	10
Claims handling	40	40
FITB	100	150
Investments in Associates	20	20
Deferred expenses	15	15
Fixed assets	30	50
Property valuations	25	25
Deferred acquisition costs	70	100
Reinsurance profit smoothing	40	80
Employment contracts	20	20
Total potential adjustments	**750**	**1,100**

The bottom line is certainly uncomfortable. The impact of the potential net tangible asset adjustments outlined herein adds to between $750m and $1,100m. Obviously a full due diligence would be necessary to achieve a firmer view. Even if the best outcome is discounted 50% severe solvency concerns would still exist.

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8. Conclusion

The extent of issues which need to be addressed in the due diligence process on a general insurer clearly indicates that it is a complex process. The potential range of outcomes is quite frightening as has been evidenced by GIO and to a lesser degree FAI. In the case of HIH similar scenarios could also exist. Unless an appropriate due diligence is undertaken on HIH by a potential bidder then clearly they are taking a major risk of over paying by a significant amount.

The problem for HIH is how to overcome present market perceptions of its financial strength. Certainly allowing a due diligence to be undertaken would calm market concerns.

The issues raised in this due diligence document have broader implications for a number of parties other than investors including:

APRA
Rating agencies
Auditors on general insurers
Actuaries of insurers
Financial analysts

It is essential for the stability of the general insurance industry and for shareholders and policyholders that these parties are able to properly interpret the financial position of the insurers. Confidence in these parties being to achieve this is somewhat doubtful.

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