HIH debacle reveals monitoring flaws

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The CEO of the Australian Prudential Regulation Authority, Graeme Thompson, admitted he had been in the job for 18 months before he knew what a prudential margin was (``It's too bad, Brad ... you're grounded", Weekend AFR, November 9-10, page 3).

Tom Karp, executive general manager, said he had actuarial training but had spent more time in life insurance than general insurance, while none of his investigators had much general insurance experience at all.

His colleague Craig Thorburn, also an actuary, who headed the team that oversaw HIH Insurance, ``did not have any first-hand experience of supervising general insurers".

It seems that the three professionals blame lack of experience for not detecting a failure that, according to my assessment, was in progress and snowballing for well over 10 years.

What about eminent actuaries who do have a lot of experience?

Two highly experienced and reputable actuaries, Richard Wilkinson for the liquidator and David Slee for HIH, give widely differing estimates of outstanding claims liabilities, $9.7 billion and $4.4 billion respectively, just 12 months apart, based on essentially the same data.

When challenged by the HIH Royal Commission to explain this enormous discrepancy of $5.3 billion, the actuaries can offer nothing better than that they made different assumptions and that the other is wrong.

So which experienced actuary should we believe? Each says the other is wrong. On that point I agree with both of them.

Both actuaries made assumptions based on their actuarial professional judgement, yet these assumptions were at odds with the unique risk characteristics of the business. Ironically, it was not knowing the key risk characteristics of the business that caused the company to collapse.

If Graeme Thompson's knowledge of prudential margins was based on either Clause 12 of the Actuarial Professional Standards (PS300, 1994), or Richard Wilkinson's witness statement, he would still suffer under a misconception.

Indeed, the definition of prudential margin offered by Wilkinson is flawed at a fundamental and rudimentary statistical level and its application can easily lead to substantial under-reserving. Yet under-reserving was the root cause of the HIH collapse!

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Returning to the issue of experience, or lack thereof, in general insurance raised by Tom Karp and Craig Thorburn of APRA, I would argue that no amount of experience in general insurance is of any learning value whatsoever if it is acquired in a flawed statistical paradigm.

We see a regulator not up to the job, actuarial documents replete with technical hogwash and experienced actuaries disagreeing about billions of dollars.

Why are the standard actuarial methods for loss reserving that were used in the days of the slide rule and are derived from an inappropriate life insurance paradigm not investigated?

Finally, in the light of the above discussion and in view of the fact that the field of general insurance is not the traditional field of actuaries, should the profession be self-regulated in that field?

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