FAI a red herring, not Trojan horse, in HIH disaster
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An AAP report on the HIH Royal Commission (``Sale of Adler stake critical in FAI's sale", AFR, April 30) quotes counsel assisting the commission, Norman O'Bryan, as stating: ``FAI was HIH's Trojan horse ... it contained the seeds of its own destruction."

HIH did not fail because of its purchase of FAI.

HIH had been marching inexorably in the past 10 to 15 years towards its ultimate fateful day of ruin, just like many other companies around the world, for essentially the same reasons.

Check out the HIH Winterthur Offering Memorandum, dated July 13, 1998, which offers shares to the public. The memorandum contains significant warning signs as to HIH's financial health and is based on the accounts as of December 31, 1997.

Here is a ``bite": ``The decline in the adequacy of claims provisions in recent years ... a significant strengthening of reserves may be required."

The losses incurred by HIH on the purchase of FAl in 1998 were largely incorporated in HIH's June 30, 2000, accounts, which still showed net assets of $952.8 million.

The liquidator's estimate of net assets nine months later was minus $5 billion. Therefore, the turnaround (difference) of $6 billion has nothing or very little to do with the purchase of FAI.

Any further loss incurred by HIH in the FAI purchase is probably less than 1 per cent of the $6 billion difference.

The key issue is to determine how plus $952.8 million became minus $5 billion nine months later. Where is the $6 billion?

Most of it can be accounted for by the differing methods and assumptions used by the liquidator to compute reserves vis-a-vis the methods and assumptions used by HIH. This means that on the liquidator's basis, the net assets of the company at year-end June 30, 2000 were also minus $5 billion. It clearly follows that the ``true" financial position of the company had been hovering around negative territory for years.

An analysis of the offering memorandum supports this conclusion. Yet the shares were oversubscribed!

A critical assumption in reserving is the assumed level of superimposed inflation. Superimposed inflation is inflation in excess of economic inflation. HIH almost certainly did not adequately identify, quantify or assess the superimposed inflation in its own long-tail lines of business for many years. Underestimation of superimposed inflation leads to chronic under-reserving, underpricing and ultimate ruin.

A company experiencing (non-recognised) high superimposed inflation has its capital eroded geometrically. Such a company can sustain (unnoticed) major reserve deficiencies and be cash flow- positive for many years before it runs out of cash abruptly.

Other companies, local and international, have gone to the wall for the very same reasons. One example just last week was UMP.

The closest the commission has come to addressing the issue of superimposed inflation was in the report of Richard Charles Wilkinson, who had undertaken the assessments of the claims reserves of the HIH Group at the request of Anthony McGrath of KPMG, the provisional liquidator.

However, according to my reading of the report, the assumed superimposed inflation rates do not appear to be based on any assessment, identification or quantification of the underlying trends in the HIH businesses.

Yet I regard such an analysis to be of paramount importance in establishing the cause of failure.

The commission has yet to adequately address this principal issue, which would explain the HIH debacle and the under-reserving that has been prevalent for many years. I regard this as critical if the commission is to adhere to paragraph (a) of its terms of reference.

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