

“Lessons from the HIH Royal Commission Report”

An address to the Australian Institute of Company Directors

by Alan Cameron

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1. I shall focus today on the lesser known lessons from the Report, not the headline grabbing sections of the executive summary, where it recommends prosecution or legal proceedings against alleged malefactors, but rather on chapter 23, the so called gallimaufry of concepts processes acts or omissions relating to the way HIH was governed. (To save you using up a precious question to ask, a gallimaufry is a hotchpotch, jumble or confused medley.)
2. What the concepts processes acts or omissions in chapter 23 have in common is that taken individually, they are not going to strike you as wicked, or too far removed from your own experience. I seek to show that while it might appear on a first reading that what is being recommended or required is more process, more compliance, that is not the right way to understand the message. Closer examination will show that what is needed is more concentration on performance, and how to achieve it, not more rules. I will also say a few words about the regulators, and how they came out of the Report, or as some of the wilder sections of the media would say and did say, performed a Houdini like escape.
3. Before doing so, I want to remind you of his opening words about corporate governance. He says in the executive summary:

‘I am becoming less and less comfortable with the phrase 'corporate governance' – not because of its content but because it has been so widely used that it may become meaningless. There is a danger that it will be recited as a mantra, without regard to its real import. If that happens, the tendency will be for those who have to pay regard to it to develop a "tick the box" mentality. The attitude might be, 'Yes, we have a state –of-the-art corporate governance model; yes it is committed to writing; and yes, the company secretary has checked that each item is in place and has included a statement to that effect in the annual report. Therefore there could be no problem in the corporation'.
4. Even those of us who spend a fair bit of their working lives in this area, share that apprehension – that this will become formulaic, rather than real. Just another role for the company secretary – not intended to disturb the usual order of things. That would be an opportunity missed. For as he says himself later in the report, "there was at least a semblance of standard governance mechanisms at work. By and large the people who were involved were not inherently bad or in some way set upon being part of a corporate disaster. HIH is a reminder, if one were needed, that a drastic fall from corporate grace can occur if those in charge lose their way." It is also a reminder that corporate governance is about substance, not about form – that the requirements for structures which are advocated, or mandated as part of best governance practice, are only justified in they are likely to help the company perform better, not for their own sake. And that you have to dig below the surface, not rely on assertions about structures.
5. That is not easy for shareholders to do; hence the requirement in the guidelines for performance evaluation. You would expect me to believe, and I do, that such evaluations to be useful, must be independent, but done from the inside, not simply by reading the annual report. Unless the evaluation is done from within, you can expect both false positives and false negatives. Some companies will look better than they deserve, and others will look worse – until you get inside, find the long serving director who is studiously independent, for example. Or the director who is always late for meetings and has never had time to read the papers, and is not only failing to contribute, but is holding up the board and causing disruption which far exceeds their positive contribution.

6. I have grouped them, these concepts processes acts or omissions in chapter 23, into four categories; committees, how they are structured and work; expectations of chairmen; the role of the board with respect to strategy; and decision making by the board; I will wrap up with some thoughts on independence.
7. First, board and committee structures. How many of you have decided that a board on which you sit can and should be its own audit committee. HIH did - in the sense that the committee always met immediately before a board meeting, and the whole board always attended. Including all 5 executives. The Report called that a troubling aspect of its processes. Now you need to understand that the report is given to understatement; many of his comments you will hear today meet that description. It sounds efficient; it sounds like a good idea. Why is it troubling? – because it meant that the committee operated as little more than an extension of the board, and therefore that there was not enough time for consideration and analysis in advance. It must have been tempting for HIH to take the view that all directors could and should undertake the audit committee role. It did concern one director; he was chairman of the committee and raised his concerns, but they were not acted on, causing him to resign in 1999. Every company which still operates in that way should re-consider. There is not and should not be a rule about this; rather, you should check whether your audit committee is operating effectively, if it is the whole board.
8. On the other hand, HIH did not have a nomination committee. But note that they are not criticised for that – they are criticised because in the absence of such a committee, it was a critical part of the chairman's role to "maintain a balanced board subject to the approval of shareholders and the views of the existing board" – as he says, "the board should have actively participated in the nomination of new members and the chairman should have taken the primary responsibility for that process ". Nor are they castigated for having a ratio of executive to non executive directors that may or may not have been ideal in the interests of the company, indeed he may be regarded by some fundamentalists as being heretical in observing that some companies may function quite effectively with a board wholly or largely comprised of executives. They *are* castigated for never assessing or re-assessing whether the way they were constituted enabled it to carry out its role of stewardship.
9. The second major issue flows naturally from the first, the role of individual directors vis a vis the chairman. Here the view that the report was generous to the chairman of HIH is well known; the press rejoice in repeating the phrase from the executive summary and chapter 6 that "the chairman was ineffective". I want to say more about the concerns raised by individual directors about the company and how it was operating.
10. HIH had the same standard agenda, prepared by the secretary and forwarded to the chairman for comment. Then it went to the CEO for comment. No other director contributed to the agenda. The result was that the agenda became pro forma and not "a living tool for organising and shaping consideration and review." That is the challenge these observations throw out to all directors; when did you last contribute to the agenda, or even consider who prepared it, what was on it, and in what order? Is your agenda also controlled by management and not the board – which does not properly reflect the true nature and scope of the board's role, or consistent with their responsibilities.
11. Like me you may be frustrated by the report's reluctance to rule on that great debate I have heard on many occasions – should minutes reflect the discussion at the meeting, or only the conclusion. The minutes of HIH did not record the course of discussion – and they are not criticised on that account. Need I say more? You can make up your own mind.
12. Several directors were frustrated by the conduct of the meetings. One prepared an analysis of what was on his mind, had a meeting with the CEO to discuss it, the CEO glanced at the paper and said the management had those matters well in hand. The director agreed to wait for the next round of budget presentations to see whether the matters had been addressed. Why did he raise those concerns with the CEO and not the chairman, I wonder? At about the same time a second director wrote to the chairman with a well argued critique of the company's governance. He concluded, perhaps generously, that HIH had a top drawer management group, but was not taking advantage of the experience which resided on the board, and should appoint a committee to review its modus operandi; if they had done so we might not have had a corporate delicti so soon thereafter. He specifically queried compressing the board and audit committee meetings into one afternoon.

13. Another specific issue raised by the second director was the lack of engagement by the board in the strategy of the company. Three directors told the Royal Commission that there was little if any analysis of the strategy, but even more extraordinary to my mind – it was not written down anywhere, and at least in one director's view, a member of the board would have had difficulty identifying it. It is passing strange that no-one could assert what the strategy of Australia's largest stand alone insurer was just a few years after its former overseas holding company had sold off their holding by an information memorandum to a wide range of institutional and other investors.
14. But the real point for me is not the desirability of an annual strategy meeting, although it would be a peculiar company which would not benefit from one – even law firms worked that out more than twenty years ago. Nor is it the issue as to whether the board or management should propose the strategy; the Commissioner is prepared to agree that the function of the board may be to set goals, that is, to approve the strategy proposed by management and monitor performance. As he says, management can propose but what matters is that it is the board who must decide – and only after rigorous analysis. The point is that it is truly extraordinary that the directors seemed unable to describe it.
15. The Commissioner concludes that the important task of holding an annual strategy meeting was simply overlooked; this is another example of his tendency to understatement. It was the task of agreeing on strategy which was overlooked. But he is right in querying how anyone could consider a particular proposal in the absence of any shared understanding of what the strategic framework of the company was. Forget the strategic plan, the piece of paper, for a moment – if you asked each director of any company, each statutory authority on whose board you sit, to identify what its strategy was, how it made its money now and would do so in the near to medium term future; would each know? ; would each answer in roughly the same way? I hope so.
16. Returning then to the concerned directors. Who called a meeting to address their concerns? Not the chairman, but the CEO. The memorandum was never given to the board, and the chairman is criticised on that account. The letter written by the other director was not circulated or dealt with effectively either, and he subsequently resigned. What a good thing he wrote that letter, and what a good thing he kept a copy, and what a really good thing he knew where to find that copy. Reflect on that next time your spouse starts to query the amount of paper you keep.
17. How many of you have been summoned to an urgent board meeting, not knowing what the agenda was, not receiving any papers in advance, finding when you get there that several of your colleagues are missing and are probably not even aware that a meeting is taking place? Are you still on that board? You deserve a bravery award. Next time you receive such a summons, remember HIIH's acquisition of FAI, which was approved at such a meeting. Of course, if the company had a well thought out and defined strategy, in the course of preparing that FAI may well have been identified as a likely target, in which case some rudimentary due diligence may have been conducted in advance.
18. This was one occasion when the chairman did assert himself by questioning whether the meeting should proceed when some directors had not received notice. He recalled being told it could, but not by whom he was told. The Report observes

"He should not have accepted a bald assertion that the meeting could proceed without testing it and ensuring that the basis of the advice was recorded in the minutes. The meeting had been convened without appropriate notice to discuss a significant acquisition which had not been an agenda item for some months [seven, in fact]. The directors could not have been expected to give due consideration to the details of the acquisition. A number of the directors had no notice of the meeting at all. Others may not have had the appropriate documentation in front of them during critical discussions. The suggestion of competition with another potential bidder was not a justification for ignoring due process"
19. This observation, the reference in particular to due process, may be misunderstood as suggesting a preoccupation with process, that concern usually identified with the public sector and regarded with disdain in some quarters, as leading to delay and inflexibility. That would be the wrong way to read this comment. It is much more an example of the general message in the executive summary - "Why did no-one at the meeting

stand back and ask themselves: is this right?" A director who did so would surely have thought -This transaction is critical to the company; how would I feel if it were to be agreed and the company committed, and I did not know about it in advance. Do unto others as you would have them do unto you, has a nice ring about it.

20. No-one is suggesting that in no circumstances may a board have an urgent meeting over an important matter and reach a quick decision. But if you do have to do that, you have to be even more careful to address the ways in which such flexibility may increase risk. And the circumstances, in which a decision on a major initiative such as an acquisition would be taken without all directors being aware of the matter, should be quite extraordinary.
21. One area in which his meaning does need to be teased out is in his discussion of the ASX Corporate Governance guidelines. A brief and necessarily incomplete recapitulation of the issues may be in order, but it should first be noted that the Council has performed an excellent job of drawing together diverse interest groups with differing and sometimes conflicting agendas; even those of us who are critical of some aspects should be careful to acknowledge the enormity of their task, and the high degree of success they have achieved.
22. What does the Report say about them and in particular about the independence of directors? The discussion commences with the Cadbury Report; Cadbury of course is the Moses of corporate governance, but with only three commandments, openness, integrity and accountability. He reminds us that Cadbury had identified independence of judgment as the essential quality that non-executive directors should bring to the board's deliberations. He then says and I quote carefully –

Apart from their director's fee and shareholdings, they should be independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement. I am wary of attempts at a prescriptive all-embracing definition of 'independence'. Accordingly material such as that contained in the Higgs report can be no more than a guide.

23. I will look first at the HHH situation before reflecting more widely on this issue. HHH had five executive directors out of 13 at the critical time, the middle of 1999. The independence of six of the remaining eight would be in doubt on the basis of Higgs' suggestions, leaving only two, both of whom had resigned by the end of the year. What does the Report say about that? It says that the real problem with the executive directors was their dominance, not their numbers, and that this coupled with the frequent failure of non executive directors to come to grips with the issues raised for their consideration, stymied the benefits of the unitary board. The dominance seems to have been dominance by senior management as such. The non executive directors had a respect for management which led to an assumption that anything they recommended must have been carefully thought out and was almost certain to be correct.
24. The directors had rather different views about the nature and quality of debate at board meetings – some thought it was open and frank, others thought the board's independence had been compromised by the influence of management. The Report concludes that "the fact that debate occurred does not necessarily mean that the requisite independence and rigour of analysis that is required of a board was practised". And that is the real challenge. How to combine collegiality among board members, so important to effective decision making, with a questioning approach to management proposals. How boards handle dissent, becomes a critical success factor. Without dissent, or at least a sceptical starting point for the debate, one queries whether the right mix of people are sitting at the table – yet frequent unconstructive dissent can fracture a board and render it ineffective.
25. I note in passing that the more diversity on boards, diversity of gender, age, background generally, (which I do support) the less likely it is that there will be automatic agreement on the way in which dissent should be expressed and handled. Chairmen and directors generally will need to think more about their approach to board meetings, and spell out the previously unspoken accords. The dissent on the NRMA boards over the years may be due at least in part, to their wide diversity not having been recognised early enough as a source of tension and difficulty.

26. What does this mean for the ASX guidelines – are they the prescriptive all-embracing definition of 'independence' which he believes should be no more than a guide? I think they might be. And that makes the recent debate about their status rather poignant. I am referring to the short piece in the Financial Review on 9 May which dealt with the ASX guideline which states that "a majority of the board should be independent directors." That has a footnote attached to it which says that "independence" is defined in Box 2.1. Below there is commentary and guidance which includes the statement "A definition of independence is contained in Box 2.1." Much is now sought to be made apparently of the fact that it says *A* definition, not *the* definition, and a footnote is to be regarded as subservient to the main text. I might agree with all of that and still weep that it is thought to matter.
27. If we are to accept the Report's guidance on this matter, we should be able to treat any list of matters which might go to a director's lack of independence as indicative, not prescriptive. Let me quote from Chapter 6.2.6
- neither the matters raised during the Commission nor my experience generally qualifies me to say whether all of the matters listed would necessarily deprive a person of independence ... [A]n attempt to be unduly prescriptive might impose undesirable rigidity, and distract attention from the critical issue of freedom from possible influences, many of which may be subtle and not susceptible to a 'check-list' approach. For example it is not immediately clear to me why a substantial shareholding in the company should be regarded as compromising independence. .. the critical question is not so much whether on objective criteria the individual is 'independent' but rather whether he or she is subjectively capable of exercising independent judgement.
28. I think what he is saying there is that there will be directors who will pass the tests set out in the box, and thereby acquire an aura of independence, when they do not deserve, by reason of an attitude of mind, a personal relationship with the CEO or chairman, a blind spot about an individual, even a need for income!, producing an unwillingness or inability to resign, which can never be captured by a list of specifics. He is concerned that that will provide false comfort. He is not going as far as Bill Beerworth's mother, who famously dismisses the importance of independence, and favours competence among those whom she entrusts with her money – don't we all!
29. Let there be no doubt – the Commissioner is in favour of independence, but does not want it determined by a narrow checklist approach. He concludes "non executive directors [need] to appreciate their distinctive role to review the performance of management and to take the lead where potential conflicts of interest and duty arise.. the benefits of good corporate governance ... are more likely to be achieved if the non executive directors are both independent and seen to be independent."
30. What should you do to report against this item? My view is that boards of listed companies or other bodies which choose or are required to report against these guidelines, should identify clearly the tests they have applied to assess independence, unless they use the contents of the Box unaltered. This approach is consistent with the freedom expressly given to the board in the guidelines, to determine that a director is independent notwithstanding some relationship, or as I would see it, factor, listed in the Box.
31. It should be noted that the requirement itself is being re-evaluated even at its source. The Higgs Report issued in January in England, contained a similar recommendation and definition which was clearly influential in the ASX Guidelines. The UK Financial Reporting Council now concedes that this recommendation "could be difficult for many smaller listed companies (below FTSE 350)", and for them the Code should provide for at least two, rather than a majority, and some encouragement to move towards a majority. A similar explicit concession to that effect here would be welcome. Other relaxations are contemplated as well – see www.frc.org.uk and a revised text is due in July.
32. Even the New York Stock Exchange is relaxing its approach in some respects. They are now proposing that the rule *requiring* (in their case) a majority of independents, not apply to controlled companies – companies in which more than 50% of the voting power is held by an individual, a group or another company. This seems logical at first blush, and one wonders how many Australian companies are similarly "controlled" – Pan Pharmaceuticals leaps to mind, where the founder and former CEO held over 50%. How realistic is it to view

any director of such a company as technically independent, since each can be removed almost at the stroke of a pen.

33. And these controlled companies are frequently the companies where the requirement is thought to produce odd results. In Australia we think immediately of the high performing companies which appear to break narrow rules – including Westfield, Harvey Norman, and News Limited. The Economist (May 31st) noted that it is frequently media companies world wide where these “rules” sit oddly with the reality of strong control by media barons – not just News, but thriving companies like Viacom and Hollinger. Until, like Disney, they cease to do so well, and then the CEO’s architect, and the CEO’s children’s pre-school director, are removed from the board.
34. The last word, so far, goes to Peter Morgan, formerly a leading fund manager at Perpetual, now running his own funds, 452 Capital. In a letter in the Financial Review on 5 June, he treats the requirements as prescriptive rules (which shows how leading professional fund managers are regarding them), and adds several more high performers to the list of those which would fail the tests (including Berkshire Hathaway). He concludes “The last thing in the world I need is to be forced [by investment benchmarking] to invest in mediocre companies governed by so-called independent directors who own no shares in the company concerned but take substantial retirement benefits that have no relationship to the company’s performance.”
35. We shall soon see how leading companies will deal with the issues in practice, as some ASX companies voluntarily report against them as at 30 June. Perhaps like Higgs in London, some early fine tuning would be desirable to ensure the viability and credibility of the guidelines, and the necessary flexibility to permit optimal performance of Australian companies.
36. So what about the regulators. A few comments. First, the board of APRA are largely relieved of blame for the train wreck which was HIIH. They did ask the right questions, and at the right time – but they were given assurances by the staff which were, with the benefit of hindsight, too sanguine. It is therefore ironic that it is the board whom the Royal commissioner recommended should be removed, in favour of a commission structure akin to ASIC, and a bill to that effect is now in the Parliament. Second, little attention has been paid to the commission's view of the role of ASIC. In the Executive Summary, the Report says

ASIC limited its involvement in HIIH's affairs because of a perception that APRA was responsible for and was in fact closely and effectively monitoring the situation. ASIC considered that it had little direct responsibility in relation to prudential regulation of insurers; that was APRA's role. I am not sure that I agree with this view of the allocation of functions between ASIC and APRA, but I cannot fault ASIC for assuming that position. It was a view that APRA shared.
37. Assuming that position? It was not a silent assumption. As chairman of ASIC I must have made 50 speeches asserting that view of the respective roles, quoting from the Wallis Report and the second reading speeches and so on. If I was wrong, no-one said so during all that time. I venture to say that it was not just APRA which shared that assumption, but Stan Wallis and the other members of his committee. And what is the opposite view – that ASIC is a shadow prudential regulator? The irony of that is that in most places where bank supervision is taken from the central bank, it is often assumed that the central bank retains a shadow supervisory role; I simply cannot understand on what basis a conduct regulator can be thought to be responsible for prudential regulation as well as its own role, and how could it justify doing so at all far less something for which it is not resourced or knowledgeable. How does ASIC deal with this conundrum in practice – I do not know.
38. But as for corporate governance, it is all about ensuring that your company is set up so as to be free to realise its full potential. Best practice governance will not ensure commercial success, but it will give you the chance for it. What I want to leave you with, then, are the three commandments of Cadbury – forget all the rules – just ensure that openness, integrity and accountability are the hallmarks of every organisation in which you serve, and you will not only sleep at night, but it is likely to be in a bed of your own choosing.