



AUDITOR GENERAL

WILLIAM O. MONROE, CPA



OFFICE OF INSURANCE REGULATION

INSURER SOLVENCY

Operational Audit

SUMMARY

The objectives of our audit were to evaluate the effectiveness of the Office of Insurance Regulation (OIR) policies and procedures established for the purpose of monitoring the solvency of domestic insurance companies and to measure the extent to which the OIR had complied with applicable laws. Our audit, covering the period January 7, 2003, through February 29, 2004, and selected actions through June 4, 2004, disclosed the following:

Finding No. 1: The design of the OIR’s financial analysis review methodologies was generally sufficient for the accomplishment of the OIR’s review objectives. However, review file documentation could be substantially improved. Review files did not include a numbering (referencing) system, and some review files’ summary notes and conclusions contained reference to unresolved issues. Well-organized and cross-referenced review file documentation can be used to enhance an organization’s ability to complete supervisory reviews, conduct training, and provide a mechanism for the performance of adequate follow-up procedures.

Finding No. 2: The design of the financial condition examination processes was sufficient for the accomplishment of OIR examination objectives. However, opportunities exist for enhancing the examination process. Examination working paper files did not include documentation of supervisory involvement in the determination of examination scope, and final draft reports did not contain references to supporting documentation.

Finding No. 3: Examination expenses due from domestic insurance companies and totaling \$4.9 million were shown as uncollected in accounts

receivable subsidiary records. The OIR indicated that a review and analysis of the receivable balances would be conducted.

Finding No. 4: Independent actuarial reviews of loss reserve estimates of domestic insurance companies were not always obtained. Because of the importance of the loss reserve estimates to setting rates and measuring insurer solvency, we believe that the OIR, when such independent estimates are not provided by the insurer, should obtain periodic independent actuarial certifications.

Finding No. 5: Annual reports required by Section 624.315(1), Florida Statutes, had not been completed for calendar years 2002 and 2003 as of June 4, 2004. The preparation and submission of these reports on a more current basis will make them more useful to legislative leadership and the Executive Office of the Governor.

BACKGROUND

Chapter 2002-404, Laws of Florida, effective January 7, 2003, created the Department of Financial Services, within which was created the Financial Services Commission (Commission), consisting of the Governor, the Attorney General, the Chief Financial Officer, and the Commissioner of Agriculture.

Within the Commission, the Office of Insurance Regulation (OIR) was established. The OIR is primarily responsible for ensuring that insurance companies licensed to do business in the State of Florida are financially viable (solvent), operating within applicable laws and regulations, and offering their insurance

products at a fair and adequate rate that does not unfairly discriminate against the buying public.

Duties relating to the OIR’s financial solvency oversight responsibility are assigned to the following three bureaus: 1) the Bureau of Life and Health Insurer Solvency, 2) the Bureau of Property and Casualty Insurer Solvency, and 3) the Bureau of Specialty Insurers. The OIR oversees the financial solvency of Florida’s insurance companies through the performance of ongoing financial analysis work (in-house desk reviews of financial statements) and periodic financial condition examinations.

The objectives of our audit were to evaluate the effectiveness of OIR policies and procedures established for the purpose of monitoring the solvency of domestic insurance companies and to measure the extent to which the OIR had complied with applicable laws. Our audit covered the period January 7, 2003, through February 29, 2004, and selected actions through June 4, 2004, and included an evaluation of relevant internal controls, interviews of OIR staff, tests of OIR review and examination files, and the application of analytical procedures.

FINDINGS AND RECOMMENDATIONS

Finding No. 1: Financial Analysis Reviews

Financial analysis reviews are conducted by the OIR for the purpose of monitoring domestic insurer solvency and statutory compliance on an ongoing basis. The reviews include financial analysis of annual and quarterly insurer financial statements and are performed using in-house created State-specific checklists and checklists obtained from the National Association of Insurance Commissioners (NAIC) Financial Analysis Handbook (Handbook). According to records of the OIR, there were, as of May 14, 2004, 128 domestic insurance companies, each of which was subject to annual and quarterly financial analysis reviews.

The NAIC financial analysis approach, as incorporated in its Handbook, increases the efficiency and effectiveness of the analysis process by breaking it into

three levels that, theoretically, direct and focus the analyst’s efforts to only those areas where significant concerns have been identified. The first level, which is completed as part of each in-house desk review, consists of a general overall analysis of the insurer and its operations. The second and third levels of analysis focus on specific topics such as, for example, investments, unpaid losses and loss adjustment expense, income statement and surplus, risk-based capital, cash flow and liquidity, reinsurance, affiliated transactions, and insurer management of general agents and third party administrators.

The OIR may take a variety of further actions as a result of concerns identified during the analysis process, including, but not limited to: requiring additional interim reporting from the insurer; scheduling a targeted (limited-scope) financial condition examination; obtaining a corrective action plan from the insurer; or restricting, suspending, or revoking an insurer’s Certificate of Authority.

We evaluated the reasonableness of the design of the processes used by the OIR to conduct the financial analysis reviews and, with respect to the execution of those processes, tested ten review files related to the OIR’s most recently completed financial review cycle of Florida’s property and casualty insurance companies. The design of the OIR’s review methodologies was generally sufficient for the accomplishment of the OIR’s review objectives. However, we did find some instances in which review documentation could be substantially improved:

- The review files did not include a numbering (referencing) system. As a result, it was not always possible for us to follow the progression of the analyst’s work and efficiently use the review files to track whether and how the analyst had disposed of particular concerns identified during the course of the review.
- Some review files’ summary notes and conclusions contained reference to pending items. The files were not always updated to reflect the resolution of these pending items or their impact on the overall review conclusion. For example, relative to one of the files we

reviewed, we found a letter sent by the OIR to the insurer requesting additional information related to discrepancies noted during the OIR’s review of the insurer’s investments. The insurer’s response to the letter stated that explanations had been provided for “most” of the issues and responses to the remaining items would be provided at some later date. Our inquiry of OIR supervisory staff disclosed that these items were not resolved until the next year-end analysis.

Well-organized and cross-referenced review file documentation can be used to enhance an organization’s ability to complete supervisory reviews of the work performed, efficiently and effectively train less-experienced analysts, and provide a mechanism to allow for the performance of adequate follow-up procedures.

The review file deficiencies disclosed by our audit can be attributed to the lack of OIR standards, policies, and procedures which sufficiently address review file organization, indexing, and cross-referencing and which clearly communicate the types of specific documentation required.

Recommendation: We recommend that the OIR adopt for its financial analysis reviews a comprehensive procedural requirement addressing file organization, indexing, content, and closure.

Finding No. 2: Financial Condition Examinations

Section 624.316, Florida Statutes, requires that the OIR conduct financial condition examinations of insurers doing business in the State of Florida. The OIR is authorized to perform financial condition examinations as often as may be warranted, but not less frequently than once every three years. Under certain circumstances, the time period may be extended to once every five years.

A financial condition examination may take the form of either a full-scope examination or a limited-scope examination. Financial condition examinations are performed on-site at the insurance company and are more comprehensive and substantive in nature than

those performed as part of the financial statement desk reviews discussed in Finding No. 1.

Financial condition examination findings and recommendations are documented in a published report. The OIR performs approximately 60 of these examinations each year.

The OIR utilizes a commercially available modular computer application program to guide and document its financial condition examination process, and all aspects of the examination working paper process are in electronic format. The application is organized by topic areas which include Planning and Internal Control, Premium Cycle, Losses and Benefits Cycle, Reinsurance Cycle, Investment Cycle, and Operating Cycle. Then, within each topic area, the application includes relevant exam modules. For example, the exam modules available in the Premium Cycle topic area include:

<u>Module</u>	<u>Description</u>
Exam 1	- Understand Overall Insurance Transactions
Exam 2	- Review Company's Premium Database
Exam 3	- Trace a Sample of Records
Exam 4	- Scan the Database for Inconsistencies
Exam 5	- Review a Sample of Reports
Exam 6	- Review Method of Marketing

We evaluated the design of the OIR’s on-site examination processes and tested 20 of the OIR’s financial condition examinations completed during the most recent complete cycle. The design of the examination processes was sufficient for the accomplishment of OIR examination objectives. However, we did find some opportunities for process enhancements. Specifically:

- Each set of working paper files we reviewed did not contain one or more of the sequentially numbered exam modules. In explanation, the OIR indicated that the examiner-in-charge was responsible for determining the modules to be included in an examination. During our audit period, supervisory involvement in this process was not documented. It is our understanding that this decision, a crucial one involving an assessment of risk and the setting of the scope

of examination procedures, was not of record approved by supervisory personnel as part of examination planning.

- The OIR’s findings contained in the final draft report do not contain references or electronic links to the specific documentation that supports each report finding. Although our tests did not disclose any findings not supported by examination file contents, the existence of a report referencing system facilitates a more efficient review of examination files by OIR supervisory staff and decreases the risk of the review process not detecting instances of misstated or unsubstantiated report findings.

Recommendation: We recommend that supervisory staff be involved in approving the scope of examination procedures and that such approval be documented. The OIR has informed us that a new checklist form was implemented in January 2004 to document supervisory approval of the scope of examination. We also recommend that for each examination, a file examination report containing specific cross-references to supporting examination evidence be prepared and maintained.

Finding No. 3: Accounts Receivable

Section 624.320(1), Florida Statutes, requires that each examined insurer pay to the OIR the expenses of its on-site financial condition examination at a rate adopted by the OIR. Examination expenses include an examiner’s compensation and travel expenses and related administrative costs.

For 20 examinations, we evaluated the extent to which the amounts invoiced represented the amounts due pursuant to law. We found that the amounts invoiced were consistent with the amounts due pursuant to the law. However, for 15 of the 20 companies, applicable accounts receivable subsidiary records indicated that some examination charges incurred in previous years had not yet been collected. For these 15 companies, these amounts totaled approximately \$474,000. Some of the accounts included examination charges invoiced as far back as October 1998.

Subsequent to our discussion of this matter with the OIR, the OIR advised us that a review and analysis of

all of the records related to this type of receivable balance would be conducted. As of May 14, 2004, a listing of these accounts receivable totaled \$4.9 million.

Recommendation: We recommend that the OIR’s review of the accounts receivable balances include, but not be limited to, a determination as to whether the amounts shown as due may have actually been paid by the insurers, as substantiated by related records of receipt, confirmation with insurers, and evidence of deposit in the State Treasury. For amounts found to be due, but not paid, the OIR should pursue collection. Accounts that are determined to be due, but now uncollectible by the OIR, should be referred for collection, settlement, or write-off, pursuant to Department of Financial Services Rule 69I-21, Florida Administrative Code, to the Department of Financial Services. The OIR should also ensure that the State’s general ledger accounts properly reflect the value of these accounts.

Finding No. 4: Independent Actuarial Opinions

Loss reserves are insurer estimates of liabilities for the unpaid costs of insured events that have occurred, including costs relating to incurred but not reported losses (IBNR). The loss reserve amount is based on an actuarially determined estimate of the value of all claims. The sufficiency of an insurer’s loss reserve balance is a key determinant of the insurer’s solvency. The loss reserve calculations and trends in the related balances are also a factor in insurer and OIR rate-setting processes.

The United States General Accounting Office (GAO) noted in a November 1990 report entitled *Insurance Regulation - The Insurance Regulatory Information System Needs Improvement* that NAIC-required actuarial certifications of reserves are sometimes done by actuaries or loss reserve specialists employed by the reporting insurance company. The GAO stated that, "given the importance of sufficient reserves to a property/casualty insurer's financial health, we believe that, ideally, this loss reserve certification should be independently verified and certified." In audit report No. 13052, *Operational Audit of the Department of Insurance*,

dated September 23, 1997, we made a similar recommendation.

In response to inquiries made during our current audit, the OIR indicated that independent actuarial reviews of loss reserve estimates are not always obtained and that independent reviews are not required by statute or NAIC guidelines.

Recommendation: Because of the importance of the loss reserve estimates to setting rates and measuring insurer solvency, we again recommend that the OIR, when such independent estimates are not provided by the insurer, obtain periodic independent actuarial certifications.

Finding No. 5: Other Matters

Section 624.315(1), Florida Statutes, requires that as early as reasonably possible, the OIR shall annually prepare a report for submission to the Speaker and Minority Leader of the House of Representatives, the President and Minority Leader of the Senate, the chairs of legislative committees with jurisdiction over matters of insurance, and the Governor. The report is to address items enumerated by the statute, including for example, names of the authorized insurers transacting insurance in this State, with abstracts of their financial statements including assets, liabilities, and net worth.

The most recent annual report submitted by the OIR covers calendar year 2001. Annual reports covering calendar years 2002 and 2003 had not been completed as of June 4, 2004. The OIR indicated that the 2002 annual report has been delayed due to programming errors and data needed for the 2003 annual report had only recently become available. The preparation and

submission of these reports on a more current basis will make them more useful to legislative leadership and the Executive Office of the Governor.

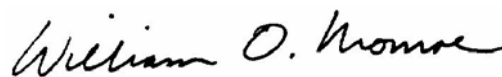
Recommendation: We recommend that steps be taken to more timely produce the annual report required by Section 624.315(1), Florida Statutes.

OBJECTIVES, SCOPE, AND METHODOLOGY

The objectives of our audit were to evaluate the effectiveness of OIR policies and procedures established for the purpose of monitoring the solvency of domestic insurance companies and to measure the extent to which the OIR had complied with applicable laws. Our audit covered the period January 7, 2003, through February 29, 2004, and selected actions through June 4, 2004, and included an evaluation of relevant internal controls, interviews of OIR staff, tests of OIR review and examination files, and the application of analytical procedures.

AUTHORITY

Pursuant to the provisions of Section 11.45, Florida Statutes, I have directed that this report be prepared to present the results of our operational audit.



William O. Monroe, CPA
Auditor General

OFFICE'S RESPONSE

In a letter dated September 23, 2004, the Commissioner of the Office of Insurance Regulation provided responses to our preliminary and tentative findings. This letter is included in its entirety at the end of this report.

To promote accountability in government and improvement in government operations, the Auditor General makes operational audits of selected programs, activities, and functions of State agencies. This operational audit was made in accordance with applicable *Government Auditing Standards* issued by the Comptroller General of the United States. This audit was conducted by Frank Belt, CPA, and supervised by David Vick, CPA, Audit Coordinator. Please address inquiries regarding this report to Don Hancock, CPA, Audit Manager, via email at donhancock@aud.state.fl.us or by telephone at (850) 487-9037.

This report, as well as other audit reports prepared by the Auditor General, can be obtained on our Web site (<http://www.state.fl.us/audgen>); by telephone at (850) 487-9024; or by mail at G74 Claude Pepper Building, 111 West Madison Street, Tallahassee, Florida 32399-1450.



DEPARTMENT OF FINANCIAL SERVICES
OFFICE OF INSURANCE REGULATION

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September 23, 2004

Mr. William O. Monroe, CPA
Auditor General
State of Florida
G74 Claude Pepper Building
111 West Madison Street
Tallahassee, Florida 32399-1450

Re: Preliminary and Tentative Audit Findings – Audit of Insurer Solvency, Office of Insurance Regulation

Dear Mr. Monroe:

This letter is being forwarded to you in response to your letter of August 23, 2004, pursuant to Section 11.45(4)(d), Florida Statutes.

The Office of Insurance Regulation has reviewed the background information, findings and recommendations that were forwarded to us in an enclosure to your letter of August 23, 2004. The enclosed information, comments and responses are keyed to your letter to the extent that this could reasonably be achieved.

I appreciate the opportunity to review and respond to the preliminary and tentative findings.

Sincerely,

Kevin M. McCarty

TS/aec

Enclosure

cc: Tom Gallagher, Chief Financial Officer, Department of Financial Services
Paul Mitchell, Chief of Staff, Department of Financial Services

...
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Information and comments prepared by the Office of Insurance Regulation in response to the Auditor General's audit of Insurer Solvency, Office of Insurance Regulation

The information and comments that follow are keyed to the preliminary and tentative audit findings and recommendations that were forwarded to the Office of Insurance Regulation in an enclosure to the Auditor General's letter of August 23, 2004.

Finding No. 1: Financial Analysis Reviews

The Annual Domestic Evaluation package that is used to support financial analysis of all Florida domestic insurers is a combination of analysis procedures that are the national standard developed by the NAIC and additional, supplemental procedures that have been developed by the Office to determine compliance with the Florida Insurance Code. The financial analysis process is a perpetual review of financial condition and regulatory compliance while the examination process assesses the accuracy of the financial statement for a specified time period. Inquiries and issues that are being followed up and tracked are typically resolved over the course of one or more quarters and may not always be completely resolved during the period under review.

In those instances in which the examiner identifies issues and determines that follow-up is warranted, it is the responsibility of the examiner, as well as that of the examiner's supervisor, to verify that all necessary follow-up is complete and is properly documented. In order to address the specific concern identified in the audit, the Office is in the process of developing an additional supervisory review procedure. When implemented, this new procedure will provide reasonable assurance that all outstanding analysis issues are followed up in a timely manner.

It should also be noted that the Office is also currently engaged in developing an electronic workflow system to support financial analysis processes. When implemented, this workflow system will incorporate an indexing and organizational system that will permit rapid and efficient identification of all financial analysis components. Moreover, we plan to incorporate design features within this system that will permit us to track issues that require further inquiry in order to ensure that all such issues are followed-up in a timely manner.

Finding No. 2: Financial Condition Examinations

Non-sequentially numbered examination modules result from using TeamMate, an electronic document management software system that is employed by the Office to create electronic financial examination work papers. TeamMate employs financial examination templates and procedures that are derived from the NAIC Financial Condition Examiners Handbook. All of the available templates are not applicable, nor are they required, for every financial examination. Rather, templates are selected based on their applicability to each specific examinations, the type of company that is being examined and the types and levels of risk that have been determined to be associated with a specific company.

Supervisory personnel work closely with the examiner-in-charge during examination planning, risk assessment and scope development. The examination supervisor's sign off on examination planning documents signals her or his formal acceptance of examination planning, risk assessment and scope. As noted above, a new checklist was implemented earlier this year that provides improved documentation of supervisory involvement in examination planning and that assures supervisory review and approval of examination scope.

It should also be noted that the Office is currently considering the most efficient and effective methodology to employ in order to ensure cross-referencing of examination findings in examination reports to the specific work papers(s) that support these findings. We have tentatively decided to create electronic links between findings in examination reports within electronic work papers to specific source documentation that supports these findings. We also plan to have links from the supporting documentation to the examination reports. This will ensure that financial examination report findings are cross-referenced to supporting work papers and all work paper findings are included in each financial examination report.

Finding No. 3: Accounts Receivable

The Bureau of Financial Services, Division of Administration within the Department of Financial Services performs the vast majority of the Office's invoicing and all of its cash receipt functions. The majority of such invoicing and cash receipts relate to examination billings.

The Bureau of Financial Services performs examination billing. After the Bureau of Financial Services creates and mails bills to insurers, it records related invoice information in Excel-based listings of unpaid invoices. These listings, together with a hard copy of each invoice, are provided to the Office. When payments are received, the Bureau of Financial Services manually matches payments to their Excel listings in order to release the receivables and then provides a hard copy of payment receipt documentation to the Office. The Office uses hard copy receipt documentation provided by the Bureau of Financial Services to manually match against previously received hard copy invoices in order to verify that payments have in fact been received. These manual processes are error prone simply because there is a need for continuous human intervention and because there is a lack of an automated interface between invoicing and cash receipts.

The Office will continue to work with the Bureau of Financial Services to develop an automated system. In the meantime, we will continue to audit the manual system to the extent practicable to ensure that invoices and payments are recorded correctly.

Finding No. 4: Independent Actuarial Opinions

We concur that loss reserve estimates are key to solvency regulation and that independent actuarial certification would add an additional layer of credibility to the reserve estimates. However, current statutes and rules, as well as NAIC guidelines, do not mandate such independence. Therefore, the Office does not have sufficient legal authority to require companies to use independent actuaries, and would be subject to challenge at the Division of Administrative Hearings if it attempted to impose such a requirement.

The Financial Analysis staff within the Office monitors all insurers on a quarterly basis. Additional reserve analysis is performed on a case-by-case basis, if concerns are noted. If questions remain, the Office may, and has, engaged independent actuaries to perform target examinations of insurer reserves. In addition to the analysis performed on a quarterly basis and targeted examinations, the Office examines all Florida domestic insurers on a triennial basis, during which time the actuarial certification provided by the insurer -- either independent or internal -- is subject to close scrutiny and in depth review by the Office's actuary to determine the adequacy of reserves.

Consistent with the NAIC Accreditation program requirements, the domiciliary regulator of foreign insurers licensed in Florida perform similar internal reserve analysis as well as conduct independent examinations, including determination of reserve adequacy, at least once every five years.

The Office sponsored legislation this past session that would allow us to require insurers, on a case-by-case basis, to submit an independent actuarial opinion if the Office deemed necessary. Unfortunately this proposed legislation did not pass and we plan to pursue similar legislation in future legislative sessions.

Finding No. 5: Other Matters – Annual Reporting

The Office came into existence on January 7, 2003. Currently the Office is in the process of finalizing its first Annual Report. This report will cover calendar year 2003, and will also contain some data that pertains to calendar year 2002. Owing to a lag in reporting periods for insurance companies, annual reports will be issued by the Office in the calendar year following the insurance data reporting year, for example, insurance companies' data for calendar year 2004 which is typically filed by insurers in March 2005 will be reported in the Office annual report for 2005.