



AUDITOR GENERAL

DAVID W. MARTIN, CPA



STATE BOARD OF ADMINISTRATION INSURANCE CAPITAL BUILD-UP INCENTIVE PROGRAM AND PRIOR AUDIT FOLLOW-UP

Operational Audit

SUMMARY

This operational audit focused on the State Board of Administration's (SBA) Insurance Capital Build-Up Incentive Program (ICBIP) and the follow-up on prior audit findings from audit report Nos. 2004-074, 2004-084, and 2006-045. Our audit included examinations of various transactions during the period March 2005 through February 2007, and selected actions taken through June 30, 2007. Our audit disclosed:

Finding No. 1: ICBIP reports did not include certain disclosures that could be helpful to the Legislature in evaluating ICBIP effectiveness.

Finding No. 2: Governing statutes do not address how ICBIP receipts and related investment earnings may be used.

Finding No. 3: Contrary to governing provisions of law, administrative costs for the ICBIP were paid from the Florida Hurricane Catastrophe Fund.

Finding No. 4: The SBA had not adopted written policies and procedures addressing the inclusion of nonperformance provisions and dispute resolution provisions in contractual agreements.

Finding No. 5: While the SBA had made progress in addressing the development of a contract administration program, written contract monitoring procedures had not yet been adopted.

FINDINGS AND RECOMMENDATIONS

Insurance Capital Build-Up Incentive Program

The Legislature, through Section 215.5595, Florida Statutes, created the Insurance Capital Build-Up Incentive Program (ICBIP) to provide to insurers State funds as a low-cost source of capital. The additional capital was for the purpose of enabling the insurers to write additional residential property insurance coverage and to mitigate property insurance premium increases.

The ICBIP's design provides for the loan of State moneys to new or existing authorized residential property insurers (insurers) in amounts up to \$25 million, or 20 percent of the total amount of funds available under the ICBIP, whichever is greater. Each loan transaction was to be memorialized in a surplus note agreement, and, consistent with the requirements of Section 215.5595, Florida Statutes, key terms of the surplus notes were to include a repayment period of 20 years, a commitment by the insurer to meet a minimum net written premium ratio¹ and a minimum contribution of new capital. Additionally, the insurer must maintain a minimum amount of surplus.² The

¹ The minimum net written premium ratio is the ratio of net written premium to surplus. After an initial period, the insurers are to have a minimum ratio of 2 to 1.

² The minimum required surplus for insurers must equal at least \$50 million (\$14 million for manufactured home insurers). The amount of surplus is equal to the difference between the insurer's admitted assets and liabilities.

surplus notes are interest bearing, with variable rates equal to the 10-year U.S. Treasury Bond rate.

The Legislature, in Section 43, Chapter 2006-12, Laws of Florida, appropriated to the State Board of Administration (SBA), the sum of \$250 million from the General Revenue Fund to fund the ICBIP. Staff of the Florida Hurricane Catastrophe Fund (FHCF) within the SBA were primarily responsible for the administration of the ICBIP. As of June 30, 2007, the SBA had negotiated 13 surplus notes totaling \$247.5 million, as shown in Table 1.

**Table 1
Insurance Capital Build-Up Incentive Program
Activity from Inception**

Insurer	Amount Surplus Note (Millions)	Amount Contributed by Insurer (Millions)	Projected New Policies
1	\$ 25.0	\$ 25.0	86,000
2	20.0	20.0	321,172
3	25.0	25.0	150,000
4	25.0	25.0	310,000
5	20.0	20.0	142,000
6	25.0	25.0	144,696
7	25.0	25.0	67,203
8	20.5	20.5	95,000
9	17.0	34.0	3,500
10	14.5	29.0	59,600
11	16.5	33.5	125,000
12	7.0	7.0	149,000
13	7.0	7.0	59,964
Totals	\$ 247.5	\$ 296.0	1,713,135

Source: Surplus note applications and surplus note agreements.

To be considered for an ICBIP loan, insurers were required to submit an application. Each application was considered by the FHCF staff and the Office of Insurance Regulation (OIR), and following the verification of application information and the application of ICBIP underwriting criteria, the loan was submitted for the approval of the SBA’s Executive Director. Our audit included tests of the procedures used to verify the loan application information, apply underwriting criteria, and close the loan transactions. Our audit also included tests to measure the extent of SBA’s monitoring of insurer compliance with the terms and conditions of the surplus loan agreements.

With respect to the controls tested, we found them to be adequate to reasonably ensure compliance with Section 215.5595, Florida Statutes. In addition, for the transactions tested, we found evidence that the SBA had complied with applicable provisions of Section 215.5595, Florida Statutes. However, as described below, our audit also disclosed the need for ICBIP reimbursement of administrative costs and recommendations for some statutory changes to address certain aspects of ICBIP administration.

Finding No. 1: ICBIP Reporting

Through the provision of a low-cost source of capital, the ICBIP is to enable insurers to write additional residential property insurance coverage and act to mitigate premium increases. We found that while ICBIP applications required insurers to estimate the number of additional policies that could, with the infusion of additional capital, be written, neither the authorizing statutes nor the terms and conditions of surplus notes required any subsequent reporting of the insurer’s progress in writing additional residential property insurance coverage or in mitigating premium increases.

The availability of this information may enhance the Legislature’s ability to measure the effect the ICBIP investment is having on the State of Florida residential property insurance market, determine whether additional appropriations for surplus notes would be effective, and consider what, if any, changes to the ICBIP could make it more effective.

Recommendation: We recommend that the Legislature consider amending Section 215.5595, Florida Statutes, to require the SBA or the OIR to report to the Legislature on a periodic basis, the extent to which, for the participating insurers, the ICBIP has contributed to an increase in the number of residential insurance policies written and to the mitigation of premium increases.

Finding No. 2: Disposition of ICBIP Repayment Account Deposits

Section 215.5595(2)(f), Florida Statutes, requires that surplus notes be repaid over a period of 20 years, with payments only of interest during the first three years of the term of the surplus note. Upon receipt of the surplus note payments from the insurers, the SBA recorded the payments into the ICBIP Repayment Account. As of June 30, 2007, the SBA had recorded in the Account, \$5.7 million in interest payments. The SBA had also recorded in the Account \$7.3 million in interest earnings derived from the investment of the initial \$250 million deposit and the interest payments from insurers. Our audit disclosed that governing statutes did not address the disposition to be made of the amounts received from the insurers or of the investment earnings derived from Account deposits.

Absent statutory provisions addressing the usage of these moneys, the SBA can only hold and invest the amounts received.

Recommendation: We recommend that the Legislature amend Section 215.5595, Florida Statutes, to provide instructions as to the allowable usage of these moneys.

Finding No. 3: Administrative Costs

Section 43, Chapter 2006-12, Laws of Florida, provided that costs and fees incurred by the SBA in administering the ICBIP shall be paid from the \$250 million appropriated for the ICBIP and limited to \$2.5 million over the life³ of the ICBIP.

Our audit disclosed that approximately \$75,000 of the \$93,000 in administrative cost attributed to the ICBIP had been paid by the FHCF. The amounts paid by the FHCF were associated with FHCF staff time spent on ICBIP activities. FHCF staff responded in a memorandum dated July 26, 2007, "...that no decision as to allocation of FHCF staff salary and benefit cost has been made."

³ The life of ICBIP is approximately 21 years based upon the 20-year term of the surplus notes and the dates the surplus notes were negotiated.

In view of the provisions of Section 43, Chapter 2006-12, Laws of Florida, which specified that the amounts appropriated for the ICBIP were to be used to pay ICBIP costs and fees, and the provisions of Section 215.555(3), Florida Statutes, which limit the use of FHCF moneys to specified FHCF purposes, it was not clear that the payment of ICBIP costs and fees constituted authorized expenditures of the FHCF.

Recommendation: We recommend that the SBA transfer from ICBIP funds the amount necessary to reimburse the FHCF for ICBIP costs and fees paid.

Prior Audit Follow-Up

In audit report No. 2004-074, we included findings and recommendations related to the establishment of the Public Employee Optional Retirement Program, also known as the Defined Contribution Plan, and in audit report No. 2004-084, findings and recommendations related to SBA's corporate governance practices. Our audit disclosed that the SBA had implemented corrective actions and taken appropriate steps to address the findings noted in these reports. However, as described in succeeding findings, we found that for audit report No. 2006-045, relating to contract administration, the SBA had taken corrective action to address some, but not all, of the audit findings and recommendations.

Finding No. 4: Contract Provisions

In finding No. 4 of audit report No. 2006-045, we recommended that the SBA ensure future contracts included clauses that provided mechanisms to address consultant nonperformance issues (penalties, for example) and contract disputes (dispute resolution procedures). While the SBA stated that it considers such provisions for inclusion within contracts on a case-by-case basis, we noted only one nonperformance provision and no dispute resolution provisions had been included in the five contracts reviewed as part of our current audit. We also found that the SBA had still not adopted written policies and procedures addressing when to include such contract clauses.

Absent such a policy, the SBA may not include in its contracts, mechanisms that could be used to compel contractor performance, address contract disputes, and avoid potentially costly litigation.

Recommendation: We recommend that the SBA adopt written policies and procedures addressing when contracts should include nonperformance penalty provisions and dispute resolution procedures.

Finding No. 5: Contract Monitoring

In finding No. 6 of audit report No. 2006-045, we recommended that the SBA continue to develop and adopt monitoring procedures and standards, including: the assignment of contract monitoring responsibilities; a methodology for determining the nature and timing of contract monitoring; and a mechanism to accumulate information to evaluate contractor performance, track contract payments and deliverables, and provide performance feedback.

Our current audit disclosed that while the SBA had made progress in addressing the development of a contract administration program (including the hiring of a Contract Analyst III and the purchase of a software program that was being implemented to track contract data), written contract monitoring procedures had not been adopted. The absence of written contract monitoring procedures increases the risk that contractor performance may not be effectively monitored and that such efforts may not be appropriately documented.

Recommendation: We recommend that the SBA continue its efforts in developing and implementing a contract administration program and that those efforts include the development and adoption of written contract monitoring procedures.

OBJECTIVES, SCOPE, AND METHODOLOGY

This operational audit focused on the SBA's ICBIP and the follow-up on prior audit findings from audit report Nos. 2004-074, 2004-084, and 2006-045. In evaluating the ICBIP, we concentrated primarily on the issuance of surplus notes and SBA monitoring of insurer compliance

with the terms of the surplus notes. Our specific objectives were to:

- Determine the effectiveness of the SBA's policies and procedures over the issuance of the surplus notes, the monitoring of the residential property insurers receiving the surplus notes, the receipt of required interest payments, and the taking of any required administrative actions.
- Evaluate management's performance in achieving compliance with controlling laws, administrative rules, and other guidelines; the economic, efficient, and effective operation of State government; the validity and reliability of records and reports; and the safeguarding of assets.
- To identify statutory and fiscal changes that may be recommended to the Legislature pursuant to Section 11.45(7)(h), Florida Statutes.

Our audit included examinations of various transactions during the period March 2005 through February 2007, and selected actions taken through June 30, 2007. In conducting our audit we:

- Interviewed selected SBA personnel.
- Obtained an understanding of internal controls and observed, documented, and tested key processes and procedures related to areas within the scope of the audit.
- Examined 3 of 13 ICBIP applications for minimum qualifications and approval; 4 of 13 surplus notes for appropriate monitoring, reporting, and receipt of interest payments; and the appropriateness of the denial for 1 of 3 rejected applications.
- Examined SBA records relative to the ICBIP records administrator contract to determine whether the records demonstrated contractor compliance with the material provisions of the contract.
- Examined the completeness of terms and conditions included in 5 contracts negotiated during the period October 27, 2005, through February 28, 2007.
- Performed various other auditing procedures, as necessary, to accomplish the objectives of the audit.

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.



David W. Martin, CPA
Auditor General

MANAGEMENT RESPONSE

In a letter dated November 28, 2007, the Executive Director of the SBA provided a response to our preliminary and tentative findings. The letter is included at the end of this report as Appendix A. Additionally, in a letter dated December 18, 2007, the Office of Insurance Regulation provided a response to finding No. 1. That letter, included at the end of this report as Appendix B, makes reference to a spreadsheet containing individual company information. The spreadsheet, to the extent its data are public information, may be obtained from the Office of Insurance Regulation.

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 conducted in accordance with applicable Generally Accepted Government Auditing Standards. This audit was conducted by Leslee Walker, CPA, and Matthew Tracy, CPA, and supervised by Allen Weiner, CPA. Please address inquiries regarding this report to Kathryn Walker, CPA, Audit Manager, by e-mail (kathrynwalker@aud.state.fl.us) or by telephone (850-487-9085).

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

**APPENDIX A
MANAGEMENT RESPONSE**



**STATE BOARD OF ADMINISTRATION
OF FLORIDA**

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EXECUTIVE DIRECTOR

November 28, 2007

Mr. David W. Martin
Auditor General, State of Florida
G74 Claude Pepper Building
111 West Madison Street
Tallahassee, Florida 32399-1450

Dear Mr. Martin:

As requested in your October 29, 2007 letter, following are our responses to the preliminary and tentative findings and recommendations which may be included in your report on the audit of the State Board of Administration's Insurance Capital Build-Up Incentive Program (ICBIP) and Prior Audit Follow-Up for the period March 2005 through February 2007.

Finding No. 1: ICBIP reports did not include certain disclosures that could be helpful to the Legislature in evaluating ICBIP effectiveness.

Recommendation: We recommend that the Legislature consider amending Section 215.5595, Florida Statutes, to require the SBA or the OIR to report to the Legislature on a periodic basis, the extent to which, for the participating insurers, the ICBIP has contributed to an increase in the number of residential insurance policies written and to the mitigation of premium increases.

SBA Response: This recommendation is directed at parties other than the SBA. While the SBA agrees that such information may be helpful to the Legislature, obtaining company specific policy data may pose a problem if the participating insurers consider the data confidential.

The SBA is available to assist the Legislature with drafting proposed amendments to Section 215.5595.

Finding No. 2: Governing statutes do not address how ICBIP receipts and related investment earnings may be used.

Recommendation: We recommend that the Legislature amend Section 215.5595, Florida Statutes, to provide instructions as to the allowable usage of these moneys.

APPENDIX A
MANAGEMENT RESPONSE (CONTINUED)

Mr. David W. Martin
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SBA Response: This recommendation is directed at parties other than the SBA. However, the SBA is available to assist the Legislature with drafting proposed amendments to Section 215.5595.

One option would be to transfer the moneys to the Florida Hurricane Catastrophe Fund (FHCF) to pay future loss reimbursements. This could reduce future bonding costs, thereby, reducing the amount of emergency assessments charged to Florida policyholders.

Finding No. 3: Contrary to governing provisions of law, administrative costs for the ICBIP were paid from the Florida Hurricane Catastrophe Fund.

Recommendation: We recommend that the SBA transfer from ICBIP funds the amount necessary to reimburse the FHCF for ICBIP costs and fees paid.

SBA Response: The SBA has requested a one-time transfer from the ICBIP funds to the FHCF to reflect services rendered by FHCF staff and fees paid for ICBIP. Moving forward, the SBA will take steps to ensure that administrative costs of the ICBIP are allocated appropriately.

Finding No. 4: The SBA had not adopted written policies and procedures addressing the inclusion of nonperformance provisions and dispute resolution provisions in contractual agreements.

Recommendation: We recommend that the SBA adopt written policies and procedures addressing when contracts should include nonperformance penalty provisions and dispute resolution procedures.

SBA Response: The SBA will consider adopting written policies and procedures addressing when contracts should include nonperformance penalty provisions; however, it is our longstanding policy not to enter into contracts with dispute resolution provisions. The alternative available to the SBA has been litigation, and while potentially costly, historically the SBA has not had to resort to this alternative often.

Finding No. 5: While the SBA had made progress in addressing the development of a contract administration program, written contract monitoring procedures had not yet been adopted.

Recommendation: We recommend that the SBA continue its efforts in developing and implementing a contract administration program and that those efforts include the development and adoption of written contract monitoring procedures.

APPENDIX A
MANAGEMENT RESPONSE (CONTINUED)

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SBA Response: As acknowledged in the report, the SBA is actively developing a contract administration program. Please note that the bulk of the SBA's contracts (by dollar volume) are investment management agreements and these agreements are actively monitored and reviewed on a regular basis by each asset class and their respective Senior Investment Officer. For all other contracts, the monitoring of services and payments is assigned to the contract owner (department) and currently, there are no written monitoring procedures for these non-investment related contracts. However, upon completion of the more advanced features of the contract management software, the SBA will adopt written contract monitoring procedures.

Thank you for the opportunity to respond to these findings and recommendations. If you have any questions, please do not hesitate to contact Ms. Rivera-Alsing at (850) 413-1259 or me at (850) 413-1250.

Sincerely,



Coleman Stipanovich
Executive Director

cc: Gwenn Thomas, Chief Operating Officer
Florida Rivera-Alsing, Chief of Internal Audit
Bruce R. Meeks, Inspector General

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APPENDIX B
OFFICE OF INSURANCE REGULATION RESPONSE



OFFICE OF INSURANCE REGULATION

KEVIN M. MCCARTY
COMMISSIONER

December 18, 2007

Ms. Kathryn D. Walker, CPA
Auditor General
State of Florida
G74 Claude Pepper Building
111 West Madison Street
Tallahassee, Florida 32399-1450

RE: Auditor General letter dated December 4, 2007 – Operational Audit of the State Board of Administration – Insurance Capital Build-Up Incentive Program

Dear Ms. Walker:

We are in receipt of the preliminary and tentative audit finding and recommendations regarding the State Board of Administration, Insurance Capital Build-Up Incentive Program. This report recommended that the Legislature consider amendments to Section 215.5595, Florida Statutes to require the SBA or the OIR (the Office) to collect data and report to the Legislature on a periodic basis regarding the additional residential property insurance policies written by participants in the Capital Build-Up Program. The Office agrees that a review of the insurers' progress in deploying the capital into the Florida insurance marketplace is appropriate, but additional reporting requirements in statute may not be necessary.

The Office has statutory authority under Section 624.424(10), Florida Statutes, to collect detailed information from companies with regard to their policy counts in our QUASAR system. Through QUASAR, we have the ability to run reports for each of the 13 companies that received the SBA funds to determine their policy counts on a monthly basis and to ascertain their policy growth.

Using available data, we have identified an additional 194,000 policies written in the Florida marketplace by participants in the Capital Build-Up Program. The attached data is current as of October. We anticipate that the numbers will increase throughout the end of the year because some of the companies are in a better position to write new business after hurricane season. (See the attached spreadsheet for individual company information.)

• • •
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APPENDIX B
OFFICE OF INSURANCE REGULATION RESPONSE
(CONTINUED)

Ms. Kathryn D. Walker, CPA
December 18, 2007
Page two

Should you require any additional information regarding the companies that received the SBA funds, please feel free to contact me at (850) 413-5000 or Mrs. Robin Westcott at (850) 413-5232.

Sincerely,



Belinda Miller

Attachment

cc: Mr. Kevin M. McCarty, Commissioner of Insurance
Mrs. Audrey Brown, Chief of Staff, Office of Insurance Regulation
Mrs. Robin Westcott, Director P&C Financial Oversight, Office of Insurance Regulation
Mr. Dan Callahan, Inspector General, Office of Insurance Regulation

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