



AUDITOR GENERAL

DAVID W. MARTIN, CPA



STATE BOARD OF ADMINISTRATION FLORIDA HURRICANE CATASTROPHE FUND Operational Audit

SUMMARY

This operational audit of the State Board of Administration (SBA), for the period March 2005 through June 2007, focused on selected core administrative activities of the Florida Hurricane Catastrophe Fund (FHCF) and the monitoring of the FHCF Records Administrator. As summarized below, our audit disclosed opportunities for improvement in controls:

Records Administrator Monitoring

Finding No. 1: The FHCF had not established contract provisions to require the Records Administrator to provide an independent auditor's report describing relevant Records Administrator internal controls and their effectiveness.

Finding No. 2: FHCF procedures did not require FHCF authorization of transfers of moneys to the Records Administrator for the payment of advances, loss reimbursements, and premium refunds.

Finding No. 3: FHCF's contact request form, which provided the insurer names and addresses to be used for FHCF correspondence and payment remittances, did not require the signature of two insurance company officers. In addition, our tests disclosed one instance in which a payment was sent to an address other than the address shown on the contact request form.

FHCF Examiners and Examinations

Finding No. 4: FHCF staff did not confirm with licensing authorities the professional designations of the examiners contracted to perform loss examinations.

Finding No. 5: The FHCF had not finalized procedures for evaluating corrected proof of loss reports.

BACKGROUND

The Florida Hurricane Catastrophe Fund (FHCF) was created pursuant to Chapter 93-409, Laws of Florida, following Hurricane Andrew. The FHCF's purpose is to provide a stable and ongoing source of reimbursement to insurers for a portion of their catastrophic hurricane losses and to protect the insurance capacity in the State. It is structured as a trust fund under the direction and control of the State Board of Administration (SBA).

Pursuant to Section 215.555(4)(a), Florida Statutes, the SBA is to enter into a reimbursement contract with each insurer writing covered policies in the State in exchange for a reimbursement premium. Insurers may elect coverage of 45, 75, or 95 percent of their losses from each covered event (hurricane) in excess of the insurer's retention, plus 5 percent of the reimbursed losses to cover loss adjustment expenses.

In the event of a hurricane, each insurer is to report its losses to the FHCF on an *Interim Loss Report* and ultimately on a *Proof of Loss* report. For each hurricane, the FHCF is to pay losses in excess of the insurer's retention level up to the maximum loss payout for any contract year. The total amount of hurricane losses that can be paid is limited by the claims paying capacity¹ of the FHCF.

At June 30, 2006, the FHCF experienced a fund deficit of approximately \$1.5 billion in the wake of the catastrophic hurricane seasons of 2004 and 2005. As a

¹ The claims paying capacity represents the sum of the balance of the FHCF as of December 31 of a contract year, any reinsurance purchased by the FHCF, and the amount the SBA is able to raise through the issuance of revenue bonds under Section 215.555(6), Florida Statutes.

result, \$1.35 billion in FHCF Series 2006A post-event bonds were issued in order to pay remaining claims. The bond debt service is to be paid through the collection of an emergency assessment of one percent levied on property and casualty² insurance policies through the year 2012. To provide liquidity to the FHCF to pay future claims, the FHCF also issued \$2.8 billion in FHCF Series 2006B pre-event notes.³

In 2007, the Legislature increased the claims paying capacity of the FHCF from approximately \$15 billion to \$28 billion. The resources to pay claims comes from FHCF's fund balance, any reinsurance purchased, and the amount the FHCF is able to raise through the sale of post-event bonds. The terms and amounts available through post-event bonding are dependent upon several factors, including the market conditions existing at the time of the proposed sale.

FHCF is administratively housed within the SBA and the SBA provides to the FHCF various services, including those relating to investment management, purchasing, human resources, and financial operations.

Records Administrator Monitoring

FHCF had contracted with a Records Administrator to provide certain administrative and record keeping services for the FHCF. These services included, but were not limited to, providing to insurers annual FHCF reimbursement contracts; calculating, assessing, and collecting reimbursement premiums; paying premium refunds; processing and paying reimbursement claims; and providing related reports on the administered FHCF activities.

Although FHCF management relied on the Records Administrator for the execution and reporting of FHCF activities, FHCF management remained responsible for the safeguarding of FHCF assets and FHCF's compliance with controlling laws, administrative rules, and contractual terms.

² Excludes workers' compensation and medical malpractice insurance.

³ Financial market volatility and liquidity issues led to bondholders not extending substantially all of the \$2.8 billion FHCF Series 2006B pre-event notes. According to bond covenants, amounts are to be repaid approximately one year from the holder's election to not extend. Thus, repayments commence in August 2008 and extend through March 2009.

During our audit, we observed that FHCF staff maintained a close working relationship with the Records Administrator. FHCF staff received and reviewed periodic activity reports summarizing premium collections, loss reimbursement payments, advances, noncompliance by insurers, and other Records Administrator activities. Additionally, the FHCF staff prepared an annual evaluation of staff satisfaction with the Records Administrator's services and received and reviewed copies of audited financial statements of the FHCF. However, our review of FHCF Records Administrator monitoring disclosed some weaknesses where improvements could be made.

Finding No. 1: Records Administrator Systems

As noted in the preceding paragraph, FHCF had contracted with a Records Administrator to provide various services and had implemented steps to monitor the Records Administrator's performance. However, FHCF had not established contract provisions to require the Records Administrator to provide a SAS 70⁴ report that described the Records Administrator's internal controls and that provided an assessment of the effectiveness of those controls.

Absent the receipt and review of such reports, FHCF lacked reasonable assurance that internal controls, significant to the accomplishment of FHCF responsibilities, were in place and functioning effectively. For example, the Records Administrator is required by contract to provide a database necessary to carry out the various FHCF processing requirements including, but not limited to retention, premium, and interest calculations; accounting; financial reporting; loss reimbursement processing; and expense processing. An appropriate SAS 70 report or similar evaluation of the relevant Records Administrator controls would have provided FHCF with a documented basis for assessing the reliability of the information and calculations derived from the database.

Recommendation: We recommend the SBA amend its Records Administrator contract to require the submission of a SAS 70 report addressing the

⁴ Statement on Auditing Standard 70 (SAS 70), Service Organizations.

effectiveness of relevant Records Administrator internal controls.

Finding No. 2: Funding Requests

When the Records Administrator required funds to make payments to insurers, a request was sent by the Records Administrator to the Financial Operations Section of the SBA. The Financial Operations Section then transferred moneys from the SBA FHCF bank account to the operating account used by the Records Administrator.

Our audit included the review of approximately \$258 million in payments for loss reimbursements, \$544 million in advances, and \$18 million in premium refund payments made by the Records Administrator. Our tests of these payments and related procedures disclosed that the Financial Operations Section did not require FHCF staff authorization prior to transferring funds to the Records Administrator.

Through FHCF review and approval of the funding requests, the FHCF could obtain additional assurance that amounts requested were for authorized purposes and in the correct amounts.

Recommendation: FHCF staff should review and approve funding requests prior to the transfer of moneys to the Records Administrator. Adequate documentation should also be maintained evidencing the review and approval.

Finding No. 3: Contact Request Forms

In order to ensure that checks for loss reimbursement payments, advanced loss reimbursement payments, and premium refunds are mailed to the appropriate insurer employee and to the correct corporate address, the Records Administrator provides a contact request form (form) to insurers for completion with the first reimbursement contract and annually thereafter for update. The form requires the insurer to provide the Records Administrator with the insurer addresses and the names of employees to whom certain types of correspondence and payments are to be mailed. Under the established procedure, changes to the contact information could be requested at any time by submission of requests via company letterhead, email, or

a revised copy of the form, downloadable from the FHCF Web site.

Our tests of the effectiveness of the FHCF authorized insurer contact form and related procedures disclosed:

- Procedures did not require the signatures of two insurer officers as assurance that the company employee names and addresses were correct.
- Records Administrator procedures did not always reasonably ensure that payments were sent to only those authorized persons and addresses reported on the form. For example, 1 of the 20 loss reimbursement payments tested was mailed to an address and a person not included on the insurer's original contact request form. Further inquiry disclosed that a pre-addressed overnight mail package specifying where and to whom an approximately \$14 million payment was to be sent had been provided to the Records Administrator. In this case, the insurer received the payment, although risks associated with the potential for diversion of the payment were increased.

FHCF staff indicated that in the case of advances and loss reimbursements, more than one individual at the insurer would be aware of the payment request since the forms filed for advances and loss reimbursements required two insurer officer signatures. FHCF staff indicated that this would help prevent the misappropriation of these payments because the insurer would be anticipating the receipt of funds and would question FHCF if the payments were not received when expected.

While the described advance and loss reimbursement payment request authorization procedures would provide some assurance as to the authenticity of these payment requests, the procedures may not preclude the misdirection of related payments or ensure payment recovery in the event that payments are diverted to unauthorized recipients.

Recommendation: We recommend that the FHCF amend the contact request form to require the signatures of two authorized insurer officers. Additionally, we recommend that the FHCF require that the Records Administrator only mail checks to the addresses and contacts shown by the properly executed forms. Further, any changes to the remittance information should be evidenced by the signatures of two authorized insurer officers.

FHCF Examiners and Examinations
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The FHCF is authorized by Section 215.555(4)(f), Florida Statutes, to inspect, examine, and verify the records of each insurer's covered policies. The FHCF contracted with examiners to perform two types of examinations of insurers, including:

- Examination of the annual submission of insurer exposure data;⁵ and
- Examination of the reported hurricane losses for which the insurer received reimbursements from the FHCF.

The FHCF designated three staff and a FHCF Audit Program Manager (Manager) to oversee the examination process. The Manager planned and coordinated the FHCF examination program and reported to the Senior FHCF Officer.

During the audit period, the FHCF contracted with five examiners to examine exposure data. The exposure exams included inspecting and examining a sample of insurer policies to determine that, among other matters, the policies were covered by the FHCF, details of the policies reported were accurate, and all covered policies were reported. For the 2004-2005 and 2005-2006 contract years, the FHCF and contracted examiners conducted 177 and 155 exposure exams, respectively.

The FHCF also contracted with one company, employing several examiners, to conduct the loss reimbursement exams. Loss reimbursement exams were to determine whether the information provided by the insurers in Proof of Loss Reports (POLs)⁶ was accurate and complete. During the audit period, 23 loss reimbursement exams were completed.

The contracted examiners provided completed exam reports to the Manager for review. Following review, the Manager provided the report to the Senior FHCF Officer for review prior to submission to the insurer. The report may instruct insurers to resubmit exposure data or POLs if the information was determined to be inaccurate or incomplete. Our review of the FHCF examinations and

examiner monitoring disclosed some areas where the FHCF could enhance its processes.

Finding No. 4: Loss Examiner Qualifications

Following the four major hurricanes in 2004 (Charley, Frances, Ivan, and Jeanne), the FHCF sought contractors who had the expertise and qualifications to conduct insurer loss reimbursement exams. On February 4, 2005, the FHCF issued an Invitation to Negotiate (ITN) for examination services and therein required respondents to meet certain minimum qualifications. Among these qualifications were a minimum of five years of experience in examining or auditing within the residential property insurance industry and the handling of insurance claims. The ITN also stipulated that key professionals assigned to the FHCF exams were to have one of five professional designations or possess other experience comparable to requirements stipulated in the ITN.

Our review of FHCF documentation for two loss reimbursement exams included determining whether the exams had been conducted by examiners with the professional designations and experience described in the ITN. While the exam files contained documents providing the examiners' names and professional licenses held, we found that FHCF staff had not, through the various professional associations, verified the professional designations of the examiners prior to the examiners commencing work on the exams.

Absent verification of each examiner's credentials, there was reduced assurance that the examiner actually possessed the necessary skills and proficiency to perform the loss reimbursement exams. Upon our request, FHCF staff subsequently obtained and provided copies of the applicable licenses and we determined that all examiners were licensed.

Recommendation: We recommend that the FHCF verify the status of the professional designations reported by the examiners.

Finding No. 5: Proof of Loss Reports

The FHCF loss reimbursement exams included an evaluation of the insurance claims summarized and reported by the insurers on the POLs, upon which

⁵ Type and dollar value of insured property covered by the FHCF.

⁶ A FHCF report for providing the dollar amount of claims paid, pending payment, and estimated outstanding for an insurer.

FHCF loss reimbursements are paid. Errors that may be detected include claims submitted for policies not covered by the FHCF, the improper application of policy deductibles, and claims submitted for damages to properties located outside a storm’s path.

In instances where significant errors were discovered, insurers were required to correct the errors and submit revised POLs. Then, to ensure that the revised POLs reflected the correction of the errors, the revised POLs should have been reviewed by FHCF staff. Our audit disclosed that FHCF staff did not review the revised POLs. For example, for one of the two examinations we reviewed, the insurer was required to file a revised POL for each of the hurricanes, Jeanne, Frances, Charley, and Ivan. Although the revised POLs were submitted, the underlying data had not been reviewed by FHCF examiners to determine whether the insurer had corrected the errors noted by the examination. In this case, the insurer owed the FHCF \$21 million, plus interest, for excess reimbursements for losses reported relative to Frances, but occurring during Jeanne. This amount was offset by over \$8 million in additional loss reimbursements owed to the insurer according to the revised POLs filed for Hurricanes Charley and Ivan.⁷

Further review of this matter disclosed that the FHCF had not implemented procedures, including a methodology, for reviewing the revised POLs. Absent such procedures, there was reduced assurance that errors were corrected and amounts due to or from the FHCF were appropriately paid.

Recommendation: The FHCF had begun the development of procedures for evaluating the accuracy of revised POLs. We recommend that the FHCF continue the development and implementation of appropriate procedures.

OBJECTIVES, SCOPE AND METHODOLOGY

This operational audit focused on selected functions of the FHCF, including premium revenues and cash receipts, refunds, loss reimbursement payments, advances to insurers for losses, exposure examinations,

⁷ Because of its insolvency, the insurer subsequently was taken over by the Department of Financial Services, Division of Rehabilitation and Liquidation. The amount that may be repaid to the FHCF, if any, was indeterminable as of the close of our audit field work.

loss examinations, and Records Administrator monitoring. Our objectives were:

- To evaluate the effectiveness of established internal controls in achieving management’s control objectives in the categories of 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 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.
- To determine whether FHCF management had established and implemented adequate controls over:
 - The refunding of premium payments and documentation to support amounts refunded for the 2004, 2005, and 2006 contract years;
 - The deterrence and detection of fraud relating to catastrophic loss claims payments;
 - The monitoring of the Records Administrator’s activities; and
 - The payment of contract payments to the Records Administrator.
- To determine whether the FHCF advance files contained sufficient, competent evidence supporting management’s approval or denial of insurers’ requests, and whether documentation supported the actual amounts paid to insurers.
- To evaluate the extent to which the FHCF policies and procedures, quality assurance and improvement program, and work products conform to standards established by rule⁸ for the specific purpose of validating the accuracy of exposures and losses through exposure and loss examination activities.
- To assess the FHCF’s effectiveness in executing exposure and loss reimbursement exam activities.

⁸ Section 215.555, Florida Statutes, and State Board of Administration Chapter 19-8, Florida Administrative Code.

Our audit included examinations of various transactions and actions occurring during the period March 2005 through June 2007. This operational audit was conducted in accordance with applicable Generally Accepted Government Auditing Standards. In conducting our audit, we:

- Interviewed FHCF and SBA personnel.
- Obtained an understanding of internal controls, and observed and documented key processes and procedures, related to the FHCF.
- Tested FHCF records relative to four insurers to determine whether information related to data calls was timely received in a manner that the Records Administrator could electronically process, and whether reimbursement premium payments were timely and properly received.
- Tested FHCF records relating to approximately \$258 million in loss reimbursements, approximately \$544 million in advances, and approximately \$18 million in premium refunds to determine whether they were:
 - Properly calculated (refunds only);
 - Paid in the correct amount;
 - Properly reviewed and approved; and
 - Disbursed to the correct insurer.

- Reviewed two exposure examinations and two loss reimbursement examinations to determine whether the examinations were performed in accordance with established procedures and whether the exams were conducted by credentialed examiners.
- Performed various other audit 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 May 28, 2008, the Interim Executive Director provided a response to our preliminary and tentative audit findings. The letter is included at the end of this report as Appendix A.

This audit was conducted by Aaron Franz, 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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May 28, 2008

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 May 2, 2008 letter, the following are our responses to the preliminary and tentative audit findings and recommendations which may be included in your report on the Operational Audit of the State Board of Administration, Florida Hurricane Catastrophe Fund (FHCF), for the period March 2005 through June 2007.

Finding No. 1:

The FHCF had not established contract provisions to require the Records Administrator to provide an independent auditor's report describing relevant Records Administrator internal controls and their effectiveness.

Recommendation:

We recommend the SBA amend its Records Administrator contract to require the submission of a SAS 70 report addressing the effectiveness of relevant Records Administrator internal controls.

SBA Response:

The SBA will complete a contract amendment with its Records Administrator, Paragon Strategic Solutions Inc., requiring them to undertake a Statement of Auditing Standard 70 report (SAS 70). The audit will be performed by an independent auditing firm and their report will be submitted to the SBA in a time frame specified by the SBA.

Finding No. 2:

FHCF procedures did not require FHCF authorization of transfers of moneys to the Records Administrator for the payment of advances, loss reimbursements, and premium refunds.

Recommendation:

FHCF staff should review and approve funding requests prior to the transfer of moneys to the Records Administrator. Adequate documentation should also be maintained evidencing the review and approval.

SBA Response:

The FHCF will be implementing policies and procedures in conjunction with the SBA's Financial Operations Section to assure that funding requests made by the Records Administrator for payments to insurers are for authorized purposes and in the correct amounts. Documentation will be maintained evidencing the review and approval by FHCF staff.

APPENDIX A
MANAGEMENT RESPONSE (CONTINUED)

Finding No. 3:

FHCF's contact request form, which provided the insurer names and addresses to be used for FHCF correspondence and payment remittances, did not require the signature of two insurance company officers. In addition, our tests disclosed one instance in which a payment was sent to an address other than the address shown on the contact request form.

Recommendation:

We recommend that the FHCF amend the contact request form to require the signatures of two authorized insurer officers. Additionally, we recommend that the FHCF require that the Records Administrator only mail checks to the addresses and contacts shown by the properly executed forms. Further, any changes to the remittance information should be evidenced by the signatures of two authorized insurer officers.

SBA Response:

The contact request form has been amended and adopted in Rule 19-8.029 F.A.C. The new Form FHCF C-1 requires the notarized signatures of two authorized officers of the company. This form was mailed to all participating insurers in May 2008 and is due back to the FHCF by June 2, 2008. Any subsequent changes to the information provided by the company require completion of FHCF C-1 form and notarized signatures of two authorized officers of the company. A new policy has been implemented so that all payments will be made only to the address and contact person listed on the contact request form.

Finding No. 4:

FHCF staff did not confirm with licensing authorities the professional designations of the examiners contracted to perform loss examinations.

Recommendation:

We recommend that the FHCF verify the status of the professional designations reported by the examiners.

SBA Response:

The FHCF has taken steps to confirm the professional designations of examiners contracted to perform loss examinations. The FHCF will also implement a procedure to verify annually that the designations continue to be active and in good standing with the appropriate licensing authority.

Finding No. 5:

The FHCF had not finalized procedures for evaluating corrected proof of loss reports (POL).

Recommendation:

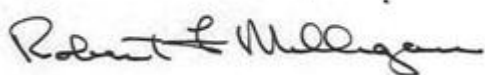
The FHCF had begun the development of procedures for evaluating the accuracy of revised POLs. We recommend that the FHCF continue the development and implementation of appropriate procedures.

SBA Response:

The FHCF has designed and is currently testing the review process for evaluating corrected proof of loss reports. The FHCF will continue its efforts to ensure proof of loss reports requiring corrections are evaluated appropriately.

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,



Robert F. Milligan
Interim Executive Director

cc: Dr. Jack Nicholson, Senior FHCF Officer
Florida Rivera-Alsing, Chief of Internal Audit
Bruce R. Meeks, Inspector General