

DEPARTMENT OF INSURANCE
FIELD EXAMINATION PROCEDURES

MAY 1973

Joint Legislative Audit Committee

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May 24, 1973

The Honorable President of the Senate
The Honorable Speaker of the Assembly
The Honorable Members of the Senate and
the Assembly of the Legislature of California

Members:

Transmitted herewith is a report on the examination practices and procedures of the California Department of Insurance. This report was prepared because of the Legislature's concern over the adequacy of the state's protection for California's life insurance policyholders.

The recently reported Equity Funding fraud has raised many questions which must be answered to restore the public's confidence in the multi-billion dollar insurance industry. Insurance companies are examined by the State Insurance Commissioner in each of the 50 states. The Commissioners of the various states have organized the National Association of Insurance Commissioners (NAIC) to promote uniformity, eliminate duplication, and improve the examination process. The problem of obtaining agreement and action by 50 states has an inhibiting influence on any changes in procedures.

California's examiners follow the NAIC procedures which are now outdated or inadequate. The development of EDP record keeping and the formation of financial conglomerates require more sophisticated examination procedures and training of examiners.

Examinations are initiated by the Commissioner of the state in which a company is incorporated regardless of the amount of business done in that state or in other states. Equity Funding Life Insurance Company, an Illinois corporation, reportedly did 30 percent of its business in California in 1972. The California department examined or participated in the examination of companies which collected only 5.2 percent of the life and disability premiums collected in California in 1971.

Honorable Members of the Legislature

May 24, 1973

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Reports have been received by California relative to examinations made by other states during the last three years of only 298 of the 423 foreign life and disability insurance companies authorized to do business in California. No examination report has been received for periods ended after December 31, 1968 for 125 foreign life and disability insurers. The last completed examination of one of the larger companies was ten years ago and nine years for another large company.

Over 60 percent of California's life insurers are audited annually by certified public accounting firms in addition to being examined by insurance commissioners. The department does not review or make use of the CPA audit reports except during examinations.

No state can single-handedly protect the interests of its policyholders through the present National Association of Insurance Commissioners' examination process. Each state must rely upon the effectiveness of the examinations of other states or CPA audits. Because of the Equity Funding fraud, the American Institute of Certified Public Accountants and the National Association of Insurance Commissioners are studying examination procedures.

It is hoped that any changes needed to more adequately protect California's policyholders will be implemented.

Respectfully submitted,



VINCENT THOMAS, Chairman
Joint Legislative Audit Committee

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SUMMARY OF FINDINGS

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INDUSTRY OVERVIEW

Examination Coverage

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- The procedures of the California Department of Insurance and those of the National Association of Insurance Examiners provide for an examination of each insurer at least once every three years.
- The California Department of Insurance has the responsibility to initiate and conduct the examination of insurers incorporated in California (domestic companies). Domestic companies collected one third of all insurance premiums collected in California in 1971 but collected only 18 percent of life and disability insurance premiums.
- In 1972, the California department examined or participated in the examination of companies which collected only 5.2 percent of the life and disability premiums collected in California in 1971.
- Reports have been received by California relative to examinations made by other states during the last three years of only 298 of the 423 foreign life and disability insurance companies authorized to do business in

California. No examination report has been received for periods ended after December 31, 1968 for 125 foreign life and disability insurers.

Qualification of Examiners 18

- The National Association of Insurance Commissioners has not set educational requirements nor required tests of the knowledge and proficiency of examiners.

Insurance Companies Audited
By Certified Public Accountants 19

- A substantial percent of domestic and foreign insurers are audited annually by certified public accounting firms in addition to being examined by insurance commissioners. The department does not review or make use of the CPA audit reports except during the commissioner's examinations.

Holding Company Systems 21

- A substantial percentage of domestic and foreign insurers are controlled by parent companies or have affiliated companies in related financial services such as equities, real estate or banking. A completely satisfactory audit cannot be made of only one company in a holding company system.

PRACTICES OF THE CALIFORNIA EXAMINERS

Scheduling of Examinations

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- A pre-examination discussion is held with the insurance company to be audited several months before an examination is scheduled. This practice decreases the effectiveness of the examinations because all element of surprise is eliminated. The commissioner's examinations consist primarily of verification of balance sheet amounts on a specified date.

Examiners Handbook and Audit Program

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- In many respects, the Examiners Handbook published by the NAIC is outdated or inadequate. California examiners follow the handbook.

Audits of Transactions

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- The reports and work papers contain very little evidence of a review of the internal control over the recording of transactions or of the tests made of these transactions. The review and tests are necessary to prove the validity of the transactions and to determine how amounts reported on the balance sheet were accumulated.

Audits of Balance Sheet Amounts

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- The audit procedures used to verify balance sheet amounts are deficient in several respects. Several of the deficiencies result even though the examiners are satisfying requirements of the Examiners Handbook.

Supervision of Field Work

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- Neither the chief of the field examination division nor the supervising insurance examiners review the work papers of California examiners. There is a need for closer supervision and review of field work.

Issuance of Reports

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- The department releases examination reports to the insurance companies and requests the insurers to distribute the report to all other states in which the insurer does business. An insurer has opportunities to alter the report before distributing it to regulatory agencies of other states.

INTRODUCTION

As requested by the Assembly Finance and Insurance Committee, we have reviewed the California Department of Insurance field examination division and certain closely-related functions of the company information and analysis division.

In April 1973, massive fraud was reported in Equity Funding Life Insurance Co., and its holding company Equity Funding Corporation of America.

Bests 1972 Insurance Report indicates that Equity Funding Corporation of America (the parent company) has organized or acquired financial service subsidiaries which consist of a company which managed three mutual funds, a bank, a savings and loan association, three insurance companies, three limited partnership investment programs in cattle breeding, oil and gas, and real estate, a company which holds a seat on three regional stock exchanges, and a registered broker dealer which holds membership in the National Association of Security Dealers.

Equity Funding Life Insurance Co. and Equity Funding Corporation of America both have executive offices in Los Angeles. The reported irregularities included millions of dollars of missing securities, the manufacture of fake insurance policies, the resale of fake policies for cash to other insurance companies, and the creation of fake loans issued against mutual fund shares which did not exist.

The insurance subsidiaries of Equity Funding Corporation of America held about 55 percent of the assets as evidenced by a pro forma consolidated balance sheet prepared for December 31, 1971.

The primary goal of the California Department of Insurance is to protect California policy holders against the insolvency of insurance companies. The commissioner's examinations, following procedures of the National Association of Insurance Commissioners (NAIC), is a primary means used by the department to achieve this goal.

The California Insurance Code gives the Insurance Commissioner the power to examine any insurer (foreign or domestic) doing business in this state whenever he deems it necessary. The commissioner may examine holding companies or affiliated companies if his normal examination of the insurer is inadequate. The cost of examinations is charged to the insurer examined.

The California Code does not require that each insurer be examined within a specific time period.

The insurance industry is regulated by the various states. Statutes in all states provide for the organization and maintenance of an insurance department. The NAIC is a voluntary organization of the commissioners of the various states to promote uniformity and cooperation among the state insurance regulatory agencies.

In California, the Legislature has acted to protect the public against the insolvency of all fire, marine, casualty and miscellaneous insurers allowed to transact business in this state by providing for the California Insurance Guarantee Association (Section 1063 of the Insurance Code). The association provides each insurer with insolvency insurance.

Assembly Bill 1075 of the 1973 session, if enacted into law, would similarly provide for a California Life and Disability Insurance Guarantee

Association to protect the public against the failure of life and disability insurance companies.

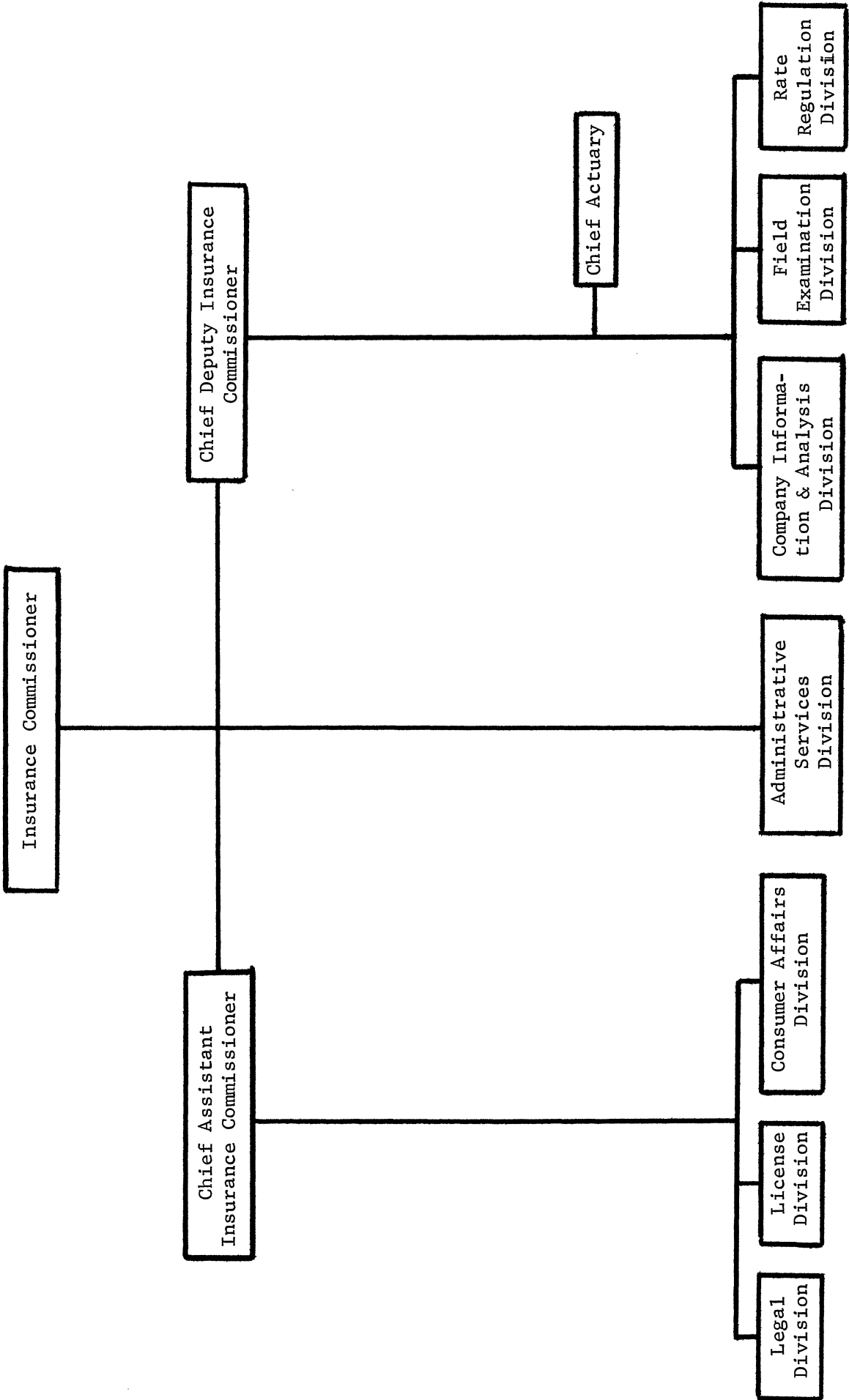
Although the above legislation and proposed legislation may adequately protect California policy holders, the continued need for audits or field examination is recognized in the legislation (Section 1063.3 of the Insurance Code, and Section 1064.11 as proposed by Assembly Bill 1075 of 1973).

The California insurance commissioner should persuade the NAIC, which is currently reviewing its examination procedures, to adopt changes necessary to regulate the insurance industry in California. This is necessary because if California's regulatory and examination procedures are not in accord with requirements of the NAIC, California would be required to regulate all insurers doing business in California without assistance from other states. Companies subject to California's regulatory procedures not accepted by the NAIC may continue to be subject to NAIC procedures as a condition of doing business in other states.

Because of the Equity Funding fraud, the American Institute of Certified Public Accountants (AICPA) is also reviewing CPA's insurance company audit procedures.

RECOMMENDATION

The California Insurance Commissioner advise the NAIC and AICPA of any changes needed to more adequately protect California's policy holders.



FIELD EXAMINATION DIVISION

The field examination division is one of seven divisions within the Department of Insurance.

The division has 52 positions authorized in 1972-73. The authorized positions consist of 49 professional and three clerical positions. The employees of the division are nearly equally divided between the San Francisco and Los Angeles offices. The positions are shown on the following Table 1.

Table 1

Authorized Positions Field Examination
Division 1972-73

<u>Number Of Positions</u>	<u>Position</u>	<u>Salary Range</u>
1	Chief, Field Examination Division	\$1,762 - \$2,148
1	Actuary	1,525 - 1,855
2	Supervising Insurance Examiner	1,525 - 1,855
10	Insurance Examiner IV	1,383 - 1,855
15	Insurance Examiner III	1,138 - 1,525
20	Insurance Examiner I/II	937 - 1,254
1	Senior stenographer	605 - 734
1	Stenographer II	522 - 635
<u>1</u>	Clerk typist	485 - 650
<u>52</u>		

The division is entirely supported by charges made to insurance companies for the cost of examinations. The funds allotted for operating the division for the year ended June 30, 1973, are as follows:

Personal services	\$ 869,100
Operating expenses	<u>137,993</u>
Total	<u>\$1,007,093</u>

The field examination division conducts field examinations of insurers admitted to do business in California. Its purpose is to discover by field audit and to report in writing the facts which establish the condition of all admitted insurers, or insurers seeking admission and report any violation of the Insurance Code of California by an admitted insurer.

INDUSTRY OVERVIEW

This chapter has been divided into several sections related to the National Association of Insurance Commissioners, examination coverage, qualifications of examiners, audits by certified public accountants, and holding and affiliated company organization structures commonly found in the insurance industry.

NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Examinations made by the California Department of Insurance are conducted in cooperation with, and conform with guidelines of the National Association of Insurance Commissioners (NAIC). Although NAIC examinations and procedures are not specifically sanctioned in the California Insurance Code, for years the department has followed this means of operations and has adequately disclosed its means of operation in budget requests presented to the Legislature. The NAIC and the department's own operating procedures provide for an examination of each insurer at least once every three years.

NAIC procedures provide that the examination is normally initiated and directed by the state in which the insurer is incorporated. Other states may participate in the examination. Most states accept the NAIC examination to satisfy their statutory requirements whether they directly participate in the examination or not.

The NAIC examination evolved to eliminate duplication of effort on the part of states, to save expenses on the part of companies and to provide some uniformity in the methods of conducting examinations.

EXAMINATION COVERAGE

In accordance with NAIC procedures, the California Department of Insurance has the responsibility to initiate and direct the examination of insurance companies incorporated in California. The following Table 2, taken from data contained in the commissioner's one hundred - fourth annual report, shows the percent of California premiums collected by companies incorporated in California compared to California premiums collected by insurers incorporated in other states for the 1971 calendar year.

Table 2

California Insurance Premiums Collected
By Domestic Companies 1971

	<u>California</u> <u>Insurers</u>	<u>Insurers -</u> <u>Other States</u> <u>Or Countries</u>	<u>Total</u> <u>Premiums</u>
Life and disability insurers:			
Life premiums collected	\$ 322,635,000 14.7%	\$1,872,023,000 85.3%	\$2,194,658,000 100.0%
Accident and health premiums earned	<u>328,544,000</u> 23.3%	<u>1,081,067,000</u> 76.7%	<u>1,409,611,000</u> 100.0%
Total life and disability	\$ 651,179,000 18.1%	\$2,953,090,000 81.9%	\$3,604,269,000 100.0%
Fire, marine, casualty and mis- cellaneous insurers:			
Direct premiums earned	1,593,521,000	2,429,267,000	4,420,822,000
Non profit hospital service plans	398,034,000 45.0%	- 55.0%	- 100.0%
Real estate title insurers:			
Premiums earned	<u>88,837,000</u> 96.5%	<u>3,250,000</u> 3.5%	<u>92,087,000</u> 100.0%
Total premiums	<u>\$2,731,571,000</u> 33.7%	<u>\$5,385,607,000</u> 66.3%	<u>\$8,117,178,000</u> 100.0%

Insurance companies incorporate in various states for a multitude of legal and financial reasons. However, statistics compiled by the Insurance Department of the State of Ohio for the year ended December 31, 1970, show that California is not unusual in that only 33.7 percent of its premiums are collected by domestic companies. The average for all states is 32.1 percent. Only five states exceed California; they are: New York, 56.4 percent; Wisconsin, 40.3 percent; Texas, 37.5 percent; Ohio 35.4 percent; and Michigan, 34.0 percent.

In 1972, the California Department of Insurance completed examinations of domestic companies which collected 21 percent of the premiums collected in California by domestic life insurance companies in 1971. The California department participated in the examination of eleven foreign life insurance companies which were completed in 1972. The eleven foreign life insurance companies collected 1.8 percent of the life insurance premiums collected in California by foreign life insurance companies. In total, the California department examined or participated in the examination of companies which collected 5.2 percent of the total life and disability premiums collected in California in 1971. The annual examination coverage of the California examiners of life and disability insurers is summarized in Table 3.

Table 3

Annual Examination Coverage of Life and Disability
Insurers By California Examiners 1972

	Premiums Collected In California By Domestic <u>Insurers</u>	Premiums Collected In California By Foreign <u>Insurers</u>	Total Life And Disability Premiums Collected In <u>California 1971</u>
Examination of insurers completed in 1972 by California examiners	\$136,629,000		\$ 136,629,000
Examinations under jurisdiction of other states participated in by California examiners completed 1972	_____	\$ 52,036,000	\$ 52,036,000
Total examined	\$136,629,000	\$ 52,036,000	\$ 188,665,000
Total premiums	\$651,179,000	\$2,953,090,000	\$3,604,269,000
Percent examined	21.0%	1.8%	5.2%

Due to time limitations, we did not compute the annual examination coverage for fire and casualty insurers by California examiners. However, based upon Table 2, which indicates 45 percent of premiums are collected by California companies, and the departments practice of examining each insurer every three years we estimate that insurers that collected approximately 15 percent of the premiums are audited annually by California examiners.

Generally, foreign insurers are examined by other states every three years and the California department receives a copy of the report. Table 4 shows the date of the latest examination of the 423 foreign life and disability insurance companies authorized to do business in California according to the department's records. Examinations have been made of 298 of the 423 insurers during the past three years. Examination reports have not been received for periods ended after December 31, 1968 for 125 insurers.

Table 4

Summary of Date of Latest Examination Report
Received of Foreign Life and Casualty
Insurers Licensed In California

	<u>Number of Companies</u>
Year ended in 1972	3
Year ended in 1971	83
Year ended in 1970	112
Year ended in 1969	<u>100</u>
Sub Total	<u>298</u>
Year ended in 1968	56
Year ended in 1967	33
Year ended in 1966 and prior years	24
No examinations made per department records	<u>12</u>
Sub Total	<u>125</u>
Total	<u>423</u>

Table 5 shows the ten largest life and disability insurers on the basis of premiums collected in California per the Insurance Commissioner's 1971 annual report and the date of the last examination according to the department's records. Large insurance companies are examined less frequently because they are generally expected to be more secure financially than smaller companies. The average time from the date of the latest examination to December 31, 1972 is 4.8 years. Best's reports that an examination of Metropolitan Life Insurance for a five-year period ended December 31, 1968 and an examination of Equitable Life Assurance Society of the United States for a period ended December 31, 1970 are in progress. Occidental Life Insurance Company of California is currently being examined by California examiners.

Table 5

Last Completed Examination of Ten Largest Life And
Disability Insurers In California
Per 1971 Annual Report

	<u>Total Premiums Collected In California</u>	<u>Last Examination Date</u>	<u>Time From December 31, 1972</u>
Prudential Insurance Company of America, Newark, New Jersey	\$334,566,000	12-31-66	6 years
Metropolitan Life Insurance Company, New York, New York	226,926,000	12-31-63	9 years
Occidental Life Insurance Company of California, Los Angeles, California	221,964,000	12-31-68	4 years
Aetna Life Insurance Company, Hartford, Connecticut	217,766,000	12-31-70	2 years
New York Life Insurance Company, New York, New York	207,558,000	12-31-69	3 years
Equitable Life Assurance Society of the United States, New York, New York	161,888,000	12-31-62	10 years
Travelers Insurance Company, Hartford, Connecticut	157,068,000	12-31-68	4 years
Connecticut General Life Insurance Company, Hartford, Connecticut	126,637,000	12-31-67	5 years
Pacific Mutual Life Insurance Company, Los Angeles, California	90,412,000	12-31-69	3 years
California-Western States Life Insurance Company, Sacramento, California	84,860,000	12-31-70	2 years

Reports of an examination made by the California Department of Insurance were completed on an average of eight months after the balance sheet date. Examinations made by other states were received by California on an average of 14 months after the balance sheet date.

QUALIFICATIONS OF EXAMINERS

The NAIC suggests that in order to be able to participate in an association examination, an examiner shall have the following qualifications.

- Regular employment by an insurance department or by an accounting firm or consulting actuary representing an insurance department to conduct its examination work.
- Two years insurance examination experience
- Independence from insurance companies examined.

The NAIC has not set educational requirements nor required tests of the knowledge and proficiency of examiners. The quality of examiners can vary from state to state and reportedly does. We, however, have gathered no evidence to indicate the quality of examiners of other states.

The California State Personnel Board specifications for insurance examiner I (the recruiting, training and first working level classifications) requires the equivalent of graduation from college preferably with a major in business administration, economics, insurance, accounting or a related field, or the equivalent of 16 semester hours of professional accounting courses given by a collegiate-grade residence institution including courses in elementary and advanced accounting, auditing and cost accounting and three semester hours of business law. The specifications for the insurance examiner II, III and IV positions require longevity in state service or experience with an insurance company in addition to the insurance examiner I requirements.

INSURANCE COMPANIES AUDITED
BY CERTIFIED PUBLIC ACCOUNTANTS

Our analysis compiled from published financial reference manuals indicates that at present a substantial percent of premiums collected in California by the insurance companies incorporated in California are collected by companies which are audited annually by certified public accounting firms. The following Table 6 shows the amount and percent of premiums collected by California insurance companies that we were able to determine as being audited by C.P.A.'s. We could not find many fire, marine and casualty insurers listed in the reference manuals.

Table 6

Insurance Premiums Collected in California in 1971
 By California Insurers that Are Audited By
Certified Public Accountants

	Life Insurance Premiums <u>Collected</u>	Accident And Health Insurance <u>Premiums Earned</u>	Fire, Marine, Casualty And Miscellaneous Insurance <u>Premiums Earned</u>
California insurance companies audited by certified public accountants	\$196,428,000 60.9%	\$200,928,000 61.2%	\$ 346,124,000 21.7%
Total California insurers per 1971 annual report	\$322,635,000 100.0%	\$328,544,000 100.0%	\$1,593,521,000 100.0%

We believe the results of our research and analysis to be conservative. Ernst & Ernst has published reports entitled, Financial Reporting Trends, Life Insurance - 1972, and Financial Reporting Trends, Fire and Casualty Insurance - 1972. These publications, based upon surveys made of information contained in

published annual reports of insurance companies whose stock is traded on major stock exchanges or over the counter markets plus large mutual companies, contained the following statements and statistics:

"Of the 250 life insurance companies covered by this survey, the financial statements of 177 companies, or 71 percent of the total, were accompanied by accountants' reports.

"The numbers and percentages of audited reports may be summarized as follows:

	<u>In 1971 and 1970</u>	
	<u>Number</u>	<u>Percentage</u>
	<u>Audited</u>	<u>of Total</u>
200 stock companies	156	78
50 mutual companies	21	42"

"Stock companies:

Audited	81
Unaudited	<u>9</u>
Total	<u>90</u>

"Mutual companies:

Audited	18
Unaudited	<u>37</u>
Total	<u>55"</u>

Although the NAIC examination is to a large degree a financial audit, the NAIC has no procedures regarding the use of the audit reports or the work of certified public accountants. We are advised through informal discussions that the California examiners are instructed to obtain photocopies of the work papers of the independent auditors if the work papers are available and to test check some of the work of the independent auditors and to limit their own examination. This appears to be confirmed by recommendations contained in a 1965 report from an industry committee to review and make recommendations regarding California insurance department examination procedures, the department's "Pre-Examination

Program" discussed later in this report, and a review of the field examination work papers of the department. The California department does not review or make use of the C.P.A. audit reports except during the commissioner's examination.

HOLDING COMPANY SYSTEMS

Our analysis made from financial reference manuals and the annual report of the California insurance commissioner for 1971, indicates that approximately 70 percent of the premium business done by life insurance companies incorporated in California is done by companies which are part of a holding company system. The following Table 7 shows the results of our survey.

Table 7

Insurance Premiums Collected In California
In 1971 By California Insurers
Controlled By Holding Companies

	Life Insurance Premiums <u>Collected</u>	Accident And Health Insurance <u>Premiums Earned</u>	Fire, Marine, Casualty And Miscellaneous Insurance <u>Premiums Earned</u>
California insurance companies controlled by holding companies	\$223,105,000 69.0%	\$228,656,000 69.6%	\$ 632,907,000 39.7%
Total California insurers per 1971 annual report	\$322,635,000 100.0%	\$328,544,000 100.0%	\$1,593,521,000 100.0%

Financial Reporting Trends, Life Insurance - 1972, and Financial Reporting Trends, Fire and Casualty Insurance - 1972, published by Ernst & Ernst, describe a "congeneric" as "...a group of two or more related corporate entities of which at least one is the prominent member of the group (alone or in combination with other insurance subsidiaries) in terms of revenues and total assets, and operations of the group are devoted primarily to broadly related financial services".

Financial Reporting Trends, Life Insurance - 1972 reports that 71 percent of the stock companies included in the survey were part of a congeneric combination in 1971 and that the number of insurance companies included in a congeneric combination has rapidly increased since 1964. The following table shows this growth.

"TABLE 12. CONGENERICS

	<u>71</u>	<u>70</u>	<u>69</u>	<u>68</u>	<u>67</u>	<u>66</u>	<u>65</u>	<u>64</u>
Number of stock life insurance companies:								
Included in a congeneric	142	141	120	80	68	54	50	40
Not included in a congeneric	<u>58</u>	<u>59</u>	<u>80</u>	<u>120</u>	<u>132</u>	<u>146</u>	<u>150</u>	<u>160</u>
	<u>200</u>	<u>200</u>	<u>200</u>	<u>200</u>	<u>200</u>	<u>200</u>	<u>200</u>	<u>200</u>
Percent of congenetics in which the parent is a:								
Holding company	64	59	61	53	21	9	8	6
Life insurance company	<u>36</u>	<u>41</u>	<u>39</u>	<u>47</u>	<u>79</u>	<u>91</u>	<u>92</u>	<u>94</u>
	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>

Financial Trends Fire and Casualty Insurance 1972 reports that 80 percent of the stock fire and casualty insurance companies in the survey were part of a congeneric organization.

These publications report that 88 percent of congenetics which include life insurance companies, and 90 percent of the congenetics which include fire

and casualty insurance companies also include noninsurance companies. Noninsurance subsidiaries were most often involved in the following:

- Equities distribution
- Financing and leasing
- Real estate development
- Consulting and research
- Computer services
- General agencies
- Banking
- Savings and loans.

The NAIC provides little guidance to auditing insurance companies which are part of a holding company system or have affiliated companies.

Section 1215.6 of the California Insurance Code provides that the commissioner has the power to order the records of holding companies and affiliates to be examined if his normal examination of the insurer is inadequate and that the cost of the examination shall be the expense of the insurer. These powers and controls possessed by the California Insurance Commissioner relate, for the most part, to domestic insurers.

It may not be practical, however, for the insurance commissioner to examine or cause to be examined a holding company or affiliates of the insurer. To date, none have been examined. First, the commissioner must show cause through his normal examination process. Secondly, the holding company may

encompass many activities other than insurance, and the cost, to be borne by the insurer, may be prohibitive.

A completely satisfactory audit cannot be made of only one company in a congeneric organization. There is danger that assets of a subsidiary not under examination may be transferred to a subsidiary under examination for audit purposes.

Auditing involves the proper synchronizing of audit procedures. For example, it may be necessary to synchronize the examination or simultaneously examine cash on hand and in the banks, securities owned, bank loans and other related items for the parent company and all subsidiaries.

Certified public accountants, reporting on the financial statements of a consolidated group of corporations have found it necessary to examine all entities of the group either themselves or through coordinating their work with that of other C.P.A.'s who may audit some of the subsidiaries.

CONCLUSIONS

No state can single handedly protect the interests of its policy holders through the present NAIC field examination process. Each state must rely upon the effectiveness of the examinations of other states.

The growth of holding company systems or "congenerics" in the insurance industry has been rapid in the last ten years. This growth and change has

added complexities and dangers to making an adequate examination. The insurance commissioners have not made changes to cope with holding companies. The examination of many insurers which are now part of a congeneric organization is no longer effective because the examinations are of only a portion of a holding company system and are made at too infrequent an interval.

We are aware of two alternatives available to the insurance commissioners without drastically increasing the cost to insurers. The alternatives are not necessarily exclusive. They are explained in the following two paragraphs.

1. Serious consideration should be given by the commissioners to accepting or requiring financial audits by certified public accounting firms in lieu of performing a financial examination providing the scope of examination, report format and accountants performing the examination are acceptable to the commissioners. The commissioners should take an active part developing the requirements for such an audit. One audit should be designed and made to satisfy the common and discrete accountability interests of the insurance company, the various state commissioners, the Securities and Exchange Commission and other interested persons. Audits made annually should be an improvement over the three-year or more delay between examinations.

2. The chief of the field examination division has suggested that insurance companies be required to maintain investments in stocks and bonds and perhaps certain other assets in a custodial account with a bank or trust company. Stocks, bonds and mortgage loans generally comprise the majority of the assets of an insurance company. NAIC procedures in the Examiners Handbook suggest that

if securities are held under a custodial agreement, the agreement should be satisfactory to the examiner. The Examiners Handbook also provides that the securities so deposited should at all times be kept separate and apart from other deposits so that they may be identified as belonging solely to the company making the deposit. Other requirements of custodial agreements could be added as deemed necessary. The policyholders could be adequately protected provided a sufficient amount of assets was held in custodial accounts.

Once the major course of action is selected, other changes in the examination processes still must be made.

PRACTICES OF CALIFORNIA EXAMINERS

We reviewed the NAIC Examiners' Handbook and the written procedures of the California examiners, held extensive interviews with management and reviewed the field examination reports and working papers for seven examinations made during 1972 under the direction of the California examiners.

SCHEDULING OF EXAMINATIONS

It has been the usual practice of the field examination division to examine domestic insurers triennially except when financial or other conditions warranted examinations at shorter intervals of time. The department's schedule of examinations due in 1972 indicates that 14 of the 80 examinations scheduled were for a shorter time interval.

The triennial examination is recommended by the NAIC. We have a serious question as to whether or not the examinations are scheduled often enough to be effective considering the rate of change currently being experienced by corporate organizations.

The California examiners generally arrange for a pre-examination discussion several months before the examination is scheduled. The NAIC states:

"Generally, the discussion should take place about six months prior to the date as of which examination is to be made.... The main purpose of the discussion should be to advise the insurer of the requirements of the examiner with respect to work to be done and records to be made available for examination purposes."

The California department has developed a "Pre-Examination Program" which is mailed out or delivered in person at a pre-audit conference about six months before the examination which indicates the records that will be needed and to some extent the tests to be made. For example, the "Pre-Examination Program" states:

- "Be prepared to submit for examination brokers' invoices for purchases and sales."
- "All large loans in amounts over \$250,000 or 1/2 percent of assets, whichever is smaller, will be examined. Other old loans which were examined in the previous examination will not be checked again unless some evidence indicates a need for such recheck. The new small loans will be examined on a sample basis."

The California department's "Pre-Examination Program" is based in part on conclusions reached in 1965 by the Industry Committee to Review and Make Recommendations Regarding California Insurance Department Examination Procedures. The industry committee recommended the utilization of pre-examination conferences to reduce cost of examinations and to maximize the use of existing records.

We are not opposed to the pre-examination conference by itself. This practice is commonly used in the auditing profession. However, the effectiveness of examination procedures used by the Insurance Commissioner depends upon their timing and may require an element of surprise particularly since the commissioner's examination consists primarily of an examination of

balance sheet amounts at a specified year-end date with very little evaluation of controls or tests of transactions.

RECOMMENDATION

The Insurance Commissioner should schedule some surprise examinations using undisclosed audit procedures at varying frequencies.

EXAMINERS HANDBOOK AND AUDIT PROGRAM

The Examiners Handbook is published by the NAIC as a general guide for examinations. Since it must take into consideration the statutory requirements and examination practices of all 50 states as well as a multiplicity of methods used by various companies, much discretion is left to the examiners.

The handbook is outdated and deficient in certain respects. For example, the procedures for examination of accounts compiled by electronic data processing systems was last amended in 1964 and does not tell how to examine the accounts. Certain other deficiencies of the Examiners Handbook relate to holding and affiliated companies, and the use of audits made by public accountants have already been pointed out in this report. Other deficiencies will be described in the following sections of this report.

Although the Examiners Handbook was not designed to be an audit program, the work papers we examined did not contain further elaboration in the form of an audit program. An audit program indicates, in summary form, the audit procedures used, and how the work was planned, coordinated and controlled.

Many of the working papers were not headed, signed, dated, numbered, indexed or cross referenced. Consequently, it was not possible for a reviewer to determine if all papers were present. In many cases, it was impossible to determine the audit procedures used, extent of tests and results thereof. Nevertheless, the findings in the remainder of this chapter related to practices of the California examiners are based to a large extent upon what could be observed from the working papers.

AUDITS OF TRANSACTIONS

In general the report and work papers contained very little evidence to indicate that any study was made of internal controls over the recording of transactions or that any tests of transactions were made. The auditor has to understand the controls and to test the flow of transactions to develop a detailed audit program and to understand how amounts reported on the balance sheet were accumulated.

Many insurance companies now record their transactions with the use of electronic data processing equipment and techniques. The commissioner has recently appointed an electronic data processing committee to study methods of auditing records maintained by insurance companies or electronic data processing installations.

Tests to determine that transactions have been properly recorded depend upon the availability of some independent source of information. The primary assets of an insurance company generally consist of stocks, bonds, mortgage loans and policy loans. The chief of the field examination division has suggested that insurance companies be required to maintain investments in

stocks and bonds in a custodial account with a bank and that the field examiners confirm the existence of the assets and obtain a record of transactions from the trustee. In our opinion, depending upon the terms of the custodial agreement and independence of the custodian, this would provide the department with good evidence of the existence of the assets and control to assure that assets are not transferred in from a parent company or affiliates for the balance sheet examination and that the dates of the transactions are properly recorded.

Other transactions cannot easily be handled by a trustee or confirmed with a trustee. The department should develop an internal control questionnaire and program to serve as a guide to indicate minimum review requirements for all parts of the examination. The questionnaire and program should include tests to verify compliance with statutory requirements and regulations of the department as well as tests over the recording of transactions.

In the past, the auditing profession has verified business in force by the examination of policy files and other data. The insurance examiners followed the same practice. In the wake of the Equity Funding scandal the profession is considering confirming the existence of policies in force by direct correspondence with policy holders. The Insurance Examiners should also formulate their position on the degree to which independent information is to be obtained to verify business in force.

RECOMMENDATION

The Insurance Commissioner should develop a standard audit program and internal control questionnaire to serve as a guide and to indicate the minimum examination that should be made.

AUDITS OF BALANCE SHEET AMOUNTS

The commissioner's procedures used to verify the balance sheet amounts are deficient in several respects. Several deficiencies result even though the examiners are satisfying requirements of the Examiners Handbook.

The following are some of the deficiencies noted:

- The work papers for the examination of several insurers did not contain evidential matter to indicate that material amounts of stocks or bonds were confirmed or counted.
- The workpapers of six of the seven insurers reviewed contained no evidential matter to indicate that policy loans were confirmed with the borrower. The Examiners Handbook does not require that policy loan balances be confirmed with the borrower.
- The work papers of five of the seven insurers examined contained no evidential matter to indicate that mortgage loans were confirmed with the borrower or the servicing institution. This is not required by the Examiners Handbook.
- The work papers of four of the seven insurers reviewed indicated that the confirmations were returned addressed to the auditor in care of the insurance company.
- The audit of reserves is headed by the field actuary who develops an audit program to verify company data used to establish the reserves. The workpapers contain little information on the extent of tests made to verify data used to calculate the reserves.

USE OF ACTUARIES

The department has a chief actuary and a field actuary. The chief actuary is required by Section 10478 et. seq. of the Insurance Code to value reserve liabilities of every admitted life insurer each year. The field actuary directs the field examination of reserve liabilities.

The department has not formalized the working relationship between the chief actuary and the field actuary. Theoretically, the field examiners should be verifying data used by the chief actuary. The newly-hired chief actuary advised us that he plans to develop procedures to coordinate the activities of the chief actuary and the field actuary and examiners.

SUPERVISION OF FIELD WORK

The Personnel Board specifications for the two supervising insurance examiners (one working out of the San Francisco office and one working out of the Los Angeles office) provides that they shall plan and direct the work of the field staff engaged in conducting financial examinations. However, in practice, the supervising examiner stationed in Los Angeles works in the field handling difficult examinations. The chief of the field examination division has assumed direct supervision of the examinations made by examiners stationed in Los Angeles without an intervening supervising examiner. The supervising examiner stationed in San Francisco supervises examinations made by examiners stationed in San Francisco. However, neither the chief examiner nor the supervising examiner in San Francisco review the working papers of the groups they supervise. Both men claim that they do not have the time.

The present division of supervisory duties was prompted by a directive by the then commissioner in 1967. The commissioner assigned the two supervising insurance examiners to the field as working examiners and provided that the chief of the field examination division would directly supervise the field examinations.

Because the working papers do not provide evidential matter to indicate that a proper audit was made and some of the examiners appear to be in need of training and supervision, we are suggesting closer supervision and review of the working papers of each examination.

RECOMMENDATION

The chief of the field examination division should assign a supervisor to review working papers for each examination to make sure that adequate steps were taken, that adequate evidential matter is obtained, and that the papers are organized so that they are susceptible to a systematic review.

INSURANCE REPORTS

The California department releases the examination reports to the insurance companies and requests and insurers to distribute the report to all other states in which the insurer does business. This practice is followed by many other states. The practice has inherent weaknesses in that an

insurer could alter the report before distributing it to the other state regulatory agencies.

RECOMMENDATION

The Insurance Commissioner should issue examination reports directly to all other states in which the insurer does business and should insist on receiving reports on examinations made by other states directly from the commissioners of those other states.



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May 22, 1973

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