

DEPARTMENT OF INSURANCE CONSERVATION AND LIQUIDATION OFFICE

Stronger Oversight Is Needed to Properly Safeguard Insurance Companies' Assets

REPORT NUMBER 2001-102, JULY 2001

Department of Insurance Conservation and Liquidation Office's
response as of July 2002

Audit Highlights . . .

Our review of the operations and internal controls of the Department of Insurance's (department) Conservation and Liquidation Office (CLO) disclosed that the CLO:

- Does not adequately safeguard and conserve assets that come under its control.*
- Has not updated estate closing plans since 1998, and has never included projected cash flow needs in these plans.*
- Does not effectively manage its contracts and its basis for allocating certain costs to insurers' estates is inequitable.*
- Has never adopted a comprehensive conflict-of-interest policy for its employees and contractors to follow.*

continued on next page

The Joint Legislative Audit Committee (audit committee) asked the Bureau of State Audits to conduct an audit of the operations of the Department of Insurance's (department) Conservation and Liquidation Office (CLO). Specifically, the audit committee asked us to determine whether the CLO has adequate internal controls to detect the mishandling of the assets of conserved and liquidated insurers. The audit committee also asked us to evaluate the sufficiency of the department's efforts to regularly monitor all CLO operations. We found that:

Finding #1: The CLO does not promptly identify and secure all assets of seized or conserved insurers.

The Conservation and Liquidation Office (CLO) does not follow recommended procedures when it inventories the fixed assets of an insurance company (insurer) that it seizes or places in conservation. In a recent example, rather than immediately completing an inventory to identify and safeguard the assets of a seized title insurance company, the CLO waited to do so until at least three weeks after it was authorized to take control of the insurer in February 2000. More recently, the CLO omitted several items from the inventory count of another conserved insurer's fixed assets. In addition, the CLO does not account for all of the assets of liquidated insurers after they are auctioned, so it does not know whether the auction company returns all of the unsold items. Such practices fail to safeguard and conserve the insurer assets that come under the CLO's control.

To ensure that it adequately safeguards the fixed assets of insurers under its control, we recommended that the department see that the CLO take the following steps:

☑ *Spent at least \$6 million of insurers' money on a claims processing system that does not meet its needs.*

Additionally, the department has allowed the CLO to continue its poor management practices by failing to properly oversee its activities.

- Develop work plans for each inventory it conducts, based on prudent business practices that include:
 - ◆ Holding preparatory meetings to discuss the inventory process.
 - ◆ Providing instructions regarding how each inventory will be taken.
 - ◆ Promptly conducting inventory counts to reduce the risk of loss.
 - ◆ Ensuring that all count sheets are pre-numbered and collected after the inventory is complete.
 - ◆ Checking all counted items to ensure that they are clearly marked or tagged to avoid omitting any.
- Train its staff in proper inventory procedures and require all personnel who participate in the inventory process to follow the new procedures.
- In its contracts with auction companies, require auction lists of sold and unsold items to include the inventory tag number and the exact same description as is included on the CLO's list of inventory available for auction, and reconcile the lists to ensure that all inventoried items are accounted for.

Department Action: Corrective action taken.

The department states that the CLO has completed a review of its fixed asset inventory policies and procedures manual and made the necessary modifications to ensure that all of the above recommendations were properly included. The revised manual was finalized on September 10, 2001, and will be used for all future inventories.

Finding #2: The CLO does not ensure that investment decisions are optimized.

We found that the CLO is not as effective as it could be in managing insurers' invested assets and budgeting for its operations, because it does not regularly update the individual closing plans for the estates it manages. Since 1998, the CLO has failed to update its estate closing plans, and it has never included an estimation of each estate's future cash flows as part of those plans. This information would be very helpful to its investment

managers in maximizing the assets of the estates they manage. In 1998, the CLO did prepare an aggregate cash flow projection that aided its investment managers. Since then, however, the CLO has neither updated estate closing plans nor projected its cash flow needs, so this information has been unavailable for making investment decisions or to more accurately budget for its operations.

In addition, since 1995, the CLO has not reviewed its investment guidelines or performance benchmark to ensure that its investment strategy is appropriate, even though the size of its investment pool has more than tripled since then. In addition, in calendar year 2000, the CLO paid \$930,000 to its investment managers, but since 1998, it has not evaluated the fees it pays to ensure that they are reasonable when compared to what other investment firms would charge to manage a pool of similar value. Consequently, the CLO may be needlessly spending estate funds on fees for its investment managers.

To maximize the return on the assets it manages, we recommended that the department ensure that the CLO takes the following actions:

- Update estate closing plans and include estimates of the future cash needs for each estate. The CLO should use this information to ensure that it reaches its goal of maximizing estate assets and to accurately plan and budget for its operations.
- Periodically reevaluate its investment strategy and benchmark to reflect changing conditions and requirements.
- Periodically review its contract for investment management services to determine whether the fees it pays are reasonable compared to what other investment managers would charge to manage an investment pool of similar value.

Department Action: Corrective action taken.

The department states that the CLO has completed updating estate plans for the 55 estates under its control as of July 2001, and developed a schedule to keep them updated.

In March 2001 the CLO requested the current investment management firms to provide their recommendations for modifying the investment strategy, and in July 2001 decided not to modify the current strategy or benchmark until new cash flows were developed and the investment function was put out for competitive bid. In August 2001 the CLO issued a request for proposal for investment management services and has since selected new investment managers who are in the process of revising the investment guidelines. According to the department, the CLO will save \$300,000 annually under its new contract with the investment managers.

Finding #3: The CLO did not always follow its procedures for awarding and managing contracts for professional services.

The CLO does not adequately manage its contracts to ensure that contract managers follow its competitive bidding policy, which specifies only three circumstances when obtaining competitive bids is not required. Two of the 10 contracts we reviewed should have been competitively bid but were not, and the reasons the CLO gave for using sole-source contracts did not appear to qualify under any of the exceptions listed in its policy. When the CLO fails to properly control and monitor its contracts, estate assets may be spent improperly or unnecessarily.

We recommended that the department see to it that the CLO:

- Amend its contracting policies and procedures to define how managers should seek competitive bids, including the type of documentation required for bids obtained by telephone, and ensure that its contract managers understand and adhere to the CLO's contracting policies and procedures.
- Assign each contract a unique number and require its contract managers and accounting staff to track payments made using a spreadsheet or other means as a control against misapplied payments or overpayment.
- Review contracts periodically to determine if and when they should be renewed, and require all contractors to adhere to all contract terms and conditions.
- Ask one vendor who provided security services to pay back \$43,340 in overpayments due to the CLO paying a higher rate than its contract specified.

Department Action: Partial corrective action taken.

The department states that on September 12, 2001, the CLO completed a contracts manual that is based on the policies and procedures used by the department, including the requirement that each contract be identified with a unique number. The CLO plans to expand the manual to include detailed processes to be followed for the various methods used to procure services. In addition, the CLO established a contract coordinator position that is responsible for ensuring that the contracting policies and procedures are followed. Finally, the CLO sent a demand letter to the contractor that received the overpayment on July 27, 2001. The contractor agreed to pay back the overpaid amount in three equal installments with the last one occurring on December 2, 2001.

Finding #4: The CLO does not ensure that it hires and promotes qualified staff.

The CLO does not ensure that it hires and promotes the most qualified applicants. For example, the CLO hired two applicants and promoted one employee who did not appear to meet the CLO's minimum qualifications. Consequently, the CLO cannot be certain that it is employing the most qualified personnel, and it may be compensating some employees for qualifications they do not possess.

We recommended that the department see to it that the CLO hire qualified applicants and promote qualified employees to positions requiring technical knowledge and experience. In addition, the CLO should also verify applicants' references, including work and education records, before making hiring decisions and should document its justification when hiring applicants and promoting employees who do not meet minimum qualifications.

Department Action: Corrective action taken.

The department states that the CLO has established a formal process to ensure that individuals who are hired or promoted meet the minimum qualification requirements of the position classification, and that references, including work and education records are always checked. The new process is documented in the CLO's procedure manual.

Finding #5: The CLO is not sure that its salary levels are still competitive.

Although the CLO has obtained market trend reports for salary scales, it has not considered and evaluated this data. As a result, the CLO has not adjusted its structure for salary ranges since 1995. When the CLO does not periodically evaluate its salary structure, it cannot be sure that its salaries are reasonable and remain competitive enough to attract and retain qualified applicants.

To ensure that its salaries remain competitive, we recommended that the department have the CLO evaluate its salary structure, using both private and public sector comparisons, to ensure that it attracts and retains qualified employees.

Department Action: Corrective action taken.

The department states that the CLO retained a consultant and completed reviewing its salary structure. This evaluation included both private and public salary comparisons. According to the department, the CLO salary structure was finalized and implemented on December 28, 2001.

Finding #6: The CLO has never established a comprehensive conflict-of-interest policy for its employees and contractors.

The CLO has never had comprehensive conflict-of-interest policies and guidelines for its employees and vendor contractors to follow. Because it lacks comprehensive conflict-of-interest policies and guidelines, the CLO cannot ensure that its employees and contractors adequately safeguard sensitive information and act in the best interest of the estates it manages.

We recommended that the department instruct the CLO to:

- Finalize, approve, and implement a conflict-of-interest policy similar to the policy used by state agencies.
- Require all designated employees and multiyear contractors to complete an annual conflict-of-interest statement.

Department Action: Corrective action taken.

The CLO has drafted its conflict-of-interest code and statement of incompatible activities, submitted it to the Fair Political Practices Commission, and is in the process of implementing it for use. According to the department, all designated CLO employees and multiyear contractors have completed an annual disclosure form.

Finding #7: The CLO's basis for allocating fixed costs unfairly burdens some insurers.

We found inequities in the CLO's basis for allocating its fixed costs to estates. Moreover, the CLO does not regularly review the status of estates to identify those that meet its criteria for sharing the fixed costs. For example, we found that for one estate the CLO did not allocate more than \$4,000 for one month's fixed costs despite the fact that staff spent 94 direct hours working on this estate's activities.

We recommended that the department have the CLO:

- Review other options for allocating fixed costs to insurers that are more equitable than its current method, and implement a method that allocates fixed costs to all insurers' estates with assets that benefit from these costs.
- Develop a system of review to ensure that insurers who should be paying a portion of the fixed costs are included in its allocation process and that insurers who should not be included are not paying these costs.

Department Action: Corrective action taken.

The department states that the CLO has reviewed the various types of costs that need to be allocated to insurers' estates and has worked with the department to finalize a methodology for allocating these costs. The department approved CLO's allocation method in December 2001 and it became effective on January 1, 2002. The department also states that as new costs are incurred or estates come under the CLO's control, it will evaluate the appropriateness of the cost allocation system for those costs and estates.

Finding #8: The CLO spent millions in estate assets to implement a claims processing system that does not effectively support its operations.

Although the CLO has spent more than \$5.7 million to implement the claims processing system it purchased in 1995, the claims system continues to be costly and inefficient, and it does not effectively support the CLO's operations. For example, although the claims system was purchased in part to improve the CLO's reinsurance claims process, reinsurance recovery claims continue to be handled manually—a process that is inefficient and prone to error. Unless the CLO properly accounts for all of its reinsurance contracts and establishes receivables for all amounts due, it cannot ensure that it bills for all the reinsurance it is entitled to and promptly collects payments owed to avoid losing interest earnings because of delayed reinsurance payments, thus providing fewer funds to pay the insurance companies' creditors.

We recommended that the department instruct the CLO to:

- Work diligently toward defining its overall claims processing system needs. If it chooses to purchase a new claims processing system, the CLO should explore the option of alternative procurement, whereby the software company would have a direct financial stake in the successful implementation of the claims system.
- Ensure that reinsurance claims are both properly accounted for and promptly billed.

Department Action: Partial corrective action taken.

The CLO issued a request for proposal on August 10, 2001, to acquire the necessary assistance to find a solution to the CLO's overall claims processing and reinsurance collection needs. The CLO states that a firm was selected and began working in December 2001. According to the department, the work will be done in three phases. As of November 2002, the department reported that it has begun implementation of the second phase.

As of January 1, 2002, the CLO had reviewed its system and processes for promptly identifying and collecting on reinsurance claims and made appropriate modifications to procedures based on the results of the review. In addition, the CLO is in the process of obtaining a suitable proposal for assistance in maximizing the recovery of reinsurance. So far, this effort has been unsuccessful but the CLO stated that it would continue to assess the feasibility of this project.

Finding #9: The department’s flawed oversight of the CLO weakens its ability to ensure that the CLO properly safeguards and manages estate assets.

Although the department considers the CLO to be exempt from several components of the State’s control system, it has failed to take the steps necessary to otherwise oversee the CLO’s activities. For example, although the CLO’s internal auditor acts as an oversight arm for the department, it does not require the internal auditor to adhere to the department’s policy that requires a two-year internal audit cycle. In fact, the current audit plan does not have the internal auditor completing his first audit cycle until 2002—nearly five years after its start. Consequently, the internal auditor has not yet reviewed the CLO’s operations in some important areas, such as its processes for inventorying the assets of the insurers it manages, preparing budgets, and the operation of its information systems. Had the department enforced its policy, some of the weaknesses we detected might have been identified and corrected sooner.

We recommended that the department:

- Strengthen its oversight process by ensuring that the CLO’s accounting and administrative controls are periodically monitored and the highest-risk areas are promptly reviewed by requiring the internal auditor to complete a full audit cycle at least once every two years.
- Ensure that when the CLO’s internal auditor reports on control weaknesses and recommends improvements, the CLO implements such recommendations or documents why it does not.

- Follow up on the CLO's efforts to implement recommendations for improvement made by external auditors and ensure the status of those efforts is regularly reported.

Department Action: Corrective action taken.

The insurance commissioner (commissioner) established an audit/oversight committee that will meet quarterly and have full access and oversight of the operations of the CLO. This committee's duties will include such things as the CLO budget and all audit activities and other functions requested by the commissioner. The committee held its first oversight meeting on September 13, 2001.

To ensure that the CLO's accounting and administrative controls are periodically monitored, the CLO will have the Department of Finance complete an internal control review once every two years and high-risk areas will be reviewed by CLO internal audit staff. The office of the internal auditor was moved within the department and now reports directly to the chief deputy insurance commissioner. Additionally, the audit/oversight committee will review the CLO audit plan.

To ensure the accurate and prompt follow up and implementation of both internal and external audit recommendations, the department states that it has made several changes, including formalizing follow-up procedures for implementing recommendations and reporting on progress to the audit committee and executive staff of the department and CLO.