



John Keel, CPA  
State Auditor

A Follow-up Audit Report on  
**The Department of Insurance's  
Enforcement of Solvency Standards for  
Insurance Companies**

March 4, 2013

Members of the Legislative Audit Committee:

The Department of Insurance (Department) has fully or substantially implemented all 18 recommendations selected from *An Audit Report on the Department of Insurance's Enforcement of Solvency Standards for Insurance Companies* (State Auditor's Office Report No. 10-009, October 2009). (See text boxes for background information on the Department and implementation status definitions.) The 2009 audit report identified weaknesses in following internal policies and procedures, maintaining required documentation, and ensuring the security of insurance company financial data.

Of the 18 recommendations fully or substantially implemented:

- The Department fully or substantially implemented eight recommendations related to internal policies for managing receiverships and administrative orders.
- The Department fully or substantially implemented four recommendations related to the financial monitoring of insurance companies for compliance with solvency standards and related controls.
- The Department fully implemented two recommendations related to controls over its central enterprise database and licensing applications.
- The Department substantially implemented two recommendations related to its financial examination process, including documentation of work performed by a third party, and completion and approval of examinations of insurance companies.
- The Department substantially implemented one recommendation related to its reviews of insurance license applicants' documentation.
- The Department substantially implemented one recommendation related to requiring special deputy receivers to conduct semi-annual evaluations of all subcontractors.

Auditors communicated other, less significant issues to the Department's management separately in writing.

#### Background Information

The Department of Insurance (Department) is responsible for regulating the insurance industry in Texas. As part of that responsibility, the Department:

- Licenses insurance companies.
- Performs financial analyses on licensed companies.
- Conducts financial examinations of licensed insurance companies.
- Manages financially troubled companies that are at risk of becoming insolvent through its conservation, supervision, and receivership process.

In October 2009, the State Auditor's Office issued *An Audit Report on the Department of Insurance's Enforcement of Solvency Standards for Insurance Companies* (State Auditor's Office Report No. 10-009). Auditors selected 18 of the 22 recommendations in that report for follow-up based on Department management's responses to the recommendations, the Department's subsequent self-reported recommendation implementation status and implementation date, and the level of risk.

#### Implementation Status Definitions

**Fully Implemented** - Successful development and use of a process, system, or policy to implement a prior recommendation.

**Substantially Implemented** - Successful development but inconsistent use of a process, system, or policy to implement a prior recommendation.

**Incomplete/Ongoing** - Ongoing development of a process, system, or policy to address a prior recommendation.

**Not Implemented** - Lack of a formal process, system, or policy to address a prior recommendation.

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Table 1 provides additional details on the Department’s implementation of prior State Auditor’s Office recommendations.

Table 1

Status of Implementation of Prior Audit Recommendations				
No.	Recommendation	Implementation Status as Reported by the Department	Implementation Status as Determined by Auditors	Auditor Comments
1	The Department should ensure that all applicants for a license submit the required documents as required by the Department’s internal policies and procedures and National Association of Insurance Commissioners (NAIC) guidelines.	Fully Implemented	Substantially Implemented	The Department has implemented effective controls to ensure that all applicants for a license submit the documents required by the Department’s internal policies and procedures and the NAIC guidelines for minimum capital and surplus statements. However, the Department has made a management decision to collect biographical affidavits only for the president, secretary, and treasurer of companies located in other states and to also rely on the insurance regulations of those other states. This differs from NAIC guidelines, which require biographical affidavits on behalf of all officers, directors, key managerial personnel, and individuals with a 10 percent or more ownership in the applicant. As a result, this aspect of the Department’s process does not comply with NAIC guidelines.
2	The Department should ensure that examiners include all work papers in the examination files when they are relying on the work of a third party.	Fully Implemented	Substantially Implemented	The Department has implemented an electronic work paper system to retain all work papers and a policy requiring examiners to detail any third-party work papers on which they relied. However, auditors tested 18 examinations that relied on the work of a third party and determined that 2 (11 percent) did not have documentation of the third-party work in the Department’s examination files.
3	The Department should ensure that all examination procedures are completed and appropriately documented. The Department should consider implementing procedures advising supervisors not to approve the completion of a file if all steps are not completed or listing the conditions under which such approvals should be authorized.	Fully Implemented	Substantially Implemented	The Department has implemented an electronic work paper system to assist examiners in completing, documenting, and approving examinations. Auditors tested examination procedures in the Department’s system and determined that the planning memorandum and examination reports were completed and reviewed for all examinations tested. The system also included all elements required by the Department’s procedures. The Department also had internal checklists for 10 (91 percent) of the 11 examinations that auditors tested.

Status of Implementation of Prior Audit Recommendations				
No.	Recommendation	Implementation Status as Reported by the Department	Implementation Status as Determined by Auditors	Auditor Comments
4	The Department should ensure that it conducts all analyses within its established time frames as stated in the Department's internal policies and procedures.	Fully Implemented	Substantially Implemented	The Department has internal policies that establish time frames for conducting analysis, and it indicated it revised those policies to address auditors' recommendations. However, the Department's analyses are not always completed in accordance with established time frames. Specifically, 11 (10 percent) of the 105 analyses that auditors tested were not completed within the established time frames. The percentage of analyses completed after the Department's time frames was higher than the results of the prior audit, which found that 18 (5 percent) of 355 analyses tested were not completed within established time frames.
5	The Department should develop formal policies and procedures regarding the review and filing of reinsurance agreements.	Fully Implemented	Fully Implemented	The Department has developed policies and procedures related to the review and filing of reinsurance agreements. Those procedures include information related to insurance checklists, timely submission of reinsurance agreements, and documentation of correspondence with insurance companies.
6	The Department should ensure that holding company documentation is properly reviewed and approved.	Fully Implemented	Substantially Implemented	Auditors reviewed the Department's process for reviewing and approving company documentation and determined that the Department approved 11 (79 percent) of 14 transactions within the required time frames. The Department completed the 3 remaining items between 11 and 31 days after the 30-day requirement for those items.
7	The Department should strengthen controls over its Financial Analysis Division's applications to ensure that access to key data is limited to only the users who need it. This should include: (1) evaluating the number of staff who have the ability to modify data and (2) segregating user access to the application code and data.	Fully Implemented	Fully Implemented	The Department has strengthened controls over the access to key data and code related to its Financial Analysis Division's applications. Auditors reviewed the Financial Analysis Division's CoList and Priority systems to verify that only a limited number of users have the ability to modify underlying data and application code and that key programming duties are appropriately segregated.
8	The Department should resolve administrative orders within the time frames specified by the Texas Insurance Code.	Fully Implemented	Fully Implemented	The Department has implemented policies and procedures to resolve administrative orders within the time frames specified by the Texas Insurance Code. Auditors reviewed two of the four administrative orders that the Department released between January 2011 and June 2012. The Department released both administrative orders within relevant time frames.
9	The Department should ensure that all provisions specified in administrative orders are met.	Fully Implemented	Fully Implemented	The Department has developed procedures to consistently monitor provisions in administrative orders. Auditors reviewed two of the four administrative orders the Department released between January 2011 and June 2012. Both administrative orders included exit memos, status memorandums, and resolution of all items before the Department released them.

Status of Implementation of Prior Audit Recommendations				
No.	Recommendation	Implementation Status as Reported by the Department	Implementation Status as Determined by Auditors	Auditor Comments
10	The Department should ensure that staff document all work performed during administrative actions.	Fully Implemented	Substantially Implemented	The Department has developed a guideline for documenting work performed during administrative actions. However, it indicated that the variety and complexity of each estate do not merit a standardizing procedure for this documentation. The lack of standardization limits the Department's ability to ensure that work is documented properly for administrative actions. Auditors reviewed two of the four administrative orders that the Department released between January 2011 and June 2012 and noted that one administrative order did not have agenda reports for some meetings with the insurance company.
11	The Department should develop written internal and special deputy receiver procedures to track and review all the takeover activities completed for an estate.	Fully Implemented	Fully Implemented	The Department has developed policies and procedures to track and review takeover activities. Those procedures include all takeover activities detailed in the contract with the special deputy receiver.
12	The Department should ensure that criminal history checks are conducted on special deputy receivers and that the results of these checks are maintained.	Fully Implemented	Fully Implemented	The Department established a process for conducting background checks that include summaries of background check results. Auditors reviewed the single receivership application that the Department received since the prior audit in October 2009. For that receivership, auditors verified that the bidder received a background check, and that the Department retained the results of that check.
13	The Department should ensure that special deputy receivers obtain fiduciary bonds and professional liability insurance within the required time frames.	Fully Implemented	Fully Implemented	The Department established policies and procedures that ensure special deputy receiverships obtain bonding and insurance and that it maintains related records. Auditors reviewed the single receivership application that the Department received since October 2009 and verified that the selected bidder was appropriately bonded.
14	The Department should ensure that special deputy receivers conduct semi-annual evaluations of all subcontractors as required by Department policy.	Fully Implemented	Substantially Implemented	The Department has a policy requiring that special deputy receivers complete annual evaluations of subcontractors. However, it did not have documentation for 1 (25 percent) of the 4 special deputy receiver evaluations that auditors tested.
15	The Department should consistently reconcile monthly receivership financial statements and quarterly financial reports filed by special duty receivers.	Fully Implemented	Substantially Implemented	The Department has revised its process to review monthly receivership financial statements and quarterly financial reports filed by special deputy receivers. However, that process did not identify omissions for 1 (25 percent) of the 4 open receiverships that auditors tested. The quarterly report for that receivership omitted two line items totaling \$2,196 in expenses, or 3.69 percent of the total expenses for that quarter. Those omissions did not affect the total expenses or cash flows reported for that quarter.

Status of Implementation of Prior Audit Recommendations				
No.	Recommendation	Implementation Status as Reported by the Department	Implementation Status as Determined by Auditors	Auditor Comments
16	The Department should ensure that a receivership's operational account balance does not exceed bonded amounts.	Fully Implemented	Fully Implemented	The Department consistently verified that receiverships' operational account balances did not exceed bonded amounts. Auditors reviewed 4 of the 40 open receiverships that the Department began after January 2011 and determined that none of the operational account balances exceeded the bonded amount in the Department's special deputy receivership agreements.
17	The Department should ensure that each employee uses a unique, unshared account when accessing Department systems. If accounts must be shared, the Department should ensure it still has the ability to identify which employee is using the account each time the system is accessed.	Fully Implemented	Fully Implemented	The Department has ensured that employees use a unique, unshared account when accessing the Department's Oracle applications. Each user ID is unique to an employee, and the Department's security manual requires that employees do not share their user IDs and passwords. The Department has also ensured that employees use a unique, unshared account when accessing the Department's Sircon system. If Sircon accounts are shared, the Department is able to identify individual employees through the account or it has limited the shared access to view-only access to prevent modification or loss of data.
18	The Department should immediately disable accounts that are no longer needed.	Fully Implemented	Fully Implemented	The Department has developed procedures to consistently disable accounts that are no longer needed. Auditors obtained a list of administrative accounts in the Department's Oracle application, Oracle database, and Sircon system and determined that each was assigned to an individual that the Department currently employed.

## Recommendations

The Department should:

- Require all applicants for a license to submit the documents required by the Department's internal policies and procedures and the National Association of Insurance Commissioners' (NAIC) guidelines.
- Require examiners to include all work papers in the examination files when they rely on the work of a third party.
- Complete and appropriately document all examination procedures. The Department should implement procedures advising supervisors not to approve the completion of a file if all steps are not completed or specify the conditions under which approvals of incomplete files are authorized.
- Conduct all analyses within time frames established in the Department's internal policies and procedures.
- Properly review and approve holding company documentation.

- Require staff in the Rehabilitation and Liquidation Oversight section to document work they perform in accordance with the *Rehabilitation Field Procedures Manual* during administrative actions.
- Require special deputy receivers to conduct annual evaluations of all subcontractors, as required by Department policy.
- Reconcile monthly receivership financial statements and quarterly financial reports filed by special duty receivers.

With one exception, the Department agreed with the above recommendations and its management's response is in the attachment to this letter. The Department has decided not to fully implement a recommendation to follow the National Association of Insurance Commissioners' guidelines related to license applicants' submission of biographical affidavits.

Sincerely,

John Keel, CPA  
State Auditor

Attachment

cc: Ms. Eleanor Kitzman, Commissioner of Insurance



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# Attachment

## Section 1

### **Objective, Scope, and Methodology**

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#### **Objective**

The objective of this audit was to determine the implementation status of prior State Auditor's Office recommendations and evaluate whether management has taken corrective actions to address selected recommendations in *An Audit Report on the Department of Insurance's Enforcement of Solvency Standards for Insurance Companies* (State Auditor's Office Report No. 10-009, October 2009).

#### **Scope**

The scope of this audit included reviewing the Department of Insurance's (Department) implementation of selected recommendations from the prior audit. Auditors selected 18 of the 22 prior recommendations based on Department management's responses to the recommendations, the Department's subsequent self-reported recommendation implementation status and implementation date, and the level of risk. The 18 recommendations were tested for the time period from January 2010 through September 2012.

#### **Methodology**

The audit methodology included identifying and collecting information on the implementation of the prior audit recommendation. To determine the implementation status of the prior audit recommendations, auditors conducted interviews, reviewed Department policies and procedures, and performed selected tests and procedures related to the Department's financial systems. Auditors selected samples of insurance license application files, examination files, insurance company analyses, holding company transactions, administrative orders, special deputy receiver background checks, special deputy receiver bonding documentation, special deputy receiver evaluations of subcontractors, special deputy receiver financial statements, and special deputy receiver operational account balances. Auditors used non-statistical sampling methods to select the samples. The test results from the samples selected cannot be projected to the entire population.

Auditors assessed the reliability of the Department's data by (1) conducting a walkthrough of systems, (2) reviewing access to key financial systems, (3) reconciling a list of insurance companies to the Department's Web site, (4) reviewing query language used to extract the population of holding

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companies, (5) reconciling administrative actions with the Department's annual report, and (6) matching receivership report totals to the Department's records.

Information collected and reviewed included the following:

- *An Audit Report on the Department of Insurance's Enforcement of Solvency Standards for Insurance Companies* (State Auditor's Office Report No 10-009, October 2009).
- Department policies and procedures related to financial analysis, financial examinations, reviewing financial statements, reviewing reinsurance, and taking over receiverships.
- The Department's *Rehabilitation Field Procedures Manual* and *Computer Security Manual*.
- The Department's insurance license applications.
- The Department's examination files.
- The Department's list of insurance companies doing business in Texas.
- The Department's list of holding company transactions.
- Administrative orders that the Department issued.
- The Department's list of special deputy receiverships.
- Background checks that the Department conducted on special deputy receivers.
- Special deputy receiver fiduciary bonds, financial statements, and wire transfers.

Procedures and tests conducted included the following:

- Conducted interviews with Department personnel.
- Tested the Department's insurance license application files for required documents.
- Tested the Department's examination files for documentation, review, and approval of examination documents.
- Tested the timeliness of the Department's insurance company analyses.
- Tested the Department's review and approval of holding company documentation.

- Reviewed access to the Department's CoList and Priority systems.
- Tested documentation, timeliness, and resolution of administrative orders.
- Tested documentation of background checks for special deputy receivers.
- Tested bonding documentation for special deputy receivers.
- Reviewed special deputy receivers' semi-annual evaluations of subcontractors.
- Tested the Department's review of special deputy receiver financial statements.
- Tested special deputy receiver operational account balances.
- Reviewed access to the Department's Oracle and Sircon systems.

Criteria used included the following:

- *An Audit Report on the Department of Insurance's Enforcement of Solvency Standards for Insurance Companies* (State Auditor's Office Report No 10-009, October 2009).
- National Association of Insurance Commissioner's filing guidelines, section II.
- Title 28, Texas Administrative Code, Sections 7.204 and 7.402.
- Title 1, Texas Administrative Code, Chapter 202.
- Texas Insurance Code, Chapters 441, 822, 823, 841, and 982.

### **Project Information**

Audit fieldwork was conducted from July 2012 through November 2012. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The following members of the State Auditor's staff performed the audit:

- Kels Farmer, MBA, CISA (Project Manager)
- Ben Carter

- Erin Cromleigh, CGAP
- Lauren Godfrey, CIA, CGAP
- Anna Howe
- Michael Karnes
- Jennifer Lehman, MBA, CIA, CFE, CGAP
- Thomas Andrew Mahoney, CGAP
- Bansari Patel, CPA
- Anca Pinchas, CPA, CIDA, CISA
- Kristyn H. Scoggins, CGAP
- Barrett Sundberg, CPA, CIA
- Michelle Ann Duncan Feller, CIA, CPA (Quality Control Reviewer)
- Ralph McClendon, CISSP, CCP, CISA (Audit Manager)

## Management's Responses

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### Texas Department of Insurance

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512 463-6464 telephone • 512 475-2005 fax • www.tdi.state.tx.us

February 25, 2013

Mr. John Keel, State Auditor  
State Auditor's Office  
P.O. Box 12067  
Austin, TX 78711-2067

Dear Mr. Keel:

Thank you for the opportunity to respond to your Follow-up Audit Report on the Department of Insurance's Enforcement of Solvency Standards for Insurance Companies. We agree with your findings and value the perspective the audit provided.

I'd like to commend the audit team for their courtesy, expertise, and professionalism during the follow-up audit. SAO staff asked critical questions and took the time to review the Department's enforcement of solvency standards for insurance companies and the status of the SAO recommendations. I am pleased that the overall conclusion found that all of the recommendations have been fully or substantially implemented. Staff is currently taking steps toward implementing the open recommendations.

We appreciate the opportunity to objectively examine our processes. If you or others have questions about our response to this audit, please contact me or Danny Saenz at 322-5040.

Sincerely,

A handwritten signature in blue ink that reads "Eleanor Kitzman".

Eleanor Kitzman  
Commissioner of Insurance

**Attachment**

**TDI's Response to  
A Follow-up Audit Report on The Department of Insurance's Enforcement of Solvency  
Standards for Insurance Companies**

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**SAO Recommendation:**

The Department should:

- Require all applicants for a license to submit the documents required by the Department's internal policies and procedures and the National Association of Insurance Commissioners' (NAIC) guidelines.

**TDI Response:**

*Management agrees with the report's findings. Management has determined that its current policies and procedures are appropriate and in compliance with Texas law. The NAIC guidelines require biographical affidavits for all officers, directors, key managerial personnel, and individuals with 10 percent or more ownership in any license applicant. Management has made the decision to only require biographical affidavits for the president, secretary, and treasurer of companies domiciled in other states and to rely on the insurance regulators of those other states.*

**SAO Recommendation:**

The Department should:

- Require examiners to include all work papers in the examination files when they rely on the work of a third party.

**TDI Response:**

*Management agrees with the report's recommendation. Management has revised its examination procedures to address the recommendations of the original review and will emphasize adherence to the procedures through its internal peer review process which occurs on a quarterly basis.*

**SAO Recommendation:**

The Department should:

- Complete and appropriately document all examination procedures. The Department should implement procedures advising supervisors not to approve the completion of a file if all steps are not completed or specify the conditions under which approvals of incomplete files are authorized.

**TDI Response:**

*Management agrees with the report's recommendation. Management has revised its examination procedures to address the recommendations of the original review and will emphasize adherence to the procedures through its internal peer review process which occurs on a quarterly basis. Additional procedure changes will be implemented by March 31, 2013, to address the approval of completed examination items where all steps*

*are not completed or specifying conditions where approval can be granted for incomplete files.*

**SAO Recommendation:**

The Department should:

- Conduct all analyses within time frames established in the Department's internal policies and procedures.

**TDI Response:**

*Management agrees with the report's recommendation and will continue to review and ensure consistent adherence to policies and procedures.*

**SAO Recommendation:**

The Department should:

- Properly review and approve holding company documentation.

**TDI Response:**

*Management agrees with the report's recommendation and will continue to review and ensure consistent adherence to policies and procedures.*

**SAO Recommendation:**

The Department should:

- Require staff in the Rehabilitation Liquidation Oversight Section to document work they perform in accordance with the *Rehabilitation Field Procedures Manual* during administrative actions.

**TDI Response:**

*Management agrees with the report's recommendation. Management has determined that its current policies and procedures are appropriate and in compliance with Texas law. Management recognizes that the matters documented during administrative actions are often critical to department actions and will emphasize adherence to policies and procedures.*

**SAO Recommendation:**

The Department should:

- Require special deputy receivers to conduct annual evaluations of all subcontractors, as required by Department policy.

**TDI Response:**

*Management agrees with the report's recommendation. Management will emphasize adherence to the policy requiring special deputy receivers to conduct annual evaluations of subcontractors through an internal review process.*

**SAO Recommendation:**

The Department should:

- Reconcile monthly receivership financial statements and quarterly financial reports filed by special duty receivers.

**TDI Response:**

*Management agrees with the report's recommendation. Management will emphasize adherence to the process to review and reconcile receivership financial statements and reports through an internal review process.*