

# **Department of Insurance:**

**Management of Its Financial Affairs  
and Programs Needs Improvement**

March 1997  
96033

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96033

The Governor of California  
President pro Tempore of the Senate  
Speaker of the Assembly  
State Capitol  
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As required by the Budget Act of 1996, the Bureau of State Audits presents its audit report concerning its review of the Department of Insurance (department). This report concludes that the department has significant deficiencies in its fiscal operations. In particular, it has not promptly established and communicated its internal budget allocations and has not adequately accounted for or collected fees billed to insurance companies. Further, the department failed to appropriately distribute revenues from automobile fraud assessments to district attorneys, the California Highway Patrol, and its own fraud division. We also report on weaknesses in the administration of certain programs. Specifically, the department's investigations bureau and financial analysis division have large backlogs of work. In addition, the department does not comply with provisions of the California Insurance Code, Section 729 et seq., requiring it to review all insurance companies at least once every five years.

Respectfully submitted,



KURT R. SJOBERG  
State Auditor

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# Summary

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## Audit Highlights...

*The Department of Insurance has weaknesses in its fiscal operations that have contributed to its problems with reduced financial resources. Most notably, the department:*

- May not collect \$4.7 million in budgeted revenues;*
- Inappropriately shifted \$2.7 million in fraud program costs to other programs;*
- Has had significant shortcomings in its billing and collection system; and*
- Incorrectly distributed automobile fraud assessment moneys.*

*In addition, it has a large work backlog in two units and has not clearly demonstrated its compliance with statutory language when reducing staff.*

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## Results in Brief

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Recent reductions in revenues and increases in expenditures at the Department of Insurance (department) have contributed to numerous shortcomings in the department's management of both its fiscal and program operations. These reductions in the department's financial resources resulted primarily from a decision and settlement in two lawsuits during 1995.

Despite its financial setbacks, the department continues to be responsible for protecting California's insurance policyholders, insurance beneficiaries, and the general public from the insolvency of insurance companies and for preventing unlawful, unfair practices by companies, agents, or brokers. To meet these responsibilities, the department certifies insurance companies, licenses agents and brokers, examines companies for solvency and compliance with the California Insurance Code (code), reviews the propriety of changes in insurance rates before they go into effect, and investigates insurance fraud.

During our review, we observed that the department can do more to deal effectively with the resource reductions. We noted the following conditions in particular:

- For fiscal years 1995-96 and 1996-97, the department was five months late in establishing and communicating the internal allocation of each annual budget. As a result, the managers responsible for controlling expenditures and generating revenues did not have important information for planning the activities in their units.
- The department did not sufficiently monitor its budget during fiscal year 1995-96. For example, at the end of the year, to avoid overspending its administrative budget, the department shifted \$3 million in administrative expenditures to another expenditure category.
- The department's system for billing and collecting revenues has serious problems. Specifically, the department is slow to send invoices, establish related listings for receivables, and collect amounts due. Currently, it has more than

\$4 million in receivables that date from fiscal years 1983-84 through 1993-94 and that may no longer be collectible. The department is now implementing a new, automated invoicing system that will establish and monitor receivables. However, because the implementation is not yet complete, we were not able to assess the department's effectiveness in addressing the significant problems with the current system.

- The department also failed to bill for all services provided and incorrectly billed for others. Consequently, for fiscal year 1996-97, we anticipate that, at its current pace, the department will collect \$4.7 million less in revenues than it anticipated.

Although the code requires the department to use revenues from Proposition 103 assessments for related expenditures only, the department has not segregated these funds continuously, promptly, or accurately. For example, the most recent calculation that the department provided to us of the results of operations for Proposition 103 activities was for the fiscal year ending June 30, 1995. Moreover, the balance that the department provided may be incorrect because the department based the amount on accounting records of questionable reliability.

In fiscal year 1995-96, the department inappropriately shifted \$2.7 million in fraud program costs to other programs, including \$741,000 to Proposition 103. As a result, the department overcharged insurance companies for Proposition 103 assessments for fiscal year 1996-97.

The department also has a weak system for identifying approximately \$16 million annually in automobile fraud assessment revenues and for distributing these revenues to district attorneys, the California Highway Patrol, and its own Fraud Branch. The department has calculated the amounts of these revenues incorrectly and also distributed incorrect amounts.

We also found that the department has not adequately managed components of two program areas we reviewed. We have the following specific concerns:

- The department does not have clear evidence that it is complying with the code's mandates to examine all insurance companies in the State every five years. The department believes that it is responsible for examining only the solvency of companies, but we believe it is responsible for examining the companies' insurance practices as well. Furthermore, the department is not on schedule for

complying with its own interpretation of the code, which is that the department is to perform reviews of companies' solvency only.

- The department's investigations bureau and financial analysis division have significant work backlogs. For example, the investigations bureau has accepted more than 5,000 complaints for which it has not completed investigations. The department expects this backlog to grow because it has also assigned the investigations bureau staff to perform 14,700 hours of a new type of work, in addition to its normal investigative work.

Further, the department cannot clearly demonstrate that it has complied with the language of the Budget Act of 1996, which requires the department to ensure that budget cuts do not disproportionately affect the provision of consumer services. Although the budget act does not define consumer services, we question the department's compliance because 70 percent of its staff reductions for fiscal year 1996-97 occurred in units that respond directly to consumers; however, these units employed only 19 percent of the department's total personnel.

Moreover, the template that the department uses for evaluating insurance companies' requests for rate changes has limited applicability to certain lines of insurance. Although the department recognizes these limitations and adapts other procedures accordingly, it does not generally adapt the template to departmental needs. In addition, the department does not consistently document its calculations or rationale when it approves rates outside the range suggested by the template.

Because the department exhibits these financial and management shortcomings, we are concerned that the department has limited effectiveness in meeting the public's need for protection from unlawful or unfair practices by insurance companies.

## ***Recommendations***

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To improve the management of its fiscal resources, the department should ensure that there is adequate managerial oversight for all financial transactions. The department should also do the following:

- Promptly establish and communicate internal budget allocations that are both reasonable and clear in defining performance expectations for each departmental unit;

- Periodically monitor actual revenues and expenditures, and hold all managers responsible for meeting their budgets;
- Ensure the prompt and accurate billing of insurance companies for all fees and assessments;
- Pursue insurance companies that do not promptly remit fees; and
- Properly account for Proposition 103 revenues and related expenditures from year to year, ensuring that Proposition 103 resources are not used to pay for unrelated expenditures.

In addition, the department should seek legislation authorizing it to assess penalties for late payment of fees.

To ensure that it correctly identifies and distributes automobile fraud assessment revenues, the department should establish appropriate written procedures for staff to follow and provide managerial oversight of the revenue distribution process.

To improve the management of its examination workloads, the department should take the following steps:

- Seek an amendment to the California Insurance Code, Section 729 et seq., limiting the nature and extent of insurance company examinations; and
- Make certain that it reviews and accepts the examination reports for all foreign or alien insurance companies within required time frames.

To ensure that it protects insurance consumers effectively, the department should do the following:

- Examine the efficiency and effectiveness of the financial analysis division's reviews of annual financial statements for insurance companies and streamline the process, if appropriate. The department should also determine the level of staffing needed for the financial analysis division to complete its mandated activities on time using the streamlined process and then budget for staff accordingly.
- Assess the adequacy of the investigations bureau's system for prioritizing and completing investigations of consumer complaints and then streamline the system, if appropriate. In addition, the department should determine the level of

staffing needed to complete the investigations bureau's work and consider raising the fees listed in Section 12978 of the code to help cover costs if additional personnel are needed.

To improve the results of the template it uses to evaluate requests to change insurance rates, the department should consider adjusting the template for certain applications. Specifically, the department should use versions of the template that include more than three years of data when assessing requests for rate changes of volatile lines of insurance. Further, the department should use the template to take into account different classes, territories, and limits within the same lines of insurance.

Finally, when confronted with statutes that the department may interpret in more than one way, such as having budget cuts not disproportionately affect the provision of consumer services, the department should ask the Legislature to clarify the mandates.

### ***Agency Comments***

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The department generally concurs with the recommendations stated in the report. Specifically, regarding the financial-related issues we describe in Chapter 1, the department states that, to a large extent, it has either implemented the recommendations or is in the process of implementing them. Regarding the program-related issues we describe in Chapter 2, the department objects to two recommendations. In the first instance, the department objects to our recommendation that it consider raising the fees listed in Section 12978 of the California Insurance Code because it opposes raising these fees in the manner required by the section. In the second instance, the department believes that the actions it took regarding specific language in the budget act were proper and responsive. This language stated, "it is the intent of the Legislature that, insofar as possible, budget reductions shall not disproportionately impact the provision of consumer services."

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# *Introduction*

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## ***Background***

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The primary responsibility of the Department of Insurance (department) is to protect California's insurance policyholders by regulating the insurance industry in the State. To meet this responsibility, the department administers programs designed to protect policyholders, beneficiaries, and the public from the insolvency of insurance companies and to prevent unlawful or unfair practices by companies, agents, and brokers. The department is also responsible for protecting the general public and policyholders from discriminatory, unlawful, or fraudulent practices and from incompetence relating to the sale of insurance. The department's activities include certifying insurance companies to conduct business in the State, licensing agents and brokers, examining insurance companies to determine whether they are financially solvent and that their practices comply with the California Insurance Code (code), reviewing and approving changes in most insurance rates before they go into effect, and investigating fraud.

For fiscal year 1996-97, the department anticipates that, through its Insurance Fund, it will receive \$129 million in revenues and transfers, spend approximately \$125 million, and fund approximately 1,050 positions. The head of the department is the elected insurance commissioner. Deputy commissioners lead the eight primary branches or divisions within the department.<sup>1</sup> The department maintains headquarters in Sacramento and other offices in the San Francisco Bay Area, the Los Angeles area, San Diego, and Fresno.

## ***Funding for the Department***

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The department funds its regulatory activities almost exclusively from different types of fees or assessments collected from insurance companies, agents, and brokers. The four primary fees and assessments, or "revenue streams," that the department collects are the following:

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<sup>1</sup>Appendix A describes the responsibilities of these branches and divisions.

- *Examination fees*, or hourly fees collected from insurance companies to cover the department's costs of conducting examinations that review a company's solvency and practices;
- *Proposition 103 assessments*, or annual assessments collected from insurance companies to cover the department's costs of administering the provisions of Proposition 103;<sup>2</sup>
- *Fraud assessments*, or annual assessments collected from insurance companies to cover the department's costs of investigating suspected fraudulent insurance activities; and
- *Fees and licenses*, or various fees collected for providing services such as certifying insurance companies, licensing brokers and agents, or selling copies of public records.

Except for the fees and licenses revenue stream, each of the department's other revenue streams has specific mandated purposes. For example, the department must spend revenues generated from the Proposition 103 assessments on administering the proposition's provisions.

Table 1 shows the amounts the department expected each revenue stream to generate in fiscal year 1996-97.

**Table 1**  
***Revenue Sources and Amounts the Department of Insurance Expects To Receive in Fiscal Year 1996-97 (In Thousands)***

Revenue Source	Expected Revenue for Fiscal Year 1996-97
Examination fees	\$ 18,345
Proposition 103 assessments	23,442
Fraud assessments	41,233
Fees and licenses	27,645
Miscellaneous revenue	3,533
<b>Total</b>	<b>\$114,198</b>

Source: 1997-98 Governor's Budget

<sup>2</sup>California voters enacted Proposition 103 on November 8, 1988. In part, the provisions of Proposition 103 established the insurance commissioner as an elected official, required insurance companies to reduce rates, and require most companies to obtain approval from the department for rate changes.

The \$114.2 million total in Table 1 does not include transfers totaling an estimated \$14.8 million from the State's General Fund.

Not only does the department fund its own regulatory operations from these revenue streams, but it also funds some operations at other state entities as well. Table 2 lists moneys from the Insurance Fund transferred to or otherwise used or available for use by other state entities during fiscal years 1993-94 through 1995-96.<sup>3</sup>

**Table 2**

***Insurance Fund Moneys Used  
or Available for Use by Other State Entities  
(In Thousands)***

	1993-94	1994-95	1995-96	Total
Department of Aging	\$2,672	\$2,876	\$2,876	\$ 8,424
California Highway Patrol	0	1,674	1,673	3,347*
State and Consumer Services Agency	378	467	467	1,312
State Fire Marshal	0	3,000	0	3,000
<b>Totals</b>	<b>\$3,050</b>	<b>\$8,017</b>	<b>\$5,016</b>	<b>\$16,083</b>

\*Chapter 1 discusses inaccuracies in the department's distribution of funds to the California Highway Patrol.

Sources: Annual budget acts and the department's accounting records.

The annual budget act, the code, and other legislation determine the appropriations from the Insurance Fund to other entities. For example, each year, the budget act sets the amount to be transferred from the Insurance Fund to the Department of Aging, which uses the moneys to help operate its Health Insurance Counseling and Advocacy Program (HICAP). Staff of the HICAP respond to questions from Medicare beneficiaries regarding the beneficiaries' health care needs. In addition, Section 1872.8 of the code requires the department to transfer annually to the California Highway Patrol 14.25 percent of the revenues collected from an assessment on companies that

<sup>3</sup>We did not include in the table those local assistance funds that the department provided to district attorneys to prosecute suspected cases of automobile and workers' compensation fraud. We also omit those funds the department paid to the Board of Equalization for administration of its Insurance Tax Program.

insure automobiles. The California Highway Patrol receives these moneys to help prevent automobile theft. For example, state law requires the California Highway Patrol to establish a toll-free hotline that channels reports of automobile theft from the public to state and local law enforcement. Further, the State and Consumer Services Agency receives an annual transfer from the Insurance Fund to pay for the activities of the insurance advisor to the governor. The annual budget act sets the amount of the transfer. Finally, in fiscal year 1994-95, Chapter 420, Statutes of 1994, created the Arson Information Reporting System within the Department of Justice, to be operated by the State Fire Marshal's Office.<sup>4</sup> This legislation also established a one-time \$3 million appropriation from the Insurance Fund to pay for operation of the Arson Information Reporting System. As of June 30, 1996, the State Fire Marshal had spent only \$601,000 (20 percent) of this one-time appropriation. Because the State Fire Marshal has until June 30, 1999, to spend moneys from this appropriation, the department does not have access to any of the unexpended balance until fiscal year 1999-2000.

### ***The Department's Financial Condition***

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Results from two lawsuits, one settled in March 1995 and another decided in July 1995, affected the department adversely by increasing the department's expenditures by nearly \$14 million and reducing its revenues by more than \$7 million. Although the department received a \$14 million loan from the State's General Fund to assist it in meeting its financial obligations, the department still faces significant financial problems. We discuss this issue further in Chapter 1.

As of January 1997, members of the Legislature were considering short-term and long-term financing alternatives to be implemented at the department. Possible short-term solutions include the return to the department of \$10 million transferred to the State's General Fund from the Insurance Fund during fiscal year 1992-93. Another short-term solution legislators are considering is allowing the department to use undeliverable Proposition 103 rebates.<sup>5</sup> Proposed long-term solutions include directing the department to assess insurance companies just once to cover the annual costs of operating the

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<sup>4</sup>The State Fire Marshal's Office is now part of the Department of Forestry and Fire Protection.

<sup>5</sup>Insurance companies must turn over undeliverable Proposition 103 rebates to the State. Currently, these funds are deposited in the State's General Fund, not the Insurance Fund.

department rather than having it collect the three dedicated revenue streams and one general revenue stream that it currently collects.

### ***Scope and Methodology***

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The Budget Act of 1996 directed our office to conduct a management audit of the department. After completing a preliminary review of the department's operations, we focused our audit on several financial and program areas within the department.

### ***Financial Areas Reviewed***

We evaluated the department's financial situation by conducting the following procedures:

- To determine the department's fiscal condition and its schedule for developing budgets for its programs, we interviewed staff in the budget office, identified when the department distributed budget information to its staff, analyzed selected budget documents, and reviewed the resolution of lawsuits and provisions of legislation having a significant impact on the department's budget.
- To assess the department's billing and collections system, we examined invoices, payment records, and financial statements, and we interviewed department staff responsible for these operations.
- To analyze the department's calculation of the hourly rates it will charge for examinations during fiscal year 1996-97, we determined the reasonableness of the factors and amounts used in the calculations and the reasonableness of the examination budget.
- To evaluate the department's calculation of the total amount to be assessed to cover its costs of administering the provisions of Proposition 103 during fiscal year 1996-97, we assessed the reasonableness of the factors and amounts used in the calculations.
- To determine whether the department correctly calculated and fairly distributed indirect costs to its bureaus, we reviewed the premises upon which the department based its

cost allocation system and determined the reasonableness of the percent of indirect costs allocated to each revenue stream.

- To evaluate the department's system for distributing revenues collected from the assessment to fight automobile insurance fraud, we reviewed the department's methods for calculating the amounts to distribute and examined the amounts and timing of the payments.
- To determine whether the department accounted for and used its revenue appropriately, we reviewed the department's monitoring of its cash flow and the monitoring of its revenues and expenditures by revenue stream.
- To determine those moneys from the Insurance Fund that were transferred to or otherwise used or available for use by other state entities during fiscal years 1993-94 through 1995-96, we reviewed state laws, annual budget acts, and department records, and we interviewed department staff.

During our fieldwork in the financial areas we reviewed, our audit efforts were hindered by the department's inability to provide us with particular records that we had requested. For example, the department could not provide us with accurate records showing the amounts it collected during fiscal year 1994-95 from the assessment to fight automobile insurance fraud, and the department could not provide sufficient documentation to support its calculations for the distribution of these revenues. As a result, we were unable to identify conclusively the amounts the department collected from this assessment for fiscal year 1994-95.

Moreover, for the period from July 1995 through March 1996, the department could not provide a summary list of the companies to which it sent invoices for the Proposition 103 assessment nor could the department show documentation for the amounts it invoiced for this assessment. Therefore, for the first three quarters of fiscal year 1995-96, we were unable to determine conclusively whether the department billed all insurance companies for their Proposition 103 assessments or whether it billed the companies correctly. In Chapter 1 of the report, we discuss additional instances of significant problems with the department's accounting records.

### ***Program Areas Reviewed***

In addition to testing several of the department's financial areas, we conducted several tests of the department's program areas. Our main focus was whether selected units are achieving their missions. To choose which of the department's several units we would review, we first identified the size of each unit's budget, the number of staff in that unit, the potential impact if the unit failed to meet its mission, and whether the unit was subject to a recent or ongoing review by another organization. We categorized each unit as "consumer services-oriented," "investigation-oriented," "prevention-oriented," or "other." We then selected from each category one unit for further review. The selected units were the claims services bureau, the investigations bureau, the financial analysis division, and the Rate Regulation Division.

For each of the four units, we identified applicable mandates critical to that unit's ability to meet its mission, and we determined the unit's compliance with these mandates. We also evaluated each unit's workload control system.

To assist us in determining the adequacy of the model used by the department's Rate Regulation Division to analyze proposed changes in insurance rates, we obtained the services of actuarial consultants from Ernst & Young, LLP, who have substantial experience in the insurance industry. Our consultants evaluated the model's validity and reliability. Specifically, the consultants determined whether:

- The model accomplishes what the department believes it does;
- The model includes only appropriate factors and omits no significant factors; and
- The model works equally well for all lines of insurance and for all types of insurance carriers.

Finally, in Appendix B, we summarize recent reviews that our office, the Department of Finance, and the department's consultants conducted on the department's operations.

### ***Other Issues Reviewed***

To identify the status of Proposition 103 hearings held by the department, we examined departmental records and verified selected information provided by the department's rate

enforcement bureau.<sup>6</sup> Department records show that 254 insurance companies were subject to the provisions of Proposition 103. As of late 1996, 169 insurance companies had settled their rollback obligations. Department records also indicate that rollback obligations totaled \$1.2 billion. Further, while 62 companies had no rollback obligations, 5 others were in conservation or liquidation.

The department has yet to finalize the rollback obligations of the remaining 18 companies. As of January 1997, the department had not completed settlement agreements for 2 of these 18 insurance companies. Also, the department had not concluded the hearing process for 11 others, including one whose hearing was scheduled to start in March 1997. Four insurance companies were appealing in Superior Court the administrative law judges' decisions regarding the companies' rollbacks. For one other company, the commissioner had adopted the administrative law judge's decision, but the company had not.

To determine whether it properly spent the \$9.4 million that the budget act appropriated to the department for fiscal year 1995-96 for holding Proposition 103 hearings, we examined the department's financial records and supporting documentation, including contracts. The department's financial records indicate that it spent or encumbered \$8.7 million during fiscal year 1995-96 on matters related to Proposition 103 hearings.<sup>7</sup> The department spent or encumbered \$6.9 million (79 percent) of this amount for contracts, primarily to hire administrative law judges, obtain expert witnesses, and hire outside counsel to help represent the department during the hearings. The purpose of these contracts appears reasonable. The department's financial records also disclose that it spent \$1.3 million (15 percent) of the \$8.7 million on salaries and benefits, and \$231,000 (3 percent) on indirect costs. These charges appear reasonable. We did not examine the remaining \$300,000 (3 percent).

To determine whether the department properly issued certificates of authority to companies desiring to sell insurance in California, we reviewed five application files. The department properly granted certificates of authority to three of

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<sup>6</sup>In part, the provisions of Proposition 103 required insurance companies to reduce by 20 percent the rates in effect at November 1987 that the companies charged policyholders. The results of a subsequent lawsuit threw out the 20 percent and directed the department to calculate the "rollback" for each company. After the department determines the rollback amount, an insurance company can appeal the department's decision by requesting a hearing before an administrative law judge.

<sup>7</sup>The Budget Act of 1996 allowed the department to spend the balance for hearings to be held during fiscal year 1996-97.

the five applicants within the 180 days required by the code. Also, the department confirmed that these three applicants met such critical criteria as providing an acceptable plan of operations and a recent examination report. In the cases of the other two applications, the department was still considering one as of January 19, 1997, while the insurance company withdrew the remaining application after the department properly determined that the application did not meet all established criteria.

To determine whether the department promptly issued licenses to individual applicants, such as brokers and agents, we examined records in and interviewed staff of the department's licensing bureau. For four of the five applications we reviewed, the department issued licenses within a length of time that did not appear unreasonable. The department did not maintain sufficient documentation to explain why it took nearly 21 weeks to issue a license to the remaining applicant.

To determine whether the department's market conduct bureau inappropriately ceased an ongoing examination of the practices of a certain insurance company, we reviewed internal documents and interviewed department staff. The department stated that it temporarily suspended the writing of the report for this examination because the department reassigned the lead examiner to complete work on another examination. Before we concluded our fieldwork, the department finished and we reviewed a draft of the suspended report. Because the draft was confidential, we cannot comment on it.

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# Chapter 1

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## ***The Department of Insurance Must Address Numerous Fiscal Problems***

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### ***Chapter Summary***

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The Department of Insurance (department) has many serious fiscal problems that it must quickly resolve. Specifically, it did not issue budgets to its staff until five months after the start of the fiscal year. This shortcoming results in problems for the department's managers when they are planning and directing their staff's activities for the year. The department also did not determine periodically whether actual revenue earned correlated with estimated amounts. If it followed this practice, the department would have learned that during the first four months of fiscal year 1996-97, the department earned only 74 percent of the revenue it anticipated; at this rate, a \$4.7 million deficit may arise by year-end. Further, the department did not bill insurance companies for all amounts that it should, did not always bill the proper hourly rate, and did not properly follow up on overdue payments from insurance companies. These poor revenue collection practices contributed to cash flow problems. Finally, the department inappropriately transferred expenditures from one program to others so that the first program could remain within its budget. For example, the department improperly transferred \$2.7 million in expenditures from its fraud program to other programs, including programs supported by Proposition 103 revenues, to avoid overspending the fraud program's budget during fiscal year 1995-96.

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Lawsuits have reduced resources by approximately \$21 million.

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### ***Two Lawsuits Have Contributed to the Department's Fiscal Problems***

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The department is currently trying to cope with significant financial setbacks resulting from legal action brought against it. The settlement of one lawsuit and the subsequent loss of another lawsuit have combined to reduce the department's financial resources by approximately \$21 million.<sup>8</sup> Specifically, in *National Fire Insurance Company et al.*

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<sup>8</sup>This \$21 million was nearly 20 percent of the department's \$104 million in operating expenditures for fiscal year 1995-96.

v. *Chuck Quackenbush*, several insurance companies alleged that the department improperly collected funds from insurance companies and disbursed the funds illegally. The department settled this case in March 1995. For part of the settlement, the department agreed to refund \$6.5 million to insurance companies, including \$1.6 million in attorneys' fees for the plaintiffs, and limit the use of Proposition 103 funds to Proposition 103 purposes only.

In its July 1995 decision for *National Association of Independent Insurers et al. v. John Garamendi (NAII)*, an appeals court concluded that the insurance commissioner lacked statutory authority to collect fees for investigating individual consumer complaints.<sup>9</sup> According to the department, the decision resulted in the loss of \$7 million in examination fee revenues that the department anticipated it would receive in fiscal year 1995-96. Furthermore, the court ordered the department to refund the amounts it had already collected for investigating consumer complaints.<sup>10</sup> The department estimated that these amounts total \$7 million.

—◆—  
A \$14 million  
General Fund loan did  
not eliminate financial  
pressures.  
—◆—

To assist the department in paying the obligations owed as a result of the adverse decision in the *NAII* lawsuit and in meeting its other financial obligations, the Budget Act of 1996 authorized a \$14 million loan from the State's General Fund to the department. The budget act also required the department to pay back this loan with interest by June 30, 1998. However, a bill that passed four days after the budget act's enactment allows the department to use moneys other than those from its existing revenue streams to repay the loan and interest. Chapter 187, Statutes of 1996, amended existing law for fiscal years 1996-97 and 1997-98. This amendment temporarily diverted to the Insurance Fund insurance-related moneys that would otherwise go to the State's General Fund. The department could then use these diverted moneys to repay the principal and interest on the loan. These insurance-related moneys, called "escheated funds," are undeliverable Proposition 103 rebates.

However, the loan and its repayment provisions have not relieved all the financial pressures on the department. For example, even with the loan, the department still has cash flow problems; it did not promptly pay amounts owed to insurance companies for the *NAII* lawsuit or amounts owed to district attorneys for prosecution of fraud cases. In fact, rather than

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<sup>9</sup>In November 1995, the Supreme Court of California denied the department's request to review the decision of the appeals court.

<sup>10</sup>Although the court did not specify the period for which the department should issue refunds, the department interpreted the order as applying since the inception of the fee.

  
*The department did not promptly pay amounts owed under the lawsuits.*  


using proceeds from the \$14 million loan to pay amounts owed to insurance companies for the *NAII* lawsuit, the department used the funds to cover general operating expenses in the first five months of fiscal year 1996-97. In October 1996, the department notified insurance companies owed money under the lawsuit that they would receive payment by January 1997, well after the July 1995 court order, because of the department's cash flow concerns. Also, the department did not disburse to the district attorneys the second payment from the automobile fraud assessment for fiscal year 1995-96, totaling \$3.9 million, until January 1997. The department originally expected to make this payment in June 1996. Finally, according to State Controller's Office estimates as of January 24, 1997, no escheated funds will be available in fiscal year 1996-97 for transfer from the General Fund to the Insurance Fund to apply to the department's \$14 million loan. The department therefore needs to monitor the amount of escheated funds available to pay the \$14 million General Fund loan, and, if necessary, make contingent plans for the payment of the loan if the escheated funds are insufficient.

Since the resolution of the lawsuits, the department has attempted to mitigate the lawsuits' effects on its financial condition. For example, for fiscal year 1996-97, according to the department, it submitted a budget request in which it attempted to increase substantially the amount of revenue generated from examination fees. However, legislation limited the increase to a much smaller amount. Also, in its effort to cut costs, the department merged field operations, consolidated office space, reduced legal fees paid to the Attorney General's Office, decreased its travel budget, eliminated vacant positions, and laid off staff.

Further, in October 1995, the department announced a 62 percent increase in the fees listed in Section 12978 of the California Insurance Code (code), effective February 1, 1996. According to the deputy commissioner for administration, the department intended this increase to be in effect for only 17 months. At the time of the announced increase, the department had the authority to raise these fees to allow it to meet the appropriation authorized by the annual budget act. However, the insurance commissioner rescinded the increase on January 31, 1996. The letter of rescission, addressed to legislative leaders, did not explain the decision to rescind the original announcement. Recent legislation has limited the fee increases allowable without legislative approval to 10 percent per year. The insurance commissioner has not subsequently raised the fees listed in Section 12978 of the code, which have remained at the same level since 1991. The department is currently opposed to raising fees in the manner established

under Section 12978, which requires that all of these fees be raised uniformly. The department believes that this requirement undermines the basic principle of a fee, which is to match costs to the fee charged. However, the same requirement to raise fees uniformly existed when the department announced the 62 percent increase in fees. The department also indicated that the insurance commissioner believes that his mission is to reduce, not increase, the cost of insurance. Thus, the department is not currently exercising its option to raise fees to help mitigate its financial problems.

To mitigate further the effect of these serious financial pressures and still fulfill its statutory obligations, the department must monitor its operations closely, maximize its revenues, and minimize expenditures. As we show in the following sections, although it has taken some steps to correct the problems we discuss, the department did not have an effective system in place at December 1996 to monitor its budgets and expenditures and does not yet have an effective system in place to monitor its invoicing and revenue collection processes.

### ***The Department Does Not Fully Use Its Budgets as Management Tools***

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Under any circumstances, detailed budgets of departmental activities are vital tools for establishing policy and managing the public resources available for the department to meet its mission. By periodically reviewing expenditures and billed and collected revenue, the department can monitor its units' compliance with budgets throughout the year and thus ensure that the department does not exceed the limits established by the budget act or those indicated in the detailed budget for each department unit. When significant fiscal constraints affect the department's operations, as is now the case, the department needs to make an even greater effort to establish quickly an appropriately detailed departmental budget, monitor compliance with that budget, and hold managers responsible for meeting their units' budgets.

—◆—  
*The department took approximately five months to notify managers of their specific budget allocations.*  
—◆—

The department has not fully used the budget process in productive ways. For example, the department has not promptly established and communicated budgets to managers who are responsible for controlling expenditures and generating revenues. According to the department, for fiscal year 1995-96, it did not communicate branch-level budget summaries to its deputy commissioners until November 1995 or give these individuals detailed budgets until January 1996. For fiscal year 1996-97, the deputy commissioners received branch

budgets in October 1996; however, it was not until December 1996 that the department communicated detailed budgets to the bureau and division chiefs who are responsible for meeting those budgets. Because the department had significant changes to its budget proposals for fiscal year 1996-97, and because the budgets were approved after the start of each fiscal year in both cases, some causes for these delays were beyond the department's control. Nonetheless, for these two fiscal years, the department took approximately five months after the budget act was signed before it notified managers of their specific budget allocations.

When they do not know their budget allocations, managers cannot adequately plan and direct their activities for the year. For example, managers cannot determine the amount of services their units will provide, how much traveling their staff will be able to do, how much training the managers can provide to staff, or even how many staff members their units will have. In commenting on how units handle five-month delays in receiving a budget, one deputy commissioner indicated that units maintain expenditures under the deputy commissioner's control at the approximate rates that existed in the prior year. Although this approach to managing resources without a budget reduces disruptions in the short term, the approach is problematic if budget allocations change significantly. If modifications occur, managers have only seven months to adapt to budget changes intended to affect an entire year. This shortened timeline limits the options available for units' reacting to budget changes and may unnecessarily disrupt program operations.

◆  
*\$2.7 million in fraud expenditures was inappropriately shifted to other programs.*

◆

Not only do we see problems with the department's establishment of budgets for its units, but we also question how effectively the department monitored its budget during fiscal year 1995-96. For example, late in fiscal year 1995-96, the department shifted \$2.7 million in expenditures incurred in the Fraud Branch to other units. The department's explanation for this transfer was that it did not have an adequate budget for administrative overhead in the Fraud Branch. However, the department did not provide any other justification for this transfer of expenditures to the other units. Therefore, we conclude that the Fraud Branch exceeded its budget, and the department transferred these expenditures to other units that did not incur the costs so that the Fraud Branch appeared to comply with its budget restrictions. In addition, to prevent the department from exceeding its total administration budget, the department reclassified \$3 million in administrative expenditures as expenditures for information technology.

The department's inappropriate transfers of expenditures during one fiscal year also affect the department's future budgets. Because the department develops its budgets according to expenditures in the previous year, the department's transfer of expenditures from one category to another distorts actual expenditure patterns. Budgets then become unrealistic because the recorded expenditures from the previous year do not reflect true costs. Although the department must adapt to changes that occur during the budget period, its budgets will have no value as management tools if the department adjusts expenditures in this way.

During our audit, the department implemented a new procedure for monitoring its budgets monthly. In January 1997, the department began distributing to deputy commissioners and division chiefs schedules that show actual expenditure amounts as of a particular date for the department's various branches, divisions, and bureaus. The schedules the department issued in January 1997 contained information as of November 30, 1996. These schedules also show the annual budget amounts and the remaining amounts available for spending. The department intends deputy commissioners and program managers to use this information to monitor and manage their expenditures. Because the department had only recently implemented this new procedure, we were unable to assess whether department staff used the information for the intended purpose. Successful implementation of this new procedure, however, depends on accuracy of the information provided and the degree to which the deputy commissioners and program managers use this information.

***The Department's Billing and  
Collections System Hinders  
Prompt Revenue Collection***

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In addition to not fully using its budget process, the department has not maximized its revenues effectively. Specifically, the department did not always promptly generate the invoices for Proposition 103 assessments, charge insurance companies for all costs it incurred when conducting examinations, promptly establish accounts receivable for these invoices, or properly follow up on unpaid or underpaid invoices. Because it has not collected essential revenues promptly and has not collected all amounts due, the department has lost revenues, including potential interest earnings, necessary to support its operations and meet its cash flow needs.

### ***The Department Generates Its Invoices Late***

◆  
*\$6.5 million in  
Proposition 103  
assessments was billed  
three months late.*

The department does not always promptly bill insurance companies for Proposition 103 assessments. For example, the department did not issue until November 1996, approximately three months late, \$6.5 million in Proposition 103 invoices for the first quarter of fiscal year 1996-97. The department also did not bill for \$6.9 million in Proposition 103 assessments for the first quarter of fiscal year 1995-96 until mid-October 1995, two months late.

Section 8776.3 of the State Administrative Manual (SAM) requires each department to prepare and send a claim document, such as an invoice, as soon as possible after recognition of a claim. Department policy dictates that the department generate and mail invoices for Proposition 103 assessments on the eighth working day of the second month of each quarter.

The department did not promptly issue the Proposition 103 invoices for the first quarter of fiscal year 1996-97 because it did not know the total amount to be assessed until October 1996. The department bases the total amount to be assessed for its administration of Proposition 103 on a combination of prior-year actual expenditures and current-year expected expenditures. Because it did not determine its expected expenditures until October, the department did not know how much it should invoice individual insurers.

However, because the department issues Proposition 103 invoices in quarterly increments generally to the same insurance companies, the department could have issued invoices using the prior-year rates and then adjusted subsequent invoices after it calculated the expected costs. By taking this step, the department would have collected revenues vital to its operations earlier than it did, and its cash flow problems would not have become so severe. Because the total Proposition 103 quarterly assessment is \$6.5 million, the amount is large enough to cause cash flow problems if the department fails to generate invoices promptly.

### ***The Department Does Not Bill Insurance Companies for All Costs It Incurs***

—◆—  
*The department did not bill for over \$181,000 in examination fees.*  
—◆—

The department does not always bill insurance companies for all costs the department incurs when conducting examinations. Sections 736 and 12992 of the code require that examination revenues be based on examination costs. However, our review of time sheets covering July through October 1996 for 39 staff working on market conduct examinations and on field rating and underwriting examinations disclosed that the department did not bill for 275 of the 11,167 hours that examination staff worked, an omission that resulted in an underbilling of \$30,800. Underbilling problems also existed during fiscal years 1994-95 and 1995-96. Staff of the field examination division determined that the department did not bill insurance companies for at least 1,588 hours staff worked and recorded on their time sheets for December 1994 through November 1995. The field examination division staff calculated the underbilling for the period to be at least \$150,903. When the department does not bill for all hours that the examination staff members work, the department must use other resources, such as revenues from fees and licenses, to fund the examination units' activities.

### ***The Department Has Billed Insurance Companies Incorrectly***

Moreover, the department does not always bill examination hours at the correct examination rates. In October 1995, to cover its costs for actuarial activities, the department calculated an hourly rate of \$240 for 1995-96 actuarial examinations. Subsequently, a report by the Bureau of State Audits stated that the department miscalculated the actuarial rate. Later in the fiscal year, the department lowered the rate to \$222 per hour. However, the department did not consistently bill actuarial examinations at either rate. At various times during the fiscal year, the department invoiced actuarial examinations at six different hourly rates: \$110, \$175, \$220, \$222, \$240, and \$245. Thus, the department overbilled some insurance companies and underbilled others.

***The Department Does Not  
Create Accounts Receivable  
When It Bills Insurance Companies***

During fiscal year 1995-96, the department did not establish accounts receivable totaling more than \$46 million when it prepared invoices for insurance companies for examination fees, Proposition 103 assessments, and other assessments. Sections 8776.3 and 10507 of the SAM require departments to establish accounts receivable when state departments prepare and send invoices. Rather than establish accounts receivable when it prepared and sent out its invoices, the department placed copies of invoices into a file until it received payment from the companies. At the end of the 1995-96 fiscal year, the department added up the remaining unpaid invoices to determine its year-end accounts receivable amount. With no automated listing to track receivables or to generate second billings, the department had to do this work manually.

Without a system to establish accounts receivable at the beginning of the billing process, the department cannot easily identify those insurance companies that do not pay their invoices and thus cannot effectively collect overdue funds. Further, failure to collect promptly all amounts due can lead to cash flow problems.

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*As of January 1997, the department had not collected \$961,000 in Proposition 103 assessments for fiscal year 1995-96.*

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As of January 9, 1997, the department had not received payment for 70 invoices generated during fiscal year 1995-96 and totaling \$960,515, or 3.5 percent, of the \$27.6 million for Proposition 103 assessments. For all 70 invoices, the department did not send out the first past-due notices promptly after the payments were due. We found only two sets of past-due notices, dated April 15, 1996, and October 3, 1996. Proposition 103 payments for the first quarter of fiscal year 1995-96 were due on November 20, 1995, but the department did not send out the first past-due notices until April 15, 1996. We also observed that the department did not sufficiently follow up on insurance companies that had underpaid. Because some of these companies disputed various invoices from the department, the department filed these invoices in a "problem file" for future review. As of January 9, 1997, the problem file contained 83 unresolved invoices, some of which dated back to 1995, more than a year earlier.

The department did not properly follow up on unpaid invoices for two reasons. First, the department appears to have no written procedures relating to the collection of accounts receivable; in fact, it could not provide us with documentation that shows the existence of such procedures. Second, the

authority the department has is inadequate to compel prompt payment of invoices. According to its chief deputy commissioner, the department does not have the statutory authority to penalize insurance companies for not paying assessments or examination fees. Although the department has the authority to suspend the certificate authorizing a company to conduct insurance business in the State, the department does not do so. The chief deputy commissioner informed us that the department expects to obtain statutory authority during the 1997 legislative session to charge a late payment fee.

***The Department Has Not Yet Fully Implemented Its New System for Accounts Receivable and Revenue Collections***

The department is aware of the problems with its accounts receivable and revenue collections and is taking steps to address these shortcomings. In 1993, it purchased a system that would automate the billings, accounts receivable, receipts, and collection system. However, competing priorities within the department in 1994 prevented the department from installing the system.

*The new system is intended to address billing and collection problems.*

In November 1996, the department continued its implementation of the automated system, which is supposed to generate invoices for the department, automatically establish a corresponding accounts receivable, create overdue notices when applicable, report the amount of cash revenue received, identify the age and amount of unpaid invoices, and perform other functions. As of January 1997, the new system issued only examination and Proposition 103 invoices. The implementation schedule for the new system indicates that it will issue most types of invoices by June 1997 and all types by June 1998. Because the department was continuing to implement this system during our fieldwork, we were unable to evaluate the system's actual performance. The system's capabilities address the concerns expressed in this chapter regarding the department's problems with billing and revenue collections; however, the system's success depends on the thoroughness and accuracy with which the department implements, maintains, and applies the system.

### ***The Department May Have a Shortfall in Examination Fee Revenues***

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For fiscal year 1996-97, the department may not generate enough examination fee revenues to cover its costs for examining insurance companies. The department calculates the hourly rate for the fees according to its annual administrative and operational budgets for examination activities and the annual number of hours that it estimates it will spend examining companies.

—◆—  
*A \$4.7 million shortfall in  
examination revenues  
may occur in 1996-97.*  
—◆—

The department's initial calculations for fiscal year 1996-97 showed that it would earn sufficient revenue from the examination fees to cover the costs associated with these activities. However, our analysis of the department's billing for examinations during the first four months of fiscal year 1996-97 disclosed that the department had earned only 74 percent of the revenue expected to date. Specifically, the department estimated that it could bill for 38,155 hours for the financial analysis examinations and the field examinations for the first four months of 1996-97; however, by October 31, 1996, it had billed for only 26,788 hours, or 70 percent of its estimate. We have not determined whether the department will be able to bill more hours in the remainder of the year to compensate for the lower billings during the first four months. However, if the department continues to bill at its current rate all hours for financial analysis, field, market conduct, and field rating and underwriting examinations, which are those with the highest revenues, we calculate that it will receive only \$13.3 million, or approximately \$4.7 million less than it projected. If this situation occurs and if it incurs all costs it budgeted, the department will not generate sufficient examination fee revenues to cover its examination costs for at least the second year in a row.

One reason for the potential shortfall in the examination fee revenues is the department's failure to compare budgeted expectations to actual performance. For example, until January 1997, more than six months into the fiscal year, the department had not developed any management reports that correlated the number of budgeted hours it expected to bill insurance companies with the actual number of hours billed. Such reports would have shown whether the examination bureaus were performing as projected and whether the department was meeting examination revenue goals for the year. Another reason for the potential shortfall in revenues is the department's failure to bill insurance companies for all the hours it worked on examinations, an issue we discuss earlier in this chapter.

### ***The Department Has Used Revenue Inappropriately***

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During our review of the department's cost allocation system for fiscal year 1995-96, we discovered an instance in which the department intentionally used revenues from the Proposition 103 assessment and examination fee revenue streams to cover indirect costs that the department should have charged to its fraud program. Sections 736 and 12992 of the code limit the department's use of revenues earned from Proposition 103 assessments and examination fees to covering only the costs related to implementing the provisions of Proposition 103 and to examining insurance companies.

To distribute the costs of its operations to appropriate programs, the department maintains a cost allocation system. Under this system, the department accumulates costs in accounts called "cost centers." The system then distributes amounts from these cost centers to one or more of the department's programs. The department allocates costs that may be distributed to multiple programs, called "indirect costs," to those programs based on the proportion of personal services costs for each program.<sup>11</sup> Examples of indirect costs include legal, accounting, and personnel services. The department allocates to specific programs those costs, called "direct costs," that may be distributed to a single program.

◆  
*The department improperly charged fraud program costs against Proposition 103 revenues.*

As we discuss earlier in this chapter, in June 1996, department staff observed that the fraud program would probably overspend its appropriation for indirect costs for fiscal year 1995-96. In response to this concern, the department adjusted its allocated costs by \$2.7 million, including diversions of \$741,000 in indirect costs from its fraud program to the Proposition 103 revenue stream and \$869,000 to the examination fee revenue stream.

The department's improper budget adjustments have only added to its financial management problems. For instance, when it calculates the Proposition 103 assessment amount for a particular fiscal year, the department bases part of its calculation upon the costs it incurred during the prior fiscal year. Because the department inappropriately charged \$741,000 of costs applicable to its fraud program to the Proposition 103 revenue stream in fiscal year 1995-96, insurance companies who pay the Proposition 103 assessment amount during fiscal year 1996-97 will absorb these costs

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<sup>11</sup>Personal services costs include staff salaries, health insurance payments, and pension fund contributions.

inappropriately. When the department improperly charged the examination fee revenue stream \$869,000 in fraud program costs for fiscal year 1995-96, the department contributed to the existing multi-million dollar shortfall in examination revenues in fiscal year 1995-96.

—◆—  
*The department did not request an increase to its indirect costs to pay for its earlier increase in fraud program expenses.*  
—◆—

The department stated that it adjusted these costs to conform to the \$19.8 million expenditure limit of the fraud program for fiscal year 1995-96. According to the chief of the accounting and fiscal systems division, although the department received approval to increase substantially the number of fraud investigators in earlier fiscal years, it did not receive approval for a corresponding increase in indirect administrative costs. Because the department bases its allocation of indirect costs upon personal service costs, when the amount of salaries and benefits charged to a program increases, the indirect costs allocated to the program also increase. However, a review of the department's proposals to augment its budget for the fraud appropriation showed that the department failed to request the corresponding increase in indirect costs.

Therefore, the department has compounded its original, obvious budgeting error—failure to ensure a proper balance between direct and indirect costs for the fraud program—with another budgeting error: its inappropriate use of moneys from two other dedicated revenue streams to cover the fraud program's overexpenditure. With both actions, the department has undermined its budget process.

### ***The Department Has Not Promptly Accounted for the Results of Its Proposition 103 Activities***

The department has failed to establish a system to match on a continuous, prompt, and accurate basis its revenues from Proposition 103 fees with related expenditures. As a result, the department cannot ensure that it is using these revenues only for the purposes mandated by law.

Section 12992 of the code limits the use of revenues earned from Proposition 103 assessments to covering the costs related to implementing the provisions of Proposition 103. Further, Section 12990 of the code requires the department to adopt an accounting system that will allow it to identify accurately those costs for Proposition 103 activities and to link the costs to fees collected for these activities. Finally, as part of the settlement in *National Fire Insurance Company et al. v. Chuck Quackenbush*, the department agreed to establish a subaccount

within the Insurance Fund for the exclusive purpose of collecting and disbursing funds for the administrative and operational costs arising from Proposition 103.

  
*The automated accounting system does not adequately summarize the results of all Proposition 103 activities.*  


Despite the clear mandate to account separately for Proposition 103 revenues and related expenditures, the department has had difficulty doing so. For instance, the department's automated accounting system separately identifies dedicated revenues and related expenditures during the fiscal year, but the system does not summarize the information in a convenient form and does not track the results of these separate operations from year to year. Instead, the department must develop this information manually, and the department is very late in identifying information from previous years. In January 1997, when we asked for the net results of operations related to Proposition 103 revenues from year to year, the department provided us only with its calculations as of June 30, 1995, more than 18 months earlier. Similarly, in October 1996, when we asked the department for cash flow information for Proposition 103 revenues for fiscal year 1995-96, the department did not have this information readily available. Instead, the department needed two weeks to compile the information for us. When we questioned the accuracy of its cash flow summary, the department submitted a revised version to us.

Further, the accounting records on which the department bases its calculations are of dubious reliability. Reporting on internal controls at the department during the fiscal year ended June 30, 1995, the Department of Finance concluded that the department's financial statements were "materially unreliable, unsupported, and virtually unauditible." The Department of Finance reported serious deficiencies in records and controls for accounts receivable, cash receipts, and cash disbursements.

Because the department's accounting records provide part of the basis for calculating Proposition 103 fees in subsequent years, the department must maintain accurate records of the results of its operations related to Proposition 103 from year to year. Carrying forward profits and losses into the calculation of subsequent years' fees is reasonable for Proposition 103 fees because generally the same insurance companies pay these fees each year. Thus, companies that the department undercharged for Proposition 103 fees in one year would generally be the same ones paying compensating amounts later. However, when the department does not maintain its accounting records in a regular, timely, and accurate manner, the department will not charge insurance companies the correct amount.

### ***The Department Has a Weak System for Distributing Automobile Fraud Revenues***

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The department's system for distributing automobile fraud assessments, which total approximately \$16 million annually, does not fully comply with statutory requirements. In addition, because of weak oversight by management, department staff responsible for calculating the distributions either was unaware of the department's system or did not comply with it. As a result, the staff did not identify all assessment revenues accurately nor distribute proper amounts to the required entities.

—◆—  
*The system for distributing auto fraud assessments is unreliable.*  
—◆—

Section 1872.8 of the code requires each insurance company doing business in the State to pay an annual assessment not to exceed one dollar for each vehicle it insures under a policy issued in the State. By regulation, the department has set this amount at one dollar. The revenues collected from this assessment go toward increased investigation and prosecution of fraudulent automobile insurance claims and economic automobile theft.<sup>12</sup> Section 1872.8 further describes the percentages the department is to use in distributing the revenues generated under this assessment. Specifically, the department is required to give 48.45 percent of the revenues to district attorneys to investigate and prosecute fraudulent automobile insurance claims, 32.3 percent to the department's Fraud Branch for enhanced investigative efforts, 14.25 percent to the California Highway Patrol (CHP) for enhanced prevention and investigative efforts to deter economic automobile theft, and 5 percent to its Fraud Branch for the maintenance of its Automobile Insurance Claims Depository.<sup>13</sup>

However, several factors contribute to the inadequacy and unreliability of the department's system for distributing revenues generated from the assessment. First, the department does not appear to have adequate records to document assessment revenues. For instance, it could not provide sufficient accounting records for fiscal years 1993-94 and 1994-95 that document the amount of revenue generated by the assessment because, according to the chief deputy commissioner, these documents were not readily available. Therefore, we were unable to verify that the department accurately accounted for

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<sup>12</sup>Economic automobile theft is automobile theft committed for financial gain.

<sup>13</sup>The Automobile Insurance Claims Depository is a database containing automobile claim information from insurance companies doing business in the State. The department uses this information to help identify individuals who submit fraudulent insurance claims.

revenues collected from the assessment, correctly calculated the distributions of the revenues, or properly distributed these revenues.

  
*The department overpaid  
the CHP and underpaid  
other entities.*  


Second, the department implemented an amendment to Section 1872.8 of the code before the amendment became effective. In September 1994, the governor signed legislation amending Section 1872.8 to include the distribution to the CHP. Because this amendment became effective on January 1, 1995, the department should have calculated the CHP's portion of the assessment based on revenues collected on or after January 1, 1995. However, the department, which bills quarterly for automobile fraud fees, calculated the CHP's portion based on its collections of the fees for the entire fiscal year. As a result, the department overpaid the CHP while underpaying the other entities. Because the department lacked adequate accounting records, we could not determine the amount the department overpaid the CHP and the amounts it underpaid the other entities entitled to the revenues.

Third, the department uses a faulty method to calculate amounts to distribute to the CHP. The department's chief deputy commissioner indicated that the department uses data for revenues collected through the end of the fiscal year to calculate the first payment amount for the CHP. The department uses data collected through December 31 after the close of the fiscal year to calculate the second, final payment amount. For example, the department would use revenue data as of June 30, 1996, to calculate the first payment amount for fiscal year 1995-96 revenue, and the department would refer to data as of December 31, 1996, to calculate the final amount. However, the department's calculation method results in two harmful effects. Specifically, the method ignores any revenues the department receives after December 31 for the prior year. The department must distribute all revenues collected from this assessment to the proper entity. Also, the method allows the department to unnecessarily hold revenues for as many as ten months before distributing them to the CHP. Because the department bills insurance companies for this assessment quarterly in arrears, it should start receiving the first revenues by November of each fiscal year. Nonetheless, the department does not make the first payment to the CHP until after the end of the fiscal year. For example, for revenues received during fiscal year 1995-96, the CHP received its first payment from the department in September 1996, nearly ten months after it should have first collected the revenue.

Fourth, the department has failed to distribute all amounts to the CHP that it should. Specifically, accounting records indicate that, from July 1, 1995, through June 30, 1996, the

department collected more than \$4.6 million in revenues related to assessments for fiscal year 1994-95. However, as of February 1997, the department had not yet disbursed the \$660,000 share of these revenues to the CHP.

  
*District attorneys were overpaid \$395,000 for their share of auto fraud revenues.*  


Finally, the department has not distributed proper amounts to district attorneys. Specifically, for fiscal year 1995-96, the department disbursed more than \$8 million to district attorneys based on its estimate that it would collect approximately \$16.7 million in revenue from automobile fraud assessment. However, as of December 31, 1996, the department collected only \$15.8 million, \$900,000 less than it estimated. Therefore, according to the department's system for distributing these moneys, the department overpaid district attorneys more than \$395,000 for fiscal year 1995-96. The department overpaid the district attorneys because it did not reduce the final payment to reflect the lower-than-anticipated collections.

Inadequate oversight has helped to create these weaknesses in the department's system for distributing revenues generated from the automobile fraud assessment. For example, department staff has not used the same criteria to calculate payments to the different entities. Specifically, the person who calculated the department's distributions to the district attorneys was assigned to the department's Fraud Branch and based the payments on an estimate of the revenues to be generated. The person who calculated the distributions to be made to the CHP was assigned to the department's accounting and fiscal systems division and based the payments on accounting reports showing amounts collected. We did not observe evidence, and the department did not provide documentation, that the department coordinated the work these individuals performed or reviewed the distributions to ensure accuracy.

The department agreed that it had weak oversight of its system for distribution of automobile fraud revenues. According to its chief deputy commissioner, the department has consolidated in its administrative branch all the functions related to fund calculations and distributions. In addition, as of January 1997, the department had appointed an individual with the appropriate skills to manage these activities. The chief deputy commissioner also stated that the department is currently developing formal procedures for disbursing automobile fraud revenues.

***The Department's Accounting  
Records Exhibit Additional Problems***

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Our review also disclosed several other problems with the department's accounting records. For example, the department continues to carry old and probably uncollectible receivables in its financial records. Section 8776.6 of the SAM describes procedures for state departments to use to write off or delete uncollectible receivables. For example, for non-employee accounts receivable, Section 8776.6 requires departments to develop collection procedures that will assure prompt follow-up on receivables and, if the procedures are unsuccessful, to prepare an analysis of various collection actions. If all reasonable collection procedures prove unsuccessful, departments may request relief from accountability of uncollectible amounts from the State Board of Control.

The department, which has not followed the SAM's procedures for deleting uncollectible receivables, maintains records of at least 1,400 separate receivables, totaling more than \$4.4 million, related to transactions that occurred between fiscal years 1983-84 and 1993-94. The department has not yet assessed which of these receivables, if any, are potentially collectible nor has it eliminated probable uncollectible receivables from its books. Maintaining records which include receivables that, because of their age, the department is not likely to collect ultimately causes extra work for fiscal staff.

◆  
Accounting records  
contain \$4.4 million in  
potentially uncollectible  
receivables.

◆  
The department also has not properly reconciled its general cash records for the Insurance Fund, including the Revolving Fund portion, with bank records. For example, the department did not identify reasons for differences of \$1.6 million and \$1.5 million for June and July 1996, respectively. The department indicated that it expects to be able to perform full reconciliations as of January 1997.

In addition, the department does not have adequate record storage and filing practices. For example, the accounting staff has kept important documents, such as invoices issued during fiscal year 1995-96 for Proposition 103 assessments and examinations, in at least 31 unlabeled or improperly labeled boxes. These boxes contain more than 2,000 invoices. Further, the invoices were not arranged consistently by number or invoice type. When we needed these documents, either we or the department's staff wasted valuable time searching manually through the boxes to try to find specific items. According to the deputy commissioner for administration, a

100 percent turnover in the department's accounting staff since February 1995 has contributed to the filing problems and to some of the other difficulties described in this chapter.

### ***Conclusion***

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The department has significant problems with its fiscal operations that make it difficult for it to deal with the recent serious reductions in its financial resources. To mitigate the effect of these reductions in resources and still fulfill its statutory obligations, the department must monitor its operations closely and maximize revenue while minimizing expenditures. The department also has not effectively used its budget or monitored either its expenditures or its invoicing and revenue collection processes. For example, the department was late in establishing the internal allocation of its budget. As a result, delays occurred in vital processes that depend on the budget allocation, including the calculation and billing of fees. When such delays occur, managers do not know how much they can spend and thus cannot appropriately plan and direct the activities within their responsibility.

The department has other significant problems with revenue collection and use. Specifically, until January 1997, the department did not monitor its billings for examinations to ensure that actual revenues will meet budgeted expectations. If it maintains its current level of billing, we estimate that the department will experience a \$4.7 million shortfall in examination revenues. Further, the department does not establish a useful listing of its receivables when it bills for services, and it does not bill for all accounts or promptly collect all amounts due.

The department also inappropriately used \$1.6 million in revenues from Proposition 103 assessments and examination fees to pay for fraud program expenses. Both Proposition 103 and examination revenues are restricted to support only costs related to their respective regulatory activities. Further, the department does not have an accounting system that matches on a continuing, timely, and accurate basis Proposition 103 funds with related expenditures, as required by statute.

Although statutes provide clear directions for the distribution of receipts for automobile fraud assessments to district attorneys and the CHP, the department has not established an effective system for distributing the nearly \$16 million in revenue. In particular, the department has not accurately identified or retained documentation of the assessment revenues, overpaid the CHP an unknown amount for one year, underpaid the CHP

\$660,000 for the next year, and overpaid district attorneys nearly \$400,000. Further, even if the department's staff complied with the current distribution system that the chief deputy commissioner described to us, the system does not ensure that the department is distributing all revenues appropriately.

Finally, the department has additional problems with its financial records. Contrary to state policy, the department has not taken steps to delete from its books old and uncollectible receivables or properly reconciled cash records to bank records. The department also has not maintained adequate document storage and filing practices.

## ***Recommendations***

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The department should monitor the amount of escheated funds available to pay the principal and interest on the \$14 million General Fund loan, and it should make contingent plans for the repayment of the loan if the escheated funds are insufficient.

To improve the usefulness of its budgets, the department should take the following steps:

- Promptly establish and communicate internal budget allocations that are both reasonable and clear in defining performance expectations for each departmental unit;
- Each month, compare actual revenues and expenditures to budget expectations, identify reasons for variances, and take appropriate actions;
- Each month, compare the number of examination hours billed to expected billable examination hours; and
- Consistently hold managers responsible for meeting their units' budgets.

To ensure that it bills and collects both properly and promptly all revenues due from insurance companies, the department should do the following:

- Make certain that its new accounts receivable and revenue accounting system corrects the problems we identified by establishing accounts receivable at the time staff prepares the invoice, tracking the accounts receivable revenue, providing a listing of aged accounts receivable, calculating interest and penalties on overdue accounts, automatically

generating second billings, and supplying for the various revenue streams a detailed listing of companies and amounts invoiced monthly, quarterly, or annually.

- Calculate Proposition 103 and examination fee rates within one month of the signing of the State's budget act. If the signing is delayed, the department should send by August 8 the invoices for Proposition 103 assessments for the first quarter of the fiscal year, billing at the prior year's rate and adjusting subsequent invoices with the actual rate calculated. For examination invoices, the department should begin billing as soon as it calculates the rates.
- Establish accounting procedures to reconcile billed examination hours to examiners' time sheets to ensure the accuracy and completeness of hours billed.
- Ensure that it bills for examinations at the correct rate.
- Develop and follow comprehensive written procedures for collecting unpaid and underpaid invoices.
- Seek legislation that enables the department to assess penalties and interest on all overdue invoice balances.

To correct its improper charging of fraud program costs to the restricted Proposition 103 and examination revenues, the department should take these actions:

- Reimburse the Proposition 103 assessment and examination fee revenue streams by \$741,000 and \$869,000, respectively, for the fraud program costs inappropriately charged to these revenue streams during fiscal year 1995-96; and
- Pass any savings for Proposition 103 from these reimbursements along to insurance companies for fiscal year 1997-98.

To prevent inappropriate charges to programs funded by dedicated revenue streams, the department should refrain from inappropriately shifting costs to programs funded by such revenue streams. It should also establish a method within its financial system to track accurately and continuously the revenues and expenditures associated with its Proposition 103 operations.

To ensure that it accounts adequately for revenues generated from its assessment to fight automobile fraud, that it accurately calculates distributions of these assessment revenues, and that it

distributes proper amounts of revenues to required entities, the department should correct the problems we identified. The department should take the following specific steps in addition to those it has already taken:

- Develop written procedures to guide staff in the activities listed above;
- Make certain that it recognizes all revenues received after the close of the fiscal year, including those received after December 31 of the following fiscal year;
- Make sure that staff use appropriate records to calculate distributions;
- Calculate payments to each entity based upon actual, not estimated, collections;
- Distribute proper amounts to each entity;
- Promptly distribute all funds collected from the assessment; and
- Ensure that staff maintains appropriate records supporting the calculations and distributions.

Furthermore, the department should make certain that these activities are subject to consistent supervisory oversight.

To improve the condition of its financial records, the department should do the following:

- Eliminate uncollectible receivables from its books and transfer collectible receivables from its former systems to its new billing and receivable system;
- Determine the reason for the differences between the department's general cash records and the bank balance, and perform timely reconciliations each month;
- Establish adequate record storage and filing practices, including retention of invoice lists;
- Communicate accurate examination rates to staff involved with invoicing procedures for examinations; and
- Develop an effective system for supervisory review of transactions for all fiscal activities.

Because the department was implementing a new accounts receivable and revenue accounting system during the period of our audit, we recommend that the Legislature direct the department to contract with an independent auditor to review that system and related records starting no later than July 1999 to determine whether the department corrected the billing, revenue collection, and documentation problems discussed in this report.

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# Chapter 2

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## ***The Department of Insurance Should Manage Several of Its Programs More Effectively***

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### ***Chapter Summary***

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In addition to numerous shortcomings in its fiscal operations, the Department of Insurance (department) also faces problems with its program operations. Specifically, the department is not fulfilling current requirements of the California Insurance Code (code) because it does not examine the practices of all insurance companies at least once every five years. Also, the department may incur unnecessary costs because it will probably be unable to review and accept on schedule the examination reports for all out-of-state insurance companies. Further, two of the department's units do not manage their workloads effectively, and the Rate Regulation Division, which is the unit responsible for evaluating rate-change requests from insurance companies, uses a computer-based model, or "template," that sometimes provides inappropriate results. Finally, the department has disproportionately reduced staff in units that respond directly to consumers, thus demonstrating questionable compliance with legislative intent contained in the Budget Act of 1996.

### ***The Department Will Not Examine All Insurance Companies Within Its Statutory Time Frame***

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Section 729 et seq. of the code directs the department to examine every insurance company authorized to do business in the State at least once every five years. In lieu of conducting some examinations, the department can accept examination reports performed by other states and covering foreign or alien insurance companies.<sup>14</sup>

Our review of the department's policies, practices, and procedures leads us to conclude that, at its present pace, the department will not fully comply with this mandate by December 31, 1997, five years after the effective date of this

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<sup>14</sup>An alien insurance company is one that is domiciled, or organized under the laws of another country. A foreign insurance company is one that is domiciled under the laws of another state.

section in the code. Moreover, not only does it fail to complete comprehensive examinations of all insurance companies every five years, but the department also may not complete the more limited solvency examinations it is required to perform.

### ***Background***

Section 729 et seq. of the code requires the department to examine insurance companies. Specifically, an amendment to Section 730 that became effective on January 1, 1993, requires, in part, that the department examine every insurance company admitted in the State not less frequently than once every five years.

As part of an examination, Section 733 requires the department to inspect and examine all the insurance company's affairs thoroughly, evaluate the company's condition and ability to fulfill its obligations, and determine whether the company has complied with all laws applicable to its insurance transactions. Section 730 also allows the department, instead of performing its own examinations, to accept examination reports performed by other states covering foreign or alien insurance companies. However, such examinations deal only with the solvency of the insurance companies.

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*The Insurance Code appears to require the department to examine insurance companies for both solvency- and practices-related issues.*

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The department's field examination division and financial analysis division examine the financial solvency of insurance companies. The field examination division examines the solvency of insurance companies domiciled in California. The financial analysis division reviews the examination reports covering foreign or alien insurance companies.

We believe that the code's present language requires the department not only to examine every insurance company admitted to do business in the State for those issues affecting the company's ability to fulfill its financial obligations, or "solvency-related" issues, but also those issues concerning the company's compliance with applicable state laws and regulations, or "practices-related" issues, as well. Typically, examples of practices-related issues include a company's marketing of its products, its underwriting of policies, or its handling of claims filed by policyholders.<sup>15</sup>

Three of the department's units examine the practices of insurance companies: the market conduct bureau, the investigations bureau, and the field rating and underwriting

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<sup>15</sup>Underwriting is the process of spreading financial risk among a pool of consumers in a manner that is equitable for the consumer and profitable for the insurance company.

bureau. The market conduct bureau examines the marketing, underwriting, and claims practices for most companies.<sup>16</sup> The investigations bureau, which began conducting examinations in fiscal year 1996-97, evaluates companies to determine whether they comply with specific statutory requirements, including the California Insurance Code, Unfair Claims Settlement Practices Regulations, and other legal requirements and industry practices. The field rating and underwriting bureau examines the rating and underwriting practices of property and casualty insurance companies.

***The Department Does Not Meet  
Requirements To Examine the  
Practices of All Insurance Companies***

—◆—  
*An examination of each  
insurance company's  
practices is not completed  
every five years.*  
—◆—

The procedures that the market conduct, investigations, and field rating and underwriting bureaus use to select the insurance companies that each bureau will examine do not ensure that the department examines the practices of each company at least once every five years. For example, rather than selecting each company for examination at least once every five years, the market conduct, investigations, and field rating and underwriting bureaus choose insurance companies according to patterns of complaints received by the department. Further, the field rating and underwriting bureau selects only those property and casualty insurance companies with annual written premiums of more than \$5 million. According to its chief, the market conduct bureau completes approximately 50 to 60 examinations per year. If the market conduct bureau completed 60 examinations per year over five years, it would complete only 300 examinations of the more than 1,400 insurance companies subject to its review. Similarly, according to the chief investigator, the investigations bureau plans to examine 60 insurance companies during fiscal year 1996-97. If the investigations bureau were to conduct 60 examinations per year over five years, it too would complete only 300 examinations of the approximately 1,400 companies subject to its review. Finally, because of the department's \$5 million minimum threshold for property and casualty insurance companies, approximately 384 of these companies are not subject to examinations by the field rating and underwriting bureau.

Therefore, the methods these bureaus use to select insurance companies for examination do not guarantee that the

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<sup>16</sup>The market conduct bureau does not examine insurance companies that write workers' compensation coverage only.

department will examine the practices of all insurance companies at least once every five years as required and thus increase the potential that unfair insurance practices will go undetected and cause continuing harm to insurance consumers. According to the chief deputy insurance commissioner, these bureaus presently use selection methods that restrict the number and types of insurance companies they examine because it is not an industry standard to examine the practices of all insurance companies every five years and the National Association of Insurance Commissioners does not require such periodic examinations.

***The Department Does Not  
Comply With the Code's Requirements  
for Several Reasons***

The department has several reasons for not examining at least once every five years the practices of all applicable insurance companies admitted to do business in the State. First, the department does not believe the code requires it to do so. Specifically, the department does not interpret Section 729 et seq. of the code as we do; it believes these sections emphasize examination of the financial solvency of companies while *allowing* the department to perform examinations of a company's practices. The department believes that the intent of these code sections was not to direct the department to examine the practices of each admitted company every five years.

◆  
*The department does not believe statutes require insurance company practice examinations every five years.*

◆  
Not only do we take issue with the department's arguments, but California's appeals court appears to disagree with them as well. In its decision concerning *National Association of Independent Insurers et al. v. John Garamendi* (July 1995), the Third District Court of Appeal of the State of California (court) made several statements that conflict with the department's beliefs. Specifically, following a fundamental rule of statutory construction, the court stated that, when disputes concerning legislative intent exist, the court "must assume the Legislature knew what it was saying and meant what it said." This statement strongly implies that if the Legislature had intended the department to examine only the financial solvency of insurance companies every five years, the Legislature would have said so. In addition, after the court determined that the code did not define the term "examination" or the phrase "business and affairs," the court concluded that "an examination of business and affairs is a broad, comprehensive review of an insurer's activities." This statement confirms that an examination needs to go beyond an evaluation of financial solvency. Finally, the court stated that although the department

has the discretion to determine *when it should conduct* an examination, the department must perform a *comprehensive* review of *all* of a company's affairs and determine, as part of that review, whether the company has complied with all applicable laws. Because of these statements by the court, we conclude that existing law requires the department to conduct at least once every five years a comprehensive examination, covering both financial solvency and practices, of every applicable insurance company admitted in the State.

◆  
The department also believes some insurance company examinations would provide little benefit.

The second reason the department does not examine the practices of all applicable insurance companies at least once every five years is that the department believes that such an effort would not use its resources productively. Specifically, the department stated that the lack of consumer complaints against a large number of companies indicates that regular examinations of the companies' practices would be a pointless exercise and an imprudent use of resources. We acknowledge that insurance consumers would receive little or no relative benefit from regular examinations of some companies. For example, the department's list of 384 property and casualty companies that do business in the State and have less than \$5 million in written premiums shows that 153 had no annual premiums during 1995. Obviously, California's insurance consumers would receive little or no benefit if the department were to examine the practices of these companies regularly. However, this same list shows 96 companies that had written premiums from \$1 million to \$5 million. California consumers may receive some benefit from the department's periodic examination of these companies.

The third reason the department offered for not examining all insurance companies every five years is that the department does not have the resources to meet the code's requirements as we interpret them. The department estimates that, to perform a regular review of every company would require departmental staffing levels perhaps nine or ten times higher than it currently maintains. We do not dispute the department's assertion that the department would need significant additional resources.

We believe that existing law regarding examinations of insurance companies is too broad. Specifically, examinations of some companies would not improve consumer protection and would not provide sufficient return for the department's costs. At the same time, we also believe that the department cannot choose administratively *not* to follow a law. Therefore, we would expect the department to attempt to have the law amended or to comply with the law.

***The Department May Not Accept  
on Schedule All Examination Reports  
for Foreign or Alien Insurance Companies***

The current pace held by the department's field examination division indicates that the department will examine the financial solvency of those insurance companies domiciled in California within the mandated five-year time frame. However, we question whether the department will, within the mandated time frame, review and accept examination reports for foreign or alien insurance companies.

As noted earlier, Section 730 of the code allows the department, instead of performing its own examinations, to accept examination reports completed by other states on foreign or alien insurance companies. Upon receiving such an examination report, the financial analysis division analyzes the report's results to determine whether they disclose any regulatory actions or adjustments to a company's financial statements of which the department needs to be aware. The analysis includes the completion of a spreadsheet summarizing the financial condition of the company.

◆  
*At its current pace, the department will not review and accept solvency reports for all of the 358 remaining companies by the December 31, 1997, deadline.*

◆  
As of December 1996, department records show that the department had not reviewed and accepted the examination reports for 358 (31 percent) of 1,164 foreign or alien insurance companies during the four years from January 1, 1993, through December 31, 1996. At its current pace of reviewing and accepting approximately 195 examination reports per year, the department will not be able to review and accept examination reports for all of the remaining 358 companies by December 31, 1997. In fact, at its current pace, it will not review and accept all reports due until October 1998, 10 months after the end of the five-year period. Because the code states that the department can accept examination reports in lieu of examining foreign or alien insurance companies, the department will incur unnecessary costs if it must examine these companies itself rather than accepting the examination reports within the time frame. For 234 of the companies, the department has not reviewed and accepted the examination reports because the reports were not yet available. In these instances, the department will have to contact the departments of insurance in other states to determine whether the examination reports will be available in time for the department to meet its goal. For the remaining 124 companies, although the examination reports were available to it, the department had not yet reviewed and accepted them.

### ***The Financial Analysis Division Is Unable To Complete Its Workload on Time***

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Like the market conduct, field rating and underwriting, and investigations bureaus, the department's financial analysis division (FAD) examines insurance companies operating in California. In addition to reviewing examination reports on foreign and alien insurance companies at least once every five years, the FAD evaluates quarterly and annual financial statements submitted by all companies admitted in the State. The FAD's mission is to ensure that consumers are protected against the financial instability of companies, to monitor continuously the financial condition of the companies and promptly identify those heading towards insolvency, to recommend corrective or regulatory action when necessary to ensure the solvency of companies, and to minimize the financial impact of insolvent companies. The FAD monitors financial stability by conducting "desk" examinations that include, but are not limited to, analyzing financial statements and identifying companies with unacceptable financial ratios, prioritizing companies based on the severity of adverse trends in their financial reports, and tracking companies designated for increased attention or regulatory action.

—◆—  
*Annual financial reviews  
for 1995 were late and for  
1996 also appear in  
danger of missing the  
deadlines.*  
—◆—

The FAD has not completed its reviews of all annual financial statements within the one-year deadline. Section 900 of the code requires each insurance company doing business in the State to submit to the department its annual financial statement by March 1. Departmental policy requires FAD staff to complete an examination of annual statements for all domestic companies by the end of each summer and for foreign and alien companies by March 1 of the following year. However, our analysis of the FAD's existing workload disclosed that, as of January 1997, the FAD had not yet completed its reviews of the annual financial statements from 76 of the 1,629 companies for which the FAD should have completed reviews by March 1, 1996. Furthermore, the FAD had a potential backlog of 212 reviews of annual financial statements that the FAD was to complete by March 1, 1997.

Because it did not promptly complete its reviews of the 1995 annual financial statements and is in danger of not finishing its reviews of the 1996 annual financial statements, the FAD cannot confirm that it promptly detects insurance companies approaching insolvency. Insolvent companies can ultimately impact thousands of California's policyholders. Further, when it does not promptly complete its reviews of all financial statements, the FAD has no assurance that it will identify troubled companies early enough to correct problems and to prevent or minimize insolvencies. For example, the FAD's

identification of companies with large losses has allowed the department to mitigate problems by taking steps such as ordering companies to stop or to limit operations.

According to the division chief, the FAD did not promptly complete its reviews of the December 31, 1994, annual financial statements and is in danger of not completing its reviews of the December 31, 1995, annual financial statements because it does not have sufficient resources. In an effort to manage its existing workload, the FAD has submitted several requests for additional staffing. For example, during fiscal year 1994-95, the FAD submitted two requests for additional staff that were not approved. In explaining its diminished productivity during fiscal year 1996-97, the FAD identified several staffing issues, including the loss of six analysts and five support staff, and the need to retrain six professional staff who transferred from another unit. Because we have not evaluated the efficiency or effectiveness of the FAD's operations, we have not determined the level of staffing that it needs to complete its work within mandated timelines.

### ***The Investigations Bureau Must Improve Some Procedures and Practices***

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Our review of the practices, policies, and procedures of the department's investigations bureau (bureau) disclosed inadequacies that lead us to question the bureau's ability to achieve its mission successfully. The essential elements of an effective investigations bureau include, among other things, established policies and procedures to govern the intake of potential investigations, properly allocated resources based on established priorities, and staffing levels maintained at a level commensurate with workload.

The bureau, within the Enforcement Branch, works under Section 12921.3 of the code and is one of the department's units that receives and investigates complaints. The bureau's mission is to protect the public by investigating misconduct by insurance companies, agents, and brokers, particularly misconduct that substantially endangers the public through falsified insurance coverage or theft of premiums. The bureau receives requests for investigations from various sources, including consumers, insurance companies, agents, brokers, and information developed within the department.

To help control its workload, the bureau centralizes in its intake unit the receipt of requests for investigations. The intake unit evaluates these requests and determines whether the bureau should initiate an investigation or obtain additional information.

The intake unit also screens out requests that are beyond its jurisdiction or have no basis for investigation. After receiving sufficient information, the intake unit opens an investigation and assigns a priority code. The bureau uses a six-level ranking system to prioritize investigations; "priority one" represents those investigations the bureau considers the most critical, and "priority six" represents the least critical. After determining available resources, the bureau then assigns the investigation to its staff. Once it has sufficient evidence that a violation occurred, the bureau reports the facts and evidence to the legal division within the department for administrative action and to other entities such as district attorneys for prosecution.

Although the bureau's intake unit has written procedures that describe the steps necessary to open an investigation, the procedures do not specifically address what the bureau requires, at a minimum, to determine whether a complaint warrants investigation. For example, the bureau lacks specific guidance for determining whether sufficient supporting information is available and justifies the bureau's investigating the complaint. Without adequate intake guidance, the department may make inappropriate decisions about which complaints to accept for investigation.

***The Investigations Bureau Does Not Always Promptly Assign Or Investigate Higher-Priority Cases***

—◆—  
*The bureau assigns some of its lower-priority work before higher-priority investigations are opened.*  
—◆—

The bureau does not assign all higher-priority investigations to its investigators before it assigns lower-priority investigations. As shown in Table 3, 122 of the 170 cases given the most critical priority code were open and unassigned for 25 months or more, yet the bureau had already assigned to investigators cases considered less critical. Specifically, during the six months prior to October 31, 1996, only 84 percent of the cases assigned to investigators had priority codes 1 or 2.

**Table 3****Assignment Status of Open Investigations  
as of October 31, 1996**

<b>Assigned After Intake</b>	<b>Priority 1</b>	<b>Priority 2</b>	<b>Priority 3</b>	<b>Priority 4</b>	<b>Priority 5</b>	<b>Priority 6</b>	<b>Total</b>
0-6 months	332	304	58	49	15	0	758
7-12 months	108	75	37	35	15	4	274
13-18 months	93	17	38	16	21	2	187
19-24 months	83	5	17	95	16	1	217
25 months or more	314	67	192	312	81	5	971
<b>Subtotal</b>	<b>930</b>	<b>468</b>	<b>342</b>	<b>507</b>	<b>148</b>	<b>12</b>	<b>2,407</b>
<b>Unassigned After Intake</b>	<b>Priority 1</b>	<b>Priority 2</b>	<b>Priority 3</b>	<b>Priority 4</b>	<b>Priority 5</b>	<b>Priority 6</b>	<b>Total</b>
0-6 months	24	71	17	58	92	3	265
7-12 months	13	129	9	23	77	20	271
13-18 months	6	2	14	42	79	16	159
19-24 months	5	2	16	43	68	11	145
25 months or more	122	31	255	417	915	66	1,806
<b>Subtotal</b>	<b>170</b>	<b>235</b>	<b>311</b>	<b>583</b>	<b>1,231</b>	<b>116</b>	<b>2,646</b>
<b>Total</b>	<b>1,100</b>	<b>703</b>	<b>653</b>	<b>1,090</b>	<b>1,379</b>	<b>128</b>	<b>5,053</b>
<b>Percentage of Unassigned Investigations</b>	<b>15.5</b>	<b>33.4</b>	<b>47.6</b>	<b>53.5</b>	<b>89.3</b>	<b>90.6</b>	<b>52.4</b>

Source: Investigations Bureau's Case Age Report as of October 31, 1996.

According to its chief investigator, the bureau has had several reasons for not assigning all higher-priority cases before lower-priority cases. For instance, caseload guidelines limit the number of higher-priority cases that the bureau may assign to an investigator. Also, the bureau assigned some lower-priority cases to its investigators because these cases were related to ongoing higher-priority investigations. In addition, gaps in higher-priority work are filled by less time-consuming, lower-priority work. Further, a portion of the bureau's workload involves background investigations for applications for certificates of authority. Although it codes this work as lower priority, the bureau assigns it to staff immediately because the applications have specific deadlines. Finally, the bureau attempts to maintain a regulatory presence in all facets of the insurance industry, even those involving lower-priority investigations.

Like the financial analysis division, the bureau has requested funding for additional staff to deal with the backlog of investigative cases. For example, for fiscal year 1995-96, the bureau requested 11 investigative and 2 supervisory positions but withdrew the request because of the fiscal problems described in Chapter 1. We have not assessed the efficiency or effectiveness of the bureau's operations. Therefore, we have not determined the level of staffing that it needs to complete its work.

Despite the reasonableness of the department's explanations for its assignment decisions, we have concerns about the impact of not assigning all higher-priority cases promptly. First, delays in investigating higher-priority cases place the public at more risk than delays in investigating other cases. For example, according to the bureau's system for prioritizing investigations, higher-priority investigations include cases that may expose the public to significant risk of loss, such as a company's transacting insurance business in the State without a certificate of authority. Second, delays in investigating complaints create the potential for loss of key evidence. The longer the bureau waits to contact witnesses and to gather corroborating evidence, the greater the chance that the witness or supporting evidence will be difficult to locate. Finally, if the bureau fails to complete higher-priority investigations promptly, it risks losing the public's confidence in its ability to protect consumers from unethical insurance companies, agents, and brokers.

### ***The Bureau Now Has Additional Responsibilities Despite Its Existing Backlog of Cases***

—◆—  
*To avoid layoffs of staff, the department directed the investigations bureau to complete 14,700 hours of reimbursable work.*  
—◆—

Despite its current backlog of investigations, the department has chosen to expand the bureau's existing responsibilities. Specifically, beginning in fiscal year 1996-97, the department's executive management directed the bureau to devote 14,700 hours, or about 19 percent of its available investigator staff hours, to examining insurance companies rather than to investigating them. The department's executive management issued this directive so that the bureau could avoid laying off staff by generating revenue from examinations that the bureau ordinarily would not receive.<sup>17</sup> According to the department's chief deputy commissioner, the scope of these examinations is to determine whether companies are "in compliance with specific California Insurance Code statutes and if their policies

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<sup>17</sup>Normally, moneys from the fees and licenses revenue stream cover the bureau's costs. By conducting examinations and billing insurance companies for the hours it spends doing so, the bureau reduces the amount of funds it needs from the fees and licenses revenue stream to support its operations.

and procedures are established so as to secure and maintain that compliance." The bureau has had the authority to conduct these examinations of insurance companies; however, according to the deputy commissioner for enforcement, the bureau has not done so in the past because of the large caseload of higher-priority investigations.

To ensure that it meets the 14,700-hour goal, the bureau has delayed investigations in progress and those pending, and it is concentrating its efforts on conducting examinations. This additional responsibility further challenges the bureau's efforts by requiring existing staff to concentrate their efforts not only on conducting their routine investigations but also on examining insurance companies.

—◆—  
*Expanding the bureau's responsibilities will increase the backlog of investigations.*  
—◆—

The department's executive management acknowledges that expanding the bureau's responsibilities will result in an increase in the overall backlog of investigations. The chief deputy commissioner stated that the department plans to deal with the bureau's backlog of investigations by reviewing the bureau's priorities and the available investigative staff. The department intends to match available resources to the pending investigations that have the highest priority.

### ***Weaknesses Exist in the Department's System for Evaluating Requested Rate Adjustments***

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To assist in its review of requests by companies to change their insurance rates, the department's Rate Regulation Division (division) uses a computer-generated model, or "template," to analyze data. We obtained the services of actuarial consultants to evaluate the validity and reliability of the template. Although they concluded that the template does what the department intends it to do, our consultants identified weaknesses in the template that limit its usefulness. Further, we found that the department is not consistent in documenting reasons why it has not followed the results of the templates.

### ***Background***

Section 1861.05(a) of the code states that no insurance rate shall be approved or remain in effect that is excessive, inadequate, or unfairly discriminatory. Section 1861.05(b) of the code requires insurance companies wanting to change the rates they charge to file a complete rate application with the department. The division is responsible for reviewing all

requests for changes in rates. Section 2648.2(b) of the California Code of Regulations (regulations) requires the department to review rate applications for completeness within 14 days of receipt. If the application is complete, the department assigns the application to staff for further review. Section 2648.2(f) of the regulations requires the department to notify the public of any rate application within 10 days after it determines that an application is complete. Section 1861.05(c) of the code establishes deadlines for the department's decisions on rate applications or the changes are deemed approved. Depending on the circumstances, these deadlines are 60 days after public notice or 180 days after the department receives the rate application.

Our review of 14 rate-change requests disclosed that, in these instances, the division reviewed rate applications for completeness within 14 days of receipt, issued a public notice within 10 days after it determined that an application was complete, and processed the applications before the expiration of the required 60-day period.

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*The Rate Regulation Division uses a template to evaluate requests for rate changes.*

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One part of the division's review process involves checking the accuracy and reasonableness of the data contained in the request. To check the data, the division uses an automated template. Generally, the staff will run two templates, one based on the specific company's data and the other on industrywide data, and each template calculates a minimum and maximum allowable rate change.

The division's procedures manual indicates that, if the proposed rate change falls within the minimum and maximum allowable percentage change, the analyst may conclude that the proposed rate is fair and reasonable. The manual also indicates that, if the proposed rate change falls outside the range, staff may conduct further analysis to determine what variable is causing the rate of return to exceed or fall short of the allowable range. Using the template's parameters and other alternative analyses, the analyst then recommends approval or disapproval of the rate-change request. Depending on the nature of the request, additional levels of review may include the senior analyst, bureau chief, actuary, division chief, and the deputy commissioner.

### ***The Rate Assessment Template Has Limitations***

According to our consultant, the template is a variation of a standard rate-making template used by insurance companies and others to estimate requirements for rate levels. With certain

reservations, our consultant concluded that the template does what the department expects it to do; that is, the template provides a range of percentages that reflects reasonable changes in the rates. Further, the template works well for those companies that have relatively stable amounts and types of business and that do not pay out on any catastrophic events. Nonetheless, our consultant had the following concerns about the template:

  
*The template may result in "distortions" under some circumstances.*  


- **The template does not work well in all situations.** Specifically, the template does not work as well for lines of insurance that are unusual or volatile, such as fidelity and surety insurance, or for those companies that experience relatively large variations in their business writings, such as variations caused by a change in marketing to focus on a different class of insurance. In these instances, the use of the template results in a distorted range of allowable rate changes because the template does not adjust for prospective changes in the companies' business writings. Further, the template uses just 3 years of data. Because single "events" can have dramatic effects on a company's losses and expenses, the department's use of only 3 years' data can skew the template's results. For example, earthquake insurance is a very volatile line in which 20 years of data is more appropriate for review rather than the 3 years allowed in the template. Huge fluctuations in rates would occur if the division were to rely solely on 3 years of data for years in which earthquake activity took place.
- **The template does not distinguish between rates charged within the same line of insurance.** For example, the template lumps "basic" rates and "bumped" rates together; that is, it consolidates within the same line of insurance rates for different classes, territories, and limits. This practice may lead to a distorted range of allowable rate changes if a company changes the types of business writings it offers over time. For example, the template does not distinguish between the basic rate a company might charge a married, 35-year old female for one class of automobile liability and the higher, bumped rate it might charge a teenage boy for another class.
- **Adherence to the template's results may in fact reduce competition in classes and territories that require higher rates to be profitable.** For example, by comparing a company's data to industry-wide data, the department may not approve a rate request necessary for those companies

that write riskier classes of insurance or lines in areas of the State that have higher risks.

- **The template includes questionable amounts for a profit factor.** Specifically, the allowable rate of return for the template ranges from (-7) to (+15). According to our consultant, the range appears to be arbitrary and may be low in comparison to the range other states use for certain lines of insurance. Also, because the department applies this rate of return to all lines of insurance a company writes, the range appears inflexible because it does not account for different rates of return for different lines of insurance within a company. For example, a company would expect a larger return for riskier lines of business than for less risky lines of business.

  
*Additional analytical procedures are needed to compensate for weaknesses in the template.*  


The department acknowledges that for some lines of insurance, such as earthquake, surety, and inland marine, the template's results are not necessarily good indicators for determining the percent rate change to approve. Further, the department agrees that the template's results are not necessarily good measures when the division is reviewing a diverse mix of classes of insurance, such as classes of vehicles that include buses, motorcycles, or motor homes. According to the division's chief, for those instances when the template does not work particularly well, the division is to review all other available sources of information to assess the reasonableness of the rate-change request. Most commonly, this review includes analyzing industrywide data for the particular line or rating component in question and also evaluating data from specific companies writing similar lines. During our testing, we observed that the division practiced this review policy.

In our opinion, the template should generally result in a range that closely reflects an allowable rate change that is not excessive, inadequate, or unfairly discriminatory. As such, the results should provide a reliable benchmark for the division's analysts to use. When the department knows the template will not result in a reasonable range of rate changes, the division should amend the template so that the division can assess rate-change requests for which the standard template is not accurate. Given the division's acknowledgment of the template's limited usefulness, we believe it is reasonable to modify the template.

***The Division Has Inadequate Documentation To Support Some Rate Approvals***

To identify trends related to the division's use of the template, we analyzed 515 rate-change requests that the department received from February 1995 through December 1996. Our review of this information provided by the department disclosed that for 230 requests, the division approved rate changes that fell outside the range provided by the template when the division used industrywide data. Specifically, 110 approved changes fell below the minimum amount identified by the template, while 120 fell above the maximum amount. To assess the reasonableness of these approvals, we evaluated 13 of these rate-change requests.

  
*In some instances the department did not document its reasons for overruling the template's guidelines.*  


We found four instances in which the division did not adequately support or justify in the case file the rate that the division approved. Further, the deputy commissioner overruled the staff's recommendation to disapprove the rate-change request for one of the four cases. In this instance, the division approved the insurance company's request for a 4 percent rate increase for its automobile liability line even though the rate fell outside of the minimum and maximum range indicated by the template. When it applied industrywide data, the template showed that a decrease ranging from 30 to 22 percent was warranted. Using the company's data, the template indicated that only a one percent increase was permissible.

When asked why the request was approved at 4 percent when the results of the template indicated that either a rate decrease or a smaller increase was appropriate, management disclosed that the division considered other conditions, such as the credibility of the company's data and the company's investment income. In addition, further analysis by the department's actuary disclosed that the company completed a supporting exhibit incorrectly. Although the division's procedures require that any calculations completed in the process of evaluating rate-change applications be retained in the case file, the file did not include documentation to fully support the impact of the other conditions described by management. Similarly, in the remaining three cases, we found that the case files did not justify the rate approval adequately.

For internal management purposes and to protect itself adequately from potential litigation, the division should enforce its policy requiring staff to maintain properly all supporting documents used to determine the reasonableness of rate changes.

***The Department Shows  
Questionable Compliance With  
Budget Act Requirements***

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The department has not clearly complied with statutory restrictions in allocating reductions in staff. Specifically, the Budget Act of 1996 stated that it was "the intent of the Legislature that, insofar as possible, budget reductions shall not disproportionately impact the provision of consumer services" by the department. Although it did not define "consumer services," one can argue that the budget act refers to those units that respond directly to consumers, such as those that receive complaints against insurance companies, brokers, or agents. These units include the claims services bureau, the rating services bureau, the underwriting services bureau, the consumer communications bureau, the investigations bureau, and the consumer services division office.<sup>18</sup> During fiscal year 1995-96, all but the investigations bureau were within the Consumer Protection and Communication Branch.

  
*The department made  
70 percent of its staff  
reductions in units that  
respond directly to  
consumers.*

  
The department's budget documents indicate that, from fiscal year 1995-96 to fiscal year 1996-97, the department reduced the number of its positions from 1,115 to 1,040, eliminating a net total of 75 positions. For the units that respond directly to consumers, the department reduced the number of positions from 208 to 155. Therefore, of the 75 reductions, 53 came from these units. Stated another way, the department applied more than 70 percent of the reductions to these units, even though these units comprised only 19 percent of the department's total staff.

The department asserted that these position reductions were consistent with the budget act's language. The department vehemently takes the position that, because its principal objective is to protect insurance policyholders, all of its activities play a role in consumer protection and consumer services. Further, the department argued that consumer protection is not reserved only to those divisions with names that include the title "consumer services." Claiming that all of its activities provide services to consumers, the department concludes that there is no possibility of a disproportional impact on the provision of consumer services from reductions of staff within a particular group of units.

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<sup>18</sup>As of February 1997, the rating services bureau and the underwriting services bureau were combined into a single bureau.

Despite the department's conclusions, we question the reasonableness of its response. Although the budget act does not define consumer services, its authors clearly meant to distinguish between the department's consumer services activities and its other operations. If the department was confused about the intent of the budgetary language, it should have shown, at the very least, a good faith effort to seek clarification.

### ***The Department Has Not Complied With Some State Statutes***

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In addition to exhibiting the management problems described earlier, the department has failed in two instances to comply with state statutes.

### ***Judges Take Too Long To Issue Proposition 103 Rollback Decisions***

—◆—  
*Administrative law judges  
did not render some  
decisions within the  
30-day time limit.*  
—◆—

Under the provisions of Proposition 103, the department calculates the amount of the rate rollback each insurance company must implement. If a company objects to the department's calculation, it can have an administrative law judge (ALJ) decide the rollback amount. Section 11517(b) of the Government Code states that if an ALJ hears a case, the ALJ shall prepare a proposed decision within 30 days after the case is submitted.<sup>19</sup>

As we noted in the introduction, department records indicate that 254 companies were subject to the provisions of Proposition 103. Although the department reached agreements concerning the amount of the rate rollbacks with most of these companies before a hearing needed to be held, 17 companies have gone to a hearing. Department records indicate that attorneys have submitted 11 of the 17 cases to an ALJ. As of January 21, 1997, the ALJs had exceeded the 30-day time limit for 5 of the cases. The number of days late ranged from 28 to 212.

The ALJs did not comply with the 30-day time limit for a number of reasons. According to the presiding ALJ, these reasons include the fact that the ALJs' support staff were not familiar with this area of law, the cases were complex, the

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<sup>19</sup> According to a department staff counsel, a case is considered "submitted" when the ALJ and both parties agree that the ALJ has all evidence necessary to render a proposed decision.

volume of testimony and exhibits was large, and the issues presented by a number of cases were unique.

Delaying decisions beyond the 30 days allowed by law further postpones the return of rollback amounts to consumers. California voters enacted Proposition 103 in November 1988, more than eight years ago. Although some of the delays in implementing the rollback provisions from November 1988 through fiscal year 1994-95 were beyond the department's control because of lawsuits filed by insurance companies, delays in issuing ALJ decisions are within the department's control and, therefore, are unacceptable.

### ***The Department Has Not Solicited Consumer Feedback Appropriately***

Section 12921.4(a) of the California Insurance Code (code) requires the department to notify persons who file complaints against insurance companies of the final actions taken on the complaints. The section also requires the department to assure the validity of the results by including a complaint-handling evaluation form with each notice of final action, or, at a minimum, with a number of randomly selected final notices. Because this code section requires "random selection" and "valid" results, we believe the section mandates the department to use statistical sampling methods if the department does not include a form with each final notice. Statistical sampling methods include identification of the population size; identification of the sampling technique; selection of an appropriate sample size, including consideration of expected error, confidence level, and precision; and a strategy for evaluating results. In addition to producing valid results, the use of statistical sampling methods promotes efficiency by helping to prevent the selection of too many sample items.

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*The claims services bureau did not use statistical sampling methods to assure "random selection" and "valid" results in its complaint-handling evaluations.*

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The department's claims services bureau (CSB) is primarily responsible for responding to consumer complaints against insurance companies regarding claims. However, the CSB does not use statistical sampling methods to survey complainants. Instead, the CSB's policy is to send complaint-handling evaluation forms to 15 percent of complainants. Therefore, under its policy, the CSB should have sent out more than 3,100 complaint-handling forms for the nearly 21,000 complaints the CSB closed from July 1995 through October 1996. However, the CSB sent forms only to 329, or 1.6 percent of the total number of complaints.

Because the CSB did not use statistical sampling methods, the CSB has no assurance that the survey responses it receives provide it with valid results. Further, if the sample size is too large, the CSB may be spending unnecessary time evaluating survey responses.

### ***Conclusion***

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Our audit disclosed several critical issues indicating that the department needs to improve the management of some of its programs whose mission is to protect California's insurance consumers and regulate the insurance industry. For example, the California Insurance Code requires the department to examine all insurance companies for both solvency-related and practices-related issues at least once every five years. Although the department itself interprets the statutes as requiring it to examine insurance companies for solvency-related issues only, the department does not even ensure that it complies with this more limited expectation. As a result, the department increases the risk that unfair insurance practices will go undetected and cause continuing harm to insurance consumers.

Other critical issues include the inability of the investigations bureau and the financial audit division to keep up with their workloads. The investigations bureau's inability to complete all of its work results in this bureau's failure to assign all higher-priority investigative cases promptly. The financial analysis division's incapacity to complete its work causes reduced assurance that the department will detect insurance companies approaching insolvency early enough to correct problems or to prevent or reduce the effects of insolvencies.

We also observed that the department uses a template, or computer-based model, that does not work well for some lines of insurance when the department uses the template to evaluate requests to change insurance rates. The department also has not consistently documented its reasons for its decisions on rate-change requests.

Further, the department has not clearly complied with the language of the Budget Act of 1996, which requires the department to ensure that any budget cuts do not disproportionately affect the provision of consumer services.

Finally, we identified two instances in which the department did not comply with statutes. In one instance, the department contributed to unnecessary delays in returning

insurance premiums to consumers; in the other instance, the department's failure to use statistical sampling may lead to potentially misleading results from a survey.

## ***Recommendations***

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To enable the department to comply with the law and yet reasonably limit the number and scope of examinations for practice-related issues it conducts, the department should seek an amendment to Section 729 et seq. of the California Insurance Code. These sections presently require the department to examine at least once every five years the solvency and practices of every insurance company doing business in the State. If these sections are amended, to ensure that the department maximizes the protection of California's insurance-buying consumers, the department should assess objectively the methods it uses to select insurance companies for practices examinations. Such an assessment should include identifying and then considering various selection methods. The assessment should also include an evaluation of each method's costs and benefits to the department as well as the risks and rewards that California's insurance consumers will derive from the method. If it is unsuccessful in its attempt to change the law, the department should develop and implement a plan that will enable it to comply with the existing statutory language. If such a plan is necessary, the department should consider reviewing, during a single examination, each insurance company's solvency and practices.

Further, to avoid any additional costs that the department will incur if it examines foreign or alien insurance companies, the department should instead obtain, review, and accept the examination reports for all applicable insurance companies.

To make certain that it protects insurance consumers effectively, the department should do the following:

- Review the efficiency and effectiveness of the financial analysis division's reviews of annual financial statements for insurance companies and streamline the processes, if appropriate. The department should also determine and budget for the level of staffing needed to complete on time the financial analysis division's mandated activities using the streamlined process.
- Assess the adequacy of the investigations bureau's system for prioritizing and completing investigations of consumer complaints and streamline its processes, if appropriate. In

addition, the department should determine the level of staffing needed to complete the investigations bureau's work and consider raising fees listed in Section 12978 of the code to help cover costs if the investigations bureau needs additional staff.

To improve the usefulness of the results from the template it uses to evaluate requests to change insurance rates, the department should consider adjusting the template. Specifically, the department should consider taking the following actions:

- For those lines of insurance that are relatively volatile, develop and implement versions of the template that enable the template to review more than three years of data; and
- Consider using the template to take into account different classes, territories, and limits within the same lines of insurance.

To make certain that its staff considers all pertinent information when reviewing applications to change insurance rates, the Rate Regulation Division should enforce its requirement that analysts use either the original or adapted template for all applications to change rates.

Further, to ensure that it adequately documents the factors that lead to approval of requests for rate changes, the department should make sure that staff adds all supporting calculations and documents to the case files and then maintains the files properly.

When confronted with a statutory direction that it could construe in more than one way, the department should seek clarification from appropriate sources.

To prevent further delays in rollback payments authorized by the provisions of Proposition 103, the department should make certain that its administrative law judges render decisions within the statutory 30-day time limit.

To promote efficiency and to ensure that it solicits valid and reliable feedback about the department's performance from persons who file complaints against insurance companies, the department needs to develop and implement a statistical sampling method that identifies the size of the complainant population; identifies the sampling technique; determines the appropriate sample size, including the consideration of expected error, confidence levels, and precision; and sets forth a plan for evaluating the results.

We conducted this review under the authority vested in the state auditor by Section 8543 et seq. of the California Government Code and according to generally accepted governmental auditing standards. We limited our review to those areas specified in the audit scope of this report.

Respectfully submitted,



KURT R. SJOBORG  
State Auditor

Date: March 13, 1997

Staff: Lois Benson, CPA, Audit Principal  
Dale A. Carlson, CGFM  
Aaron L. Bolin  
Christiana Mbome  
Phyllis Miller, CPA  
Tone Staten, CPA  
Ken L. Willis

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# *Appendix A*

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## *Principal Branches and Divisions of the Department of Insurance*

**A**s of February 1997, the Department of Insurance (department) was organized into eight main branches or divisions.

### ***The Financial Surveillance Branch***

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The largest units within the Financial Surveillance Branch are the financial analysis division and field examination division. These two divisions are responsible for ensuring the solvency of insurance companies. The financial analysis division maintains ongoing surveillance of companies to identify those in or approaching a weak financial condition. To accomplish this task, the financial analysis division reviews quarterly and annual financial statements filed by the companies. Further, according to the department's chief deputy commissioner, the financial analysis division also reviews examination reports covering companies that are not domiciled in California. The field examination division conducts field audits of companies admitted or seeking admission to California to determine their financial condition and methods of operation. The purpose of the examinations is to protect California citizens against losses from insolvency of the companies and to determine that companies are fair and just in claims payments and treatment of policyholders.

### ***The Consumer Services and Communications Branch***

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The department's Consumer Services and Communications Branch consists of five bureaus: claims services, rating and underwriting services, market conduct, field rating and underwriting, and consumer communications. This branch investigates consumer complaints regarding the practices of insurance companies, and it examines companies to determine whether their practices violate California laws and regulations. The claims services bureau investigates and resolves complaints of unfair claims practices. The rating and underwriting services bureau investigates and resolves underwriting complaints and

rate complaints involving automobile, life, disability, workers' compensation, and property and casualty lines of insurance. It also handles requests for assistance that do not involve claims. The market conduct bureau evaluates a company's compliance with statutes and regulations concerning the business of insurance. The field rating and underwriting bureau enforces statutes and regulations through on-site examinations and special investigations of the rating and underwriting practices of property and casualty companies earning more than \$5 million in annual premiums. The consumer communications bureau responds to telephone inquiries covering the full range of insurance-related problems. Callers using the department's toll-free telephone number reach the consumer communications bureau.

### ***The Fraud Branch***

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The Fraud Branch reviews suspected fraudulent insurance claims. When it confirms a violation, this branch reports violators to the insurance company, the appropriate licensing organization, and the district attorney of the county where the violation occurred. The branch also maintains the Automobile Insurance Claims Depository, which is a computer database that stores information from two national insurance claims databases and from other claims information received by the branch.

### ***The Enforcement Branch***

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The Enforcement Branch consists of three units: the investigations bureau, the licensing bureau, and the conservation and liquidation office. The investigations bureau investigates alleged violations of law by agents, brokers, insurance companies, and others. It also provides investigative services as requested by other units within the department. The licensing bureau is responsible for determining the qualifications and eligibility of applicants for brokers and agents licenses. It also maintains records of licenses issued and administers tests for obtaining licenses. Pursuant to court appointment and approval, the conservation and liquidation office operates, rehabilitates, and liquidates insurance companies that are in hazardous financial condition or a state of insolvency.

### ***The Rate Regulation Division***

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The Rate Regulation Division is responsible for administering California's rating laws.<sup>20</sup> In addition, its staff is responsible for calculating the rollback liabilities of insurance companies and for reviewing and analyzing requests from insurance companies to change their rates subject to Proposition 103.

### ***The Legal Division***

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The Legal Division consists of four bureaus: rate enforcement, corporate affairs, compliance, and policy approval. The rate enforcement bureau is responsible for implementing the ratings laws enacted as part of Proposition 103, and it also represents the department in hearings for rate rollbacks and in prosecuting enforcement actions related to the rating and underwriting practices of insurance companies. The responsibilities of the corporate affairs bureau include reviewing and processing applications for certificates of authority, enforcing California's insurance laws against those who are not authorized to practice in the State, and participating in the monitoring of insurance companies that are experiencing financial or operational difficulties. The compliance bureau reviews and takes action on complaints alleging statutory violation by licensed and unlicensed companies, agents, and brokers. The Legal Division's policy approval bureau develops regulations and policies pertaining to the design of disability, life, and workers' compensation insurance products, and it enforces the statutes and regulations related to the provision of these products.

### ***The Policy, Research, and Special Projects Division***

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The Policy, Research, and Special Projects Division encompasses three bureaus: legislation and program implementation, policy research, and statistical analysis. The legislation and program implementation bureau analyzes proposed legislation pertinent to the department and represents the department in the legislative process. The policy research bureau develops topics, ideas, and programs of particular interest to the insurance commissioner. The statistical analysis bureau designs and conducts various data analyses for the department's collecting and compiling data for

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<sup>20</sup>"Rating" is the valuation of the risk of an individual or organization.

research projects and statistical reports. This bureau is also responsible for conducting rate comparison studies mandated by Proposition 103.

***The Administration Branch***

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The Administration Branch is responsible for the general management of the department's offices as well as for the department's administrative services, information technology, business services, personnel, labor relations, budgeting, training, accounting, and internal audits.

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# *Appendix B*

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## *Recent External Reviews of the Department of Insurance*

Since 1994, different organizations have reviewed many activities of the Department of Insurance (department) and have made recommendations for improvement.

### *Recent Reviews by the Bureau of State Audits*

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In April 1994, we issued a report describing the results of our review of the department's calculation of Proposition 103 assessments and examination rates and of our analysis of its revenues and expenditures. Our report disclosed that the fees the department assessed for Proposition 103 were not based on actual costs. The department agreed with our conclusion and stated that it would implement changes in its accounting system to correct the problems in its cost allocation process.

In April 1994, our office also issued a report that described the department's performance in implementing, administering, and planning for the termination of the California Residential Earthquake Recovery Program. The report stated that, despite the department's lack of enforcement authority and program stability, the department accomplished the fundamental purpose of the legislation. The department agreed with this conclusion but disagreed with specific statements, findings, and conclusions included in the audit report.

In May 1994, our office issued a report that analyzed the effectiveness and efficiency of the department's Conservation and Liquidation Division. Among other issues it presented, this report disclosed that the Conservation and Liquidation Division did not properly manage its consultant and legal contracts. With few exceptions, the department concurred with our conclusions and recommendations.

We issued a follow-up audit report in January 1996 that described our evaluation of the department's implementation of the recommendations from the April 1994 audit report regarding the department's calculation of Proposition 103 assessments and examination rates. We concluded that, although the calculation of the Proposition 103 assessments was

generally accurate, the examination rates were inaccurate. We also concluded that, if the department did not correct these rates, the department would understate its billings for fiscal year 1995-96 by \$1.6 million. The department agreed with the information and stated that it had made major system improvements. It also acknowledged that additional refinements were needed in the process by which it established examination rates.

While conducting fieldwork related to the issues covered in our present report, we examined the department's implementation of the eight recommendations from our January 1996 report. The department has implemented or is in the process of implementing all eight recommendations, including our suggestion that the department revise its rates to cover its examination expenses for fiscal year 1995-96.

In April 1996, we issued a follow-up report that reviewed the operations of the department's conservation and liquidation office (CLO).<sup>21</sup> In this report, we assessed the effectiveness of the corrective actions taken or planned regarding the recommendations from our May 1994 audit. This report concluded that, although the CLO had developed a strategy and management plans for the conservation and liquidation of conserved insurance companies, it had achieved only limited success in distributing the assets of liquidated companies and closing their estates. The department generally concurred with the findings and recommendations in our report.

During the fieldwork for the issues covered in our present report, we also examined the department's implementation of the 13 recommendations from our April 1996 report. Our analysis indicates that the department has implemented or is currently implementing 12 of the 13 recommendations. The remaining recommendation is still at the department's legal division for review.

### ***Recent Reviews by the Department of Finance***

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Within the past year, the Department of Finance (DOF) has issued two reports covering different aspects of the department's fiscal operations. The DOF conducted these reviews at the request of the department. In March 1996, the DOF reported the results of a study and evaluation of the department's overall internal control structure. In this report, the DOF identified

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<sup>21</sup>The department renamed this unit since our May 1994 report.

material weaknesses within the department's internal control structure and concluded that the department's financial statements were "virtually unauditible." The DOF issued 84 recommendations in its report. In the department's response to the report, the department's deputy commissioner for administration stated that the department will implement the recommendations from this examination as soon as practicable.

In November 1996, the DOF issued a report covering its review of the fiscal operations of the department's workers' compensation fraud program. In part, this report identified material weaknesses in the distribution and allocation of expenditures charged to the various fraud programs and in the internal accounting controls within both the Fraud Branch and the department. The DOF made 11 recommendations for improving the department's operations. The department generally agreed with the findings.

### ***Recent Reviews by Consultants***

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Since mid-1996, the consulting firm of KPMG Peat Marwick LLP (KPMG) and consultants from California State University, Sacramento, have reviewed and reported on three areas of the department. In a report issued in July 1996, KPMG provided a strategic assessment of the department's field operations to help refocus the department's mission, reshape its organization, and improve how the department serves the State of California. KPMG included 25 recommendations in this report. According to the deputy commissioner of the Enforcement Branch, the department has implemented or is currently implementing all of these recommendations.

In conjunction with the California State University, Sacramento, Center for Management Services, KPMG also conducted a review of the organizational structure and operating processes used within the department's Legal Division. KPMG issued its report in October 1996. KPMG concluded that various internal and external constraints have restricted further improvement in the Legal Division. Additionally, the Legal Division's units have multiple work sources and tasks that allow opportunities for staff interruptions because the units lack centralized reception, tracking, prioritization, monitoring, and reporting. The department plans to implement all 31 recommendations from this report.

Further, in November 1996, a consultant from California State University, Sacramento, issued a report that assessed the current operations of the department's Legal Division and developed recommendations for strategies the Legal Division could use to

serve its constituents effectively and efficiently. In addition to other issues it discussed, the consultant's report concluded that some adjustments in the Legal Division's work processes could create efficiencies in providing mission-related services. The department plans to implement in the future all of the recommendations from this report.

Also in November 1996, KPMG issued its report reviewing the case management system and processes within the department's Fraud Branch. In addition to other issues it presented, the KPMG report disclosed that the Fraud Branch's use of teams dedicated to investigating automobile, workers' compensation, or special operations fraud was inflexible and did not take full advantage of resources. According to the department's chief deputy commissioner, the department has implemented or is currently implementing all 107 recommendations in the recent KPMG report.



**CHUCK QUACKENBUSH**  
INSURANCE COMMISSIONER

March 6, 1997

Mr. Kurt Sjoberg  
State Auditor  
Bureau of State Audits  
660 J Street, Suite 300  
Sacramento, CA 95814

Dear Mr. Sjoberg:

As requested by your staff, the California Department of Insurance (Department) is pleased to provide this response to your review of the Department's operations. The Department's response to specific recommendations is included in the attachment to this letter. While we generally concur with the recommendations as stated in the report, we must also respond to certain specific findings with information which will explain what action we may or may not have taken with respect to the findings.

**CHAPTER ONE FINDINGS**

It is evident from the Bureau of State Audits report that one of their major concerns is the financial management of the Department. This too has been a major concern of Commissioner Quackenbush throughout his first two years in office. Indeed, at least nine of the twelve issues in Chapter One can be traced directly to severe and chronic structural deficiencies in the Department's fiscal management as far back as 1991. A review of two audits performed by the State Controller--one in 1991, the other in 1993--reveals that not only were these same issues present at that time, but that they were ignored and even allowed to deteriorate further (from 1992 through 1994 the Department's administrative staff was reduced, and there was no successful effort to respond to the Controller's findings).

In June of 1995, as the Department was closing its books on the 1994/1995 fiscal year, Commissioner Quackenbush became so concerned about the Department's fiscal condition that he requested an urgent review by the audit bureau of the Department of Finance. This emergency audit revealed critical problems which would demand a major, concerted effort to remedy; the audit urgently recommended an increase in staffing levels combined with increased expertise and management oversight. Given the complexities and severity of the issues, and the constraints of the civil service system, the Commissioner initiated a plan which was intended to stabilize the Department's fiscal operations within two years. The Department is in the process of addressing this objective and several operating components are being implemented.

Therefore, we feel it is fair to note that the majority of the issues identified by the Bureau of State Audits are long-standing problems which have been recognized by the Department and are properly being addressed. We are extremely confident of this fact, and we would welcome a follow-up review within a reasonable period of time.

More specifically, the following steps have been taken which are pertinent to the findings of the Bureau of State Audits:

- Two audits by the Department of Finance were requested by the Department (includes the one mentioned above and another to review the handling of Workers Compensation Fraud Assessment funds).
- In 1995, the Department commenced the consolidation of the accounting staff to Sacramento, eventually creating a turn-over in personnel of almost 100%.
- For the FY 1996/97 budget, which was the first budget cycle whereby Commissioner Quackenbush had the opportunity to plan staff utilization priorities from start to finish, the Department added staff resources to address previous audit findings.
- The Commissioner brought in new management over the Administration Branch, and insisted that the new Deputy Commissioner have an extensive background in state government systems and financial management. Further, a Financial Planning division has been created, and a new manager with specific skills has been hired to assist in the management of the Department's fiscal affairs. This new division brings together under one supervisor all of the functions associated with revenue analysis, and expenditure monitoring and control.
- To address many additional operational and structural deficiencies throughout the Department, the consulting firm KPMG Peat Marwick was retained in the fall of 1995. The recommendations of this report have provided a blue-print for significant streamlining of the Department's operations, and contributed significantly to the Department's ability to absorb an abrupt \$21 million reduction in resources.
- The new Deputy Commissioner of Administration reprioritized spending to ensure that funds were available to complete the implementation of the new and critical accounts receivable and revenue accounting system.
- The Department has implemented an extensive budget tracking and monitoring system to ensure that funds are spent appropriately and that revenues are generated sufficiently.

In summary, during his first two years in office Commissioner Quackenbush has established the staff, system, and processes to address successfully the serious deficiencies which have been languishing in the Department since at least 1991.

Following are more detailed responses to the specific findings.

*The Department Does Not Fully Use Its Budgets as Management Tools*  
*The Department Has a Potential Shortfall in Examination Fee Revenues*

The Department acknowledges that budget information for Fiscal Years 1995/96 and 1996/97 was not communicated to managers on a timely basis. However, there were extenuating circumstances which contributed to the delay.

The 1995/96 budget was not enacted until August 1995. In addition, the enacted budget contained an unallocated reduction of \$2.6 million which required the Department to reassess its program expenditures and delayed the development of final budget allotments for distribution to managers.

The 1996/97 budget contained a last minute legislative reduction of \$2 million, with a corresponding reduction in the Department's authority to generate examination fee revenues by a like amount. An unplanned reduction of this magnitude required a complete reassessment and prioritization of all of the Department's program responsibilities. As a result, final budget allotments reflecting realigned program expenditures were not immediately available for distribution to managers. In addition, the distribution of monthly budget reports was delayed until installation of the necessary software program to extract relevant data from the Department's CALSTARS accounting system.

As a budget management tool, the Department has implemented a formal process to communicate budget information to managers on a regular basis. This budget management process will hold managers accountable for managing their budgets by providing them with current data to monitor and control their expenditures, and to assess and adjust their revenue generating capability.

With the budget management process in place, the Department will ensure that the budget detail for Fiscal Year 1997/98 will be provided to managers shortly after enactment of the budget. The detail will include the budget plan for generating the necessary revenues to fund authorized expenditures.

This distribution of budget detail will be followed by the distribution of monthly budget allotment and expenditure reports to enable managers to monitor and control their expenditures. These reports have been provided to managers since January 1997 with the transmittal of November 1996 data. In addition, monthly revenue status reports will be provided to monitor managers' progress in generating the budgeted revenues. The revenue status reports will provide a

Mr. Kurt Sjoberg  
State Auditor  
Bureau of State Audits  
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comparison of the number of actual billed hours to the billable hours and revenue budgeted for each program, as well as to the number of billable hours identified for each program in the Department's Time Activity Reporting System (TARS). These reports were first provided to managers in January 1997 as part of the Department's mid-year expenditure and revenue review.

The mid-year review referenced above is part of the budget management process that provides for a quarterly review of the Department's expenditure trend and revenue generating capability. These reviews assign accountability to managers by requiring them to prepare an expenditure management plan and a revenue assessment plan. These plans will identify significant issues or fiscal problems warranting the Department's attention, as well as corrective steps the managers will take to resolve those issues and problems.

The results of each review will be used to determine the Department's course of action for the balance of the fiscal year. The accuracy of expenditure and revenue/billable hours estimates made in each review will be determined by the subsequent quarterly review. The Department has recently completed its mid-year review, which will be followed up with a third quarter review in mid-April 1997.

The implementation of the budget management process described above is consistent with the audit recommendations to improve the usefulness of the Department's budgets.

#### *The Department Generates Its Invoices Late*

The Department generates invoices for Proposition 103 assessments based on the terms of the settlement agreement in the National Fire lawsuit and in the California Insurance Code Section 12991. However, this code section states the Department may not levy any fees under Section 736 or 12979 unless the fees are created in compliance with Section 12992 and 12293. These code sections require the Department to first determine the actual costs of performing either examination or Proposition 103 activities. As a result of this legal requirement, we believe Proposition 103 billings are contingent upon the accumulation of actual costs data reflected in our year-end financial reports. These reports are not normally available until 45 days after June 30 of each fiscal year.

Along with past historical cost, anticipated cost for the current year must be accounted for in the Proposition 103 assessment. However, as indicated by the auditors, this process is dependent

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upon the passing of the annual Budget Act. We will review our year-end closing process to determine if these necessary financial reports can be completed more expeditiously in order to generate invoices earlier.

In addition, the Department has reallocated resources to establish a Revenue Analysis and Management unit which is responsible for, among other things, ensuring that Proposition 103 and examination fee rates are calculated on a timely basis upon enactment of the annual budget and completion of the year-end financial statements.

The Department's action is consistent with the audit recommendation to invoice and collect all revenues due from insurance companies properly and promptly. However, we will implement the recommendation in the report.

*The Department Does Not Bill Insurance Companies for All Costs It Incurs*

The Department has implemented in FY 1996/97, a system to ensure that all billable hours are invoiced. In addition to special TARS data being distributed to program managers, as recommended by the auditors in January 1996, new billing reports from our new accounts receivable system are also being distributed. These reports will allow bureau supervisors to reconcile billed hours with time reported by staff to ensure that all billable time reported on the employees' time sheets are billed. In addition, a new Revenue Analysis and Management unit was formed September 1996 to provide a secondary level of control to ensure full cost recovery.

*The Department Has Billed Insurance Companies Incorrectly*

The errors identified by the auditors will be corrected with the accounts receivable system which will become operational in the 1996/97 fiscal year. The implementation of the new accounts receivable system has eliminated the possible clerical errors which occurred during the 1995/96 FY. There were instances when the incorrect hourly rate for services was utilized due to the adjustment of the hourly rates to reflect actual costs of services.

*The Department Does Not Create Accounts Receivable When It Bills Insurers*

The new accounts receivable system entered the production phase in November 1996 and corrected this finding. This new system establishes an accounts receivable for invoices in the month they are created. The system provides an invoice register, open and closed receivable listings, and provides that past due notices be generated on a 30; 60; and 90-day basis.

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The system currently generates all invoices for the Department's examination activities amounting to \$18.8 million. Annual and quarterly billings for the Certificate of Authority and Proposition 103, respectively are generated from this new accounts receivable system. Billings for these two areas amount to \$27 million.

*The Department Has Not Yet Fully Implemented Its New System For Accounts Receivable and Revenue Collections*

Portions of the new accounts receivable system have been implemented and were placed into production as of November 1996. As of February 1997, only two existing billing processes remain to be incorporated into this new system. The Policy Approval filing fees and the annual Fraud General Assessment generate approximately \$2.2 million collectively, and are scheduled for production in July 1997.

*The Department Has Used Revenue Inappropriately*

In making the adjustment discussed in this section, Department accounting staff felt that this action was appropriate. However, we will defer to the Bureau of State Audits and make the appropriate adjustments indicated in the recommendation.

*The Department Has Not Promptly Accounted for the Results of Its Proposition 103 Activities*

The Department utilizes the state's uniform CALSTARS accounting system and has established the necessary fund detail within the Insurance Fund to separately identify Proposition 103 revenues and expenses. As further discussed with the auditors, a more convenient automated report reflecting the cash and fund balance of Proposition 103 activities on an on-going basis is needed. The Department will pursue other opportunities to report the results of Proposition 103 operations more timely.

*The Department Has A Weak System For Distributing Automobile Fraud Revenues*

The Department has reviewed and implemented procedures for the accounting and distribution of automobile Fraud Assessment Revenues. Specifically, we have consolidated all the functions that relate to fund distribution and calculation in the Administration Branch and have appointed an individual with the appropriate skills to monitor and manage these activities.

*The Department's Accounting Records Exhibit Additional Problems*

The areas pointed out by the auditors are ongoing problems which have been identified in prior audit reports. The lack of complete corrective action is due to limited resources in the

Accounting Office to address the clearing of old accounts receivable items. With the passage of the 1996/97 FY budget, additional resources have been made available and this is one of the items that will receive priority attention by the accounting staff.

## CHAPTER TWO FINDINGS

I would like to respond to your recommendation in this chapter that arises from your findings related to the Investigations Bureau. That recommendation is that we consider raising fees listed in Section 12978 of the Insurance Code to help cover costs if additional staff are needed. We are opposed to raising fees in the manner that is currently required by this section of the Insurance Code which requires 178 fees to be uniformly raised or lowered. This approach undermines the basic principle of a fee in that there is no relationship between costs and the fee being charged. We believe that fees should be linked to the costs of providing the service, and the Department even proposed legislation in early 1996 that would have allowed the Commissioner to raise and lower fees according to costs. That proposal met with opposition and eventually became a bill that limited the Commissioner's authority to raise fees to a maximum of 10%. This bill, however, did not change the requirement that all fees be raised or lowered in unison.

### *The Department Shows Questionable Compliance With Budget Act Requirements*

I also would like to respond to the finding that, contrary to the 1996 Budget Act language, the Department has made significant reductions in areas that disproportionately affect the provision of consumer services. We disagree. We believe that the Budget Act language speaks for itself, and that our staff reductions and reorganization were responsive to it. If the Legislature intended to define precisely which division or bureau was to be protected, it would have said so. Clearly, our Consumer Services Division is mandated to respond to and protect the interests of consumers, just as is our Enforcement Branch, our Legal Division, and Financial Surveillance, for example. The basic underlying principal of a regulatory agency is to provide protection of consumers interacting in the marketplace. The Governor's Budget reiterates this broad interpretation as evidenced by the first two sentences under the description of the Department in the Governor's Budget:

The principal objective of the Department of Insurance is to protect insurance policyholders in the State. To accomplish this objective, the Department conducts examinations of insurance companies and producers to ensure that operations are consistent with the requirements of the Insurance Code.

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\*As we point out on page 52 of our report, although the budget act does not define consumer services, its authors clearly had a distinction in mind between the department's consumer services activities and its other activities.

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We feel that our actions in this regard were entirely proper and responsive to the specific language of the Budget Act.

We appreciate this opportunity to respond to the findings in your report. We hope you will agree that the Department is making significant progress in addressing the very serious issues which have been of long-standing concern to the Legislature and California policyholders.

Sincerely,

A handwritten signature in black ink, appearing to read "Kenneth L. Gibson". The signature is fluid and cursive, with a prominent flourish at the end.

KENNETH L. GIBSON  
Chief Deputy Commissioner

Attachment

## Attachment

### Chapter 1

#### Recommendations

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We generally concur with all of the recommendations in this chapter, and to a large extent we have either implemented these recommendations or are in the process of implementing these recommendations. However, it is necessary to provide some clarifying perspective on the circumstances surrounding the following recommendation:

*To correct improper charging of fraud program costs to the restricted Proposition 103 and examination revenues, the department should take these actions:*

- *Reimburse the Proposition 103 assessment and examination fee revenue streams by \$741,000 and \$869,000, respectively, for the fraud program costs inappropriately charged to these revenue streams during fiscal year 1995-96; and*
- *Pass any savings for Proposition 103 along to insurance companies for fiscal year 1997-98.*

**Response:** While we concur with this recommendation, it should be noted that in making this adjustment Department accounting staff felt that this action was appropriate. If the staff had felt that this adjustment was inappropriate, the adjustment would not have been made. However, we will defer to the Bureau of State Audits and make the appropriate adjustments indicated in the recommendation.

### Chapter 2

#### Recommendations

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*To enable the department to comply with the law and yet reasonably limit the number and scope of examinations for practice-related issues it conducts, the department should seek an amendment to Section 729 et seq. of the California Insurance Code. These sections presently require the department to examine, at least once every five years, the solvency and practices of every insurance company doing business in the State. If these sections are amended, to ensure that the department maximizes the protection of California's insurance-buying consumers, the department should assess objectively the methods it uses to select insurance companies for*

*practices examinations. Such an assessment should include identify and then considering various selection methods. The assessment should also include an evaluation of each method's costs and benefits to the department as well as the risks and rewards that California's insurance consumers will derive from the method. If it is unsuccessful in its attempt to change the law, the department should develop and implement a plan that will enable it to comply with the existing statutory language. If such a plan is necessary, the department should consider reviewing, during a single examination, each insurance company's solvency and practices.*

**Response:** The Department will support any attempt to amend the Insurance Code to make it clear that the five-year requirement under discussion applies only to financial examinations and not practices examinations. Section 730 of the Insurance Code, for example, is derived from the National Association of Insurance Commissioners' Model Law on Examinations, and this Model Law was intended to address the timing and conduct of financial examinations. In the absence of any change to this section of the Insurance Code, the Department would continue its historical and documented practice regarding financial and practices examinations.

*Further, to avoid any additional costs that the department will incur by examining foreign or alien insurance companies, the department should instead obtain, review, and accept the examination reports for all applicable insurance companies.*

**Response:** We concur with this recommendation.

*To make certain that it protects insurance consumers effectively, the department should do the following:*

- *Review the efficiency and effectiveness of the financial analysis division's reviews of annual financial statements for insurance companies and streamline the processes, if appropriate. The department should also determine and budget for the level of staffing needed to complete on time the financial analysis division's mandated activities using the streamlined process.*

**Response:** The audit report states that the Financial Analysis Division (FAD) will be unable to review and accept, within the five-year cycle required by Section 730 of the Insurance Code, examination reports on all 1164 foreign and alien insurers licensed in this state on which examinations were performed by other states. The State Auditor found that 358 examination reports of 1164 have not been reviewed by FAD since January 1, 1993. Of the 358 examination reports, 234 were not even available.

Since all states have adopted a five-year or shorter examination cycle by statute or rule, we are confident that, in the future, examination reports will be made available on a timely (five years or less) basis to this Department. In addition, FAD has updated its examination logging and review procedure. Furthermore,

FAD has already begun the process of contacting all 234 companies and their domiciliary commissioners to obtain copies of their most recent examination reports or the status of current examinations in progress. Review of the 124 companies with currently unreviewed examination reports are being given priority status in order to reduce that backlog.

The audit report also states that the FAD was unable to complete 76 reviews of 1994 annual statements by March 1, 1996 and may be unable to complete 212 reviews of 1995 annual statements by March 1, 1997.

FAD's inability to complete the reviews is due to the increasing complexity of financial and corporate affairs filings over the last several years, combined with denial of requested additional positions during recent years' budget deliberations, and the recent loss of key personnel.

To correct the deficiencies noted in the report, the FAD will reevaluate its procedures for conducting financial reviews and then determine its necessary level of staffing. The FAD will also reassess the goal of completing the review of all assigned companies in one year and will consider further enhancements in its priority screening, including even heavier reliance on automated financial structured tests and ratios.

- *Access the adequacy of the investigation bureau's system for prioritizing and completing investigations of consumer complaints and streamline its processes, if appropriate. In addition, the department should determine the level of staffing needed to complete the investigation bureau's work and consider raising fees listed in Section 12978 of the code to help cover costs if the investigations bureau needs additional staff.*

**Response:** We will review our systems for opening investigations, prioritizing investigations, and will streamline these processes if possible. We also will estimate the additional resources required to complete all cases that are currently backlogged and to stay current on all cases that may come in the future.

*To improve the usefulness of the results from the template it uses to evaluate requests to change insurance rates, the department should consider adjusting the template. Specifically, the department should consider taking the following actions:*

- *For those lines of insurance that are relatively volatile, develop and implement versions of the template that enable the template to review more than three years of data; and*

**Response:** Data requirements in general are dictated by regulation; therefore any changes to the data requirements would require changes in the regulations. Moreover, companies often report more than three years of rate making analysis in

Exhibit 20 for those lines of insurance that are more volatile. However, we will consider any feasible alternative to our current practice that allow us to consider more than three years of data.

- *Consider using the template to take into account different classes, territories, and limits within the same lines of insurance.*

**Response:** We currently do not use the template for classification rate making because, among other reasons, we do not believe that the data would be credible when it breaks down to classes or territories. Also, the Department has different measures for handling class relativities. However, to the extent possible, the Department will consider any feasible manner in which the template could be used to take into account different classes, territories, and limits within the same lines of insurance.

*To make certain that its staff considers all pertinent information when reviewing applications to change insurance rates, the Rate Regulation Division should enforce its requirement that analysts use either the original or adapted template for all applications to change rates.*

**Response:** Our current procedure requires analysts to use the original template for all rate changes. If the indications are outside established parameters, we will enforce our requirement that analysts run an adapted template.

*Further, to ensure that it adequately documents the factors that lead to approval of requests for rate changes, the department should make sure that staff adds all supporting calculations and documents to the case files and then maintains the files properly.*

**Response:** We will enforce our requirement that staff fully document case files to reflect the decisions that are made on rate requests.

*When confronted with statutory direction that it can be construed in more than one way, the department should seek clarification from appropriate sources.*

**Response:** As we have indicated in the letter from our Chief Deputy Commissioner accompanying this attachment, we feel very strongly that our actions in this regard were proper and responsive to the statutory language in question.

*To prevent further delays in rollback payments authorized by the provisions of Proposition 103, the department should make certain that its administrative law judges render decisions within the statutory 30-day time limit.*

**Response:** The Department will continue to do everything within its authority to ensure that its administrative law judges render decisions within the statutory 30-day time limit.

*To promote efficiency and to ensure that it solicits valid and reliable feedback about the department's performance from persons who file complaints against insurance companies, the department needs to develop and implement a statistical sampling method that identifies the size of the complaint population; identifies the sampling technique; determines the appropriate sample size, including the consideration of expected error, confidence levels, and precision; and sets forth a plan for evaluating the results.*

**Response:** Our ability to meet our goal of soliciting consumer feedback from a 15% random sample of consumer complaint files was hampered by staff reductions, personnel issues and other problems. However, we have begun sending our complaint evaluation forms on a regular basis, and we will work with our statisticians to ensure a statistical sampling method that incorporates all of this recommendation.

cc: Members of the Legislature  
Office of the Lieutenant Governor  
Attorney General  
State Controller  
Legislative Analyst  
Assembly Office of Research  
Senate Office of Research  
Assembly Majority/Minority Consultants  
Senate Majority/Minority Consultants  
Capitol Press Corps