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Key Points of Report

An Audit Report on the Contracting Practices of the Texas Life, Accident, Health, and Hospital Service Insurance Guaranty Association

August 2000

Overall Conclusion

When it selected a management firm (Management Firm) to run its operations, the Texas Life, Accident, Health, and Hospital Service Insurance Guaranty Association (Association) did not ensure that it received the best value for its contract. Because the Association used insufficient contracting practices, it received only one proposal from a firm composed of former Association employees and signed a \$1.1 million contract in 1998. Without requiring further proposals, the Association renewed its contract with the Management Firm for three years with an annual fee of \$1.2 million in 1999. Since it established the contract, the Association has not sufficiently monitored the Management Firm to make sure that it provides quality services at a reasonable price. Furthermore, the Association's Board contracted with a principal of the Management Firm to be the executive director and supervise the Association's operations.

The Management Firm administered \$205 million in assets and \$43 million in expenditures in 1999. The Association is a non-profit entity responsible for paying claims and continuing policy coverage, as limited by law, of insolvent life, accident, and health insurance companies.

Key Facts and Findings

- The selection process the Association used to hire a management firm to run its operations lacked fairness and objectivity. The process was compromised by a short time line for the procurement, limited solicitation, and a lack of detailed evaluation criteria. Furthermore, the final contract lacks specific provisions to ensure that the Management Firm provides quality services.
- The contractor was reimbursed \$43,382 in unallowable expenses. The contract does not contain a provision that requires the Management Firm to reimburse the Association for these expenses. Consequently, the Association may have to negotiate or seek legal remedies to collect the overpayments it made.
- The Association needs to improve its contracting practices for third-party administrators (TPA). We identified two instances in which the Association and the contractors providing TPA services did not comply with laws related to contract establishment and licensure.
- The Department of Insurance (Department) needs to improve its oversight of the Association so that it can ensure that its recommendations are implemented. Without sufficient oversight, the Department cannot determine if the Association is acting in the best interest of Texas life, accident, and health policyholders.

Contact

Cynthia L. Reed, CPA, Audit Manager, (512) 936-9500



Office of the State Auditor

Lawrence F. Alwin, CPA

This audit was conducted in accordance with Government Code, Sections 321.0132 and 321.0133.

Executive Summary

Contracting practices used by the Texas Life, Accident, Health, and Hospital Service Insurance Guaranty Association (Association) to select a management firm to run its operations (Management Firm) were not sufficient to ensure that it received the best value. As a result, the Association received only one proposal from a firm composed of former employees of the Association and signed a one-year contract in 1998. At the same time, the Association contracted with a principal of the Management Firm to be the executive director of the Association.

Subsequently, the Association renewed the management services contract for a three-year term. The Management Firm received \$1.2 million in 1999 to manage \$205 million in assets and \$43 million in expenditures. The Association does not conduct sufficient monitoring of the Association's operations or verification of the performance reported by the Management Firm. The Association is a non-profit entity responsible for paying claims and continuing insurance coverage, as limited by law, of insolvent life, accident, and health insurance companies.

The Department of Insurance (Department) also needs to improve its oversight of the Association. According to the Texas Insurance Code, the Association is under the immediate supervision of the Department.

Did the Association's procurement processes ensure that a contractor was fairly and objectively selected to run its operations and that it received the best value?

With a short time period given to potential bidders, no public notice of the procurement, and no detailed criteria on which to evaluate the bids, the Association's selection process lacked fairness and objectivity. Furthermore, the contract lacks specific provisions to

ensure that the Management Firm will provide quality services.

The payment method the Association used for the contract is reasonable. Although a more thorough procurement process may have resulted in the Association receiving a better value, its administration costs per staff member are reasonable when compared to those of the Texas Property and Casualty Insurance Guaranty Association.

Although the Association is not required to follow competitive procurement practices, competition is important to ensuring that an entity receives quality services at the best price.

The Association's Procurement Process Was Not Objective and Lacked Formal Evaluation Criteria

The practices used to select a contractor to run the Association's operations were not fair and objective. Consequently, the Association received only one proposal from a firm composed of former employees of the Association. The Association's contractor selection practices were limited by:

- Short timeline for the procurement
- Limited solicitation process
- Lack of detailed evaluation criteria
- Insufficient documentation for the procurement

The Board of Directors of the Association (Board) considered the fairness of the procurement process, and using selected information provided by the Department, decided that it was fair for a single year. However, the Board did not undertake another competitive procurement before it renewed the contract for a three-year term.

Executive Summary, continued

Contract Provisions Do Not Ensure That the Management Firm Will Provide Quality Services

The contract with the Management Firm does not contain results-oriented performance standards or workload measures for the contractor to meet. Consequently, the Association cannot ensure that it receives quality services. While the contract permits termination of the contract for cause, it does not contain penalties for noncompliance with terms. Without penalties, the Association may be unable to enforce the terms of the contract and hold the Management Firm accountable.

The Payment Method the Association Used Is Reasonable

Although the Association cannot be assured that it received the best value for the management services, the Board's payment method of a flat fee for the contract appears to be reasonable. A comparison with the Texas Property and Casualty Insurance Guaranty Association (TPCIGA) shows that administration costs per staff member for the Association are reasonable. The Association's costs were 12 percent higher than TPCIGA's in 1998 and 15 percent higher in 1999. Although the two guaranty associations perform the same broad functions, it should be noted that the types of claims they process are different.

Do the Association's oversight practices ensure that the Management Firm consistently provides the contracted services at a reasonable price?

The Association's oversight practices are not sufficient to ensure that the Management Firm consistently provides the required services at a reasonable price. The executive director of the Association, also a principal in the Management Firm, is responsible for

looking after the interests of the Association. Furthermore, the Association does not sufficiently monitor the day-to-day operations run by the Management Firm.

The Management Firm was reimbursed \$43,382 in unallowable expenses. The contract does not contain a provision to require the Management Firm to reimburse the Association for unallowable expenses. Consequently, the Association may have to negotiate or seek legal remedies to collect the overpayments it made.

Furthermore, the Association has not established performance measures for all aspects of the operations run by the Management Firm. Without results-oriented measures for key functions, the Association cannot assess the Management Firm's, and therefore its, performance.

Do the Association's procurement practices for third-party administration ensure that contractors are fairly and objectively selected and that it receives the best value?

The Association's procurement of third-party administrators (TPAs) who process claims for insolvent companies needs to be improved. Competitive procurement practices used by the Association ensure that it receives a fair market value for TPA services. The Association spent \$304,548 for TPA services in 1998 and 1999. However, we identified the following two instances in which the Association and contractors providing these services were not in compliance with the law:

- An insurance company began providing TPA services five months before the contract was signed.

Executive Summary, concluded

- Seven independent contractors who did not have licenses to operate as TPAs were paid \$21,677 for their services.

Does the Department of Insurance provide sufficient supervision of the Association's operations?

The Department needs to improve its oversight of the Association. Without sufficient oversight, the Department cannot ensure that the Association acts in the best interest of Texas' life, accident, health, and hospital service insurance policyholders.

Specifically, we noted that:

- Management-approved written policies and procedures for oversight do not exist.
- The Department has not established additional rules and regulations as permitted by law to supervise the Association. Without appropriate rules and regulations, the Department may not be able to require the Association to follow its recommendations.
- The Department either did not document the results of quarterly and special board meetings of the Association or did not document them within a reasonable time frame. Complete and timely documentation is necessary to ensure that all concerns are brought to the Commissioner of Insurance's attention promptly in case any action is necessary.

Summary of the Association's Response

The Association's Audit Committee concurs with all recommendations and plans to recommend to the full Board to work with the Department to implement the recommendations in this report. Detailed responses follow each recommendation. The

Association's summary response is included in Appendix 3.

Summary of the Department's Response

The Department supports the recommendations made to the Association. Furthermore, the Department concurs with recommendations made to the Department. Specific responses follow each recommendation. The Department's summary response is included in Appendix 3.

Objectives, Scope, and Methodology

One objective of this audit was to determine if the Association's contracting and oversight practices are sufficient to ensure that contractors are fairly and objectively selected and that the Association receives the best value. Additionally, we determined whether the Department provides sufficient supervision of the Association's operations.

The scope of our project included a review of contract administration and oversight processes at the Association and LaShelle, Coffman, and Boles, LLP. We also reviewed oversight practices at the Department. The review was performed using documentation from 1997, 1998, 1999, and 2000. The audit was conducted in accordance with *Government Auditing Standards*.

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Background

The Texas Life, Accident, Health, and Hospital Service Insurance Guaranty Association (Association) is responsible for continuing insurance policy coverage as limited by law. The Association is also responsible for paying claims and other policy benefits of insolvent insurance companies. The Association is a non-profit entity under the direct supervision of the Department of Insurance (Department). The Commissioner of Insurance appoints a nine member Board of Directors (Board) to oversee the Association's operations.

The Association employed a full-time staff to run its operations until 1997. Late that year the Association decided to privatize its operations. After a short procurement process, the Association awarded a one-year contract in 1998 to the only bidder, a firm composed of former employees of the Association. At the same time, the Association contracted with a principal of the firm to be the executive director. Subsequently, the Association renewed the contract with this firm (Management Firm) for a three-year term. The Management Firm performs all of the Association's operations including financial records' maintenance, estate asset and policy obligation evaluation, investing, reinsuring, selecting and overseeing subcontractors, and representing the Association in multi-state insolvencies. Refer to Appendix 2 for a flowchart of the relationship between the Department and the Association.

Section 1:

Did the Association's procurement processes ensure that a contractor was fairly and objectively selected to run its operations and that it received the best value?

Contracting practices used by the Association to select a management firm were not sufficient to ensure that it received the best value. With a short time period given to potential bidders, no public notice of the procurement, and no detailed criteria to evaluate the bids, the process used to select a management firm to run the Association's operations (Management Firm) lacked fairness and objectivity. The Management Firm received a flat fee of \$1.2 million in 1999 to administer \$205 million in assets and \$43 million in expenditures.

Furthermore, the final contract lacks provisions to ensure that the Management Firm will provide quality services. Although a more thorough procurement process may have resulted in the Association receiving a better value, its administration costs per staff member are within 12 to 15 percent of those of the Texas Property and Casualty Insurance Guaranty Association.

The Association is not required by law to follow competitive procurement procedures; however, competition provides some assurance that the State receives quality services at the best price.

Section 1-A:

The Association's Procurement Process Was Not Objective and Lacked Formal Evaluation Criteria

The Association's practices to select a management firm to run its operations were not fair and objective. Consequently, the Association received only one proposal from a firm composed of former employees of the Association and awarded this firm a \$1.1 million contract in 1998. At the same time, the Association contracted with a principal of the Management Firm to be the executive director of the Association. The Association subsequently renewed the management services contract for a three-year term.

The management firm selection practices were not fair and objective for the following reasons:

- Timeline was too short for the procurement – The Association only provided prospective bidders 13 calendar days to review the Request for Proposals (RFP) and submit a proposal. This time frame included the Thanksgiving holidays, shortening the time bidders had to compile proposals. Furthermore, bidders were given fewer than two business days to submit questions regarding the proposal from the time the RFP was mailed (see Table 1).

Table 1

| Calendar of Procurement Events 1997 | | | | | | |
|-------------------------------------|---------------------------------------|-------------------------|--------------------|------------------|----------|--------|
| Monday | Tuesday | Wednesday | Thursday | Friday | Saturday | Sunday |
| November 17 | 18 | 19 | 20 | 21 Mailed RFP | 22 | 23 |
| 24 | 25 Bidders Questions Due 2:00 p.m. | 26 | 27 Thanksgiving | 28 | 29 | 30 |
| December 1 | 2 | 3 Bids Due 2:00 p.m. | 4 | 5 | 6 | 7 |
| 8 Contract Awarded | 9 | 10 | 11 | 12 | 13 | 14 |

Note: The shaded days represent holidays, weekends, or days before the procurement process started and after it ended.

- Limited Solicitation – The Association did not publicly advertise the procurement, and minimal effort was spent to generate the list of potential bidders. For example, the Association did not supplement the list by contacting the National Organization for Life and Health Insurance Guaranty Associations for suggestions.
- Lack of Detailed Evaluation Criteria – The Association did not develop detailed evaluation criteria prior to the receipt of proposals. Broad evaluation criteria were included in the RFP. Although the subcontractor who evaluated the single proposal received was able to provide the points awarded in each category, he was unable to provide the method used to assign those points. Thus, there is no record of how proposals were to be scored according to these

criteria. Detailed scoring criteria should be developed and documented before proposals are received to ensure that the evaluation is objective.

- Lack of Negotiation and Protest Procedures – The RFP did not include procedures for filing a protest or the negotiation of contract award. One verbal complaint was received regarding the procurement process; but the complainant did not follow up with a written complaint or proposal, nor did the complainant attend the publicly accessible board meeting in which the proposals were evaluated.
- Insufficient Documentation – The Association did not maintain sufficient documentation about the procurement process. The Association only kept copies of the RFP, the list of prospective bidders, and the single proposal received. The Association did not keep the evidence that RFPs were mailed to bidders, detailed evaluation criteria, or the detailed evaluation of the single proposal received. It is important to maintain such documentation in case of a protest.

The Board considered at length the fairness of the procurement process as it was implemented. The Board decided that it was fair for the single year contract they were negotiating (1998). Procurement-related information received from the Department was a key factor in the Board's decision that its procurement process was fair. The Department:

- Informed the Association that it was required to give bidders at least 10 calendar days for this procurement.
- Volunteered to provide a list of prospective bidders used for the Texas Health Insurance Risk Pool management services.
- Provided a copy of the Invitation for Bids for the Texas Health Insurance Risk Pool management services and suggested that the Board use this document as an example for its Request for Proposals. The Board and its subcontractors confirmed that the Invitation for Bids was used as a model.

However, the Board did not commit to another competitive procurement process after the first year as originally intended, and in fact, renewed the contract for a three-year term. While the length of the contract term is acceptable, the Board should have re-bid the contract at the end of the first year, given their concerns about fairness.

Recommendation:

The Association should:

- Conduct a competitive procurement process for management services at the end of the contract term. The Association should consider a contract term longer than one year for this procurement. The Association may want to have proposals submitted for different payment methodologies (for example, flat fee, hourly rate, or a combination) to determine which method is most cost-

- Allocate more time to the procurement process to ensure that bidders are given sufficient time to prepare proposals and ask questions. Considering the scope of services to be provided, it would be advisable to allow bidders at least 10 business days (from the date of publication of the RFP) to submit questions. It would also be advisable to allow bidders approximately 30 business days (from publication) to submit bids.
- Use a variety of sources to compile the list of potential bidders, including suggestions from the National Organization of Life and Health Guaranty Associations. The Association should also notify the public of its intent to solicit proposals.
- Develop detailed scoring criteria for each category on which the proposals will be evaluated. These criteria should be developed before bids are received to ensure objectivity in the evaluation process.
- Enhance RFPs to include clauses reflecting procedures for contract negotiation and protests.
- Retain documentation of the procurement process. Minimum documentation would include:
 - The RFP
 - The list of prospective bidders
 - Evidence that RFPs were mailed to bidders
 - Questions received from bidders and the answers given
 - Bids received
 - Evaluation criteria
 - Evaluations of bids received

Association's Response:

The Association believes that the process in connection with the late 1997 Request for Proposal (RFP) to select a Management Firm for 1998 was not unreasonable in light of the following circumstances: No law or regulation required an RFP to be used; the actual process used was suggested by the Texas Department of Insurance; and the independent auditors and legal counsel retained by the Board in connection with this process advised the Board that their actions were reasonable. The Audit Committee will, however, recommend that the full Board implement the recommendations suggested by the State Auditor's Office regarding a competitive procurement process for management services at the end of the current contract term. Based on prior informal comments of various members of the Board not on the Audit Committee, the Audit Committee believes that the full Board will in fact adopt a competitive procurement process for management services at the end of the current contract term consistent with guidance provided by the State Auditor's Office.

Department's Response:

The Department fully supports the Auditor's recommendations to conduct a competitive bidding process for management services and to take steps to strengthen the procurement process.

In 1997, when the Association expressed interest in contracting for management services, the Commissioner instructed the Association to follow a competitive bidding process. In two board executive sessions in November and December of 1997, Department staff members provided general information to the board about the Texas Health Insurance Risk Pool (THIRP) Invitation for Bid (IFB) process that was underway at the Department. In the November 1997 meeting, Department staff reminded the board that if the Association decided to privatize operations, the services should be bid out.

In 1997, the Department was informed that the Association engaged outside legal counsel and an external accounting firm to serve as expert advisors on the contracting and procurement process. Additionally, the accounting firm was engaged to prepare the RFP used by the Association.

The Association received only one response to their Request for Proposal and elected to award the contract to that sole bidder. The board's stated intention was to award a contract for a one-year period only and then re-evaluate and re-bid the services. The Department expressed concerns to the Association about the terms of the contract and failure to have a true competitive bidding process. The Department understood that the Association would re-evaluate and strengthen its contracting process and procedures at the end of the one-year contract.

Section 1-B:

Contract Provisions Do Not Ensure That the Management Firm Will Provide Quality Services

The contract with the Management Firm does not contain results-oriented performance standards or workload measures for the contractor to meet. The contract also does not identify how the contractor's performance will be evaluated. Consequently, the Association cannot ensure that it receives quality services. While the contract permits the Board to terminate the contract for cause, it does not contain penalties for noncompliance with terms. Without penalties, the Association may not be able to enforce the terms of the contract and hold the Management Firm accountable.

The contract does contain requirements for regular financial reporting and annual financial audits by external CPAs. The contract also gives the State Auditor's Office access to all Association books and records. However, the contract does not address the ownership and transfer of the Association's books and records upon termination of the contract.

Recommendation:

The Association should include additional contract requirements when the current contract expires. The Association should develop and include in its management services contract performance standards and workload criteria by which it will evaluate the contractor and the contract fee. We suggest that the Association work with the Department of Insurance to develop these quantitative and qualitative measures. Additionally, the contract should contain enforcement mechanisms and provide the Association the ability to modify the fee as indicated by performance standards and workload criteria. The contract should also contain provisions for the reimbursement of unallowable expenditures. The existing contract could be modified to include this provision.

The Association should also include clauses to address ownership and transfer of Association books and records upon termination of the contract. If the Association uses a multi-year contract, it should consider including additional clauses to protect it against changing circumstances such as a sudden fluctuation in the volume of work.

Association's Response:

The Audit Committee intends to recommend that the full Board implement the recommendations of the State Auditor's Office set forth in the Audit Report under Section I-B: Contract Provisions Do Not Ensure that the Contractor Will Provide Quality Services. The Audit Committee will recommend: (1) the adoption of specific performance standards developed with the input of the Texas Department of Insurance; and (2) the addition of contract provisions (a) to modify the management services fee based on the satisfaction or non-satisfaction of the performance standards, (b) to allow recovery of expenses not properly reimbursed to the Management Firm, and (c) to address the ownership and transfer of Association's books and records.

Department's Response:

The Department agrees with the Auditor's recommendation to include additional requirements in future contracts. During 1997, 1998 and 1999, the Department expressed concerns to the Association's board about the terms of the contract. In addition to the Auditor's recommendations, the Department suggests that the Association: (1) reconsider the use of contract provisions that allow for terminating the contract only for cause; (2) include provisions requiring the contractor to make its books and records available for audit by the Department's auditors and the State Auditor's Office; and (3) define precisely which contractor expenses are reimbursable.

Section 1-C:

The Payment Method the Association Used Is Reasonable

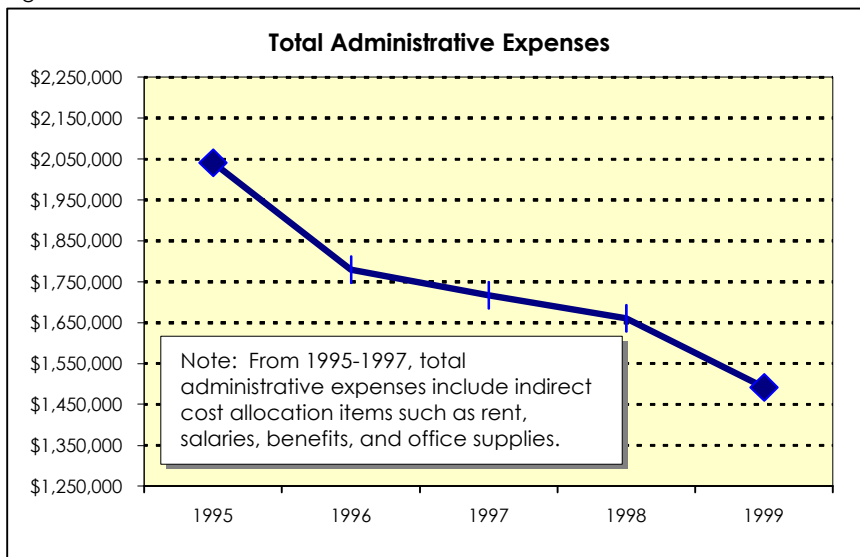
As the Association did not use a competitive procurement process, it cannot be assured that it got the best value for the management services contract. However, the Board's payment method of a flat fee for the contract appears to be reasonable. A comparison with the Texas Property and Casualty Insurance Guaranty Association (TPCIGA) revealed that administration costs per staff member for the two guaranty associations are comparable as well. Although the two guaranty associations perform the same broad functions, it should be noted that the types of claims they process are different.

Before the contract was awarded, the Board discussed at length the issues of payment method and amount. The Board considered the budget and actual costs incurred for management of the Association in prior years to determine if the proposed fee would be cost beneficial. The Board also discussed the benefits of a flat fee versus a rate structure. The Board chose to use a flat fee because it wished to cap the Association's annual expenses as the volume of work can fluctuate. The Board also felt a flat fee was more practical because the Board only meets quarterly.

Using a flat fee for this type of service is not uncommon. A brief survey of other states' privatized life and health guaranty associations revealed that they used both flat fees and hourly rates.

The Association did not document in writing why it decided to use a flat fee for the management services contract or the cost-benefit analysis used to determine the reasonableness of the fee. If tapes of the Board meetings had been unavailable, the Association would have been unable to substantiate that it had performed a cost-benefit analysis and that it considered the pros and cons of different payment methodologies.

Figure 1



Source: The Association's Financial Statements, 1995-1999

The Association's total administration expenses have decreased since 1995 and since the Association was privatized in January 1998 (see Figure 1).

Furthermore, an analysis of administration costs per staff member indicates that the Association's costs are reasonable when compared to TPCIGA. The Association's administration costs were 12 percent higher in 1998

and 15 percent higher in 1999. Administration costs for the two guaranty associations included some of the following items:

- Salaries and benefits
- Rent
- Furniture and equipment
- Office supplies

Recommendation:

The Association should document its rationale for the payment methodology and the reasonableness of the payment amount when entering into significant contracts such as the one for management services. Documentation of this type would include a cost-benefit analysis of the contract and any discussion or evaluation of the various payment methodologies considered.

Association s Response:

The Audit Committee intends to recommend that the full Board appropriately document its rationale for the payment methodology and the reasonableness of the payment amount when entering into significant contracts such as the one for management services (the State Auditor s Office sole recommendation on this topic).

Department s Response:

The Department agrees with the Auditor s recommendation to document the decision-making processes when entering into contracts.

Since member insurers can offset assessments against the state premium tax, the end result is that funds utilized by the Association affect tax dollars. To ensure accountability, as stressed to the Association in 1997, 1998 and 1999, the Department strongly encourages the use of an hourly fee payment methodology, as compared to a fixed-fee approach, for all future contracts. The contractor should be required to submit a detailed break-down of activity to the Association to support billings.

Do the Association's oversight practices ensure that the Management Firm consistently provides the contracted services at a reasonable price?

The Association's oversight practices are not sufficient to ensure that the Management Firm consistently provides the required services at a reasonable price. The executive director of the Association, also a principal in the Management Firm, is responsible for looking after the interests of the Association. The Association does not conduct sufficient monitoring and independent verification of items such as out-of-pocket expenses, budget versus actual costs, and claims processed. The contractor was reimbursed \$43,382 in unallowable expenses in 1998, 1999, and 2000.

Furthermore, the Association has not established performance measures for services other than timeliness of claims processing. Without results-oriented measures for key functions performed by the Management Firm, the Association cannot assess its, and therefore the Association's, performance.

While the Association requires the contractor to provide quarterly reports of its activities and the status of compliance with the contract, these reports have never been audited for accuracy by an independent party. The Management Firm was reimbursed for the following unallowable expenses:

- \$22,659 for copies made on the contractor's equipment. According to the contract, the Management Firm is responsible for personnel, equipment leases, and office supplies. As a result, the copying expenses are covered by the fixed fee paid to the Management Firm.
- \$20,723 to subcontract with third-party administrators (TPAs) for audits of claims without getting approval from the Board. The contract also does not clearly specify that this work is outside the scope of the Management Firm's responsibility.

The contract does not contain provisions that require the Management Firm to reimburse the Association for unallowable expenses. Consequently, the Association may have to negotiate or seek legal remedies to collect the overpayments it made.

Performance measures for only a subset of the Association's operations performed by the Management Firm have been established. The Association only measures the timeliness of claims processing. Other important areas the Management Firm manages include investments and reinsurance. Without results-oriented data in these key areas of operation, the Association cannot be assured that the Management Firm is managing its budget, investment, and reinsurance functions effectively. Furthermore, the Association's internal reports indicate that the Management Firm has significantly exceeded the performance targets for timeliness of all claims measures for the past seven quarters, which indicates that more ambitious targets may be necessary.

Board members stated that they gauge the Management Firm's performance by reviewing quarterly reports provided and comparing its performance to that of other states. The Board also discusses the Management Firm's performance annually in order to set the next year's fee. However, the Board does not sufficiently document this discussion, nor does it document the comparison of the Management Firm's performance relative to other states. As a result, we were unable to verify the evaluation criteria the Board used.

The Association does not provide sufficient oversight of the Management Firm's TPA functions. The Association paid the Management Firm \$14,350 for TPA expenses in 1998 and 1999. However, the Board is considering using a competitive process to solicit bids for an independent review of the TPA functions performed by the Management Firm.

Recommendation:

We recommend that the Board:

- Perform independent monitoring of the Management Firm's day-to-day operations and verification of the reported performance and expenses.
- Develop performance measures for all aspects of management services provided by the contractor. The Board should consider measures such as investment income versus investment assets, recoveries versus receivables, and administrative and total cost per claim. The Board should also establish more ambitious targets for claims processing measures and ensure that targets for the newly developed measures are challenging and achievable.
- Formalize and document its evaluation of the Management Firm's performance. The evaluation of the Management Firm should be based on the performance measures developed.
- Attempt to recover the unallowable expenses reimbursed to the Management Firm.

Association's Response:

The Audit Committee believes that the Board has provided meaningful oversight of the Management Firm. First, it should be noted that since 1998, or when the day-to-day management of the Association became privatized (the period at issue in the audit), the Board has been composed of accomplished executives and professionals appointed by the Texas Commissioner of Insurance. Of the Board's nine (9) members, five (5) have been officers or senior business executives or professionals of insurance companies, and the remaining four (4) have been public representatives who were experienced attorneys, accountants or auditors. In almost all cases, the candidates for the company members were recommended by Texas principal life and health insurance company trade association, the Texas Association of Life and

Health Insurers, to the Executive Director for referral to the Commissioner for consideration.

Candidates for public members were typically recommended by legislators or volunteered their services. In addition, for the audit period in question none of the members of the Board have been related to or affiliated with the Management Firm in any way other than through their service as Board members, and none have, or have ever had, a direct or indirect pecuniary interest in the Management Firm. In short, the Board has been a sophisticated Board with actual experience with complex business contracts with no conflicts of interest with the Management Firm. The Audit Committee does note, however, that the current majority of the Board were not on the Board for most of the audit period in question.

The Board retained a Board special legal counsel separate from the legal counsel retained by the Management Firm for assistance on various Association matters to advise the Board regarding its retention of, and dealings with, the Association's private management services firm. The Board's special legal counsel was directed to determine that such actions were consistent with Article 21.28-D of the Texas Insurance Code and other applicable Texas legal provisions, the Association's Bylaws, and the Association's Plan of Operations.

Each year the Board adopts an annual budget and operating plan (the latter of which includes action items to be implemented by the Management Firm). The Board directs the Management Firm to manage the Association, to the extent possible, consistent with the annual budget and the annual operating plan. The Management Firm is also directed by the Board to manage the Association consistent with the Management Services Agreement, the performance standards applicable to the Management Firm adopted by the Board at its July 30, 1999, meeting, the Association's Bylaws, the Plan of Operations and applicable Texas law.

Consistent with standard corporate governance practices, oversight of the Management Firm and its compliance with these directives have been accomplished through Board meetings, where substantial documentation regarding the activities and results of the Management Firm is reviewed. Additional oversight of the Management Firm is accomplished through (a) Board Committee meetings and (b) telephonic and letter contacts between Association officers (often the Chairman and the Vice Chairman of the Association) or Board committee members and the Management Firm. The documentation of this oversight is found in (a) the minutes prepared and tapes recorded in the manner prescribed by the Open Meetings Act for such Board meetings and Board committee meetings and (b) correspondence regarding Association matters. The full Board meetings occur at least quarterly, and in 1999 and in 2000 there were additional specially called meetings. Board committee meetings have occurred on an as needed basis consistent with the Association's Bylaws, and informal telephone calls and correspondence occur as warranted.

Five days prior to each scheduled Board meeting, Board members receive a package of confidential information for review. Each member is well aware of the need for advance reading since the considerable amount of material to be covered precludes

such study during the Board meeting. Each book binder packet includes the following:

- *Report of the Executive Director on important developments since the last full Board Meeting*
- *Detailed report on compliance with the management services contract and the related performance standards for such contract*
- *Status report on compliance with the current annual operating plan*
- *Report on Association expenses*
- *Report on estate distributions and recoveries*
- *Projected claims and expense obligation report*
- *Financial summary on selected estates*
- *Complaint log*
- *Claims payment performance report*
- *Phone call summary report*
- *Budget variance reports*

Examples of a Board book binder are normally appreciably more lengthy than the official minutes of any full Board meeting. All of the materials in a Board book binder are discussed or reviewed at the full Board meeting, each of which such meetings typically lasts approximately five (5) hours.

At the full Board meetings, the Board also reviews, and where necessary and appropriate, also approves (often with Board-directed adjustments) the following items: (i) the financial statements for the Association (which are audited each year by an independent certified public accounting firm) that reflect developments for the previous three months, (ii) attendance by Management Firm personnel of National Organization of Life and Health Guaranty Associations (NOLHGA) or NOLHGA committee meetings and the insight/information gained from attendance of such meetings, (iii) status reports on selected impaired estates and the Management Firm s activities with respect to such estates, (iv) all contracts involving insolvent estates including third party administrator and assumption reinsurance contracts (which are first negotiated or reviewed and then recommended by the Management Firm), and (v) any proposed changes to the policy and procedure manual of the Association.

Specific Board Committees separately and additionally review Management Firm performance. For example, the Board s former Governance Committee (now absorbed into the Audit Committee) and the Audit Committee since privatization have taken an active role in overseeing the management of the Association. The Governance Committee was specifically established to assist in and oversee the transition to the privatization of management. The Audit Committee recommends the annual financial audit, and since approximately 1996 has recommended measures to improve the internal controls of the Association, which the full Board has reviewed and approved. In the mid-1990s Peat Marwick was retained to establish a policy and procedure manual (which has now been modified to take into account privatization). Since the adoption of the policy and procedure manual until 1999, the Board, at the recommendation of the Audit Committee, has each year engaged an independent accounting firm to conduct an agreed upon procedures review to review certain

aspects of the internal controls structure and safeguards in place for the Association. After each agreed upon procedures review, the auditors briefed the Board on the findings, and appropriate measures have been implemented. No agreed upon procedures review was undertaken in 1999 or this year because the Audit Committee wished to first receive the State Auditor's Office Audit Report before another such agreed upon procedures review was commenced. The Audit Committee intends to consider at its next meeting the scope of the annual external audit and the attendant evaluation, and suggestions for improvement, of internal controls in the Management Firm's system.

In addition, the Assessment/Investment Committee reviews the auditing of all books and records of the Association relating to assessments levied upon the member insurers, provides recommendations to the Board regarding the investment of Association funds, oversees LCB's management of the Association custodial account with an institutional custodian for the purpose of safekeeping securities purchased in the name of the Association, and oversees the investments made by the management firm in securities backed by the full faith and credit of the United States that have maturities not exceeding three months.

There is routine oversight of significant financial transactions. All expenditures over significant dollar amounts must be approved by a member of the Board. Settlements in excess of significant dollar amounts must be approved by the Board or approved by a member of the Executive Committee and ratified by the Board at its next meeting.

The Audit Committee is, however, amenable to supplementing the above oversight practices and procedures. The Audit Committee intends to recommend that the full Board work with the Texas Department of Insurance to develop an enhanced method of independent monitoring of the Management Firm and improved verification of the reported performance. As noted earlier, the Audit Committee also intends to recommend that the full Board work with the Texas Department of Insurance to establish meaningful and appropriate performance standards for all key aspects of management services provided by the contractor. The Audit Committee will also recommend better documentation of the contractor's performance.

The Audit Committee intends to recommend that the full Board carefully analyze the allowability of the copying costs totaling \$22,659 and of the audit of claims costs totaling \$20,723 noted in the Audit Report, with the intentions of the parties when the contract was entered into being taken into account. The Audit Committee will also recommend that should the full Board determine after such analysis that all or part of such costs were not properly reimbursable, it will make demand on the Management Firm to reimburse the Association for unallowable expenses. If necessary (although not anticipated to be necessary) the Audit Committee believes the Association will not hesitate to seek its legal remedies in order to recover the funds.

State Auditor's Follow-Up Comment:

While we acknowledge that the Board receives and reviews financial and performance information before its quarterly meetings, the Board's oversight is not sufficient

because most of the information is self-reported by the Management Firm and is not independently verified.

Department's Response:

The Department strongly supports the Auditor's recommendations to: (1) strengthen controls through on-going, independent monitoring of the contractor; (2) verify data reported to the board; (3) develop meaningful performance measures; and (4) formalize the contractor evaluation process.

The Department expressed concern in previous communications to the Association regarding lack of independent monitoring of operations and contract deficiencies. The Association has the responsibility to take immediate steps to provide for on-going, independent monitoring of Association operations conducted by the contractor.

The Department believes that the Association has an obligation to recover all amounts determined to be overpayments. Even though the contract does not contain specific language requiring the contractor to refund any amounts received but not due, the Board can and should utilize all appropriate means to seek return of these amounts. It is not likely, in this instance, that the contractor would risk termination of the contract for cause or jeopardize the chance for future contracts. The Department agrees with the Auditor that the terms of future Association contracts must be strengthened.

Section 3:

Do the Association's procurement practices for third-party administration ensure that contractors are fairly and objectively selected and that it receives the best value?

The Association needs to improve its procurement of TPAs that process claims for insolvent companies. Competitive procurement practices the Association used ensure that it receives a fair market value for TPA services. The Association spent \$304,548 for TPA services in 1998 and 1999.

However, we identified two instances in which the contractors providing these services were not in compliance with the law. The Association needs to update its policies and procedures for selection and monitoring, and the Management Firm should maintain sufficient documentation related to the procurement of TPAs.

The two instances of noncompliance include:

- One contractor began providing TPA services five months before the contract was signed. In addition, the contractor (an insurance company) did not notify the Department of Insurance of its intent to provide TPA services before it started providing the services. Texas Insurance Code, Article 21.07-6, Section 11(a), allows a TPA to provide services only after it has a written agreement with the Association. Furthermore, Texas Administrative Code, Title 28, Section 7.1607, requires a life, health, and accident insurance company to notify the Department of its intent to provide TPA services and obtain approval.

- Seven independent contractors who did not have licenses to operate as TPAs were paid \$21,677 for their services. According to Texas Insurance Code, Article 21.07-6, Section 3, an entity may not operate as a TPA unless it obtains a certificate of authority from the Department.

We also identified policies and procedures for TPA contracting and monitoring functions that were either not documented or needed to be updated to reflect current practices. Documented policies and procedures promote the consistent use of contracting and monitoring practices.

The management firm that runs the Association's operations uses RFPs to solicit proposals from licensed TPAs and insurers to process insolvent companies' claims. Competition among the TPAs ensures that the market determines the price for the services. It also provides the Association assurance that it receives a fair market value. Contracts with TPAs contain the necessary provisions to hold TPAs accountable to the Association. For example, contracts include acceptable claims processing error rates and penalties in case the vendor exceeds the established thresholds. The Association also conducts periodic on-site monitoring visits to determine whether TPAs are meeting the established performance criteria.

Recommendation:

The Association should establish written contracts with all TPAs before they are allowed to begin providing services. The Association should also ensure that all providers are either licensed or have notified the Department of Insurance of their intent to provide TPA services and obtained necessary approvals as required by law.

The Association should also update the policies and procedures for TPA contracting and monitoring functions performed by the Management Firm. The Association should document the following:

- Process and sources used to create the list of potential bidders
- Process used to transmit the RFPs to potential bidders
- Weights assigned to the criteria used to evaluate bids
- Risk assessment performed to identify TPAs that warrant an on-site monitoring visit

The Association should also ensure that it maintains sufficient documentation related to the contracting practices used for TPA services. Please refer to the list of minimum documentation provided in the recommendation for Section 1-A.

Association's Response:

The Audit Committee intends to recommend that the full Board adopt the recommendations of the State Auditor's Office for improving practices for third-party administration. The Audit Committee will also recommend that the two cited instances of noncompliance with applicable third party administration be thoroughly

studied and the findings in that regard should be taken into account when developing enhanced practices and procedures for third party administration.

Department's Response:

The Department fully supports the Auditor's recommendations regarding contracts with TPAs, updating Association policies and procedures for TPA contracting and monitoring and maintaining sufficient evidence to document the procurement process. Additionally, the Department recommends that proper licensing and compliance with state statutes, and Department rules and regulations be included as a provision of all Association contracts with TPAs.

Section 4:

Does the Department of Insurance provide sufficient supervision of the Association's operations?

The Department needs to improve its oversight of the Association. Without sufficient oversight, the Department cannot ensure that the Association acts in the best interest of Texas' life, accident, health, and hospital service insurance policyholders.

Adequate oversight consists of three key components:

Develop and implement policies and procedures.

Consistently execute the policies and procedures to perform oversight and make recommendations.

Follow up on recommendations and enforce them.

Management-approved, written policies and procedures for oversight of the Association do not exist. Two versions of incomplete policies and procedures have been in draft for more than two years. Without formal policies and procedures, the Department cannot ensure consistent oversight of the Association. Department management has agreed to complete and implement the policies and procedures for oversight of the Association.

Furthermore, the Department has not established administrative rules and regulations to carry out oversight responsibilities as permitted by law (Texas Insurance Code, Article 21.28-D, Section 21). Without appropriate rules and regulations, the Department may not be able to require the Association to implement its recommendations.

Although the Department staff attend the Association's quarterly and special board meetings, memoranda documenting those meetings were either not prepared in a timely manner or not prepared at all. Without complete and timely documentation, it is likely that key issues and concerns that arise in these meetings may not be brought to the Commissioner of Insurance and senior Department management's attention in time for them to take action. Memoranda documenting the results of the meetings were prepared on the average 12 weeks after the meetings were held between October 1997 and January 2000. Moreover, two special board meetings regarding the privatization of the Association were not documented at all. It was during one of these meetings that Department staff provided critical information to the Board about the contracting practices used by the Department.

Recommendation:

The Department should:

- Complete policies and procedures relating to its oversight of the Association. Written policies and procedures should establish clear responsibilities for the Department and the Association, the scope and frequency of oversight activities, and specific assessment criteria. The Department should follow its policies and procedures to monitor the Association's performance.
- Develop administrative rules and regulations for the Association to follow so that the Department can ensure that the Association implements its recommendations.
- Document key issues and concerns that arise in the Board meetings, and ensure that appropriate senior managers at the Department review the results in a timely manner. The Department should also formally communicate its concerns to the Board in a timely manner, and staff members should follow up later to determine if the Association has taken steps to correct the problems.

Department's Response:

The Department agrees that the draft internal policies and procedures should be finalized and adopted for use. The Department is currently reviewing, enhancing and formalizing those policies and procedures.

The Department is considering rules and regulations to encourage compliance such as: (1) formal management conferences with the board chair, board audit committee or full board; (2) examinations as authorized by Article 21.28-D, Section 15; (3) special purpose audit services by outside contractors under the authority of Article 21.28, Section 12(j); and (4) State Auditor audits as authorized by Article 21.28, Section 12(k) as deemed necessary by the Commissioner. Additionally, the Department will consider including in its recommendations for the next legislative session a statutory change authorizing the Commissioner or his designee to sit on the Association's board as a non-voting member.

Although there was a delay in formalizing staff notes taken during Association board meetings, staff routinely briefed the Senior Associate Commissioner-Financial Program within a few days after the board meetings. A procedure for promptly formalizing staff notes will be included in the oversight policies and procedures.

Objectives, Scope, and Methodology

Objectives

Our objectives were to determine the following:

- Do the Texas Life, Accident, Health, and Hospital Service Insurance Guaranty Association's (Association) procurement processes ensure that contractors are fairly and objectively selected and that the Association receives the best value?
- Do the Association's oversight processes for contractors ensure that they consistently provide the contracted services at a reasonable price?
- Does the Department of Insurance (Department) provide adequate supervision of the Association's operations?

The work was performed at the request of the Department and the Association. The third objective was added during fieldwork.

Scope

The scope of this audit included reviewing contract administration and oversight controls and processes at the Association. We also reviewed the Department's oversight practices. Our work encompassed all phases of the Board's and LaShelle, Coffman, and Boles, LLP's contract administration practices, including contractor selection, contract establishment, payment methodology, and monitoring activities. We also reviewed management services, third-party administration, reinsurance, and selected legal and professional contracts and letter agreements. We used documentation from calendar years 1997, 1998, 1999, and 2000.

Methodology

We collected and analyzed information and performed selected audit tests and procedures.

Information collected:

- Interviews with board members of the Association, contractors, and Department staff members

Documentary evidence such as:

- Requests for Proposals
- Contracts and results of contract monitoring reviews
- Board meeting minutes

- Policies and procedures relating to contract administration and oversight
- External audit reports
- Budget and other financial information
- Plans of operation

Procedures and tests conducted:

- Tests of processes used to select, reimburse, and monitor contractors
- Review of documentation related to the Association's operations
- Examination of selected expenditure invoices and vouchers
- Analysis of volume of work and costs
- Survey of other states' fee and organizational structures
- Review of documentation related to the Department's oversight of the Association

Criteria used:

- Texas Insurance Code, Chapter 21
- Texas Government Code, Chapter 2155
- Texas Administrative Code, Title 28
- State Auditor's Office's Contract Administration Model

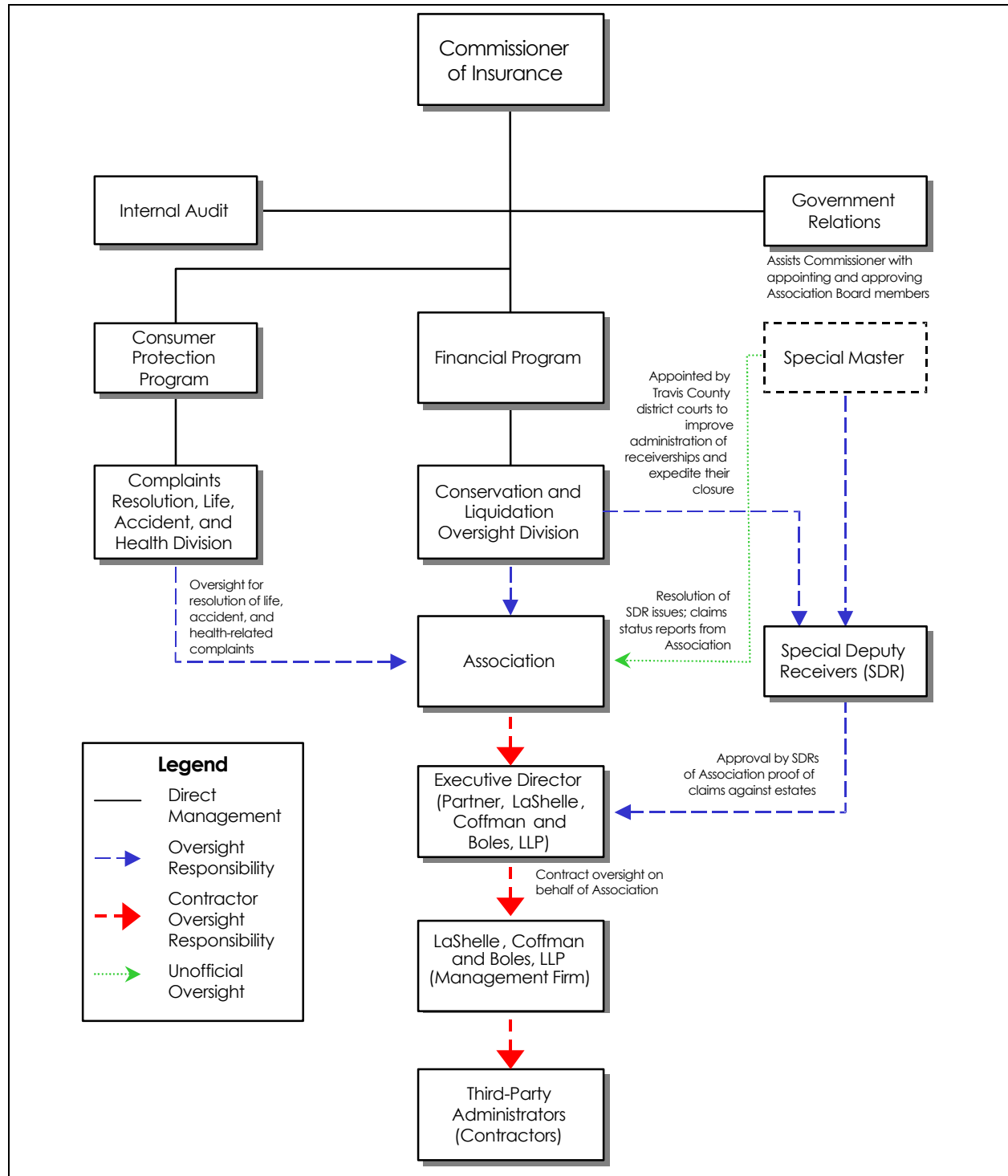
Other Information

We conducted fieldwork from April 2000 through June 2000. The audit was conducted in accordance with *Government Auditing Standards*.

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

- Vandita Zachariah, MBA (Project Manager)
- Susan Van Hoozer, MBA
- Anthony Chavez
- Ron Franke, MBA
- Barbette Mays
- Leslie P. Ashton, CPA (Quality Control Reviewer)
- Cindy Reed, CPA, Audit Manager
- Deborah Kerr, Ph.D. (Audit Director)

Relationship Between the Department of Insurance and the Texas Life, Accident, Health, and Hospital Service Insurance Guaranty Association



Summary Responses From the Association and the Department

The Association s Summary Response



August 23, 2000

VIA FEDERAL EXPRESS

Mr. Lawrence F. Alwin, CPA
Office of the State Auditor
Robert E. Johnson Building
1501 North Congress Avenue
Austin, Texas 78701

Re: Office of the State Auditor's Audit Report on the Contracting Practices of the Texas Life, Accident, Health, and Hospital Service Insurance Guaranty Association (the "Association")

Dear Mr. Alwin:

Because it was impractical for the full Board of Directors (the "Board") of the Association to meet to develop a response to the captioned Office of the State Auditors' Audit Report, the Audit Committee of the Board was tasked to respond on behalf of the Board. The Audit Report and the Audit Committee's proposed response to it was, however, circulated to all individual Board members prior to the delivery of the Audit Committee's response to the State Auditor's Office.

At the outset, on behalf of the full Board, the Audit Committee wishes to commend and thank the Office of the State Auditor for its objective and professional assessment of the Association's historical contracting practices and constructive guidance on how to improve contracting practices in the future. The Audit Committee also wishes to emphasize that it will recommend that the full Board (many members of which were not on the Board at the time of many events at issue in this Audit Report) be fully committed to working cooperatively with the Texas Department of Insurance (the "TDI") in the future to make necessary improvements as expeditiously as practicable. Based on prior informal comments of various Board members, the Audit Committee believes that the Board will adopt its recommendations.

Specific observations of the Audit Committee with respect to various sections in the Audit Report have been previously provided and we understand that they will be set forth in the body of the report. Our more significant points are summarized below:

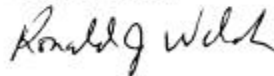
The process in connection with the 1997 Request for Proposal was not unreasonable because: no law or regulation required an RFP to be used; the actual process used was suggested by the TDI; and the independent auditors and legal counsel retained by the Board in connection with this process advised the Board that their actions were reasonable. The Audit Committee will, however, recommend that the Board adopt

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a competitive procurement process for management services consistent with guidance provided by the Office of the State Auditor. The Audit Committee will also recommend adding various contract provisions suggested. The Board, whose members have actual experience with complex business contracts and have no conflicts of interest with the Management Firm, has historically provided meaningful oversight of the Management Firm consistent with standard corporate governance practices. The Audit Committee will recommend, however, working with the TDI to develop an enhanced method of independent monitoring of the Management Firm and improved verification of the reported performance. The Audit Committee will recommend that the Board carefully examine the allowability under the contract of the noted copying costs and of the audit of claims costs and seek to recover any unallowable costs. The Audit Committee will also recommend that the full Board (1) adopt the recommendations for improving practices for third-party administration and (2) study the two cited instances of noncompliance with applicable third party administration legal requirements and take appropriate responsive action.

In conclusion, the Audit Committee respectfully acknowledges that the Audit Report provides impartial and constructive guidance on how to improve the Association's contracting practices. The Audit Committee intends to recommend that the full Board work more closely with the Texas Department of Insurance to appropriately implement the various recommendations in the Audit Report.

Very truly yours,



Ronald J. Welch
Chairman
Audit Committee
(409) 766-6578
Email: ron.welch@anico.com

The Department's Summary Response



Texas Department of Insurance
Office of the Commissioner, Mail Code 113-1C
333 Guadalupe • P. O. Box 149104, Austin, Texas 78714-9104

Jose Montemayor
Commissioner of Insurance

August 14, 2000

Vandita Zachariah, Project Manager
State Auditor's Office
1501 N. Congress, Suite 4.224
Austin, TX 78701

Reference: Department Responses to Draft Audit Report

Dear Ms. Zachariah:

The Department's responses to the draft report on the Texas Life, Accident, Health, and Hospital Service Insurance Guaranty Association audit are attached. I sincerely appreciate your efforts in this matter.

Please contact Dennis Veit, Internal Audit Director, at 475-2990 if you have any questions.

Sincerely,

A handwritten signature in cursive script that reads "Jose Montemayor".

Jose Montemayor
Commissioner of Insurance

Attachment

Lynda Nesenholtz, General Counsel
Stan Wedel, Chief of Staff
Dennis Veit, Director, Internal Audit

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

Department s Summary Response:

The Department fully supports recommendations made in this report to conduct a competitive bidding process for management services and other contracts, and to take steps to strengthen the overall procurement / contracting process. Further, the Department agrees that the Association must provide for on-going, independent monitoring of the contractor s operation on behalf of the Association. The board should take steps to correct this control weakness immediately.

The Department also agrees that deficiencies in the management services contract must be corrected to fully protect the Association s interests. Although the Auditor found that the flat fee payment methodology for management services appeared reasonable, the Department believes it is in the best interest of the Association to contract for services on a hourly fee basis. The Department believes that an hourly fee basis, with a requirement that the contractor submit detailed billings, provides a stronger control.

The Department agrees with the Auditor that the Association should take those steps necessary to recover expense reimbursements not allowed by the terms of the management services contract.

The Department is currently reviewing and enhancing internal oversight policies and procedures. Those policies and procedures will be formally adopted shortly. A requirement to promptly formalize staff notes, taken during Association Board meetings, will be included in the oversight policies and procedures. Additionally, the Department is considering rules and regulations to encourage the Association to comply with Department recommendations.

The Department would like to thank the Association s board members for their willingness to address the concerns noted in this report, and looks forward to working with the board during that process.