

An Audit Report on

Management Controls of the Texas Property and Casualty Insurance Guaranty Association



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Key Points Of Report

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Key Facts And Findings

Overall, management controls at the Texas Property and Casualty Insurance Guaranty Association (Association) are generally effective. The Board of Directors and management of the Association should continue to strengthen specific management controls to improve accountability and control costs.

- The Board of Directors should approve limits on investment risks that are compatible with the Association's overall mission in order to lessen the risk of future investment losses. The Association lost \$3.3 million on sales of investments in 1994, primarily due to interest sensitive investments. Investment earnings of \$13.3 million offset investment losses.
- Management can improve accountability and control costs by:
 - Improving performance measures for claims processing.
 - Taking a more active role in planning and monitoring automation projects. The Association abandoned automation projects costing \$282,582 in 1994.

The Association's purpose is to pay, fairly and in a timely manner, valid insurance claims involving insolvent property and casualty insurance companies, according to Texas laws.

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This management control audit was authorized by the Insurance Code, Article 21.28, §12(k), and was conducted according to Government Code, §321.0133.

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Executive Summary

Overall, management controls at the Texas Property and Casualty Insurance Guaranty Association (Association) are generally effective. The Board of Directors and management of the Association should continue to strengthen specific management controls to improve accountability and control costs. Management controls provide assurance that the Association achieves desired outcomes, or that management identifies and takes needed corrective action. The Association's management improved controls during 1994 and during the course of this audit.

The Board Of Directors Should Approve Limits On Investment Risks That Are Compatible With Its Overall Mission

The investment policy allows greater risk taking than necessary to meet the Association's primary mission of timely payment of insurance claims. The policy allows emphasis on longer term investments with maturities of up to ten years. Investments with longer terms until maturity have greater risk of future losses with rising interest rates. The policy also allows the portfolio to contain 25 percent of investments in derivatives in the form of mortgage backed securities (MBSs) and collateralized mortgage obligations (CMOs).

Despite a generally conservative approach to investments (Figure 1, page 10), the Association lost \$3.3 million on sales of investments during 1994. Most of these losses (90 percent of \$3.3 million) arose from sales of securities having maturities greater than five years. Investment earnings of \$13.3 million offset investment losses.

The Association may save as much as \$175,000 in 1995 investment manager fees. Generally, the Association uses two investment managers whose fees are based on percentages of the portfolio balances that they manage. Because of one investment manager's higher fee structure, the Association paid \$43,893 more than the other manager would have charged in the fourth quarter of 1994. Annualized for 1995, this would amount to about \$175,000 in higher investment manager fees. Lower fees may be available through contract renegotiation, or transfer of investment funds to the lower cost investment manager.

Management Can Improve Performance Measures For Claim Processing And Develop A Statutorily Required Appeal Procedure

The Association's performance measures for claims processing are incomplete and do not provide information on timeliness of processing, cost to process individual claims, or the Association's capacity to process claims. Performance measures are important because of statutory requirements for the Association to provide "prompt payment of claims" and to "avoid excessive delay in payment."

The Association's "Plan of Operation" does not include an appeal procedure for rejected claims as required by the Insurance Code. The lack of an appeal procedure may cause the Association to incur litigation costs even on claims the Association properly denies. Without a formal appeal procedure, parties with denied claims must either remain unpaid or pursue litigation.

Executive Summary

The Board Of Directors Can Enhance Oversight Effectiveness And Accountability With Improvements In Management Reporting And Internal Audit And By Defining Board Committee Responsibilities

Management does not report periodically to the Board on the Association's compliance with the Insurance Code, its Plan of Operation, and its policies. A primary purpose of a Board of Directors is the oversight of an organization, including "corporate governance." In a practical sense, the Association's enabling statute, Plan of Operation, and its policies define "corporate governance" for the Association. Limited reporting on compliance with key aspects of corporate governance can result in instances of noncompliance going undetected.

Association management created internal audit in 1993, and we commend management for creating the position. However, management did not require internal audit to comply with professional standards during 1994. Compliance with professional standards can provide the Board of Directors with more thorough and independent assurance about the Association's financial information, internal controls, compliance with statutes and key policies, and the efficient and effective employment of its economic resources.

The Board Of Directors Can Increase The Use Of Competitive Bidding In Awarding Significant Contracts And Adopt A Policy On The Expenditure Of Funds

The Board of Directors should use competitive bidding when awarding significant contracts.

The Association generally uses a competitive bidding process, but did not use competition in awarding two contracts involving significant expenditures. These contracts were for automation consulting and asset recovery services involving expenditures of \$504,538 in 1994.

The Board has not adopted a policy that guides management to ensure that Association expenses are reasonable, ordinary, and necessary. Two examples of administrative expenses amounting to \$8,927 appear to be higher than necessary. Entertainment expenses, authorized by a management approved policy, do not appear to further the Association's mission of paying claims for insolvent insurance companies.

Management Should Take A More Active Role In Planning And Monitoring Automation Needs

At a strategic level, the process for long-term planning of automation needs has been ineffective. The lack of foresight and planning by management resulted in automation costs that management could have minimized. The cost of the Association's abandoned automation projects was more than \$282,582.

At an operational level, standards and procedures for developing automation projects have been inadequate. The Association had no documented standards or procedures for the development of automation projects. Also, management had no reports to show the cost of developing an interim claims system, which the Association subsequently abandoned.

Executive Summary

Management responses:

Key Facts & Findings

- *The Association's investment earnings of \$13.3 million substantially offset the \$3.3 million in losses on sales of investments occurring in 1994 during an unprecedented period of interest rate increases. Our investment earnings during the first four months of 1995 are \$8.9 million. We believe our overall results validate our conservative investment policy as approved by our Board of Directors, and the Commissioner of Insurance.*
- *Benchmarking performance for claims processing is an issue that is being addressed by the National Conference of Insurance Guaranty Associations. The Texas Guaranty Association has made tremendous strides in improving accountability through the implementation of an external audit program by its member companies. Recommendations of the companies have been implemented as part of the process of improving accountability and controlling costs.*
- *The Guaranty Association informs claimants of their rights and obligations under the Guaranty Act (including the process by which claimants may appeal the denial of a claim by the Guaranty Association) through correspondence entitled "Summary of Rights and Obligations Under the Guaranty Act".*
- *The Association developed a steering committee to ensure a direct role is taken by management in all future planning and monitoring activities*

for automation. A national effort involving Texas as the lead Association has been formulated through NCIGF for the future development of a claims system utilizing combined resources of all participating Associations. This joint effort will minimize all future costs relating to automation, and keep management directly involved and apprised of the process.

Executive Summary

We agree with the State Auditors finding that management controls improved during 1994, and continue to improve with time. As a start up organization, we faced rapid growth in a short period of time. The Board Members have been instrumental in providing oversight and direction to management through their participation at Board meetings, and the establishment of sub-committees to work directly with staff. The Texas Board was one of the most active in terms of meeting with staff. They met more than all other guaranty funds in the country, with the exception of Louisiana. It is only one of three in the country with public members. It has the unique distinction of being the only Board in the country with a public member as Chairman. The Board's commitment was the key component in strengthening management controls to improve accountability and control costs.

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Detailed Issues and Recommendations

The Board of Directors and management of the Texas Property and Casualty Insurance Guaranty Association (Association) should continue to strengthen management controls to improve accountability and control costs. Management controls provide assurance that the Association achieves desired outcomes, or that management identifies and takes needed corrective action. The Association's management improved controls during 1994 and during the course of this audit.

Effective management controls for the Association that maintain accountability and control costs are important for reasons that include:

- Texas taxpayers will provide more than half (58 percent, or \$189 million) of the 1994 revenues that fund the Association.
- As a "nonprofit" entity, the Association does not have a profit incentive as a constraint on expenses that "for profit" entities have.
- As a "quasi-governmental" entity, the Association is not subject to oversight of expenditures that state agencies receive such as through the appropriations process.

The Association, created by the Legislature, is a unique association of property and casualty insurance companies. Its mission is to pay covered insurance claims for insolvent property and casualty insurance companies in a timely manner according to the laws of Texas.

Section 1:

The Board Of Directors Should Approve Limits On Investment Risks That Are Compatible With Its Overall Mission

Section 1-A:

The Investment Policy Allows Greater Risk Taking Than Necessary To Meet The Association's Primary Mission Of Timely Payment Of Insurance Claims

The investment policy allows greater risk taking than necessary to meet the Association's primary mission of timely payment of insurance claims. The following aspects of the Association's investment policy create greater than necessary risk and the possibility of future losses:

- The policy allows emphasis on longer term investments with maturities of up to ten years. Investments with longer terms until maturity have greater risk of future losses with rising interest rates.

- Changes in the investment policy in 1993 created expectations of higher investment earnings. The Association changed its investment policy to allow investments in higher yielding securities. In effect, the policy authorizes the Association and its investment managers to pursue higher risks to obtain higher yields.
- The policy places heavy reliance on investment managers to make investment decisions. The Association's policy states that "It is the intention of the Association to allow investment managers full discretion within the scope of these investment guidelines and applicable statutory parameters." As a result, an effective investment policy is important to provide appropriate risk limits to investment managers.
- The policy allows an investment manager's portfolio to contain up to 25 percent in derivatives. (Broadly defined, derivatives are financial instruments whose value is linked to, or "derived" from, changes in some underlying stock, bond index, commodity, or other asset, such as a mortgage.) The policy allows derivatives in the form of mortgage backed securities (MBSs) and collateralized mortgage obligations (CMOs). The policy authorizes a total of more than \$100 million in derivatives based on present portfolio size. Uncertainties associated with MBSs and CMOs coupled with the 25 percent investment limit may allow greater overall risk taking than is necessary. The Association invested \$20 million in MBSs and CMOs (about five percent of the portfolio) as of December 31, 1994. (The policy also has a separate limit that CMOs not exceed more than 15 percent of the portfolio.)
- In its risk assessment of investments, the policy does not require any independent evaluation of risks associated with derivatives (MBSs or CMOs) in its portfolio.
- The policy did not require management to obtain estimates of changes in portfolio market values due to adverse changes in interest rates. This information could allow the Association's Board of Directors and management to better assess risk, as well as the effect (potential losses), of rising interest rates on portfolio market values.
- The policy has no express prohibition against borrowing in the investment process. Borrowing can magnify the effects of both investment gains and losses. Borrowing caused another governmental entity (Orange County, California) to experience extraordinary losses in conjunction with derivative investments.

Despite a generally conservative approach to investments (see Figure 1, page 10), the Association lost \$3.3 million on sales of investments during 1994. Most of these losses (90 percent of \$3.3 million) arose from sales of securities having maturities greater than five years. Losses in 1994 on sales of investments were the third largest expense of the Association (after claims administration and employment expenses).

Investment earnings of \$13.3 million (net of investment advisor fees of \$518,583) offset investment losses.

The Association also reported an additional \$7 million in "unrealized" losses on the investment portfolio. The "unrealized" losses reflect the difference between cost and market values as of December 31, 1994. Most of the unrealized losses (74 percent, or more than \$5 million) were in investments with maturities greater than three years and are sensitive to changing interest rates. The Association indicates that it recouped most of the \$7 million in unrealized losses in early 1995 as market values rose.

Despite the losses incurred in 1994, the investment policy has strengths that protect it from the extraordinary losses experienced by other governmental corporate investors. These strengths include:

- The policy does not allow high-risk mortgage backed securities as defined by the Federal Financial Institutions Examination Council (FFIEC).
- The Association uses separate investment custodians and investment managers.
- The Association uses independently prepared indexes to evaluate investment manager performance.
- The policy requires diversity of risk using limits or exclusions on certain types of investments.
- The Association began disclosing information on realized investment losses within footnotes of its 1994 financial statements. The Association disclosed unrealized losses in monthly financial statements throughout 1994.

Investment losses occurred in part due to unusually frequent interest rate changes. The Federal Reserve raised interest rates a total of six times in 1994 and again in January 1995. As interest rates rise, market values of interest sensitive investments decline.

Recommendation:

We recommend that the Association improve its investment policy and reduce exposure to future losses by:

- Aligning its investment policy risks with its overall mission to pay claims in a timely manner. The Association can define clearly acceptable risks using shorter limits on investment maturities.
- Lowering the maximum amount of derivatives (MBSs and CMOs) allowed in the portfolio.
- Considering the use of an outside rating service to evaluate risk of derivatives in the portfolio.
- Requiring management to obtain estimates of changes in portfolio market values due to adverse changes in interest rates.

- Prohibiting borrowing for investments without the Board of Directors' express authorization.

Management's Response:

We believe the investment policy is adequately aligned with our mission. Current guidelines provide an estimated 1 year of funds in short term with the balance of the portfolio in longer term investments. While it is true there are greater risks in longer term investments, there is a corresponding opportunity of greater return. Most estate claims (by count of estates versus dollars) may be paid in three years but payment patterns for specific very large estates including ECC and TEIA workers comp and other workers comp estates will not follow this pattern, nor will the environmental files. These reserves together are over \$300 million which is 3/4 of our total reserves. The majority of the \$300 million in pending payments will be paid out far beyond the duration level of our portfolio. With current average portfolio duration at 3.2 years, we do not feel out of line with duration levels for the portfolio given the long-tail nature of many of the above referenced claims.

We believe the policy outlines acceptable risks and has adequate safeguards. As the auditor noted, mortgage backed securities must pass the FFIEC test as stated in the investment policy. By definition, passing this test indicates the low risk of the investment. CMOs must be AAA Moody's or S&P as stated in the policy. These are investment grade instruments, also of low risk. The balance of the portfolio is in U.S. Treasuries, commercial paper and U.S. government agencies. The Association does not and has not dealt in high risk securities.

The Board will consider lowering the percentage of mortgage backed securities and CMOs in the portfolio. CMOs for 1994 averages 4% of the portfolio with mortgaged backed averaging 2.4%.

CMO investment limits are currently 15% of each managers portfolio, with a 25% limit on combined passthroughs and CMOs.

We believe the tests prescribed in the investment policy are adequate to evaluate the CMOs and mortgage backed securities.

The portfolio could be evaluated relative to its market value versus changing interest rates. We continue to mark all investments to market monthly as market values change. Doing this evaluation on a prospective basis seems rather speculative. This exercise seems of questionable value beyond the very short term. We believe actions of the Federal Reserve are not clearly predictable beyond the very short term, if then.

We agree that borrowing for purchase of investments should not be allowed without the Board of Directors authorization. Borrowings of this nature have not occurred. With the Board's consent, we plan to amend the investment policy to include this provision.

Auditor's Follow-Up Comment:

1) The Association's independent CPA firm made the following recommendation in a March 24, 1995, report to the Board of Directors:

"Investments - The Association's investment policy allows for the purchase of securities with maturities up to ten years from the date of purchase. This exposes the portfolio to increased investment risk.

We (the CPA firm) recommend that the Board consider amending this policy to more closely match investment maturities with cash flow needs. Most claims are estimated to be paid within three to five years."

We believe this recommendation by the Association's independent CPA firm supports our recommendation that the Association use shorter limits on investment maturities.

2) Indeed, the actions of the Federal Reserve are not clearly predictable beyond a very short term, if then. We are certain, however, that interest rates will periodically rise and fall over time, as they have historically, thus creating the future potential of gains and losses as interest rates change.

A variety of sources (e.g., banking regulators, Federal Reserve officials) suggest that obtaining information about changes in portfolio values due to prospective changes in interest rates may be a constructive effort.

With a similar intent, the American Institute of Certified Public Accountants (AICPA) developed specific questions that can help top management and boards of directors gain a better understanding of their investment activities. In part, the AICPA poses the question, "Do the right persons have the right information to make decisions?" In attempting to answer this question, the AICPA also asks "Do we know how the value of our derivatives will change under extreme market conditions?" Obtaining information of the impact of a one percent rise or fall in interest rates on portfolio values may better inform the Association's management and Board of Directors of the magnitude of possible future gains or losses due to changing interest rates.

Also, one of the Association's investment managers indicates in their literature that they have the capability to determine the total return of securities under various interest rate scenarios.

Figure 1

Texas Property and Casualty Insurance Guaranty Association Investment Portfolio as of December 31, 1994			
Type of investment	Cost	Market Value (estimated)	Percent of Portfolio (at market)
Short-term promissory notes (commercial paper)	\$156,167,691	\$156,167,691	37.3%
U. S. Treasury Bills	\$29,498,977	\$29,521,418	7.1%
U. S. Treasury Notes	\$203,823,668	\$197,982,401	47.3%
Other Treasury Mutual Funds	\$697,810	\$697,810	0.2%
Mortgage Backed Securities and Collateralized Mortgage Obligations (GNMA, FNMA, FHLMC)	\$20,329,845	\$19,824,245	4.7%
U. S. Government Agency Discount Bonds and Notes	\$6,799,628	\$6,728,486	1.6%
African Development Bank	\$2,343,548	\$2,072,240	.5%
Asian Development Bank	\$2,612,291	\$2,264,350	.5%
Accrued Interest	\$3,207,021	\$3,207,021	.8%
Totals	\$425,480,479	\$418,465,662	100.00%

Note: Most of the Association's portfolio (91.7 percent) is in commercial paper and U.S. Treasury bills and notes.

Section 1-B:

**The Investment Policy Does Not Define How And When
Management Should Summarize Investment Results For Reporting
To The Board Of Directors**

The investment policy does not define how and when management should summarize investment results for reporting to the Board of Directors. An investment policy should require interim and annual reports to provide a mechanism for monitoring investment activities. Better controls on the quality and frequency of information presented to the Board of Directors for their consideration would minimize the risk of ineffective oversight occurring.

The Association's contracts with investment managers do include requirements on reporting investment activities to management. These requirements assist management's review of investment activities.

Recommendation:

We recommend that the Board of Directors define in its Plan of Operation minimum reporting requirements to the Board by management for the Association's investment activities.

Management's Response:

Performance evaluation and reporting are defined in the investment policy indicating investment manager performance is to be evaluated quarterly in comparison to the investment policies specified indices. Note that the managers have outperformed the indices in all quarters for 1994. The Investment Committee chair requested (at the December, 1994 Board Meeting) that we provide quarterly reports to the Board regarding investment performance. A report set was provided for the April 13, 1995 Board meeting and we will continue compliance.

The investment policy contains very specific language about how the investment managers are to report monthly to the Executive Director on their performance including yields, earnings, market value, realized and unrealized gains and losses, indices comparisons, etc. As this is included in the investment policy and the managers are required to be in compliance with the policy we do not see the need to include requirements in the manager's contract as well.

The Board will consider formal adoption of reporting requirements for inclusion in the Plan of Operation.

Section 1-C:

Savings In 1995 Investment Manager Fees Of As Much As \$175,000 May Be Possible

The Association may save as much as \$175,000 in 1995 investment manager fees. Investment manager fees in 1994 totaled \$517,583 and represented the seventh largest expenditure of the Association.

Generally, the Association uses two investment managers whose fees are based on percentages of the portfolio balances that they manage. The Association hired one manager to be responsible for short term or cash management funds. The other manager is responsible for longer term funds.

In late 1994, the short-term investment manager began to manage longer term funds as well. Because of the short-term manager's higher fee structure, the Association paid \$43,893 more than the other manager would have charged. Annualized for 1995, this would amount to about \$175,000 in higher investment manager fees which the Association can avoid if it pays fees at the lower rate. For funds greater than \$100 million, the short-term manager's fees are three times higher than the other manager's fees.

Recommendation:

We recommend that the Association either move its longer term funds to the lower investment fee structure, or renegotiate the investment manager's contract to reduce the higher fee structure.

Management's Response:

Because of growth in longer-term investments, the Investment Committee has opted to split duration funds among the two managers on an approximate 50/50 basis. The possible savings cited of \$175,000 is possible only if the Association opts to change policy, which would reduce portfolio diversification and move all duration funds to one manager thus saving a 15 basis point fee differential on the first \$100 million (since all funds would now be under one manager) and a 10 basis point fee differential on funds over \$100 million. This policy change will be considered by the Board. Assuming the current policy stands, savings of \$10,000 per year are possible by renegotiating the over \$100 million fee with the one manager who charges 15 points for over \$100 million funds versus the 5 points charged by the other manager. This renegotiation has taken place and the 15 point manager is now on a performance fee basis with a 5 point floor.

Section 2:

Management Can Improve Performance Measures For Claim Processing And Develop A Statutorily Required Appeal Procedure

Section 2-A:

Performance Measures For Claim Processing Are Incomplete

The Association's performance measures for claim processing are incomplete and do not provide information on timeliness of processing, cost to process individual claims, or the Association's capacity to process claims. We noted the following:

- Claim processing reports do not show estimated backlogs in the Association's capacity to process claims. For example, Association reports indicate 19,626 unprocessed unearned premium claims as of December 31, 1994. The Association suggests that it has the capacity to process about 1,000 to 1,500 unearned premium claims per month. This represents an estimated backlog of between 13 and 19 months needed to process this type of existing, covered claim. This backlog estimation does not reflect an additional 74,997 unearned premium claims now in a class action lawsuit to determine whether the additional claims are covered (should be paid) by the Association.
- Conclusions on timeliness and cost of claim processing efforts are not clear from existing reports. Current reporting on claim processing indicate overall activity levels (i.e. numbers of claims) and overall elapsed time (months or years to process).

- The Association reports overall costs to process claims, but not on an individual claim basis.

Statutes divide the Association's claim responsibility into three separate "lines" of insurance: automobile insurance, workers' compensation insurance, and "other" lines of insurance. Comments in this section on performance measures relate to claims other than workers' compensation claims. In addition to Association monitoring, the Texas Workers' Compensation Commission also monitors timeliness of workers' compensation claims.

Evaluating claim processing performance is more difficult for the Board of Directors and those outside the Association when relying on incomplete performance measures. Evaluating whether processing times and costs are reasonable or excessive, and whether processing delays are within the control of the Association, is difficult. The Association depends on others to provide documentation that would allow claim processing to continue. Access to claim records and the quality of claim file documentation contribute to delays that are not always within the Association's control.

The Association recently developed performance measures for the initial phases of acquiring an estate (an insolvent insurance company). This improves accountability for the early phases of an estate. However, these performance measures do not define, measure, and report the time and cost to process an individual claim file.

Performance measures are important because of statutory requirements for the Association to provide "prompt payment of claims" and to "avoid excessive delay in payment." The Association relies on a manual, supervisory review of claim files to ensure that claims are processed timely.

In part, excessive turnover in the claim director position has limited the development of performance measures. Three individuals held the position during the last two years (1993-1994).

Association research shows that most claims are already "old" by the time the Association has responsibility for processing. The Association reviewed open claims according to accident year to develop data on the age of claims. Three of every four claims are five or more years old. One of every three is at least ten years old. The age of files contributes to the difficulty in completing documentation needed to process and pay covered claims.

During this audit, two insurance companies conducted reviews of the Association's claim processing activities at the Association's request. Regarding workers' compensation claims, the reviewers commented that key management personnel were "responsible, professional, and knowledgeable, both managerially, and technically," and that claim adjusters were "technically sound." The separate review of automobile claims issued an overall opinion that the Association had done an ". . . excellent job in establishing proper procedures and methods to increase productivity, efficiency, and accountability. . . ."

Both outside reviews made constructive recommendations to improve claim processing procedures. One recommendation suggested that the Association establish "a method for creating a calendar system whereby the representative (i.e. claim adjuster) reports to management their progress on a scheduled basis." This external recommendation parallels our finding in this section on the need for performance measures to monitor timeliness of processing.

Recommendation:

We recommend the Association define and report performance measures that include elements of time, cost, and capacity to process claims. We also recommend that the Association periodically continue outside reviews of its claim processing function and commend it for developing this review procedure.

Management's Response:

The Association has prepared a Performance Standard that outlines the time lines, after the acquisition of an estate, for performance goals in the first 24 hours, the first 90 days, and the first 6 months. This performance standard tracks the uniqueness of the Association's claims operation as opposed to the ones utilized in the standard insurance industry. The Association has met with several member companies to determine how various timelines are documented. We learned that the member companies rely on the same manual procedures of supervisory review of claim files to assure that claims are being processed timely.

The Association has determined average file loads that can be handled by a claims adjuster and a litigation specialist. All of the litigated and non-litigated claim files are on the claims processing software so that statistical data can be tracked. Through the use of monthly production reports from the computer, the Association is able to track the production of each individual adjuster, each regional office, and the entire production of the Association for all covered loss claims. These reports are monitored monthly by management. In keeping with our Board's objective, over 25% of the claim file load is outsourced to approved contractors in the private sector.

The Association is reviewing its practices, procedures, and management systems to possibly better define the cost per claim of claims processing.

The unearned premium claims are another unique feature of the Association's work product. Once a carrier is placed into receivership, the policies are canceled, and the remaining unearned premium is a covered claim that is processed by the Association along with covered loss claims. Because the universe of unearned premiums arising out of policies issued will always be greater than the universe of the covered loss claims, the statistical numbers for the UEP claims will always be greater than the covered loss claims. UEP claim counts are further skewed because of delays in acquisition of records, such as the policies of the insolvent insurer; when this occurs the Association can not begin its statutory obligation of paying covered claims.

In 1994 the Association recognized the large volume of UEP claims that were being presented for processing, and has responded appropriately to address this surge of business activity. First, the Association recognized the uniqueness in how a UEP claim should be processed and had a special software program written that automated processing and saved time. This new software program was put into use effective April 1, 1995. In addition to improved automation, the Association recognized that more individuals needed to be cross-trained to process UEP claims to assist in the backlog, and process future estates. Training began in Dallas in 1994, with three individuals cross-trained to process UEP claims. In 1995 three individuals in Houston will be cross-trained, which will increase the total number to eight, including the two original personnel in Austin. The results of the UEP training and the UEP automated software program should have a dramatic impact on the backlog by the end of 1995.

The Association is committed to excellence, and will continue to have periodic outside reviews of its claims processing functions.

Section 2-B:

The Association Does Not Have An Appeal Procedure For Rejected Claims

The Association's "Plan of Operation" does not include an appeal procedure for rejected claims as required in the Insurance Code. The lack of an appeal procedure may cause the Association to incur litigation costs even on claims the Association properly denies. Without a formal appeal procedure, policyholders with denied claims must either remain unpaid or pursue litigation. An appeal procedure could help persuade claimants that the Association used "due process" in denying claims and, therefore, minimize the incidence and cost of litigation.

To reduce legal costs, the Association is emphasizing the use of mediation rather than litigation. The Association could incorporate this improvement as part of an appeal process. The Association's procedures provide an internal review of claims that are denied payment to ensure that nonpayment in whole or in part is appropriate.

Recommendation:

We recommend the Association comply with statutory requirements and improve customer service by developing an appeal procedure as required by the Insurance Code.

Management's Response:

The guaranty association does have a procedure for the appeal of the denial of a covered claim. The procedure authorized by Art. 21-28-C, Insurance Code ("Guaranty Act") is the same procedure that a claimant would have under the policy

of insurance for which coverage is sought, i.e., the filing of a lawsuit against the insured of an impaired insurer under a liability policy or the filing of a lawsuit against the guaranty association by the insured on a first party claim. This procedure is described for the claimants in correspondence sent to claimants by the guaranty association in a document outlining the claimant's rights and obligations under the Guaranty Act.

Currently, the Guaranty Act does not authorize, create or require an administrative procedure for appealing the denial of claims. The guaranty association is, however, interested in considering any modification to the Guaranty Act that would increase the effectiveness and decrease the cost of guaranty association activities. One such consideration could be seeking statutory authority to move from the current system to an administrative procedure for appealing a claim under the Guaranty Act. While such a procedure could avoid costly litigation, it would do so by limiting a claimant's right to a trial de novo. Any such change would require the balancing of competing interests by the guaranty association board of directors and, ultimately, the legislature.

The guaranty association will prepare and submit an amended Plan of Operation to the Commissioner of Insurance incorporating any appropriate changes or clarifications.

Auditor's Follow-Up Comment:

The Guaranty Act (Article 21.28-C, Section 9(d)(4)) states in part:

"(d) The plan of operation must: . . . (4) provide . . . a procedure for appealing the denial of claims by the association. . . ."

Management's responses indicate that the Association has a "procedure" for the appeal of a claim which has been denied and, therefore, meets "technical compliance" with statutory requirements. However, we believe the Association and others could benefit from an appeal procedure that included alternatives to a "litigation only" approach as used now as an appeal procedure. We recommend that the Association evaluate implementing an appeal process that reduces costs to the Association and considers the interests of affected parties.

Section 3:

The Board Of Directors Can Enhance Oversight Effectiveness And Accountability With Improvements In Management Reporting And Internal Audit And By Defining Board Committee Responsibilities

Section 3-A:

Management Does Not Routinely Report To The Board Of Directors On Compliance With Its Enabling Statute, Plan Of Operation, And Policies Adopted By The Board

Management does not report periodically to the Board of Directors on the Association's compliance with the Insurance Code, its Plan of Operation, and its policies. Limited reporting on compliance with key aspects of corporate governance can result in instances of noncompliance going undetected.

We noted the following instances where the Association's Plan of Operation does not meet statutory requirements:

- The Plan of Operation does not include a procedure for appealing the denial of claims by the Association as required by statute.
- The Plan of Operation does not provide that member insurers may appeal final actions or decisions of the Association to the Commissioner of Insurance, nor does the Plan establish the amount and method of reimbursing members of the Board of Directors for expenses.

A primary purpose of a Board of Directors is the oversight of an organization including "corporate governance." In a practical sense, the Association's enabling statute, Plan of Operation, and its policies define "corporate governance" for the Association. The enabling statute for the Association defines many responsibilities for the Association. The Plan of Operation is required by statute and provides for the "fair, reasonable, and equitable administration of the Association." Policies establish expectations and guidelines for employees in daily operations of the Association.

Management reporting to the Board of Directors is improving. Beginning with 1994 results, board members will receive an annual report on Association activities, including progress in attainment of the Association's 1994 Strategic Plan. This information will assist the Board in evaluating the progress and performance of the Association and its management.

Recommendations:

We recommend management develop a quarterly "Report of the Executive Director to the Board" which includes important matters such as status of compliance with relevant statutes, its Plan of Operation, and the Association's policies.

Management's Response:

The Board of Directors have been receiving monthly packets of information from the Executive Director since January of 1995. These packets contain information regarding the Association's compliance with policy issues previously adopted by the Board. Board meetings have always reflected updates and clarifications on the 21.28C, or the Guaranty Act. The minutes of the Association meetings are reflective of the variety of issues being presented to the Board during Executive Session. The Plan of Operation is reflected in the Guaranty Fund Statutes. Any changes must be submitted to the Insurance Commissioner for his approval prior to changes being implemented. The only change to the Association Plan of Operation was the Investment Policy. This change was submitted and approved by the Commissioner. Any other changes to the Plan of Operation will be developed with Board input.

Section 3-B:

Management Did Not Require Internal Audit To Comply With Key Professional Standards In 1994

Association management created internal audit in 1993, and we commend management for creating the position. However, management did not require internal audit to comply with professional standards during 1994. Examples of noncompliance with standards include:

- lack of an annual audit plan approved by the Board of Directors
- lack of independence by reporting to management rather than the Board
- lack of periodic peer reviews

Management is moving the internal audit function toward greater compliance with professional standards. During the audit, we noted that the internal audit function will begin reporting to the Board of Directors to improve its independence.

Compliance with professional standards can provide the Board of Directors with more thorough and independent assurance about the Association's financial information, internal controls, compliance with statutes and key policies, and the efficient and effective employment of its economic resources. An ineffective internal audit function may leave the Association more susceptible to undetected errors, irregularities, fraud, waste, or abuse. The Institute of Internal Auditors and the Comptroller General of the United States publish standards for internal auditing.

Recommendations:

We recommend that the Board of Directors require internal audit to comply with standards common to industry and government.

Management's Response:

In order to be in compliance with the auditing standards as promulgated by the Institute of Internal Auditors, the Texas Property & Casualty Insurance Guaranty Association's Internal Audit started to report internal audit matters to the Finance & Audit Committee and administratively to the Executive Director in early 1995. In April 1995, the Board unanimously passed a motion to adopt the Audit Committee Charter and the Internal Audit Charter and approve the Project /Audit Schedule for Calendar Year 1995. Internal Audit has and will continue to comply with auditing standards.

Section 3-C:

Most Committee Responsibilities Of The Board Of Directors Are Undocumented

Six of the Board's seven standing committees did not define and document their respective responsibilities. The Board established seven standing committees by 1994. Only one of these committees formally defined its responsibilities. Because committees provide oversight at the practical level for the Board, committee performance (and, therefore, Board oversight) is less likely to be effective when the expectations or responsibilities are informal and undocumented.

Recommendations:

We recommend that the Board of Directors amend the Plan of Operation to include the significant responsibilities of each standing committee. We noted the Board began formal consideration of all committee responsibilities in its meeting agenda for February 9, 1995.

Management's Response:

Two committees were established in 1993 to assist staff in reviewing and interpreting policy developed by the Board. The Personnel Review Committee formally established its roles and responsibilities in November of 1993. On April 13, 1995, the Board of Directors adopted an audit committee charter and statement of responsibility outlining roles and responsibilities for the Finance and Audit Committee, as well as the Investment Committee. All remaining committees will be defined in a similar manner to ensure consistency in Association operations. Management will prepare the changes for approval to the Board, and as an amendment to the plan of operation for approval by the Commissioner of Insurance.

Section 3-D:

Management Does Not Provide Important Training For Board Members

Management does not provide important training for board members in relevant areas such as fiduciary responsibilities, investments, claim processing, and open meetings. Training is important to ensure that board members collectively possess knowledge or expertise needed to understand complex insurance and insolvency matters. Board members have significant responsibilities covering:

- over \$400 million in investments
- complex litigation (such as environmental claims)
- financial reporting issues
- statutory compliance (such as open meetings and records requirements)

Individual board members provide a variety of experiences, skills and interests. Five members represent the insurance industry and four members represent the public. Training is also important because board members may have fiduciary responsibilities that can translate into personal liability.

The Association shows the ability to provide quality training materials for employees, especially claim processing. The Association created and updates reference materials that provide a clear understanding of the uniqueness of the statutory requirements for claim processing.

Recommendation:

We recommend that Association management provide for periodic training of board members in needed and relevant areas such as fiduciary responsibilities, investments, claim processing, and open meetings.

Management's Response:

A training program for new Board members will be developed that provides the following items.

1. *Guaranty Fund Operations:*
 - a) *Current Staffing*
 - b) *Strategic Plan*
 - c) *Budget*
 - d) *Annual Report*
 - e) *Audit Reports*
2. *Open Meetings/Open Records*
3. *Fiduciary Responsibilities*
4. *Introduction to Money Managers*

Of the nine board members, five are insurance company executives with extensive years of experience in insurance company operations. Out of the four public members, two are plaintiff attorneys, one is a deputy director for an insurance pool, and the Chairman is a successful independent business man. Our need for training has been minimal with the makeup of the current Board. The Association does see a need for establishing a training program for new members to advise of the total responsibilities, liabilities and protections they inherit on being selected to serve. A training program should provide some consistency in how the Board operates as new members are selected.

Section 4:

The Board Of Directors Can Increase The Use Of Competitive Bidding In Awarding Significant Contracts And Adopt A Policy On The Expenditure Of Funds

Section 4-A:

The Board Of Directors Should Use Competitive Bidding In Awarding Significant Contracts

The Board of Directors should use competitive bidding in awarding significant contracts. The Association generally uses a competitive bidding process, but did not use competition in awarding two contracts involving significant expenditures. These contracts were for automation consulting and asset recovery services. Inception to date expenditures (1992-1994) for these contracts amounted to \$903,667. More than half of the expenditures (\$504,538) occurred in 1994.

Also, the Association did not periodically evaluate contractors for performance and compliance with contract terms during 1994. The Association's Board of Directors have not adopted policies that address contract management. Without monitoring a contract, the Association receives limited assurance that contractors follow performance standards included in contracts. Management assigned responsibility for contract evaluation to internal audit beginning in 1995.

In these two contracts, the Association is not assured that it receives the best combination of price, terms, and performance. Their overall cost is likely higher than if competitively bid or, alternatively, if Association employees provided these services. In the consulting contract for automation, the primary billing rate was \$85 per hour and included the free use of five personal computers belonging to the Association.

Recommendation:

We recommend that the Association use a competitive process in awarding significant contracts. We also recommend that management carry out its plans to periodically evaluate contractors using the Association's internal audit function.

Management's Response:

Effective May 1994, all major purchases have been completed in accordance with a draft purchasing policy that requires the solicitation of bids or proposals on a competitive basis for all major purchases of commodities or services. The contracts for automation consulting and asset recovery services were executed prior to May 1994; because these services were secured prior to execution of the Association's purchasing guidelines, they were not procured in accordance with prevailing policy.

The Board of Directors formally adopted the "TPCIGA Purchasing Guide", a compilation of its procurement policies and procedures, at its April 13, 1995 meeting, and all future major transactions (purchases of \$1,000 or more) will be executed in accordance with its requirements.

Consistent monitoring will be assured for all current and future contracts entered into by the Association by adhering to a two-phased approach to monitoring. At the time of contract execution, a contract manager will be designated whose responsibilities will include periodic review of contractor performance in accordance with performance standards set out in the procurement documents, and subsequently, the contract. Thereafter, the Association's Internal Auditor will periodically review current contracts being administered by the Association for compliance with contract terms and conditions.

Section 4-B:

The Board Has Not Adopted A Policy On Association Expenses

The Board has not adopted a policy that requires Association expenses to be reasonable, ordinary, and necessary. Management drafted a policy on purchasing in May 1993, including criteria that Association expenses should be reasonable, ordinary, and necessary. This policy has not been adopted by the Board.

Certain expenses incurred by the Association either do not appear to further its mission of paying claims for insolvent insurance companies, or seem higher than necessary. The following examples total \$8,927:

- The Association conducted a retreat for its management and Board of Directors in October 1993. The total cost of the retreat for three days and two nights was \$8,111. The concept of a retreat can be a productive event; however, the amount of this expenditure seems high. Lodging costs alone were approximately \$3,623 (more than \$235 per night).
- The Board of Directors held an emergency meeting, including dinner at a local restaurant, at a cost of \$816 for 16 individuals. We believe the cost of the dinner (\$51 average per person) was high.

Also in 1994, management adopted a policy on travel expenses that authorizes entertainment expenses.

Recommendation:

We recommend that the Board of Directors approve all Association policies, including a policy that provides the Association with guidance on expenses. We recommend the Board adopt policies that further the Association's attainment of its mission, with Association funds used for reasonable business expenditures rather than entertainment.

Management's Response:

With respect to the recommendation that the Board of Directors approve all Association policies, including a policy that provides the Association guidance on expenses, there are three primary policy documents that are reviewed by the Board of Directors.

A. Historically and currently, the Board of Directors considers and adopts an annual budget that establishes policy parameters for expenditure of funds.

B. The Association's Travel Policy, which has been in use for several years, sets out expenditure policies pertinent to travel. The Board will consider formal adoption of a travel policy.

C. The Board of Directors formally adopted the "TPCIGA Purchasing Guide", a compilation of its procurement policies and procedures, at its April 13, 1995 meeting, and all future major transactions (purchases of \$1,000 or more) will be executed in accordance with its requirements.

Although the Association's general eligibility guidelines did indicate that entertainment expenses are an eligible expense if incurred by the Board or incurred or authorized by the Executive Director, this provision was and is still narrowly construed to include only dining-related expenses for people with which the Association is otherwise engaged in official business. The fact remains that only necessary, appropriate and reasonable expenses directly related and pertaining to official Association business are reimbursable. However, the current language is misleading and inaccurate and is therefore being amended to exclude entertainment expenses altogether, since it was never intended that anything other than dining expenses would be eligible.

Section 5:

Management Should Take A More Active Role In Planning And Monitoring Automation Needs

Section 5-A:

The Association's Process For Long-Term Planning Of Automation Needs Has Been Ineffective

At a strategic level, the process for long-term planning of automation needs has been ineffective. The Association's planning for automation was reactive rather than anticipatory.

- The lack of foresight and planning by management resulted in automation costs that could have been minimized. The Association abandoned in-process automation projects in favor of adopting automation capabilities of a company that became impaired (insolvent) in February 1994. The cost of the Association's abandoned projects was more than \$282,582. The choice to use an insolvent company's automation capabilities for the Association's claim processing needs may have been the best available option at that time.
- As of December 31, 1994, the Association had no clear plans for automation beyond March 31, 1996, the termination date of a contract with an outside data processing service.
- The Association cites automation initiatives in its 1994 strategic plan. However, there was no formal monitoring or evaluation of progress in meeting the plan during 1994.
- Ineffective planning is due, in part, to the lack of an established system or process to trigger senior management's involvement in decision making for automation. Since 1992, the Association placed extensive reliance on outside consultants for planning and other information-related projects. The Association paid more than \$852,465 in automation consultant fees over 30 months ending December 31, 1994.
- Significant actual growth in claim processing indicates an over reliance on initial strategic planning assumptions in an automation consultant's report. A consultant began the Association's long-term planning for automation in mid-1992. The consultant stated a key assumption in a September 28, 1992, report to the Association:

"There was general agreement that total P&C activity was unlikely to increase significantly in the next two to five years. . . . To permit management flexibility in this policy area, we have based our recommendations on the assumption of an *increase of as much as twenty-fold in association claims processing* from current levels."

Actual growth in Association claim processing in early 1994 became significant and began to exceed initial assumptions less than 17 months after planning began. The Association cites an increase in processing monthly checks from 500 per month at the end of 1993 to 10,000 per month in early 1994.

Recommendation:

We recommend that management develop and document plans for automation beyond March 31, 1996.

We recommend that management take a more active role in planning and monitoring automation needs. One way to accomplish this is to establish an executive steering

committee that would periodically establish plans and review and monitor the current automation environment. We noted that the Association began carrying out this recommendation during this audit.

We also recommend that management document a cost-benefit analysis that compares extensive use of consultants with the lower costs of hiring personnel.

Management's Response:

Automation plans beyond March 1996 are being developed as evidenced by Board approval of a migration feasibility study for our claims system to a system even more cost-effective than our shared service bureau arrangement. This analysis will document our long-term direction for our primary system.

We believe senior management has been very active in automation issues as evidenced by participation in the decisions made to migrate from the PC system to a high-volume environment and negotiating the agreements necessary to put this in place along with an agreement to migrate to a more cost effective service bureau platform. The move to a single system was sensible and a necessity given the overwhelming amount of data and volume processing needs incurred with the insolvency of ECC, the election to process TEIA claims of \$200 million, and the subsequent election of approximately 50 estates in 1994, and all of their outstanding claims.

Moving forward, we have formalized our activities as follows. We have established a formal management steering committee that will direct automation efforts comprised of senior management representing our respective divisions that use the system(s). The feasibility study cited above is under committee control. We have also had a claims system users group established since the 3rd quarter of 1994, which directs minor enhancements to the system with oversight by the steering committee whose members participate in the user group meetings.

Consultant activity has continued, but at a greatly reduced level. We acknowledge their activity must be cost effective. We would point out that a savings of \$1.2 million for the Association was achieved when a consultant's recommendation for automation direction was implemented freeing the Association of long-term contracts for hardware and software not suited to our long-term needs.

Section 5-B:

Standards And Procedures For Developing Automation Projects Have Been Inadequate

At an operational level, standards and procedures for developing automation projects have been inadequate. We noted the following:

- The Association had no documented standards or procedures for the development of automation projects.
- The Association had no reports to show the cost of developing an interim claims system, which the Association subsequently abandoned.
- Information Systems (automation) management personnel no longer with the Association have not been replaced.
- The Association placed extensive reliance on outside automation consultants.

Controlling an automation project includes specifying clear responsibility and accountability for meeting project requirements, budgets, schedules, and objectives. The absence of controls over the development of automation projects can result in delays, excessive costs, and the ultimate risk of not meeting user needs.

Recommendation:

We recommend that management establish appropriate controls over the automation process, including:

- developing and documenting standards and procedures for development of automation projects
- assigning specific responsibility with Association management for meeting project requirements
- monitoring development of automation projects against budgets, schedules, and objectives

Management's Response:

We will document standards and procedures for development. The feasibility study referenced above has specific requirements and a budget. Our commitment to formalize the process has been established by this project.

On major projects, the meeting of project requirements will be driven and reviewed by the steering committee. This would include budgeting, scheduling deadlines, and an assessment of overall project objectives having been defined and met. Budget approval for data processing activity is vested in the Board. Monitoring is the responsibility of the steering committee.

Objectives, Scope, And Methodology

Objective

Our audit objective was to review and evaluate management processes and control systems within the Texas Property and Casualty Insurance Guaranty Association and to identify strengths and opportunities for improvement. The audit evaluated the control system in place as of December 31, 1994.

The evaluation focused on answering the following questions:

- Are investment policies and procedures effective? (page 5)
- Is oversight provided by the Board of Directors effective? (page 17)
- Are purchasing policies and procedures effective? (page 21)
- Is the process to develop information systems effective? (page 23)
- Are there potential problems in the Association's ability to pay workers' compensation claims? (page 32)
- Is performance measure reporting for claim processing effective? (page 12)
- Is the Association effective in identifying the future financial impact on Texas from environmental claims? (page 33).

Scope

The scope of this audit included consideration of Board of Director and management oversight and the Association's management of information systems.

The consideration of Board of Director and management oversight included a review of:

- accuracy of financial information
- claim processing performance measures
- significant Association policies and procedures
- strategic planning

The consideration of the Association's management of information systems included a review of:

- accuracy of data in system
- ability of system to meet users needs
- strategic information systems planning
- automation project standards

Methodology

The methodology used on this audit consisted of collecting information, performing audit tests and procedures, analyzing the information, and evaluating the information against established criteria.

Information collected to accomplish our objectives included the following:

- Interviews with management and staff of the Texas Property and Casualty Insurance Guaranty Association
- Enabling legislation ("Guaranty Act" in the Texas Insurance Code)
- Other relevant state statutes and regulations
- Association documents, memoranda, publications, policies, and contracts, including:
 - Plan of Operation
 - Board minutes
 - Audited financial statements for 1993 and 1994, and other financial records
 - Organizational chart
 - Performance standards
 - 1994 Strategic Plan
- Investment manager reports, invoices, contracts, and request for proposal responses
- Consultant reports
- Association generated data such as:
 - Automated claim reports
 - Individual and summary receivership reports

Tests and procedures conducted:

- Review of investment controls
- Review of claim processing performance measures
- Review of financial data
- Assessment of the Association's planning process
- Statutory compliance

Analytical techniques:

- Comparison of budgeted with actual expenditures
- Aging analysis of investments
- Analysis of revenues by source

Criteria used:

- State Auditor's Office Management Control Methodology
- State Auditor's Office Accountability Project Methodology (general and specific)

- Other standards and criteria developed through research (see Reference List - Appendix 3)

Other Information

We conducted fieldwork from November 1994 to February 1995. We performed the audit in accordance with applicable professional standards, including:

- Generally Accepted Government Auditing Standards
- Generally Accepted Auditing Standards

There were no significant instances of noncompliance with these standards.

The following members of the State Auditor's Office completed the audit:

- Carleton S. Wilkes, CPA (Project Manager)
- Ester Jayme
- Jon D. Nelson, CISA
- Lisa Walters
- Barnie Gilmore, CPA (Audit Manager)
- Craig Kinton, CPA (Director)

We would like to acknowledge the assistance of Josef Martin, CPA (Texas Department of Insurance).

Background

The Texas Legislature established the Texas Property and Casualty Insurance Guaranty Association (Association) in the 1970s to provide a safety net for policyholders and claimants in the case of insurance company insolvency. This Association is the largest of the three similar associations in Texas for insolvent insurance companies. The two other insurance related associations are for title companies and for life, accident, and health insurance companies.

Mandatory assessments on all licensed property and casualty insurers doing business in Texas provide the Association with most of its funding. Insurance companies receive tax credits, taken over several years, in the amount of the assessments they pay. As a result, assessments reduce the tax collections of general revenues in Texas (affecting taxpayers). The Association may also receive funding from available net assets of an estate (insolvent insurance company).

The Legislature altered the process of liquidating insurance companies in the 72nd Legislature, effective January 1, 1992. Before the changes included in House Bill 62, the Texas Department of Insurance's Liquidation Division (Department) had the primary responsibility for most aspects of liquidating an insurance company. The legislatively mandated changes gave the Association direct responsibility for processing and payment of covered claims in future insolvencies. These changes reduced the Department's principal role to the marshaling of assets and payment of non-covered claims.

The Association's efforts during 1994, its second full year under the statutory changes, reflected an extraordinary growth in claim processing workload. As part of the final move toward "privatization" of the receivership function mandated by House Bill 62, the Association accepted claim paying responsibility for more than 40 existing estates that predated 1992. Also, in early 1994, the Employers Casualty Company became the largest Texas-based insolvency in history. Total Association claim reserves (estimated liabilities) grew from \$40 million to \$413 million. The year ended with 131,071 claims to be processed and closed, with 20,995 claims processed and closed during the year. Personnel grew from 58 to 120 which included opening regional offices in Dallas and Houston.

The Association cites its mission as: "To promote and deliver fair and timely payment of claims, in accordance with the laws of the State of Texas, to all individuals having valid claims resulting from in-force policies issued by insolvent insurance companies licensed in Texas."

Reference List

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Issues For Future Study

The Association should continue to monitor potential problems involving the Association's ability to pay workers' compensation claims and the impact of environmental claims on taxpayers and the Association.

Appendix 4-A:

The Association Has Adequate Resources To Pay Known Workers' Compensation Claims In A Timely Manner For Approximately Two To Four Years

The Association has adequate resources to pay known workers' compensation claims in a timely manner for approximately two to four years. However, diminishing resources from assessments may adversely affect the Association's ability to pay workers' compensation claims in future years.

The combination of cash on hand and available through assessments suggests that the Association has the necessary resources to pay existing and known workers' compensation claims over the next few years. The Association is also generally effective in monitoring the adequacy of funds needed for timely payment of workers' compensation claims.

The ability to pay potential claims from future insolvencies cannot be predicted with any degree of accuracy at this time. Two major factors may contribute to future difficulties in the Association's efforts to pay workers' compensation claims:

- **Assessment base is declining** -- Based on data through 1993, the total of workers' compensation premiums that are subject to assessment is declining over the past several years. In 1990, industry premiums subject to assessment totaled \$4.1 billion; in 1993, the total decreased to \$2.0 billion. (Insurance premiums written by the Texas Workers' Compensation Insurance Fund are increasing, but their premiums are not subject to assessments by the Association. The Fund wrote about 18.5 percent of workers' compensation insurance in Texas in 1993.)

Premiums are declining for a variety of reasons, including beneficial ones such as the workers' compensation marketplace is regaining its economic health. The Texas Workers' Compensation Research Center indicates that the "improved loss experience resulting from workers' compensation reforms enacted in the 1989 Legislature as Senate Bill 1, coupled with the aggressively competitive role of the new Texas Workers' Compensation Insurance Fund, brought Texas employers significant reductions in workers' compensation rates during and immediately after fiscal year 1994."

- **Assessment rate will decrease** -- The assessment rate will decrease from three percent to two percent on January 1, 1996, as provided for in the Insurance Code. The Legislature temporarily raised the assessment rate to

three percent. The Association is recommending a statutory change to temporarily continue the current assessment rate of three percent for workers' compensation claims.

Recommendation:

We recommend that the Association continue to monitor the assessment base to ensure that the Association identifies any problems at an early stage. A continuation of the three percent assessment rate, which would require legislative action, may be a prudent, precautionary measure by the Association.

Management's Response:

The Board and management continue to monitor this area. Premiums have declined from 1990 to 1993 as indicated, which has reduced our assessment capacity. On the other hand, preliminary 1994 numbers indicate \$2.7 billion in assessable premium which is an increase of \$.7 billion over 1993. We are confident in our ability to pay claims for the next several years but we will continue our review efforts. We have included an extension of the 3% assessment rate in our current pending legislation.

Appendix 4-B:

The Financial Impact Of Environmental Claims On Texas Taxpayers Cannot Be Determined Now With Certainty

The financial impact of environmental claims on Texas taxpayers cannot be determined now with certainty. Many future events will affect the impact on insurance companies and the ultimate outcome on taxpayers. Future events include:

- amendment of Superfund legislation at the federal level
- decisions by the courts
- the ability of insurance companies to both estimate and add to their reserves (liabilities) to pay environmental claims

The Association is taking action in areas it can control to address the impact of environmental claims. A broad definition of environmental claims would include complex matters such as hazardous wastes, toxic dump sites, and asbestos damages.

The Association:

- has environmental claim experience on its legal staff
- monitors environmental claim activity separately
- uses a consultant to refine estimates of environmental claim liabilities
- is active in national associations that address environmental problems as they affect Texas' guaranty associations

On a national level, the financial impact of environmental claims is likely to be significant. One firm (A.M. Best & Company) estimates that total losses nationally, including uninsured losses over a period of years, may approach \$2 trillion. The insurance industry's share (of the \$2 trillion) amounts to a net present value of \$132 billion, or 72 percent of the industry's current capital and surplus.

A. M. Best research shows that losses will concentrate in less than approximately 50 companies that wrote environmental insurance coverage. The size of losses, coupled with the concentration of losses in a few companies, will likely result in future mergers and insolvencies of insurance companies.

Recommendation:

We recommend that the Association continue its efforts to monitor the impact of environmental claims on its overall mission.

Management's Response:

The Guaranty Association intends to continue its efforts to monitor the impact of environmental claims on its activities. TPCIGA is presently involved in both leadership and significant participatory roles in the most active NCIGF Coordinating Committees dealing with the largest and most imminent environmental and toxic claims. These committees will be instrumental in establishing the liability faced by all guaranty funds, and specifically assist Texas in quantifying its exposure.

Copies of this report have been distributed to the following:

Legislative Audit Committee

Honorable James E. "Pete" Laney, Speaker of the House, Chair
Honorable Bob Bullock, Lieutenant Governor, Vice Chair
Senator John Montford, Chair, Senate Finance Committee
Senator Kenneth Armbrister, Chair, Senate State Affairs Committee
Representative Robert Junell, Chair, House Appropriations Committee
Representative Tom Craddick, Chair, House Ways and Means Committee

Governor of Texas

Honorable George W. Bush

Legislative Budget Board

Sunset Advisory Commission

Texas Property and Casualty Insurance Guaranty Association Board of Directors

Mr. Ken Wendler, Chair
Mr. Brian Boales, Vice Chair
Ms. Catherine Mauzy, Secretary/Treasurer
Mr. Merle Gardner
Mr. Robert Hoagland
Mr. Mark Howell
Ms. Carol Loughlin
Mr. Synott McNeel
Mr. G. Ron Nichols

Texas Property and Casualty Insurance Guaranty Association

Mr. Marvin Kelly, Executive Director

Texas Department of Insurance

Mr. Elton Bomer, Commissioner