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An Report on the Statutory Audit of Liquidation Oversight and the Texas Insurance Guaranty Associations

December 1996

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Key Points of Report

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Overall Conclusion

Receivership management controls are generally effective and improving within the four entities responsible for liquidation of insolvent insurance companies. These entities include the Texas Department of Insurance (Department), which has primary oversight responsibility; the Texas Life, Accident, Health & Hospital Service Insurance Guaranty Association; the Texas Property and Casualty Insurance Guaranty Association (Property Association); and the Texas Title Insurance Guaranty Association (Title Association).

All the entities previously visited by the State Auditor's Office have addressed shortcomings reported in prior reports. Although management controls within the liquidation process are generally effective, we found opportunities for further improvements at the Property Association, the Department, and the Title Association.

Key Facts and Findings

- The Property Association has a continuing pattern of not using competitive bidding for some of its significant expenditures. More than $1.6 million in purchases involving five contractors since 1993 were not competitively bid. Property Association management has revised the purchasing policy to strengthen the contractor selection process.

- The Property Association's investment policy emphasizes longer-term investments and allows higher-risk investment in mortgage-backed securities. This policy contributed to $3.3 million in investment losses (offset by $13.3 million in investment earnings) experienced in 1994 due to rising interest rates. The Board of Directors has reduced the percentage of mortgage-backed securities in the $285 million portfolio and intends to change policy to also limit portfolio duration.

- The Property Association has implemented prior-year recommendations saving $88,000 annually. Additional opportunities exist for potential annual savings of $191,000.

- Liquidation Oversight (within the Department) can further improve special deputy receiver (SDR) monitoring by auditing contract compliance reports prepared by SDRs. In addition, Liquidation Oversight should revise the standard SDR contract to clarify which travel and administrative expenses are reimbursable with estate assets.

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This statutory audit was conducted in accordance with Insurance Code, Article 21.28 (k).

Executive Summary

Receivership management controls are generally effective and improving within the four entities primarily responsible for liquidation of insolvent insurance companies. These entities include the Texas Department of Insurance (Department), which has primary oversight responsibility; the Texas Life, Accident, Health & Hospital Service Insurance Guaranty Association (Life Association); the Texas Property and Casualty Insurance Guaranty Association (Property Association); and the Texas Title Insurance Guaranty Association (Title Association).

All the entities previously visited by the State Auditor's Office have taken steps to address shortcomings reported in prior reports. Although management controls within the liquidation process are generally effective, we found opportunities for further improvements at the Property Association, the Department, and the Title Association.

The Property Association Can Improve a Noncompetitive Purchasing Process, Reduce Investment Risk, and Enhance Public Accountability

The Property Association has a continuing pattern of not using competitive bidding for some of its significant expenditures. More than $1.6 million in purchases involving five contractors from 1993 to present were not competitively bid. In addition, information regarding the Property Association's prior experience with bidders was withheld from a contractor selection committee, hampering the committee's ability to select contractors with the best combination of price, terms, and service. Obtaining the best value for purchases is important because Texas taxpayers ultimately pay most of the Property Association's expenses. Property Association management has implemented changes to the purchasing policy to strengthen the contractor selection process.

The Property Association's investment policy emphasizes longer-term investments and allows higher-risk investment in mortgage-backed securities. This policy contributed to $3.3 million in investment losses (offset by $13.3 million in investment earnings) experienced in 1994 due to rising interest rates. The Board of Directors has taken steps to reduce the percentage of mortgage-backed securities in the $285 million portfolio and intends to change policy to limit portfolio duration.

The Property Association has implemented prior-year recommendations creating annual savings of $88,000. This report identifies opportunities for additional potential annual savings of $191,000 at the Property Association.

The Texas Department of Insurance Has Responded Well to Its Role in Managing Liquidation Oversight, With Additional Improvements to Monitoring of Special Deputy Receivers Still Possible

Liquidation Oversight has taken steps to address all recommendations from the March 1994 *Audit of the Receivership Process* (SAO Report No. 94-097). They have fully implemented 10 of the 12 recommendations.

By implementing the prior recommendations, Liquidation Oversight has:

- Improved the selection process for special deputy receivers (SDRs) and their subcontractors

- Enhanced monitoring of the performance of SDRs and their subcontractors
- Strengthened strategic planning
- Enhanced early coordination of entities involved in liquidation
- Saved money for Texas taxpayers

Texas Department of Insurance Moved Liquidation Oversight to the Financial Program

The Texas Department of Insurance has reorganized Liquidation Oversight, moving it to the Financial Program from the Legal Program. The move took place on June 1, 1996. It is too early to draw conclusions about how well the new alignment will work. One benefit, beyond improved career paths for Liquidation Oversight employees, may be better coordination between Liquidation Oversight and Conservation. A potential risk is that ailing companies may be pressed into liquidation earlier than under the old alignment. Well-designed controls segregating the functions of Conservation and Liquidation Oversight can lessen the risk.

Liquidation Oversight can further improve SDR monitoring by auditing the contract compliance reports SDRs prepare and submit to Liquidation Oversight. In addition, conducting occasional, unannounced visits to SDRs could give Liquidation Oversight greater assurance of detecting noncompliance with contract provisions.

The Title Association's Management Controls Are Generally Effective While Opportunities Exist to Improve Contracting and Investment Practices

The Title Association's approach to contract management may not always hold contractors accountable for providing the desired quality of service at the expected cost. Nothing came to our attention to indicate inadequate services provided by existing contractors. However, the Board of Directors could improve its contracting procedures by including clearly stated performance expectations in significant contracts. Doing so would clarify expectations and protect the Board of Directors against misunderstandings.

In addition, the Title Association lacks a formal, written investment policy containing portfolio diversification limits. As a result, the Title Association has more than 99 percent ($7.1 million) of its cash in an uninsured mutual fund. The mutual fund's underlying investments are backed by the full faith and credit of the U.S. Government; however, the mutual fund is not.

Placing all its funds in one investment could subject the Title Association to undue market risk because of a lack of diversification. The State of Texas recognized the risks of inadequate diversification in the Public Funds Investment Act (Government Code, Chapter 2256.014). Although the Title Association is not subject to the Public Funds Investment Act, voluntary compliance with the guidance it provides on diversification could benefit the Title Association.

The Life Association Makes Continuing, Significant Improvements

The Life Association has substantially implemented the recommendations from our March 1994 *Audit of the Receivership Process* (SAO Report No. 94-097).

- The Life Association revised its policies and procedures for reviews of special deputy receiver expenditures to complement reviews performed by the Department. In addition, the Life

Association participates in status conferences held by the court.

- The Life Association now includes a significant amount of performance information as supplementary (unaudited) information in its strategic plan and annual financial report.

- The Life Association has implemented effective policies and procedures to resolve consumer complaints within 60 days.

Summary of Management's Responses

In general, management of the Texas Department of Insurance and each of the guaranty associations concur with the recommendations in this report. In addition, the Department concurs with the responses from, and actions taken by, the guaranty associations.

Each entity's management response follows the individual findings in the main body of the report, beginning on page 5.

Summary of Audit Objectives and Scope

The Texas Insurance Code requires the State Auditor's Office to conduct an annual audit of Liquidation Oversight. The objectives of this audit were to:

- Follow up on the status of findings and recommendations from prior State Auditor's Office audit reports.

- Review the contractor selection and monitoring processes used by the Texas Department of Insurance and the insurance guaranty associations.

The scope of this audit included the following entities involved in the process of liquidating insolvent insurance companies:

- Texas Department of Insurance, with emphasis on the Liquidation Oversight section

- Texas Property and Casualty Insurance Guaranty Association

- Texas Life, Accident, Health & Hospital Service Insurance Guaranty Association

- Texas Title Insurance Guaranty Association

The Property Association Can Improve a Noncompetitive Purchasing Process, Reduce Investment Risk, and Enhance Public Accountability

Section 1-A:

The Property Association's Procurement Process Is Not Effective as a Competitive Procedure

The Texas Property and Casualty Insurance Guaranty Association (Property Association) has a continuing pattern of not using competitive bidding for some of its significant expenditures. In June 1995, we recommended that the Board of Directors (Board) use competitive bidding in awarding significant contracts. We previously identified two contracts with expenditures of $903,667 that the Property Association did not award in a competitive process. In this report, we identify two additional companies selected noncompetitively. The Property Association paid these two companies more than $700,000 in 1995 and 1996 to date.

Additionally, an investment manager employed by the Property Association was not originally selected through competitive bidding. The investment firm participated in a request for proposal process with its bid dated April 8, 1993. The date of the original contract with the investment firm is dated one month earlier on March 3, 1993. As a result, this investment advisor was selected prior to the competitive bidding process.

Property Association policy allowed executive management to circumvent a competitive process when hiring outside contractors. The Property Association's Executive Director followed Board-authorized policy, but in doing so circumvented a process intended to be competitive. This involved hiring companies for cost-containment and third-party administration services. This was accomplished by replacing recommendations from the Property Association's own selection committee with the Executive Director's selections. As a result, management's attempt to implement a previous audit recommendation encouraging competition was ineffective. The effect is that the companies hired were not selected using a competitive process. When they occur, actions to overrule the selection committee should be documented. However, with a well-designed selection process in operation, actions to overrule should be rare.

Nothing came to our attention to indicate the existence of any irregularities in the final selections. However, the process used and approved by the Property Association

Texas Taxpayers Ultimately Pay Most of the Property Association's Expenses.

Control of expenses such as investment manager fees are important because Property Association expenses directly affect taxpayers. Since the Property Association is a quasi-governmental, not-for-profit entity, control of expenses is dependent on management decisions, as reviewed by the Board of Directors. The Property Association does not receive scrutiny of expenditures through the appropriation process because it is not a state agency. Assessments on the insurance industry partially fund Property Association expenditures. Insurance companies pass the assessments onto taxpayers by taking advantage of tax credits allowed by the State.

creates the appearance of impropriety, raising questions of whether favoritism or bias inappropriately influences the selection process.

Both companies chosen by the Executive Director were rated poorly by the selection committee. The selection committee ranked the cost-containment firm eleventh out of thirteen comparable companies and the third-party administrator eighth out of eleven comparable companies. The selection committee said this about one company chosen by the Executive Director: "Not meeting qualifications, bills not being paid on time. Fee quotations not correct. This was a canned proposal."

The Property Association's purchasing guide, approved by the Board of Directors in April 1995, gives the Executive Director full responsibility for authorizing purchasing decisions. In essence, that gives the Executive Director authority to disregard the selection committee's recommendations. Placing full authority for purchasing decisions in the hands of one individual unnecessarily increases the risk or appearance of favoritism or bias.

Recommendation:

We recommend that the Board of Directors strengthen the contractor selection process to ensure no single person has the unilateral ability to select and hire contractors. We also recommend full implementation of a competitive selection process for contractors. Executive management should retain the ability to veto selections for just cause, but no single individual should have sole decision-making authority.

Management's Response:

We concur and have responded to this concern. Management has initiated changes to the Association's purchasing policy which will strengthen the contractor selection process. Under the current purchasing policy (adopted April 1995), contractor selections are made by recommendation of a multi-member selection committee, with final approval of the Executive Director. The Association agrees that deviations from selection committee recommendations may be necessary but should be rare. Pursuant to the SAO's recommendations, an amendment to the policy has been adopted requiring the Executive Committee of the Board of Directors to approve any deviation from the selection committee's recommendation. Proposed changes were adopted by the Board at the October 31, 1996 Board of Directors' meeting.

Information that may have made a difference was withheld from the selection committee. According to the Executive Director, he had information about contractors that he did not share with the committee. For example, he did not share information regarding previous experiences with one third-party administrator. The

Executive Director's rationale was that committee members were more likely to make objective decisions if they only considered information submitted by bidders.

The Property Association should select contractors in a fair process assuring the best possible combination of price, terms, and service. Private sector companies and not-for-profit organizations such as the Property Association can benefit from using competitive processes when seeking favorable prices and terms. Obtaining the best value for purchases is important because Texas taxpayers ultimately pay most of the Property Association's expenses.

Recommendation:

We recommend executive management ensure the selection committee has all pertinent information to allow informed decision-making, including past performance.

Management's Response:

We concur. Management has prepared a change to the Association's purchasing policy which stipulates that contractor selection committees shall receive and consider all pertinent information necessary to form an opinion regarding the qualifications and capabilities of contractors including information regarding past performance and pending litigation. The Board adopted this policy change at the October 31, 1996 Board of Directors meeting.

What Happens When Interest Rates Rise?

As interest rates move up and down, it affects all securities in the market. Traditionally, the effect is greater on the longer-term securities. Think of it this way: Long-term securities are the tip of a whip, short-term notes are the handle. A slight wrist movement will have a nominal effect on the whip handle but create considerable momentum at the tip and a sharp snap as well. Because of the magnification effect, long-term bond traders are extremely sensitive to any event or movement that might forecast an increase in overall interest rates.

(Source:
Rhett D. Harrell, CPA, Governing, June 1995)

Section 1-B:

The Property Association Should Improve Both Its Investment Practices and Investment Policy to Lower Risk and Expenses

The Property Association's investment policy emphasizes longer-term investments with maturities of up to ten years. Additionally, the policy allows higher-risk investments in mortgage-backed securities. Management can control risk and still obtain reasonable returns by establishing appropriate limits on investment maturities. Risk can also be managed in part by matching demands for cash (such as for claims payments) with investment maturities, without exceeding the average estate life. The average estate life is now approximately 5½ years.

Longer-term investments are more sensitive to losses in market value when interest rates rise. To avoid a loss, the Property Association would have to hold the investment to maturity or wait for interest rates to drop, making those funds unavailable for operations. This could result in additional assessments on insurance companies to generate operating cash. About 24 percent ($68 million) of the Property Association's investments have maturities exceeding five years.

The Property Association's investment policy allows mortgage-backed securities as long as they have prepayment assumptions of about ten years. These prepayment assumptions are directly affected by factors such as home sales, refinancings, seasonality, and overall age of the mortgage-backed security. These initial assumptions change over time, directly affecting the market value of the investment. As a result, understanding prepayment assumptions is vital in dealing with mortgage-backed securities.

States, local governments, and other public entities are not immune from losses due to interest rate changes. TexPool, which the Texas State Treasury managed, lost more than $97 million in 1994 due in part to rising interest rates.

Even U.S. Treasury bills, long considered risk-free, can lose money. Ironically, most high profile losses in the United States during the last decade involved government securities, supposedly the safest investments. Yet some of these portfolios lost billions of dollars just the same.

Previous State Auditor recommendations on reducing investment risk are consistent with opinions expressed by the Property Association's independent CPA firm and one of its investment managers. One investment manager, in a letter to the Property Association, reviewed the investment guidelines of the Property Association.

The investment manager expressed, in part, the following:

> To further control the overall risk of the portfolio, investment guidelines may be amended to restrict the movement of the portfolio's duration between two and four years (the benchmark's duration is three years).

The independent CPA firm stated in 1995:

> Investments - The Association's investment policy allows for the purchase of securities with maturities of 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.

These recommendations by the Property Association's independent CPA firm and one of its investment managers support our recommendation that the Property Association use shorter limits on investment maturities.

Recommendation:

We recommend that the Board of Directors ensure management fully implements previous recommendations regarding investments, including:

- Aligning its investment policy risks with its overall mission to pay claims in a timely manner. The Property Association can define clearly acceptable risks using shorter limits on investment maturities.

- Lowering the maximum amount of mortgage-backed securities

- Requiring management to "stress test" the portfolio by obtaining estimates of changes in portfolio market values due to adverse changes in interest rates

Management's Response:

The Association's investment policy will be reviewed by the Board's Finance & Audit Committee, which is charged with making recommendations to the full Board regarding the investment policy.

It is our intent to limit our portfolio duration to +30% of the Lehman Intermediate Government benchmark, currently three years. This limitation will provide an easily measurable control which will properly define risk limitations for the portfolio as a whole.

We further plan to lower our percentage on mortgage backed securities from 25% to 20%. There will be some impact, but holdings have rarely exceeded 20% for this sector.

We also plan to "stress test" our portfolio. We have negotiated support from our custodian to provide this service to us at no charge and have received the third quarter reports.

Using two investment managers cost the Property Association an additional $150,000 in 1995. In 1995, the Property Association used two investment managers, rather than one, to manage long-term investments. This policy cost the Property Association an additional $150,000 in fees, about 20 percent of its total investment manager fees.

The two investment managers calculate their fees based on the value of the portfolios they manage. Both charge a higher fee for the first $100 million under management, with a lower fee applied to the remaining portfolio balance. Because the Property Association uses two investment managers, it pays the higher fee not once, but twice.

Using one investment manager for long-term investments would avoid this additional cost.

The Property Association partially addressed higher costs by renegotiating a contract with the more expensive investment manager in 1996. They obtained savings of $22,000 for the first quarter 1996, annualized this is about $88,000.

One important concern the Property Association expressed is diversification of investments in its portfolio. However, using one investment manager need not adversely affect the goal of diversification. The Property Association can direct the investment manager to select investments that achieve diversification to supplement guidance already in place in the investment policy.

Recommendation:

We recommend that the Property Association's Board of Directors evaluate the continued cost-effectiveness of using two investment managers, rather than one, for long-term funds. If the Board of Directors finds that continued use of multiple investment managers complements the Property Association's overall portfolio strategy, then we recommend rebidding the investment managers' contracts periodically using a competitive process. In addition, we recommend that the investment managers file financial disclosure statements with either the Property Association's internal auditor or legal counsel.

Management's Response:

The results of three years of activity were reported to the Board of Directors at the October 31, 1996 Board meeting. We will evaluate the results of these three years activity relative to the SAO recommendation. This item has been referred to the Finance and Audit Committee for their recommendation to the full Board.

One investment manager's contract now contains an incentive clause for up to $129,000 in higher fees that may be unnecessary. The Property Association added a new, performance-based fee when renegotiating an investment manager's contract. The new fee could cost the Property Association $129,000 in additional fees if the investment manager's performance exceeds established benchmarks during 1996.

In the June 1995 *Audit Report on Management Controls of the Texas Property and Casualty Insurance Guaranty Association* (SAO Report No. 95-136), it was reported that the Property Association could potentially save $175,000 in investment manager fees for 1995. The Property Association partially carried out the recommendation by renegotiating a contract with an investment manager to reduce fees. The renegotiation saved $32,056 in investment manager fees for 1995. However, the incentive clause was added to the contract to compensate for the fee reduction.

The increased investment yields they can generate often justifies performance-based fees. However, the Property Association's agreement to pay a performance-based fee appears excessive for the following reasons:

- Performance-based fees are unnecessary. The Property Association contracts with two firms for investment management services. The other investment manager provides the same services without the performance-based fee, and still exceeds the Property Association's performance benchmark for investments. It appears the Property Association could avoid the performance-based fee either through renegotiation or by moving investments to the lower-cost investment manager.

- Performance-based fees encourage higher risks. The performance-based fee encourages the investment manager to seek greater returns, potentially exposing the Property Association to higher risks than currently experienced. Considering that performance-based fees are unnecessary, encouraging the investment manager to take on greater risk appears unwarranted.

Recommendation:

We recommend the Property Association renegotiate the contract with the investment manager to delete the incentive clause.

Management's Response:

We concur. The Association has renegotiated the incentive clause provision of our contract with one manager. This clause will no longer exist effective January 1, 1997.

Section 1-C:

Overall Evaluation of the Property Association's Performance by Interested Parties Is Difficult Without Meaningful Performance Measures

The Property Association's performance measures for claims processing are incomplete and do not provide information on timeliness of processing, costs per claim, or processing capacity.

To its credit, the Property Association has taken steps to begin improving performance measurement. Property Association management participated in total quality management training offered by The University of Texas Quality Center in 1996.

Management is now working on a framework for measuring performance and anticipates having it in place within the next year.

The Property Association currently reports one performance measure to the Texas Department of Insurance, who in turn reports it to the Legislative Budget Board. The measure is "the percentage of claims paid within 60 days of claim date." The Property Association uses assumptions, rather than actual performance, to calculate the measure. This defeats the meaningfulness of this measure. The Property Association calculates the measure based on the assumption that workers' compensation claims are all paid within 60 days and all other claims are not.

Evaluating claims processing performance is difficult for the Board of Directors and interested parties outside the Property Association when they must rely on incomplete performance measures.

Recommendation:

We recommend that the Property Association complete implementation of appropriate performance measures and make them available to interested parties outside the Property Association.

Management's Response:

We concur. Management will complete implementation of appropriate performance measures and make them available to appropriate parties outside the Association including the Texas Department of Insurance and the State Auditor's Office. Management has initiated a total quality management/quality improvement program, supported by training of key staff members. By the completion of this process, projected for the spring of 1997, the Association will set relevant and meaningful performance standards and implement performance measurement systems for key business processes. This current effort will include evaluating the use of our Internal Auditor to review and report to the Board as well as other interested parties.

The Association's efforts to set relevant performance standards are not new. However, attempts at defining standards using benchmarks from other guaranty associations have been limited by variations in the requirements of claims inventories. The Association recognizes that it will need to develop its own standards. This will be accomplished through a process of detailed analysis of key business processes, and will be undertaken in collaboration with the Department of Insurance.

Figure 1

Status of Recommendations from the June 1995
Audit Report on Management Controls of the Texas Property and Casualty Insurance Guaranty Association
(SAO Report No. 95-136)

The June 1995 report addressed management processes and control systems within the Property Association.

Recommendation	Status	Comments
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 Property Association can define clearly acceptable risks using shorter limits on investment maturities.	Implementation underway	About 24 percent ($68 million) of the Property Association's investments have maturities exceeding five years. _Management's Response_: *See page 9 for management's response to this issue.*
• Lowering the maximum amount of derivatives (mortgage-backed securities and collateralized mortgage obligations) allowed in the portfolio.	Implementation underway	The Board has voted to divest the portfolio of collateralized mortgage obligations (CMOs). In addition, the Board amended the investment policy, no longer authorizing purchases of CMOs. At its December 12, 1996, meeting the Board will consider revising the investment policy to lower the percentage of mortgage-backed securities allowed in the portfolio from 25 percent to 20 percent. _Management's Response_: *See page 9 for management's response to this issue.*
• Considering the use of an outside rating service to evaluate the risk of derivatives in the portfolio.	No longer applicable	The Board voted to divest the portfolio of CMOs.
• Requiring management to obtain estimates of changes in portfolio market values due to adverse changes in interest rates.	Implementation underway	The Property Association plans to "stress test" the portfolio. _Management's Response_: *See page 9 for management's response to this issue.*
• Prohibiting borrowing for investments without the Board of Directors' express authorization.	Implemented	Prohibition now reflected in policy

Figure 1 (continued)

Status of Recommendations from the June 1995 *Audit Report on Management Controls of the Texas Property and Casualty Insurance Guaranty Association* (SAO Report No. 95-136) The June 1995 report addressed management processes and control systems within the Property Association.		
Recommendation	**Status**	**Comments**
We recommend that the Board of Directors define in its Plan of Operation minimum reporting requirements to the Board by management for the Property Association's investment activities.	Implemented	Reporting requirements now included
We recommend that the Property 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.	Partially implemented	Using two investment managers for long-term funds cost the Property Association $150,000 in 1995. The Board is evaluating the results of using two investment managers over the last three years. *Management's Response*: *See pages 10 and 11 for management's response to this issue.*
We recommend the Property Association define and report performance measures that include elements of time, cost, and capacity to process claims.	Implementation underway	The Property Association has initiated a total quality management/quality improvement program and anticipates having a performance measurement system in place by the spring of 1997. *Management's Response*: *See page 12 for management's response to this issue.*
We also recommend that the Property Association periodically continue outside reviews of its claim processing function and commend it for developing this review procedure.	Implemented	The Property Association is planning additional reviews. Claims processors are physically in-house and on-line to allow Property Association review.
We recommend the Property Association comply with statutory requirements and improve customer service by developing an appeal procedure as required by the Insurance Code.	Implemented	The Property Association completed and implemented an appeals procedure.

Figure 1 (continued)

Status of Recommendations from the June 1995 *Audit Report on Management Controls of the Texas Property and Casualty Insurance Guaranty Association* (SAO Report No. 95-136) The June 1995 report addressed management processes and control systems within the Property Association.		
Recommendation	**Status**	**Comments**
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 Property Association's policies.	Implementation underway	Information presented to the Board is improving. *Management's Response*: *Management will continue improving the information provided to the Board.*
We recommend that the Board of Directors require internal audit to comply with standards common to industry and government.	Partially implemented	The Property Association has addressed most internal auditing standards. However, the internal auditor has not undergone or scheduled peer reviews required by standards. *Management's Response*: *The Board has adopted auditing standards. We will arrange for a peer review through either the State Agency Internal Audit Forum or a commercial provider.*
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.	Implemented	Board minutes reflect adoption of committee responsibilities, although the Property Association's updated Plan of Operation does not contain designation, definition, or responsibility statements for committees.
We recommend that Property Association management provide periodic training for Board members in needed and relevant areas such as fiduciary responsibilities, investments, claim processing, and open meetings.	Implemented	The Property Association now provides training for new Board members. The Association offers periodic training for existing Board members as needed.

Figure 1 (continued)

Status of Recommendations from the June 1995 *Audit Report on Management Controls of the Texas Property and Casualty Insurance Guaranty Association* (SAO Report No. 95-136) The June 1995 report addressed management processes and control systems within the Property Association.		
Recommendation	**Status**	**Comments**
We recommend that the Property Association use a competitive process in awarding significant contracts.	Implementation underway	The Board amended the Property Association's purchasing policy at its October 31, 1996, meeting. *Management's Response*: *See page 6 for management's response to this issue.*
We also recommend that management carry out its plans to periodically evaluate contractors using the Property Association's internal audit function.	Implemented	N/A
We recommend that the Board of Directors approve all Property Association policies, including a policy that provides the Property Association with guidance on expenses. We recommend the Board adopt policies that further the Property Association's attainment of its mission, with funds used for reasonable business expenditures rather than entertainment.	Implemented	Policy edited and improved
We recommend that management develop and document plans for automation beyond March 31, 1996.	Implemented	Planning ongoing
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 Property Association began carrying out this recommendation during this audit.	Implemented	A steering committee is in place and planning efforts are ongoing.

Figure 1 (concluded)

Status of Recommendations from the June 1995 *Audit Report on Management Controls of the Texas Property and Casualty Insurance Guaranty Association* **(SAO Report No. 95-136)** The June 1995 report addressed management processes and control systems within the Property Association.		
Recommendation	**Status**	**Comments**
We recommend that management document a cost-benefit analysis comparing extensive uses of consultants with the lower costs of hiring personnel.	Implementation underway	Contracting decisions for automation consultants and the investment functions are candidates for cost benefit analysis. <u>*Management's Response*</u>: *We concur. The Association currently performs cost/benefit analyses.*
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 Property Association management for meeting project requirements • Monitoring development of automation projects against budgets, schedules, and objectives	Implemented	N/A

Figure 2

Texas Property and Casualty Insurance Guaranty Association Investment Portfolio						
	As of December 31, 1994			As of December 31, 1995		
Investment Type	Amortized Cost	Market Value (Estimated)	Percentage of Portfolio (at Market Value)	Amortized Cost	Market Value (Estimated)	Percentage of Portfolio (at Market Value)
Commercial Paper	$ 156,167,691	$ 156,167,691	37.3%	$ 63,505,075	$ 63,713,203	22.3%
Collateralized Mortgage Obligations	$ 10,044,831	$ 9,799,571	2.3%	$ 3,847,099	$ 4,760,661	1.7%
U.S. Treasury Issues	$ 233,322,645	$ 227,503,819	54.4%	$ 153,378,410	$ 158,599,958	55.5%
Federal Agency Issues	$ 6,799,628	$ 6,728,486	1.6%	$ 12,073,381	$ 12,549,287	4.4%
Mortgage-Backed Pass Through Securities	$ 10,285,014	$ 10,024,674	2.4%	$ 35,840,815	$ 37,218,666	13.0%
Cash Equivalents	$ 697,810	$ 697,810	0.2%	$ 387,422	$ 387,422	0.1%
Short-Term Notes and Bonds	$ 4,955,839	$ 4,336,590	1.0%	$ 4,880,018	$ 4,854,445	1.7%
Accrued Interest	$ 3,207,021	$ 3,207,021	0.8%	$ 3,719,213	$ 3,719,213	1.3%
Totals	**$ 425,480,479**	**$ 418,465,662**	**100.0%**	**$ 277,631,433**	**$ 285,802,855**	**100.0%**

The Department Has Responded Well to Its Role in Managing Liquidation Oversight, With Additional Improvements to Monitoring of Special Deputy Receivers Still Possible

Section 2-A:

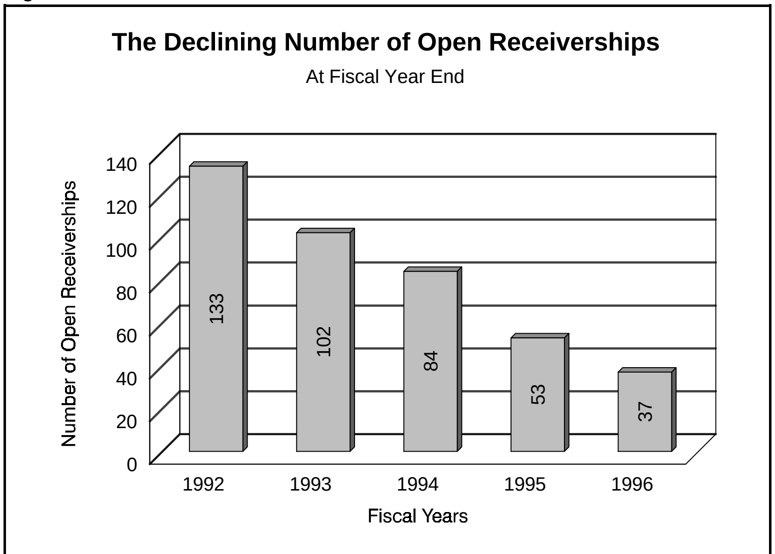
The Department Adjusted to Declining Texas Insurance Insolvencies by Moving Liquidation Oversight to the Financial Program

The Texas Department of Insurance (Department) has reorganized Liquidation Oversight, moving it to the Financial Program from the Legal Program. The move took place on June 1, 1996. Declining insolvencies prompted the Department to reallocate Liquidation Oversight's resources while retaining the knowledge, skills, and abilities of the work force.

Two trends worked together to reduce Liquidation Oversight's workload:

- The number of insolvent insurance companies is declining.
- The average age of the remaining insolvent estates is increasing. As insolvent estates age, the work required to liquidate and oversee them declines.

Figure 3



Source: Liquidation Oversight

The declining number of insolvencies led to less work and created a human resources issue. Analysts working for Liquidation Oversight found their financial skills in less demand in the Legal Program, limiting their career choices. This became more significant when the workload declined to the point where Liquidation Oversight needed fewer analysts. Moving Liquidation Oversight to the Financial Program, where financial skills are in greater demand, opens additional career options for the analysts.

Liquidation Oversight joins the Conservation Division within the Financial Program. Conservation is responsible for rescuing troubled insurance companies. Once Conservation refers a company for receivership, and the courts agree by placing the company into receivership, Liquidation Oversight (working on behalf of the Commissioner as Receiver) oversees the special deputy receiver's estate liquidation business plans.

It is too early to draw conclusions about how well the new alignment will work. One benefit, beyond improved career paths for Liquidation Oversight employees, may be better coordination between Liquidation Oversight and Conservation.

A potential risk is that ailing companies may be pressed into liquidation earlier than they would have been under the old alignment. Well-designed controls segregating the functions of Conservation and Liquidation Oversight can lessen the risk.

Recommendation:

We recommend close monitoring of the success of the new alignment to ensure early identification of problems.

Management's Response:

Management agrees that there is the potential perception or appearance that companies would be placed in receivership sooner than normal. These issues were raised when the restructuring was first considered. However, after due diligence in looking at our procedures, we are convinced that troubled companies will be processed as before the restructuring. Management will continue to monitor those processes that existed prior to the restructure to ensure early identification of situations that may be perceived as a problem. Additionally, the district court provides a significant control because Conservation must present evidence of insolvency and that a rehabilitation plan is not feasible or possible in order to place a company in receivership.

Section 2-B:

The Department Has Implemented Prior-Year Recommendations to Improve the Liquidation Oversight Process

Liquidation Oversight has taken steps to address all recommendations from the March 1994 *Audit of the Receivership Process* (SAO Report No. 94-097). Ten of the twelve recommendations are fully implemented. One recommendation was partially implemented and one is no longer applicable because of changes in the process. As a result, Liquidation Oversight is to be commended for improving the process for liquidating insolvent insurance companies.

By implementing the prior recommendations, Liquidation Oversight has:

- Improved the selection process for special deputy receivers (SDRs) and their subcontractors
- Enhanced monitoring of the performance of SDRs and their subcontractors
- Strengthened strategic planning
- Enhanced early coordination of the entities involved in liquidation
- Saved money for Texas taxpayers

Section 2-C:

Liquidation Oversight Can Further Improve SDR Monitoring by Auditing Contract Compliance Reports Prepared and Submitted by SDRs

Liquidation Oversight began requiring SDRs to "self-report" contract compliance in response to recommendations made in the March 1994 *Audit of the Receivership Process* (SAO Report No. 94-097). However, Liquidation Oversight neither reviews nor audits the reports to determine their accuracy. Auditing contract compliance reports submitted by SDRs would further improve monitoring. In addition, conducting occasional, unannounced visits to SDRs could give the Department greater assurance of detecting any noncompliance with contract provisions.

Liquidation Oversight conducts periodic on-site visits to SDRs, but these visits do not routinely include procedures to detect the accuracy of the SDRs' self-reporting. Liquidation Oversight analysts schedule on-site visits in advance with SDRs. The purpose of these on-site visits is to gauge an SDR's overall progress in administering an estate.

Early assessment of contract compliance is important as an effective means of both deterring and detecting poor performance. Liquidation Oversight is responsible for ensuring that the State receives the best value when the Commissioner, as Receiver, contracts with SDRs. Measuring reported performance against contract provisions can help ensure consistent quality service from SDRs, which benefits affected insurance consumers and taxpayers.

Recommendation:

We recommend that Liquidation Oversight improve SDR monitoring by auditing reports on contract compliance. Liquidation Oversight can accomplish this concurrently with its regular schedule of on-site visits at SDR offices. In addition, we recommend that Liquidation Oversight consider periodic unannounced site visits to SDRs. If unannounced visits are not practical, then we recommend conducting site visits on short notice of one or two days.

Management's Response:

Management agrees that auditing reports on contract compliance will improve SDR monitoring. Management has initiated steps to improve audit guidelines for SDR monitoring. Although staff have conducted unannounced site visits in the past, and supports the concept, management is concerned about wasting resources if the SDR is unavailable at the unannounced site visit. However, periodic visits on short notice of one or two days will be conducted.

Section 2-D:

Liquidation Oversight Should Revise the Standard SDR Contract to Conform With Current Policy

Liquidation Oversight allows certain SDRs to technically violate their contracts by reimbursing travel and administrative costs from receivership estate assets. The standard SDR contract limits travel reimbursements to the rates enjoyed by state employees. In addition, the contract specifically holds SDRs responsible for their own administrative costs.

We found one example of an SDR who commutes each week from Houston to the SDR's Austin office. In addition, the SDR maintains an apartment in Austin. The SDR charges both the apartment and the commuting costs to the assets of the receivership estate, with Liquidation Oversight's approval. This SDR also charges administrative costs to the estate, in addition to his regular fee.

The reimbursement of these types of travel expenses would not normally be available to state employees. Therefore, the reimbursements violate the contract.

Recommendation:

We recommend that Liquidation Oversight revise the standard SDR contract to clarify which travel expenses SDRs may reimburse with estate assets. We also recommend that Liquidation Oversight evaluate whether allowing SDRs to reimburse administrative costs is necessary, and revise the contract accordingly. Once the contract is revised, Liquidation Oversight should require SDRs to comply with contractual provisions related to administrative and travel costs.

Management's Response:

Liquidation Oversight adopted a policy covering the takeover of insurers that permits SDRs to reimburse travel expenses from their home offices to the offices of the estate and for costs of operating the estate office. Contracts previously executed were not *formally amended to reflect this policy. The most recent contract between the Commissioner, as Receiver, and the SDR did reflect this change in policy.*

Management agrees that any changes in SDR contracts must be documented by either a letter agreement or written amendments to the contracts and will do so in the future.

Figure 4

Status of Liquidation Oversight Recommendations from the March 1994
Audit of the Receivership Process
(SAO Report No. 94-097)

The March 1994 report addressed controls involved in the receivership process, including those at the Texas Department of Insurance, special deputy receivers, and the guaranty associations.

Recommendation	Status	Comments
We recommend that Liquidation Oversight coordinate with the Conservation Division to make available the information needed to efficiently prepare an initial business plan.	Implemented	Coordination between Liquidation Oversight and Conservation improved before the reorganization (see Section 2-A). Coordination should improve further following the reorganization.
We recommend that special deputy receiver applicants submit estimates of their administrative costs in total, and on a monthly basis, as part of their bid proposal to administer an estate. The Department should also consider placing additional emphasis in the negotiation process with special deputy receivers to ensure terms that reflect a final and best offer.		SDR applicants now submit estimates of administrative costs as part of the bid proposal.

Figure 4 (continued)

Status of Liquidation Oversight Recommendations from the March 1994
Audit of the Receivership Process
(SAO Report No. 94-097)
The March 1994 report addressed controls involved in the receivership process, including those at the Texas Department of Insurance, special deputy receivers, and the guaranty associations.

Recommendation	Status	Comments
We recommend that Liquidation Oversight ensure that special deputy receivers maximize the use of competition available in the marketplace in the selection of subcontractors. This includes appropriate negotiations as to price, terms, and other matters to reach a final and best offer. We recommend that special deputy receivers provide to Liquidation Oversight: • A reasonable justification that subcontractor selections are in the best interest of the estate • Evidence that cost, expertise, and more than one firm was considered in the selection process.	Implemented	Liquidation Oversight has a process in place to maximize the use of competition when special deputy receivers select subcontractors. When appropriate, special deputy receivers negotiate with subcontractors to reach a final and best offer. Special deputy receivers prepare cost/benefit analysis to justify hiring subcontractors.
We recommend that the evaluation process used to select special deputy receivers emphasize and evaluate separately the management ability and prior liquidation experience of the individual requesting appointment as special deputy receiver. The Department should consider the need to conduct pre-appointment interviews of special deputy receiver applicants.	Implemented	The Commissioner, as Receiver, through an independent selection committee, conducts interviews of prospective special deputy receivers when appropriate. Liquidation Oversight is not directly involved in the selection process. The Commissioner, as Receiver, had prior experience with all SDRs hired in recent years.

Figure 4 (continued)

Status of Liquidation Oversight Recommendations from the March 1994 *Audit of the Receivership Process* (SAO Report No. 94-097) The March 1994 report addressed controls involved in the receivership process, including those at the Texas Department of Insurance, special deputy receivers, and the guaranty associations.		
Recommendation	**Status**	**Comments**
We recommend the Department assign contract compliance responsibility and on-site evaluations of special deputy receivers to Liquidation Oversight. We recommend that on-site visits occur within 90 days of the special deputy receiver's appointment to promote early problem identification. We also recommend that Liquidation Oversight consider having the special deputy receivers' "self report" on contract compliance using a checklist prepared by Liquidation Oversight that reflects the contract in force. Self-reporting would be subject to verification by Liquidation Oversight and review during subsequent audits.	Implemented	Liquidation Oversight is now responsible for evaluating contract compliance and conducts on-site reviews of SDRs. Liquidation Oversight conducts on-site visits to SDRs within 90 days of appointment. SDRs now self-report compliance with contract provisions. In this report, we further recommend that Liquidation Oversight audit self-reporting by SDRs (see Section 2-C).
We recommend that Liquidation Oversight develop improved "pro forma" contracts for use by special deputy receivers in significant relationships with professionals. Additional contract provisions could include, for example: • A maximum or ceiling price • Deliverables and delivery dates • Appropriate fees for travel time • Allowable expenses, if any • Allowable markups on pass-through costs • Performance expectations • Penalties for subpar performance • Incentives for excellence where appropriate • Contract cancellation terms	Partially implemented	Liquidation Oversight has developed a draft "pro forma" contract for SDRs to use when hiring outside legal services. The draft is slated for distribution to SDRs for comment. Liquidation Oversight developed "pro forma" contracts for outside accounting and auditing services. *<u>Management's Response</u>*: *Management agrees that pro-forma contracts should be distributed as soon as practical. The contract for outside legal services is undergoing final review in preparation for final distribution to SDRs.*

Figure 4 (continued)

Status of Liquidation Oversight Recommendations from the March 1994 *Audit of the Receivership Process* (SAO Report No. 94-097) The March 1994 report addressed controls involved in the receivership process, including those at the Texas Department of Insurance, special deputy receivers, and the guaranty associations.		
Recommendation	**Status**	**Comments**
We recommend that Liquidation Oversight assess the need for implementing a litigation management system. We recommend periodic evaluation of outside counsel using guidelines similar to those used by the RTC. We recommend that Liquidation Oversight evaluate review procedures used by special deputy receivers to monitor legal fees. We also recommend that Liquidation Oversight consult with the Attorney General's Office for the most appropriate controls over the selection and approval of outside counsel.	Not applicable	The large volume of litigation creating the need for these recommendations has substantially declined. Liquidation Oversight monitors legal fees paid by SDRs. SDRs monitor and evaluate the performance of outside counsel. The SDRs report the results of their evaluations to Liquidation Oversight. SDRs must provide Liquidation Oversight a cost/benefit analysis to justify hiring outside counsel.

Figure 4 (continued)

Status of Liquidation Oversight Recommendations from the March 1994 *Audit of the Receivership Process* (SAO Report No. 94-097) The March 1994 report addressed controls involved in the receivership process, including those at the Texas Department of Insurance, special deputy receivers, and the guaranty associations.		
Recommendation	**Status**	**Comments**
We recommend that Liquidation Oversight continue to make improvements in reporting such as: • Developing a current reporting standards manual as a reference for Liquidation Oversight analysts and special deputy receivers and to document current reporting standards • Identifying efficient reporting practices of successful special deputy receivers to share their successes with other special deputy receivers • Requiring special deputy receivers to report costs separately by type of task (such as reporting, administration, legal, accounting, etc.) • Providing prompt feedback on report adequacy to special deputy receivers	Implemented	Liquidation Oversight continues to improve the financial and administrative reporting of SDRs. Current reporting standards have been communicated to SDRs while the SDR manual is finalized. Presentations of "good practices" are given by SDRs at quarterly conferences. SDRs report costs separately by type of task. Liquidation Oversight analysts correspond monthly with SDRs regarding comments and/or questions arising from reviews of SDR reports.
We recommend that Liquidation Oversight provide special deputy receivers with a practical definition of a cost benefit analysis and enforce the cost benefit reporting requirement. The practical definition includes the required format, information content, guidance on when cost benefit analysis reporting is required, and how Liquidation Oversight will use this as a control. As reporting by special deputy receivers improves, Liquidation Oversight can place increased emphasis on reviewing and approving planned expenditures before they occur.	Implemented	Memos to SDRs have defined cost benefit reporting while the SDR manual is finalized.

Figure 4 (concluded)

Status of Liquidation Oversight Recommendations from the March 1994 *Audit of the Receivership Process* (SAO Report No. 94-097) The March 1994 report addressed controls involved in the receivership process, including those at the Texas Department of Insurance, special deputy receivers, and the guaranty associations.		
Recommendation	**Status**	**Comments**
We recommend that the Department refine its evaluation of its resource needs by completing strategic planning efforts now underway. Liquidation Oversight's strategic plan should include analysis of the resources required to provide effective oversight, those resources available, and plans to resolve any differences. Additional resources, if needed, could be provided by either a temporary reallocation within the Department, or a pass-through of costs to the estates where appropriate to do so. Also, strategic planning efforts should include reporting of performance measures which indicate how well Liquidation Oversight achieves its goals and objectives. For instance, the percentage of lawsuits in mediation would be one significant performance measure.	Implemented	Liquidation Oversight has completed preparation of its strategic plan, including performance measures and action plans.
We recommend that the Department develop policies and procedures, in cooperation with the guaranty associations, which would allow an early and coordinated involvement of all liquidation entities, including the appointed special deputy receiver.	Implemented	Coordination and communication among all entities improved in recent takeovers.
We recommend that the Department reevaluate the current investment strategy to increase the overall yield to the estates while maintaining a comparable or low risk. The Department should consult with Treasury representatives to identify appropriate investment alternatives.	Implemented	Investment strategy revised based on discussions with State Treasury Department.
We recommend that the Department pursue a statutory increase in the threshold for court approval of claim settlements and asset sales from $1,000 to $10,000.	Implemented	Liquidation Oversight recommended the statutory change in the 1995 legislative session. The change was enacted.

The Title Association's Management Controls Are Generally Effective; However, Opportunities Exist to Improve Contracting and Investment Practices

The Texas Title Insurance Guaranty Association (Title Association) is responsible for paying covered policyholder claims against insolvent title insurance companies. As of August 31, 1996, the Title Association was overseeing the liquidation of one insolvency. The Title Association's Board of Directors has found it unnecessary to hire employees because of the small volume of work entailed in liquidating the one existing estate. Instead, the Title Association contracts for all services.

Management controls at the Title Association are appropriate and generally effective given its mission and small workload. However, opportunities were found in which the Board of Directors can improve its policies and practices related to contract management and investments.

Section 3-A:

The Title Association Should Include Performance Standards in Significant Contracts

The Title Association's approach to contract management may not always hold contractors accountable for providing the desired quality of service at the expected cost. Nothing came to our attention to indicate weaknesses with services provided by existing contractors. However, opportunities exist to improve procedures used by the Board of Directors when entering future contractual relationships.

The Title Association's working relationship with its legal counsel is based on engagement letters which outline, in general language, the terms of their agreement. The engagement letters are enforceable contracts, terminable at will by the Board of Directors. However, the engagement letters do not include specific language clearly stating the Board of Directors' performance expectations. Misunderstandings could result in unacceptable performance if clear expectations are not disclosed.

The Title Association has a contract with a sister guaranty association to provide certain administrative and accounting functions. The Title Association also contracts with a third-party administrator for claims processing services. Neither of these contracts includes performance standards to enable the Board of Directors to assess contractor performance. As a result, if a contractor's performance is substandard, it may be difficult to terminate the contract or negotiate a solution.

The uncomplicated approach the Title Association takes toward contracting reflects its small size and volume of contracting. The Title Association engages in significantly fewer contracts than its sister guaranty associations. Through the first nine months of 1996, the Title Association expended $26,000 for contracted services.

Although it has not created significant risks at this time, it appears prudent for the Title Association to adopt the following recommendations for future contracts. Doing so would clarify expectations and protect the Board of Directors against misunderstandings.

Recommendation:

We recommend that the Title Association adopt a policy to ensure that all significant business relationships are documented in written contracts which include clearly defined expectations and performance standards.

Management's Response:

The Title Association acknowledges the recommendation and has instructed its legal counsel to develop performance standards for its contracts with vendors other than professionals such as legal counsel and auditors. Professionals will continue to be engaged on the basis of engagement letters customary to those professions and terminable at the will of the Title Association. All of the Title Association's current contracts contain provisions allowing unilateral termination by the Title Association on written notice.

An outline of the performance standards for third-party administrators will be reviewed by the Board of Directors at its January 1997 meeting.

State Auditor's Follow-up Comment:

We will work with the Title Association to further improve controls over contract management. Although engagement letters for professional services are terminable at will, we continue to recommend inclusion of clearly defined expectations or performance standards in all significant contracts, including those for professional services.

Section 3-B:

The Title Association's Investments Are Not Diversified, Insured, or Guided by a Formal Investment Policy

The Title Association has placed more than 99 percent ($7.1 million) of its cash in a mutual fund that is not insured. In addition, the Title Association lacks a formal, written investment policy containing portfolio diversification limits. The Board of

Directors has issued general investment guidelines during its meetings. However, the guidelines have not been formally adopted as policy and do not address issues on diversification, liquidity, and risk.

The mutual fund's underlying investments are backed by the full faith and credit of the U.S. Government; however, the mutual fund is not. This could subject the Title Association's funds to undue market risk because of the lack of diversification. Should the mutual fund experience losses, the Title Association's funds would not be protected.

Mutual funds are an attractive choice for relatively small investors such as the Title Association; they offer access to a professionally managed portfolio that may not otherwise be available. However, no investment is risk-free. Investing in mutual funds involves risks that can include fluctuation on the value of principal, lack of performance guarantees, and loss of some decision-making control.

Inadequate diversification of investments concentrates risk within a portfolio. Investing heavily in the same type of instruments magnifies the associated risks. Placing funds in various instruments, each having a different risk level, can achieve a reduction in overall risk.

The State of Texas has recognized the risks of inadequate diversification. The Public Funds Investment Act (Government Code, Chapter 2256.014) states that local governments and state agencies shall not invest:

- More than 80 percent of their average fund balance in mutual funds, *including* money market mutual funds

- More than 15 percent of their average fund balance in mutual funds *other than* money market mutual funds

Although the Title Association is not subject to the Public Funds Investment Act, the guidance it provides on diversification could benefit the Title Association.

Recommendation:

We recommend that the Title Association develop a written investment policy addressing liquidity needs and clearly setting the Board of Directors' expectations for portfolio diversification and allowable risk levels. The Title Association should consider including percentage limits on types of investments to clearly indicate the portfolio diversification requirements. The Title Association may wish to incorporate the guidelines included in the Public Funds Investment Act. In addition, the Title Association should set minimum standards for cash and cash equivalents, based on anticipated cash needs over a 6- to 12-month horizon.

Management's Response:

The Title Association acknowledges the recommendation. At the Board of Directors' meeting in January 1997, a committee will be appointed to review and recommend an investment policy for the Title Association.

Section 4: THE TEXAS LIFE, ACCIDENT, HEALTH & HOSPITAL SERVICE INSURANCE GUARANTY ASSOCIATION

The Life Association Makes Continuing, Significant Improvements

The Texas Life, Accident, Health & Hospital Service Insurance Guaranty Association (Life Association) has substantially implemented the recommendations from our March 1994 *Audit of the Receivership Process* (SAO Report No. 94-097) by:

- Revising its policies and procedures for reviews of special deputy receiver expenditures to compliment the reviews performed by the Texas Department of Insurance. In addition, the Life Association participates in status conferences held by the court.

- Including a significant amount of performance information as supplementary (unaudited) information in the strategic plan and annual financial report

- Implementing effective policies and procedures to resolve consumer complaints within 60 days

Recommendation:

We recommend that the Life Association continue building on its progress and accountability by mentioning in its annual financial report that copies of its strategic plan are available upon request.

Management's Response:

Management of the Association will continue to prepare annual strategic plans and in concurrence with the finding of the State Auditor will mention in its next annual financial report that copies of the Association's strategic planning document will be made available upon request.

Figure 5

<table>
<tr><td colspan="3">Status of Life Association Recommendations from the March 1994
Audit of the Receivership Process
(SAO Report No. 94-097)
The March 1994 report addressed controls involved in the receivership process, including those at the Texas Department of Insurance, special deputy receivers, and the guaranty associations.</td></tr>
<tr><th>Recommendation</th><th>Status</th><th>Comments</th></tr>
<tr><td>We recommend that the Life Association:
• Define and report outcome or performance measures which indicate the degree of attainment of their primary mission.
• Include these measures as supplementary (unaudited) information with their annual financial report.</td><td>Implemented</td><td>The Life Association includes quantifiable performance information in its strategic plan and reports performance results to the Board of Directors. Also, management reports performance results in the annual report.</td></tr>
<tr><td>We recommend that the Life Association:
• Establish a policy expressed as a goal to resolve consumer complaints within 60 days.
• Communicate status of the complaint to the policyholder if not resolved within a reasonable amount of time.
• Provide for a monthly review of the complaint log by an individual independent of the complaint process to ensure that complaints are resolved in a timely manner.</td><td>Implemented</td><td>The Life Association has implemented effective policies and procedures to resolve complaints.</td></tr>
<tr><td>We recommend that the Life Association consider defining its role in reviewing special deputy receiver monthly expenditures to complement Department of Insurance Oversight procedures. This would include clarifying its written procedures to allow accomplishment of its role.</td><td>Implemented</td><td>The Life Association revised policies and procedures regarding the review of special deputy receivers' monthly expenditures to complement reviews performed by the Texas Department of Insurance.</td></tr>
</table>

Appendix 1:

Objectives, Scope, and Methodology

Objectives

The audit objectives were:

- To follow up on findings and recommendations from the following State Auditor's Office audit reports:

Report Title	Date Released	SAO Report No.
Audit of the Receivership Process	March 1994	94-097
Review of Management Controls at the Texas Department of Insurance	December 1994	95-036
An Audit Report on Management Controls of the Texas Property and Casualty Insurance Guaranty Association	June 1995	95-136

- To review the contractor selection and monitoring processes used by the Texas Department of Insurance and the insurance guaranty associations to determine whether:
  - The best contractors are objectively selected
  - Contractor performance is sufficiently monitored

Following up on prior State Auditor's Office reports, plus additional procedures related to contracting, fulfills the audit requirements of Article 21.28 of the Insurance Code. Article 21.28, Section 12(k) codifies the State Auditor's authority to audit the receiver (Texas Department of Insurance), special deputy receivers, and the guaranty associations.

Scope

The Texas Insurance Code requires the State Auditor's Office to conduct an annual audit of Liquidation Oversight. The scope of this audit included the following entities involved in the process of liquidating insolvent insurance companies:

- Texas Department of Insurance, with emphasis on the Liquidation Oversight section

- Texas Property and Casualty Insurance Guaranty Association (Property Association)

- Texas Life, Accident, Health & Hospital Service Insurance Guaranty Association (Life Association)

- Texas Title Insurance Guaranty Association (Title Association)

The scope of this audit is addressed in part by the objectives stated above. In addition, the scope included a review of contracting processes for special deputy receivers at the Texas Department of Insurance and third-party administrators at the Property Association. The scope also included an on-site visit to one special deputy receiver to determine compliance with contractual requirements administered by the Texas Department of Insurance.

The scope of this audit also included a review of policies and procedures related to contracting and investments at the Title Association. Follow-up procedures were not applicable at the Title Association for this initial audit by the State Auditor's Office.

Methodology

The methodology for this audit consisted of conducting interviews, collecting information, reviewing documents, performing data analysis, and reviewing policies and procedures at the four entities visited.

<u>Information collected</u> to accomplish the audit objectives included the following:
- Prior audit reports related to the receivership process and the entities involved
- Texas Insurance Code and General Appropriations Act
- Plan of Operation for the Property Association
- Strategic planning documentation
- Financial records
- Internal and external audit reviews
- Organization charts
- Minutes of Board of Directors' meetings
- Performance measures and standards
- Investment policies and strategies
- Investment performance reports
- Purchasing policies and procedures
- Policies and procedures for the selection and monitoring of special deputy receivers

<u>Procedures conducted and analysis techniques used</u>:
- Review of appropriate documentation that identifies or supports the status of implementation of recommendations
- Reviews of financial and statistical data

- Identification of existing controls in each applicable area
- Evaluation of the adequacy of controls
- Review of monitoring of special deputy receivers
- Analysis of investment portfolios, including an incremental aging analysis
- Review of procedures used to calculate performance measures
- Review of contracts
- Risk analysis of potential issues

Criteria used:
- State Auditor's Office Management Control Methodology
- Other standard audit criteria established during fieldwork
- Applicable statutes

Other Information

Fieldwork was conducted from January 23, 1996, through May 3, 1996. The audit was conducted 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.

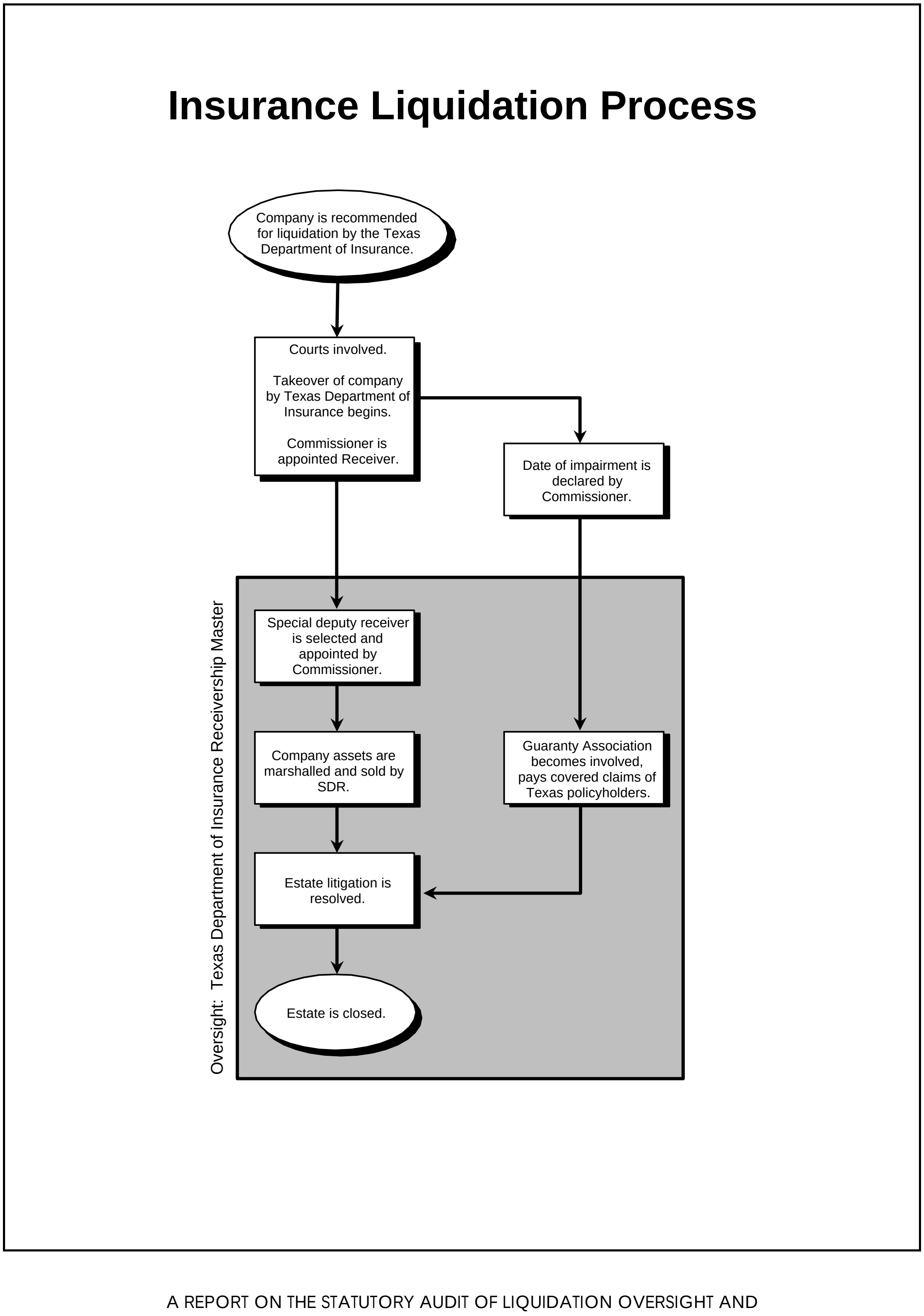
The following members of the State Auditor's Office completed the audit:

- R. Walton Persons, CPA (Project Manager)
- Carleton S. Wilkes, CPA
- Kevin B. Baker, CPA
- Barbara K. Collins, CCP
- Barnie Gilmore, CPA (Audit Manager)
- Craig Kinton, CPA (Director)

Appendix 2.1:

Flowchart of the Insurance Liquidation Process

Figure 6



Appendix 2.2:

Entities Involved in the Insurance Liquidation Process

Figure 7

Entity	Basic Responsibility
	Texas Department of Insurance
Commissioner of Insurance	The Commissioner is appointed the Receiver for insurance companies declared insolvent. In addition, the Commissioner is required by statute to oversee the three guaranty associations.
Liquidation Oversight Section of the Finance Program	Liquidation Oversight is responsible for: • The monitoring and evaluation of special deputy receivers on behalf of the Receiver • The monitoring and oversight of the guaranty associations for the Commissioner
Contract Administration	Division responsible for developing and executing contracts with special deputy receivers
Conservation Division	Division responsible for rehabilitating insurance companies and recommending companies for liquidation.
	Private Sector Contractors
Special Deputy Receivers	Individuals or firms appointed by the Commissioner of Insurance, as Receiver, who are responsible for liquidating insolvent insurance companies.
Subcontractors	Individuals or firms, hired by special deputy receivers, that provide professional services to an estate, such as legal, accounting, and asset recovery services.
Third-Party Administrator	Firms that provide claims processing services; hired by guaranty associations.
	The Courts
Receivership Special Master	Representative of the court that provides judicial oversight and monitors the status of liquidation; appointed by the court
	Guaranty Associations
Texas Property and Casualty Insurance Guaranty Association	Responsible for paying covered policyholder claims against insolvent property and casualty insurance companies
Texas Life, Accident, Health & Hospital Service Insurance Guaranty Association	Responsible for paying covered policyholder claims against insolvent life, health, accident, and hospital service insurance companies
Texas Title Insurance Guaranty Association	Responsible for paying covered policyholder claims against insolvent title insurance companies

Appendix 2.3:

Background on the Liquidation Process

The 72nd Legislature, Second Special Session (1991) privatized the process of liquidating insurance companies effective January 1, 1992. Before the changes included in House Bill 62, the Texas Department of Insurance's Liquidation Division had the primary responsibility for most aspects of liquidating an insurance company.

Under the legislatively mandated changes, the Commissioner of Insurance, as Receiver, acting through Liquidation Oversight, monitors and evaluates special deputy receivers selected to liquidate insolvent insurance companies. Liquidation Oversight analyses business plans, budgets, and expenses of all special deputy receivers. Liquidation Oversight also monitors the guaranty associations to ensure that all receivership claims and complaints are handled properly. Liquidation Oversight houses estate records during and after receivership.

Three components in overseeing receiverships are:

- **Special Deputy Receivers -** When insolvent insurers are placed in receivership by the district courts of Travis County, Article 21.28 of the Texas Insurance Code requires that the Commissioner be designated as receiver. In most cases, the Commissioner hands over administration of the receivership estates to special deputy receivers (SDRs).

- **Guaranty Associations -** Covered claims against receivership estates are funded by one of three guaranty associations. The associations were previously required to handle all covered claims for receivership estates formed after January 1, 1992. As of September 1, 1994, they completed assumption of claims processing responsibilities for all pre-1992 receiverships. The associations assess member insurance companies for part of the funds needed to pay claims and recover the remainder from estate assets.

- **Special Master -** The district courts in Travis County have appointed a special master for an indefinite term to improve administration of receiverships and expedite their closure. The special master can become more involved with receivership details and hold speedier hearings than might be possible with a district judge. The special master can also ensure that affected parties receive adequate notice of hearings. Receivership court costs are funded out of estate assets.

Appendix 3:

Comparison of the Guaranty Associations

Figure 8

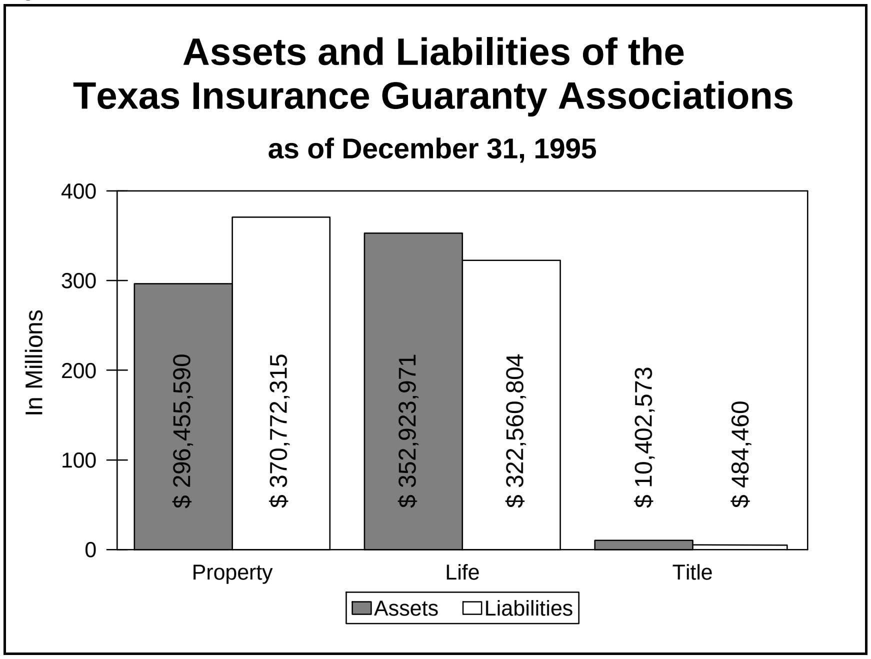


Figure 9