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An Audit Report on

The Texas Department of Insurance's Annuities Regulation

August 2009
Report No. 09-052



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Overall Conclusion

The Texas Department of Insurance (Department) has implemented controls that are generally operating effectively to ensure that companies' annuity form filings comply with applicable laws and regulations. In addition, the Department licenses and regulates individuals who sell annuities according to relevant laws and regulations. However, there are opportunities for the Department to strengthen controls in these areas.

The Department ensured the annuity forms that insurance companies filed comply with laws and regulations by (1) providing training to the specialists who review these forms; (2) developing, using, and periodically updating checklists and actuarial spreadsheets tailored for the different types of forms submitted; (3) conducting random audits of submitted forms that are exempt from preapproval; (4) ensuring that management reviews a sample of forms that have been approved or disapproved by specialists in the Life/Health Division; and (5) developing an "implementation plan" after each legislative session.

Based on auditor testing of license types that permit the holders to sell annuities, the Department:

- Licensed only individuals who met all statutory requirements for those license types.
- Maintained the proper status in its licensing system for licenses that had been revoked.
- Conducted audits of licensees' continuing education efforts that were generally effective in identifying noncompliance with laws and regulations.

What Is an Annuity?

An annuity is a type of financial insurance contract that can accumulate value and provide a steady stream of income over a long period of time.

There are three types of annuities: fixed, variable, and equity-indexed.

- Fixed annuities generate earnings at a current interest rate that is set annually by the insurance company.
- Variable annuities are highly dependent on the performance of the stock market and generally make no guarantees about earnings.
- Equity-indexed annuities base returns on changes in stock, bond, and money markets, but they also guarantee a minimum interest rate.

Source: *Understanding Annuities*, Texas Department of Insurance (<http://www.tdi.state.tx.us/pubs/consumer/cb078.html>).

Audited Areas

The Texas Department of Insurance's (Department) Life/Health Division examines annuity forms that are subject to review that insurance companies file with the Department. During those reviews, Department staff ensures that policies, contracts, certificates, and related insurance forms comply with Texas laws.

The Department's Licensing Division processes agent licenses. Two license types are eligible to sell annuity products: (1) General Lines -Life Accident Health and HMO and (2) Life Agent.

Regulation of individuals who sell annuities also is monitored by the Department's Consumer Protection Program and Enforcement Program. The Consumer Protection Program is the primary point of contact for individual consumers with insurance questions or complaints about agents or companies. The Enforcement Program investigates allegations and takes a variety of civil disciplinary actions. Both programs may refer complaints or cases to the Department's Fraud Unit for possible criminal prosecution.

Source: The Department.

This audit was conducted in accordance with Texas Government Code, Section 321.0132.

For more information regarding this report, please contact Kelly Linder, Assistant State Auditor, or John Keel, State Auditor, at (512) 936-9500.

In addition, the Department generally processed and resolved complaints, and it identified, investigated, and resolved enforcement cases involving annuities and individuals who sell annuities, in compliance with relevant laws and regulations. It also routinely opened a concurrent enforcement case when a fraud case against a licensee was initiated.

However, the Department should strengthen its controls by ensuring that:

- It maintains documentation of its legal staff's approvals of changes to checklists that Department staff use when reviewing the forms insurance companies submit.
- Insurance agents are required to make up any deficiencies in statutorily required continuing education hours.
- Complainants receive the statutorily required quarterly updates until their complaints are closed.
- It promptly removes access to automated data for individuals who no longer require such access.

The Department also should:

- Improve its documentation of training provided to the specialists who review annuity form filings.
- Formally document and strengthen some licensing procedures.
- Strengthen procedures for internally reviewing processed complaint files and communicating enforcement case results.
- Investigate whether it can perform market analyses for annuity policy sales.

Summary of Management's Response

The Department agreed with the findings and recommendations in this report. The Department's management responses to the specific recommendations in this report are presented immediately following each set of recommendations in the Detailed Results section of this report.

Summary of Information Technology Review

The Department has adequate information technology (IT) general controls, including logical access and software application change controls, as well as adequate application controls. Auditors assessed IT controls over the Department's information systems and other automated processes used in the

review of form filings, license and complaint processing, and enforcement case handling.

Summary of Objectives, Scope, and Methodology

The objectives of this audit were to determine whether the Department:

- Regulates annuities by ensuring that companies' annuity form filings comply with applicable laws and regulations.
- Licenses and regulates individuals who sell annuities according to relevant laws and regulations.

The scope of the audit covered the Department's regulatory activities during fiscal years 2007 and 2008, which included the activities of the Department's (1) Life, Health, and Licensing; (2) Consumer Protection; (3) Enforcement; and (4) Fraud programs. Auditors reviewed the Department's processes for regulating annuity form filings and the processes for licensing and regulating individuals who sell annuities. Auditors also evaluated the automated systems and processes that support the functions reviewed.

The audit methodology included collecting information and documentation, conducting interviews with Department management and staff, performing selected tests and other procedures, and analyzing and evaluating the results of the tests.

Auditors identified less significant issues that were communicated separately to the Department in writing.

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Detailed Results

Chapter 1

The Department Has Implemented Controls That Generally Ensure That Companies' Annuity Form Filings Comply with Applicable Laws and Regulations; However, the Department Should Strengthen Some Controls

Annuity Form Filings

During fiscal years 2007 and 2008, the Texas Department of Insurance's (Department) Life/Health Division received 18,079 form filings, which consisted of 55,576 individual forms. Of these forms, 7,701 were related to annuities, which were submitted by 184 individual companies.

As of January 2009, the Department had 12 staff members who received training to review annuity forms.

The Texas Department of Insurance (Department) has implemented controls that are generally operating effectively to ensure that companies' annuity form filings that are subject to review comply with applicable laws and regulations; however, it should strengthen some controls by maintaining documentation of the legal reviews of checklist updates and improving documentation of training provided to forms review specialists (see text box for more information on annuity form filings).

The Department's effective controls include: providing training to specialists who review annuity form filings; developing, using, and periodically updating checklists and actuarial spreadsheets tailored for the different types of forms submitted; conducting random audits of submitted forms that are exempt from the preapproval process; ensuring that management reviews a sample of forms that have been approved or disapproved by specialists in the Life/Health Division; and developing an "implementation plan" after each legislative session.

Chapter 1-A

The Department Should Document the Legal Review of All Changes Made to Form Filings Checklists

Checklists that specialists in the Department's Life/Health Division use to review annuity form filings are an effective control to ensure that filings comply with laws and regulations. However, the Department should strengthen this control by maintaining documentation of the legal reviews of changes made to the checklists.

The Department updates the checklists to reflect current annuities laws and regulations. In addition, Life/Health Division staff may request changes to help insurance companies and the Division's specialists understand Department expectations. To ensure that the checklists remain consistent with current laws and regulations, legal reviews of any substantive changes should be performed and documented.

Auditors reviewed the most recent revisions made to 5 of 16 annuity-related checklists the Department uses. The revisions were made between April 2007 and March 2009. Although notes prepared by Life/Health Division staff refer

to various legal reviews, the Department did not have documentation showing that legal staff had reviewed any of the most recent revisions to the five checklists.

Recommendation

The Department should ensure that it maintains documentation of legal staff reviews of all substantive changes made to form filings checklists.

Management's Response

Management agrees and has already initiated corrective action.

Although legal review is routinely sought on all substantive changes made to form filings checklists, the following additional steps will be implemented to ensure that documentation is maintained of those reviews:

- *The Life/Health Division drafted revision to the "Developing and Updating Checklist Procedure" to clearly and consistently incorporate the review and recommendation of Policy Development Counsel (PDC), the agency legal section.*
- *The draft document has been forwarded to PDC for input and comments.*
- *The final "Developing and Updating Checklist Procedure", which incorporates comments from all parties; will be communicated to staff involved in the development of checklists and saved in the Life/Health Division's Training Folder and distributed to PDC. The new procedure will also be included in staff training.*

Person Responsible for Implementation: *Ana M. Smith-Daley, Deputy Commissioner, Life/Health Division.*

Target Date for Implementation: *September 1, 2009.*

Chapter 1-B

The Department Should Develop and Consistently Apply Written Policies and Procedures to Document Training Provided to Specialists

The Department adequately documents the training provided to forms review specialists in its Life/Health Division. However, the Department should strengthen this control by developing and consistently applying written policies and procedures to document specialists' training in sufficient detail.

Specialists receive multiple training classes to prepare them to review specific annuity products; however the Life/Health Division has not developed written procedures addressing how it will document this training. Supervisors use a one-page “forms assignment list” to determine which specialists are qualified to review which annuity form filings. Updates to this list are made based on e-mails from the trainer that document a specialist’s completion of specific training. However, the assignment list is not sufficiently detailed regarding training to review annuity riders. Although there are five different types of annuity riders, each of which requires specific training, the assignment list refers only to “annuity riders” as a single category. Auditors identified several specialists that the assignment list showed as qualified to review annuity riders; however, the Life/Health Division could not provide auditors documentation that these specialists had received training in all five types of riders.

In addition, the Life/Health Division could not provide the e-mail documentation showing that a specialist had actually received training in an annuity product for which the specialist was reported as a qualified reviewer on the assignment list. The lack of detailed training documentation increases the risk that an assignment may be made to specialists who are unqualified in the types of products assigned to them for review.

Recommendation

The Department should ensure that its Life/Health Division develops and consistently applies written policies and procedures for documenting training provided to forms review specialists. The procedures should ensure that all training is documented in sufficient detail.

Management’s Response

Management agrees and has already initiated corrective action.

Life/Health Division assigned a Task Force consisting of Life/Health Division’s trainers, mail assigners and forms review specialists to review the training database, the mail assignment documentation, and class attendance sheets to make recommendations on improvements that will enable the Division to use one source of information for training documentation, product knowledge, mail assignment, and performance reviews. The recommendation will be considered by the Life/Health Division’s management team, who will implement the new process to ensure that detailed and complete documentation regarding the training of forms review specialists takes place. This process will be actively managed by the deputy commissioner, trainers, team leaders and directors. The documentation will also identify forms review specialists who, because of their expertise in applicable areas, are exempted from formal training classes. This new training documentation will

be implemented incrementally with a final completion date for roll-out January 2010. The Task Force members have already held their initial meeting and detailed paper documentation will begin immediately for all training classes.

Person Responsible for Implementation: *Ana M. Smith-Daley, Deputy Commissioner, Life/Health Division.*

Target Date for Implementation: *January 2010.*

The Department Licensed Insurance Agents to Sell Annuities in Accordance with Relevant Laws and Regulations; However, It Should Strengthen Its Enforcement of Continuing Education Requirements and Certain Licensing Procedures

The Department licensed individuals who sell annuities according to relevant laws and regulations, and it conducted audits of licensees' continuing education efforts that were generally effective in identifying noncompliance with laws and regulations. However, it should enhance its enforcement of licensee continuing education requirements by requiring licensees to make up any missed continuing education credit hours (in addition to paying any fines for such noncompliance) and strengthening its continuing education audit procedures. In addition, the Department should document and strengthen certain licensing procedures.

Licensing Requirements

Texas Insurance Code, Section 4001.105, states that to obtain a license, an individual must:

- Be at least 18 years old.
- Have passed the required licensing examination within the past 12 months.
- Have not committed an act for which a license may be denied in Texas Insurance Code, Chapter 4005.
- Have submitted the application, appropriate fees, and any other information required by the Department.

The Department effectively ensured that it licensed only individuals who met statutory requirements for license types that permit the holder to sell annuities. Each applicant in all 59 new license applications tested met all statutory requirements (see text box for a list of the requirements). In addition, the Department's licensing system accurately showed when a license had been revoked.

The Department obtained Department of Public Safety (DPS) and Federal Bureau of Investigation (FBI) fingerprint-based criminal background checks for all 25 applicants who were Texas residents in the sample of applications the Department received during fiscal year 2008 that auditors tested. In addition, the Department properly safeguarded the hard copy and electronic records of the criminal background checks.

State law does not expressly require the Department to conduct criminal background checks on all licensees. The Department began performing name-based criminal background checks on all new license applicants in 1996. In January 2007, the Department began requiring fingerprint-based criminal background checks for all new license applicants. In addition, the Department receives notifications from DPS of all updates to the criminal history information for individuals who applied for an insurance license since April 2007. Auditors' analysis of the license database indicates that 22 percent of Texas resident licensees as of August 31, 2008, had not been subjected to a criminal background check because they were licensed prior to 1996, which was when the Department began performing criminal background checks on all applicants. (See Appendix 2 for more information on the Department's criminal background check procedures.)

The Department Should Require Licensees to Make Up Any Continuing Education Deficiencies and Improve Its Auditing Procedures

The Department's continuing education audits were generally effective in identifying licensees' noncompliance with continuing education requirements specified in state law and the Texas Administrative Code. However, the Department's rules in the Texas Administrative Code do not require licensees to make up identified deficiencies in the required number of hours of continuing education. Instead, the Department usually imposes an automatic fine of \$50 for each hour that an audited licensee is below the required minimum. In addition, the Department's audit procedures do not require auditors to look for instances in which an audited licensee claimed credit for taking the same course more than once during the two-year reporting period.

State law and the Texas Administrative Code generally require licensees eligible to sell annuities to obtain at least 30 hours of continuing education during each two-year reporting period. Statute and Department rules indicate that continuing education classes should enhance a licensee's knowledge, understanding, and professional competence. Among other restrictions, Title 28, Texas Administrative Code, Section 19.1010(c), states that, "A licensee may not receive credit for teaching or completing the same continuing education course more than once within the same reporting period."

The Department audits approximately 1 percent of eligible licensees for compliance with continuing education requirements. Auditors tested a random sample of 30 continuing education audits processed during fiscal years 2007 and 2008 of licensees authorized to sell annuities. Of the 30 audits tested, 28 were for licensees who were required to meet continuing education requirements. Thirteen (46 percent) of these 28 licensees did not complete the continuing education requirements.¹

Generally, the Department imposes an automatic fine on licensees identified as noncompliant with continuing education requirements, but it does not require those licensees to make up the number of missed credit hours. Imposing only a monetary penalty without any requirement to make up the missed credit hours might not serve as a sufficient deterrent to licensee noncompliance. In addition, some noncompliant licensees might not maintain sufficient knowledge, understanding, and professional competence, which could be particularly important when dealing with the complexities that often accompany annuities.

¹ The actual noncompliance rate observed in the auditors' sample is probably higher than the rate in the total population of licensees who sell annuities because many of the licensees selected for audit, and therefore also included in the State Auditor's Office's random sample, were audited because the licensees had notified the Department that they did not meet the continuing education requirements.

Auditors also identified one instance in which the Department's audit did not detect that a licensee took the same eight-hour course twice during the license reporting period and claimed credit for it both times. Although Department rules prohibit licensees from claiming credit for the same course more than once, its written audit procedures do not specifically remind the auditor to look for this rule violation. The Department accepted all 31 credit hours reported by this licensee instead of disallowing 8 credit hours and fining the licensee \$350 for the resulting 7-hour deficiency.

The Department stated that it has begun requiring continuing education providers to electronically report all credit hours earned by licensees. As a result, it expects to be able to use automation to more easily identify all licensees who appear to be deficient in meeting continuing education requirements.

Recommendations

The Department should:

- Make any necessary rule or process changes to require licensees to make up any deficiencies in statutorily required continuing education credit hours in addition to paying administrative fines.
- Include in its written audit procedures a review of credit hours to identify any credit hours reported for the same continuing education course.

Management's Response

Management agrees with the recommendation to improve its auditing procedures. With regard to requiring licensees to make up any continuing education deficiencies in statutorily required continuing education credit hours in addition to paying administrative fines, the Department will explore necessary changes to implement the recommendation.

As noted in the State Auditor's report, the Department has entered into a contract with an outside vendor for operation of a continuing education compliance system requiring continuing education providers to electronically report all credit hours earned by licensees. As a result, it expects to be able to use automation to more easily identify all licensees who appear to be deficient in meeting continuing education requirements and to automatically collect fines for deficiencies.

The Department believes that the new continuing education compliance system using roster reporting and the ability to automatically collect fines for deficiencies, in place of random auditing, should greatly increase compliance with the continuing education requirements.

The Department sought the use of automatic fines as a cost effectiveness tool for the regulation of compliance with continuing education requirements. The legislature enacted Section 4005.109 of the Texas Insurance Code “(t)o expedite the department’s processing of certain violations of this code.” The Department adopted 28 Texas Administrative Code Section 19.1016 – Automatic Fines with an effective date of January 6, 2003 to establish the automatic fine amounts and process for assessment of fines.

During the rule adoption, a commenter asked whether a licensee who was found to be deficient and who paid the appropriate automatic fine would also be required to complete the deficient number of hours of CE. The Department responded that “The penalty for not completing the required number of hours in a reporting period is an automatic fine as set forth in 19.1016(b)(1). The statute is very specific regarding the number of credit hours required per reporting period and states that failure to obtain the required number of credit hours is a violation that is subject to an automatic fine. 29 Tex Reg 75 (2003).” The rule history here indicates that payment of the fine would bring the licensee back into compliance and that making up hours was not required (nor could it substitute for payment of the fine).

In light of your recommendation, the Department will reevaluate its position and the impact such change would have on handling deficiencies. We will consider what rule or policy changes would be needed.

Person Responsible for Implementation: Matt Ray, Deputy Commissioner, Licensing Division

Targeted Date for Completion: The Department will immediately modify its written audit procedures to require a review of credit hours to identify any credit hours reported for the same continuing education course in the same licensing period. The new automated continuing education tracking system will not allow a licensee to receive credit hours for the same continuing education course within the same licensing period.

By August 31, 2010, the Department will evaluate the recommendation of requiring completion of deficient continuing education hours in addition to the payment of an automatic fine, evaluating how the additional requirement would impact with the desire for expediency in processing expressed in Section 4005.109 of the Texas Insurance Code, and consider what rule or policy changes would be needed to require both.

The Department Should Document and Strengthen Certain Licensing Procedures

The Department licenses individuals who sell annuities according to relevant laws and regulations. However, it should strengthen the controls over its licensing procedures by (1) developing written policies and procedures for license approvals and renewals, (2) formally reconciling license application fees received from its external contractor to the number of applications processed by the contractor, and (3) removing the ability of license processors to delete an automated license notification.

The Department does not have written policies and procedures for its license approval and renewal processes. Written policies and procedures help ensure continuity in the event of employee turnover and that employees consistently perform their duties as intended by management.

In addition, the Department's Licensing Division reconciles the amounts its external contractor for license applications and testing reports it has collected to the amounts deposited. However, the Department does not reconcile the amount received from the contractor to the number of applications processed by the contractor. Without performing such reconciliations, the Department cannot ensure that it has received all of the money that applicants should have paid to the licensing contractor.

Finally, license processors can delete an automated license limitation notification or "flag" from a licensee record in the automated license processing system to which the Department subscribes. The license limitation flag is intended to prevent a license from automatically being approved or renewed in the automated system until a special review is performed by an employee, other than a license processor, who is authorized to perform such review. By allowing license processors to retain the ability to delete this flag, which they do not need to perform their regular job duties, the Department increases the risk that license processors could inadvertently or intentionally permit a license to be approved or renewed without being subject to the intended special review.

Recommendations

The Department should strengthen its procedures over license processing by:

- Developing written procedures for all license processing functions.
- Performing formal reconciliations of the amount of application fees the Department receives from the contractor to the number of applications that the contractor processed.

- Investigating whether it or the developer of the automated license processing system can remove the license processors' ability to delete license limitation flags.

Management's Response

Management agrees and has already initiated corrective action.

Although the Licensing Division maintains and utilizes various written procedures throughout the Division, the Department agrees that developing a more formalized procedural manual would be useful. The Department will take the necessary steps in its production and implementation.

The Department has a team of individuals from Agency Planning, Accounting and Licensing who have been working for several months on analyzing the collection of licensing fees with the purpose of developing a formal reconciliation of all fees collected. The Department has processes in place that serve to confirm that fees are received for all processed filings but is aware that additional data needs to be collected to allow the Department to reconcile fees collected to a transaction level. The review team has made great progress in cataloging process flows, assessing alternatives and developing a viable solution which the Department believes can be developed in the first quarter of the year 2010.

The Department will take necessary steps to investigate and implement the necessary controls such that license processors will not have the ability to delete license limitation flags. The Department will initiate action to ensure that the removal of license limitation flags is limited to management level staff.

Person Responsible for Implementation: Matt Ray, Deputy Commissioner, Licensing Division

Target Date for Implementation: First Quarter of 2010.

The Department Generally Handled Annuity Complaints and Enforcement Cases in Accordance with Laws and Regulations; However, the Department Should Strengthen Some Controls

The Department generally has adequate controls to ensure that its complaint resolution and enforcement processes related to annuities comply with relevant laws and regulations. However, the Department should strengthen controls by:

Complaints and Enforcement

Complaints: The Department received 80,404 complaints during fiscal years 2007 and 2008; 666 of these complaints were annuity related.

Enforcement cases: The Department opened 4,588 enforcement cases from fiscal year 2007 through May 1, 2009; 74 of these cases were annuity related.

- Ensuring that complainants receive the statutorily required quarterly updates.
 - Improving internal procedures for reviews of processed complaint files.
 - Notifying complainants when enforcement cases have been closed.
 - Improving communication between its Enforcement Program and Licensing Division regarding intended agent license limitations.
- Investigating whether it can perform the same types of market analyses for annuity policy sales that it performs for other lines of insurance.

The Department's Consumer Protection Program has written policies and procedures for handling consumer complaints, and the Department's Web site accurately reflects the public information that is in the Department's internal complaint system.

The Department's Enforcement Program also has written policies and procedures for handling enforcement actions against licensees, and it prioritizes and processes enforcement cases in compliance with applicable regulations and Department policies and procedures.

In addition, the Department's Fraud Unit opened cases referred to it by the Enforcement Program. Similarly, when the Fraud Unit initiated a case against a licensee, the Enforcement Program opened a concurrent case as required by Department policy.

Chapter 3-A

The Department Should Strengthen Controls Over Annuity Complaints Processing

The Department generally processes annuity-related complaints in accordance with laws and regulations. However, the Department should strengthen controls over its procedures by ensuring that complainants receive the

statutorily required quarterly updates and improving internal procedures for reviews of processed complaint files.

The Department's Consumer Protection Division's (Consumer Protection) procedures do not require quarterly updates to be sent to complainants. Instead, it notifies complainants when their complaint is opened and when it is resolved. As a result, complainants of complaints for which processing time exceeds 90 days may not be receiving all the required quarterly updates. Texas Insurance Code, Section 521.003, requires the Department to notify all parties involved in a written complaint about the complaint's status at least quarterly until final disposition.

Auditors tested notifications for 76 annuity-related complaints opened during fiscal years 2007 and 2008. Only 5 complaints took more than 90 days to close; however, Consumer Protection did not send the required quarterly status updates to the complainants of these 5 complaints.

Consumer Protection lacks an automated control to ensure that the required quarterly notifications are sent to complainants. It should be noted that most complaints are closed in fewer than 90 days. Of the 666 annuity-related complaints that Consumer Protection received during fiscal years 2007 and 2008, only 32 (4.8 percent) were closed in more than 90 days. Consumer Protection closed those complaints within 41 days, on average.

In addition, Consumer Protection's procedures for performing first- and/or second-level reviews ("audits") of processed complaint files included the following weaknesses:

- The same auditor can function as the first- and second-level reviewer. For 7 of 48 files requiring two audits that the State Auditor's Office tested, the same Consumer Protection auditor performed both audits. This lack of segregation of duties decreases the effectiveness of a two-level audit process.
- All items on the electronic audit checklist default to "Yes" before auditors make any entries. This default setting may cause an audit procedure to be marked as completed prior to some or all of the checklist items being reviewed.
- Some audits did not detect apparent coding omissions or errors. Six (18 percent) of 33 audited complaint files tested by the State Auditor's Office contained coding omissions or errors. Five files did not include a code indicating that the complaint involved a senior citizen as required by Consumer Protection procedures. The sixth file inaccurately categorized a justified complaint as unjustified. The Department uses these codes when reporting complaint statistics both internally and externally. Omissions or errors in these codes would result in inaccurate complaint reporting.

Recommendations

The Department should strengthen its controls by ensuring that its Consumer Protection Division:

- Develops and implements written procedures to ensure that complainants are notified on a quarterly basis until their complaints are resolved.
- Requires different auditors to perform each level of review.
- Requires auditors to enter all answers to checklist questions.
- Emphasizes to complaint processors and auditors the need to use accurate and all applicable complaint codes.

Management's Response

Management agrees.

Although the average processing time to resolve a complaint for the past 10 years was significantly less than 90 days, additional steps have been implemented to assure that every party receives quarterly complaint status updates:

- *On April 30, 2009, Complaints Resolution staff was trained regarding several ways to record their contacts with complaint parties quarterly: Complaint Inquiry System (CIS) journal entries to note telephone conversations; interim letters to consumers on pending files; and copying consumers on additional correspondence to insurance industry carrier, agents, and other parties.*
- *On May 12, 2009, Complaints Resolution conducted an auditor training noting that insurance specialists are required to communicate with the complainant via phone or in writing if a file is pending more than 30 days.*
- *The Department's Complaints Workgroup team, including managers and senior staff from each Department program that handles complaints, reviewed these procedures at their May 14, 2009, quarterly meeting. Division of Workers' Compensation (DWC) staff note that they update a complainant on the status of the complaint if the complaint is not linked to an existing claim, otherwise the complaint is confidential; this is noted in DWC's procedure manual and included in staff training.*
- *On May 18, 2009, the complaints procedure manual was updated to state that the insurance specialist must provide the consumer with a copy of all follow-up correspondence or send the subject entity's interim response along with a status update to the complainant.*

- *On July 21, 2009, a request to revise the CIS audit screen so that Item 7 will read: “Internal procedures were followed? (i.e., parties updated quarterly?)” is in the process of being implemented by ITS.*

These actions were taken to strengthen our complaint audit procedures:

- *The procedure manual was updated to expressly state that all three complaint functions (working a complaint, the first-level audit, and the second-level audit) must be performed by three different people (May 12, 2009). Auditor training about separation of functions, correct coding, and internal procedures was completed (May 12, 2009).*
- *The default “yes” answer was removed from the Complaint Inquiry System audit screen. It is blank at the start of the first- and second-level audits so the auditor must answer each question with a “Y” or “N” (July 16, 2009).*

The Department’s standard is that all appropriate codes and keywords should be applied to a complaint:

- *Complaint specialists and auditors discussed the standard for coding complaints and reviewed the list of codes and keywords in a staff meeting (May 14, 2009).*
- *The Department’s Complaints Workgroup reviewed this standard at their quarterly meeting (May 2009).*
- *DWC and Health and Workers’ Compensation Network complaints staff also had training on standards for coding complaints (April, June, July, and August 2009).*

Person Responsible for Implementation: Audrey Selden, Senior Associate Commissioner, Consumer Protection.

Target Date for Implementation: September 30, 2009.

Chapter 3-B

The Department Should Strengthen Controls Over Enforcement Case Processing

The Department generally handles annuity-related enforcement cases in accordance with laws and regulations. However, it should strengthen controls over the processing of enforcement cases by ensuring that its Enforcement Program notifies complainants when cases have been closed and improving the communication between the Enforcement Program and the Licensing Division regarding intended agent license limitations, which subject a license application or renewal to further review by Department staff.

Eleven of 15 cases tested lacked documentation showing that any closing correspondence had been sent to the complainant. The Enforcement Program's procedure manual requires such correspondence.

The Department's Enforcement Program opened 210 enforcement cases against agents during fiscal years 2007 and 2008 that required license limitations to be maintained in the Licensing Division's agent licensing system. Of these, auditors identified six system files that did not show the license limitations. The reasons for the discrepancies included incorrect or confusing instructions from the Enforcement Program to the Licensing Division, the Licensing Division not receiving the limitation instructions, and removal of the limitations by Licensing Division staff without prior approval by either Licensing Division or Enforcement Program management. It is important that license limitations be accurately maintained because such limitations are intended to automatically subject a license application or renewal to further review by Department staff.

Recommendations

The Department should:

- Ensure that its Enforcement Program consistently notifies complainants when an enforcement case is closed.
- Ensure that its Enforcement Program consistently provides clear instructions regarding license limitations to the Licensing Division.
- Ensure that Licensing Division staff do not remove license limitations without obtaining appropriate management approval.

Management's Response

Management agrees and has already initiated corrective action.

These actions have been taken to ensure complainants are notified when an enforcement case is closed:

- *In May 2009, closing letters to complainants were updated to create a closing letter which is tailored to the case disposition. These form letters were distributed to all members of Enforcement Division via email. The letters were also saved to a shared drive which is accessible to all members of Enforcement Division.*
- *On June 11, 2009, the "Final Closing Steps" area of the Request for Disposition (RFD) was revised to emphasize the importance of closing letters to complainants by placing this step first on the list. The time*

frame for issuance of closing letters was outlined in writing and on the RFD.

These actions have occurred to ensure Enforcement Division provides clear instructions regarding license limitations to the Licensing Division:

- *March 19, 2009, Enforcement Management provided a reminder to team members regarding Administrative Review and use of the license limitations function.*
- *June 1, 2009, Enforcement Division team members and support staff were reminded to pay close attention to the Administrative Review area and Disposition Code AR/LL (Administrative Review/License Limitations) on RFDs.*
- *June 17, 2009, Enforcement Management reiterated to staff the need to ensure consistency between the Administrative Review area and the AR/LL disposition code was stressed.*
- *As RFDs are processed, Enforcement's Division Chief, Team Leaders and support staff are more attentive to the Case Disposition Codes and Administrative Review area on the RFD. Staff members are asked individually to correct discrepancies between these two areas of the RFD.*

The Department will take necessary steps to investigate and implement the necessary controls such that license processors will not have the ability to delete license limitation flags. The Department will initiate action to ensure that the removal of license limitation flags is limited to management level staff.

Person Responsible for Implementation: Catherine Reyer, Associate Commissioner, Enforcement.

Target Date for Implementation: Immediately.

The Department Should Investigate Whether It Can Perform Market Analyses for Annuities

The Department does not perform the same types of market analyses for annuity policy sales that it performs for other lines of insurance. Those analyses allow the Department to determine whether an insurance company's results appear out of the norm, suggesting the existence of potential market conduct problems in a particular line of insurance (see text box for more information about market analysis). The Department primarily relies on its analyses of complaints to determine whether further investigation, which could include an on-site examination, of an individual company is warranted. The Department has not conducted any on-site examinations of annuities as a result of these complaint analyses.

What Is Market Analysis?

A market analysis program is a system of collection and analysis of data and other information. The indicators that result from the analysis provide a basis for regulators to initially screen and follow up with insurers whose results are out of the norm and help focus resources on insurers with potential market conduct problems.

Source: *Market Regulation Handbook 2008*, Volume I, National Association of Insurance Commissioners.

The following statement in a report by the U.S. General Accounting Office suggests that a market analysis program should go beyond an analysis of complaints:

We found that in many states, market analysis consisted largely of monitoring complaints and complaint trends and reacting to significant market issues. Analyzing complaints and complaint trends does provide regulators with useful and important information and should be part of any market analysis program. However, other types of information can also help regulators identify and deal with market conduct issues, including data from financial reports, rate and form filings and other company filings, routine and special requests for company data and information from other federal and state regulators.²

Recommendation

The Department should investigate whether it can perform the same types of market analyses for annuity policy sales that it performs for other lines of insurance.

Management's Response

Management agrees with the recommendation and has already initiated corrective action. While the raw data to conduct market analysis has been available, it is now being put into tools and applications that will facilitate its use in future market analysis.

² *Insurance Regulation: Common Standards and Improved Coordination Needed to Strengthen Market Regulation*, U.S. General Accounting Office Report No. GAO-03-433, September 30, 2003. Effective July 7, 2004, the U.S. General Accounting Office's name was changed to the U.S. Government Accountability Office.

The Department's market analysis program is largely based on the model promulgated by the National Association of Insurance Commissioners (NAIC). The Department currently uses two tools developed by the NAIC, referred to as the Market Analysis Review System (MARS) and the Market Analysis Prioritization Tool (MAPT). MARS has an application for annuities that the Department intends to use in the next round of analysis reviews. A MAPT annuity application is currently being developed by the NAIC. Finally, the NAIC is also developing a Market Conduct Annual Statement (MCAS) and plans to make MCAS data available to all states in 2010.

In addition, comprehensive financial examinations, which are conducted on 3 to 5 year cycles for every insurer, typically require market conduct procedures to be performed, and stipulates that the financial examiners interact with the Market Conduct Division should problems arise from the financial examiners' review.

Person Responsible for Implementation: Ignatius Wheeler, Chief Examiner, Financial Exams.

Target Date for Implementation: Final implementation will extend through 2010 because of the NAIC's application development schedule.

The Department's Controls Over Information Technology Systems Are Adequate; However, It Should Improve Access Controls

The Department has adequate information technology (IT) general controls, including logical access and software application change controls, as well as adequate application controls. However, the Department should strengthen user access controls by (1) promptly deleting access to automated data of employees who terminate employment or no longer need such access to perform their regular job duties and (2) implementing formal periodic reviews of user access.

Auditors reviewed user access to the Department's Policy Approval Tracking System (used for form filings), Complaints Inquiry System (used for complaints processing), and Case Tracking System (used for tracking enforcement cases) and identified several weaknesses. Specifically:

- Active user accounts existed for individuals who no longer required access to the applications, including former employees, former interns, and an employee candidate who did not accept the job offered. Department management stated that it had requested the access to be removed for some of the identified accounts.
- E-mails from Human Resources notifying managers of employee terminations were sometimes sent several days after the employee's separation date. Managers who have the ability to remove, or initiate a request to remove, an employee's user access cannot take such action promptly unless they are notified of an employee's termination on a timely basis.

Title 1, Texas Administrative Code, Section 202.25(3)(B), requires that a user's access be appropriately modified or removed when the user's employment status or job responsibilities change. Ensuring that user accounts are removed or modified on a timely basis reduces the risk of unauthorized access to the applications and the underlying data.

In addition, the Department does not have written procedures that require periodic user access reviews, and it does not routinely perform such reviews, to ensure that current users are assigned appropriate access based on their job responsibilities. Title 1, Texas Administrative Code, Section 202.21, states that owners of an agency's information resources are responsible for reviewing user access lists.

Recommendations

The Department should:

- Ensure that it promptly deletes user access to automated applications upon a user's separation from the Department or a notification by supervisors of a change in the user's job duties.
- Develop and implement written procedures to perform periodic reviews of user access to ensure that each user is assigned appropriate access based on his or her job responsibilities.

Management's Response

Management agrees and has already initiated corrective action.

The Information Technology Services (ITS) division has implemented a monthly reporting process in which Local Area Network (LAN) accounts that have not been logged into for 90 days are identified. The procedures will be used to identify those accounts and revoke access. The procedures also include a process for handling accounts for temporary workers, contract workers and interns.

ITS is re-instituting the Computer Security Liaisons (CSL) group. Each program area will designate a Computer Security Liaison. The Information Security Officer will provide training for the CSL to ensure these designees understand their role. Additionally, the Information Security Officer will coordinate and conduct quarterly meetings with the CSL group to address current security-related topics.

ITS is providing two reports to each Program Area's Computer Security Liaison (CSL) to assist the programs ability to follow agency policy that requires periodic review of access accounts to disable inactive users:

- 1. Monthly reports listing users and privileges to network drives, folders and files.*
- 2. Monthly reports listing users and privileges to Oracle applications.*

These reports are available to the Program Areas' CSL each month. The CSL is notified via email when the report is available for review each month.

Person Responsible for Implementation: Jeff Byington, Information Security Officer, Information Technology Services.

Target Date for Implementation: September 1, 2009.

Appendices

Appendix 1

Objectives, Scope, and Methodology

Objectives

The objectives of this audit were to determine whether the Texas Department of Insurance (Department):

- Regulates annuities by ensuring that companies' annuity form filings comply with applicable laws and regulations.
- Licenses and regulates individuals who sell annuities according to relevant laws and regulations.

Scope

The scope of this audit covered the Department's regulatory activities during fiscal years 2007 and 2008, which included the activities of the Department's (1) Life, Health, and Licensing; (2) Consumer Protection; (3) Enforcement; and (4) Fraud programs. Auditors reviewed the Department's processes for regulating annuity form filings and the processes for licensing and regulating individuals who sell annuities. Auditors also evaluated the automated systems and processes that support the functions reviewed.

Methodology

The audit methodology included collecting information and documentation, conducting interviews with Department management and staff, performing selected tests and other procedures, and analyzing and evaluating the results of the tests.

Information collected and reviewed included the following:

- Data and supporting documents for fiscal years 2007 and 2008 for the following areas: (1) form filings received, (2) approved general lines and life agent licenses, (3) continuing education audit process, (4) new complaints received, (5) new enforcement cases opened, (6) agents placed on administrative review, and (7) fraud cases opened.
- The Department's implementation plan for the 78th, 79th, and 80th Legislatures.
- Checklists the Department used to review annuity filings.

- Training provided to Department staff who review annuity filings.
- Management's review of annuity filings.
- Actuarial spreadsheets used in annuity form filings reviews.
- The Department's policies and procedures manuals.
- The Department's contract with its external license applications and testing contractor.
- Management reports used by the Department's Consumer Protection Program.
- Complaints audit checklist.
- Job descriptions for certain employees in the Department's Enforcement Program.
- Reconciliations that the Department's Enforcement Program performed.
- Management reports used by the Enforcement Program.
- Program code for selected computerized processes.
- *Market Regulation Handbook 2008*, National Association of Insurance Commissioners.

Procedures and tests conducted included the following:

- Gaining an understanding of the Department's processes for regulating annuity form filings, licensing individuals who sell annuities, and regulating those licensees, which includes complaints and enforcement case processing.
- Testing significant controls the Department uses to regulate annuity form filings and the licensees.
- Reviewing various processes the Department uses to regulate annuity form filings and licensees to determine compliance with applicable laws and regulations.
- Testing applications and Department records to determine whether new licensees were qualified to receive a license.

Criteria used included the following:

- Texas Insurance Code.
- Texas Government Code.

- Texas Occupations Code.
- Texas Administrative Code, Title 28, Part 1 (Texas Department of Insurance), Chapters 1, 3, 19, and 21, and Title 1, Part 10 (Department of Information Resources), Chapter 202.
- The Department's policies and procedures manuals.

Project Information

Audit fieldwork was conducted from April 2009 through June 2009. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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

- Roger Ferris, CPA (Project Manager)
- Hillary Eckford, CIA (Assistant Project Manager)
- Rebecca Beachy, CIA, CGAP
- Fabienne Robin, MBA
- Gary Leach, MBA, CISA, CQA (Information Systems Audit Team)
- J. Scott Killingsworth, CIA, CGAP, CGFM (Quality Control Reviewer)
- Kelly Furgeson Linder, CIA, CGAP (Assistant State Auditor)

The Department's Criminal Background Check Procedures

Prior to 1996, the Texas Department of Insurance (Department) did not perform any criminal background checks on applicants for insurance licenses. Beginning in 1996, the Department began performing criminal background checks on all applicants for an initial license or new license type, although it did not retroactively apply this process to insurance agents who were already licensed. These background checks were typically name-based checks (including name, birth date, and Social Security number), which is considered a less effective method than a fingerprint-based background check.

In January 2007, the Department began requiring fingerprint-based criminal background checks for all applicants for new licenses, which included existing licensees applying for another type of insurance license. The applicants paid the cost of these background checks.

In addition, the Department participates in the Department of Public Safety's (DPS) "rap back" program, which automatically notifies the Department of all updates to the criminal history information for individuals who applied for an insurance license and for which the Department obtained a fingerprint-based background check since April 2007.

State law does not expressly require the Department to conduct criminal background checks on all licensees. However, Texas Government Code, Section 411.106(a)(1), authorizes the Department to obtain applicants' criminal history record information from DPS. In addition, Texas Insurance Code, Section 4001.103(b), permits the Department to deny a license to an applicant who fails to provide a complete set of fingerprints when requested by the Department.

Background Check and Rap Back

Of the 176,207 active licensed Texas residents as of August 31, 2008, for all insurance types:

- 38,926 licensees (22 percent) had not received a criminal background check.
- 137,281 licensees (78 percent) had received a criminal background check.

Of the 137,281 licensees who had received a background check:

- 93,779 licensees (53 percent of all active licensees) applied for their license before April 2007 and were not included in DPS's rap back program.
- 43,502 licensees (25 percent of all active licensees) were included in the DPS rap back program.

Source: Auditor analysis of license data provided by the Department.

Because the Department did not retroactively apply its criminal background check processes to existing licensees, some licensees who received their license prior to 1996 have never been subjected to a criminal background check. Auditors' analysis of the Department's license database showed that 22 percent of Texas resident licensees as of August 31, 2008, were not subjected to a criminal background check (see text box for more information). These licensees would receive a background check in the future only if they apply for a new type of insurance license or allow their existing license to expire for at least one year and then reapply for a license.

In addition, the Department will not receive any updated criminal history information on an additional 53 percent of Texas resident licensees as of August 31, 2008 (unless a licensee applies for a new type of license or reinstatement of a license expired for at least a year)

because those licensees received only a name-based background check or received a fingerprint-based check prior to April 2007.

It should be noted that the Department processes a significant number of new applicants each year, all of whom will be subject to the fingerprint-based background checks and will be included in the DPS rap back program. As a result, the percentage of total licensees covered by these more extensive background check and update procedures should steadily increase.

Copies of this report have been distributed to the following:

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The Honorable Joe Straus III, Speaker of the House, Joint Chair
The Honorable Steve Ogden, Senate Finance Committee
The Honorable Thomas “Tommy” Williams, Member, Texas Senate
The Honorable Jim Pitts, House Appropriations Committee
The Honorable Rene Oliveira, House Ways and Means Committee

Office of the Governor

The Honorable Rick Perry, Governor

Department of Insurance

Mr. Mike Geeslin, Commissioner of Insurance



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