

December 30, 2019

Keely Martin Bosler, Director
California Department of Finance
915 L Street
Sacramento, CA 95814

Dear Ms. Keely Martin Bosler,

In accordance with the State Leadership Accountability Act (Leadership Accountability), the Department of Insurance submits this report on the review of our internal control and monitoring systems for the biennial period ending December 31, 2019.

Should you have any questions please contact Catalina Hayes-Bautista, Chief Deputy Commissioner, at (916) 492-3733, catalina.hayes-bautista@insurance.ca.gov.

GOVERNANCE

Mission and Strategic Plan

The California Department of Insurance's (CDI) mission is "[w]e act to ensure vibrant markets where insurers keep their promises and the health and economic security of individuals, families, and businesses are protected." CDI's vision is "[I]nsurance Protection for All Californians." Consumers, insurance companies, and agent/broker licensees rely on CDI to ensure that insurance products and services are provided in a timely manner to consumers, and that CDI delivers fair and equal benefits. To meet these expectations, CDI ensures that insurers are solvent, consumer complaints are addressed in a reasonable and equitable manner, and insurers and licensees interact fairly in the marketplace.

CDI was created in 1868 as part of a national system of state-based insurance regulation. In 1988, California voters passed Proposition 103, a citizen-led initiative, expanding CDI's authority as well as changing the Insurance Commissioner from an appointee of the Governor to an independent statewide officer, elected by popular vote. Proposition 103 also required prior approvals of property and casualty rates, including personal auto and homeowner insurance.

With annual direct premiums of \$310 billion, California is the largest insurance market in the United States and the fourth largest insurance market in the world. In the normal course of business, CDI annually processes more than 8,000 rate applications, issues approximately 190,000 licenses (new and renewals) and performs hundreds of financial reviews and examinations of insurers doing business in California. CDI annually receives more than 170,000 consumer assistance calls, investigates more than 37,000 consumer complaints and, as a result, recovers more than \$84 million a year for consumers. CDI also annually receives and processes tens of thousands of referrals regarding suspected fraud against insurers and others and conducts criminal investigations resulting in thousands of arrests every year.

In January 2019, a new Commissioner was elected to the role of Insurance Commissioner. This report

identifies risks that were carried from the previous Administration and highlights the various controls and remedies this Administration plans to implement in addressing the aforementioned risks. CDI's goals and strategies are summarized below:

Goal 1: We provide excellent, fair and responsive service.

Strategies:

- Excel at our core competencies.
- Implement federal and state laws that improve access to health care.
- Protect and support consumers.
- Provide transparent, consistent, timely communications and oversight.
- Fairly prosecute violations of law.
- Ensure the solvency of insurance companies and protect policy holders and creditors in conservation and liquidation.

Goal 2: We advance effective and efficient business processes.

Strategies:

- Continuously evaluate department processes toward implementing operational improvements.
- Coordinate priorities and operations within and across programs.

Goal 3: We value our resources and use them wisely.

Strategies:

- Be an employer of choice.
- Recognize and reward employee achievements.
- Establish explicit priorities.
- Strategically procure and allocate resources.

Goal 4: We promote innovation and professional growth.

Strategies:

- Ensure a strong institution through strategic recruitment, training, cross training, mentoring, and promotional opportunity.
- Foster a culture of creative problem solving.
- Develop state-of-the-art information technology solutions.

Control Environment

CDI management is actively involved in maintaining an effective control environment through continuous ongoing monitoring facilitated by its Enterprise Planning Risk and Compliance (EPRC) Office. All levels of CDI management are responsible for ensuring that adequate internal controls are in place within their respective program areas. The business unit managers and process owners (Program Monitors) are CDI's first line of defense, and are tasked with the responsibility to address potential risks as the risk owners.

Any critical items identified are evaluated by Program Monitors and executive leadership for mitigation.

CDI's senior executives consult on the highest-level priorities to properly address issues, assign resources and monitor progress. EPRC evaluates internal control systems on a quarterly basis to ensure risks are adequately addressed. The responsibilities of executive monitoring sponsors are assigned to the Chief Deputy Commissioner, Senior Deputy Commissioner, and Special Counsel to the Commissioner. Their responsibilities include verifying that CDI internal control monitoring practices are implemented and functioning as intended.

CDI ethics and values are communicated formally through written codes of conduct and policies, staff meetings, memos, etc. and informally during day to day operations. Managers are held to a higher standard and are expected to model the behavior. Employees are empowered to report ethical concerns to management or through the CDI and/or State Auditor Whistleblower Program.

CDI aims to maintain a competent workforce through a number of initiatives. The CDI Office of Strategic Planning and Human Resources Management Division offers opportunities for training and development with classes geared to address core competences for the various classifications. CDI has a succession plan and provides leadership courses to prepare emerging professionals for leadership roles. Management documents policies and procedures to ensure staff have resources to follow.

Information and Communication

CDI's main avenue for risk communication is through the quarterly Enterprise Risk Management (ERM) meetings. The purpose of these meetings is to: communicate the ongoing monitoring process; discuss and document the monitoring and testing of internal controls; and, evaluate progress.

Pertinent departmental topics and concerns are discussed at CDI's weekly executive staff meetings. CDI management then communicates relevant information down and across reporting lines. Information also flows up from staff members to management in staff meetings. Management selects the appropriate methods of internal communication from a range of newsletters, new employee orientation, emails, bulletins, employee training, staff meetings, and the Department's intranet site.

To facilitate communication of reliable information, CDI utilizes committees as part of the governance structure. Among other responsibilities, these committees assist in evaluating and communicating both operational and financial information. For example, they review program requests with significant financial impact, such as, major information technology system purchases and projects. Because of collective information and analysis, these committees are able to come up with solutions to complex problems and provide recommendations to leadership.

All information that will be released publicly is vetted by subject matter experts, then reviewed by program leadership, and CDI's Communications Team. Depending on the importance and nature of the information, it may also be reviewed by the Chief Deputy Commissioner, Senior Deputy Commissioner, or Special Counsel to the Commissioner. Once information is believed to be accurate, CDI communicates publicly through CDI's external website, social media pages, or other pertinent media. Program specific information that needs to be communicated to external stakeholders may be communicated in person, over the phone, or through email by the designated Program contact.

MONITORING

The information included here discusses the entity-wide, continuous process to ensure internal control

systems are working as intended. The role of the executive monitoring sponsor includes facilitating and verifying that the Department of Insurance monitoring practices are implemented and functioning. The responsibilities as the executive monitoring sponsor(s) have been given to: Catalina Hayes-Bautista, Chief Deputy Commissioner; Michael Martinez, Senior Deputy Commissioner; and Bryant Henley, Special Counsel to the Commissioner.

All levels of CDI management and personnel are empowered to report any internal control deficiencies within their respective program areas. In a more formalized fashion, CDI utilizes designated Branch Monitors who report to their daily organizational hierarchy and to the CDI ongoing Enterprise Risk Management (ERM) process. Through the ERM process, CDI maintains a risk assessment database to document risks and the associated ongoing monitoring. Branch monitors evaluate internal controls to ensure they are functioning as intended. The CDI SLAA agency facilitators assure the ERM database is updated and facilitates quarterly meetings with all branch monitors to review ongoing monitoring efforts.

Depending on the severity and/or likelihood of issues discussed at the quarterly meeting, risks are elevated for resolution. Branch monitors are experienced in discerning the 'due diligence' of impact on business processes and they assist in identifying critical issues. Where possible, critical issues are mitigated immediately. Risks that are considered enterprise-wide may require additional oversight by internal auditors, IT management, and/or the Chief Information Security Officer, senior executive management, up to and including the Commissioner.

RISK ASSESSMENT PROCESS

The following personnel were involved in the Department of Insurance risk assessment process: executive management, middle management, front line management, and staff.

The following methods were used to identify risks: brainstorming meetings, employee engagement surveys, ongoing monitoring activities, audit/review results, other/prior risk assessments, consideration of potential fraud, and performance metrics.

The following criteria were used to rank risks: likelihood of occurrence, and potential impact to mission/goals/objectives.

RISKS AND CONTROLS

Risk: Business Continuity and Technology Recovery Plan

CDI has both a Business Continuity Plan and a subordinate Technology Recovery Plan. While efforts have been made to ensure the plans are adequate, the two plans do not meet all the State Administrative Manual (SAM) requirements and are not fully integrated. Per SAM 5325, the concept of business continuity is based on the identification of all business functions and critical infrastructure within a state entity, and then assigned a level of importance to each business function. The Technology Recovery and Business Continuity Plans should be aligned in the identification of recovery strategies to ensure systems, functions, and infrastructure can be brought online quickly.

The lack of Business Continuity and Technology Recovery Plan integration could compromise CDI's responsiveness and recovery after a disaster, lead to a degradation in service, or undermine CDI's statutory requirements.

Control: Emergency Drills, Seminars and Workshops

To mitigate the risk of compromised responsiveness in the event of a disaster, CDI conducts annual seminars and workshops to review the Business Continuity Plan, Emergency Procedures and Evacuation Plan while also conducting emergency drills, including fire and earthquake drills.

Control: Plan Integration

CDI proposes to integrate the Business Continuity and Technology Recovery Plans. Both plans are updated regularly and submitted to the appropriate oversight agencies.

Risk: Internal Audit Oversight

The Internal Audit Unit which falls under Enterprise Planning, Risk, and Compliance Office (EPRC), did not have a manager for the majority of 2019. The EPRC Chief position was also vacant for a year. When the Lara Administration came into office, they made it a priority to fill the EPRC chief position and strengthen internal controls. The EPRC Chief position has since been filled. While strides have been made to address the leadership void in EPRC, the Internal Audit Unit is recovering from a knowledge gap which led to auditors' failure to complete assignments within budget hours and deadlines. There was no subject matter expert to coach, train and direct audit staff. Subsequently, the audit plan was not met, and no follow-up reviews were conducted on the completed audits.

Control: Supervisory

In August 2019, CDI hired a retired annuitant to temporarily serve as the subject matter expert. The EPRC Chief was hired in October 2019, and the Department is in the recruitment process for an Internal Audit Manager; CDI anticipates having someone in the position by January 2, 2020. The Internal Audit manager will be responsible for developing the audit plan along with the Department's Audit Committee. The Internal Audit manager also will coach, train, and direct staff to ensure the audit plan is met.

Risk: Delayed Financial Statements

CDI's implementation of FI\$Cal went live in July 2018 and the Department has been able to transact purchases and contracts, among other business needs within the system. However, the Department faced an impediment with overhead cost allocation. Cost allocation tables did not transfer correctly into FI\$Cal and this has impacted the reconciliation process and financial statement processing. As a result, CDI experienced significant challenges as the Department worked to close the 18/19 fiscal period. In an ordinary year, fiscal periods are closed in August. In 2019, however, it was not until mid-November that CDI was able to close the 18/19 fiscal period. Further exacerbating the issue is that transacting in FI\$Cal is presently more time consuming and CDI does not have enough staff resources to address the delays.

Without financial statements, programs are operating without a clear indication of available funding and there is risk of overspending. The Department's internal controls are therefore weakened.

Control: Manual Expense Tracking

To avoid potential overspending, managers are monitoring program spending manually along with CDI having long standing internal controls to mitigate misuse of funds. All purchases over \$5,000 are reviewed by the Budget Office.

Control: Additional Resources

CDI submitted a Budget Change Proposal requesting additional staff to process FI\$Cal transactions and it is currently pending review by the Department of Finance.

Risk: Human Resources

The human resources risk addresses the availability of an adequate and knowledgeable workforce with sufficient training and skills to meet the organizational goals and objectives into the future. This includes recruitment, hiring, succession planning, and retention. For example, there are issues affecting cohesion and recruitment/retention within CDI in the Enforcement Branch (EB) and the Rate Regulations Branch (RRB).

The EB ensures licensees comply with applicable insurance law and regulations, remain solvent and meet their obligations to insurance policyholders. The branch protects consumers by investigating and prosecuting individuals, employers, companies and licensees accused of Insurance Code violations, including fraud. EB's biggest recruitment/retention challenge is with the fully sworn peace officers that compose approximately 66 percent of the Fraud Division (FD). FD sworn staff make significantly less in salary than sworn peace officers at other state agencies such as the Department of Justice and the Department of Corrections and Rehabilitation. Since 2010, FD has lost a significant number of staff to these other agencies. New applicants may decline CDI positions when they realize other agencies pay more for the same job classification. As a result, some cases are not investigated, or the investigation is postponed. These staffing challenges have result in FD not opening as many fraud investigations due to under-staffing as well as insufficient time/cost to recruit, conduct interviews, perform lengthy/in-depth background checks, and train new employees. This ultimately impacts CDI's mission which is to protect consumers against insurance fraud.

The RRB is responsible for review of property and casualty rates and class plan filings to ensure the rating factors are in compliance with applicable statutes and regulations. The RRB relies on actuaries and Insurance Rate Analysts to review rate filings. The risk in the RRB is caused by inadequate staffing due to low compensation for actuaries compared to the private sector, and lack of a career path for insurance rate analysts to promote into an actuarial position.

Control: Case Prioritization

Cases referred to the EB are triaged to ensure those that pose the highest risk to consumers are prioritized.

Control: Salary Adjustment and Ongoing Recruitment

CalHR recently reached agreement with represented employees through Service Employees International Union to approve a special salary adjustment for Insurance Rate Analysts, and Investigators in Range C.

The CDI Human Resources Management Division recently established a Talent Acquisition Team to develop specific/targeted outreach strategies for classifications that are challenging to recruit and retain. Efforts are being made to broaden the Department's outreach efforts.

Control: Minimum Qualifications

CalHR is currently working on a statewide consolidation of actuarial classifications which would modify the minimum qualifications needed for appointment and better align the classification series with actuarial positions in the private sector, thereby increasing the candidate pool.

In addition, CDI is requesting to broaden the education requirements in the minimum qualifications of the Investigator and Special Investigator classifications to allow for any four-year degree, which is similar to some state departments. The current requirements are restricted to certain types of degree and limits the candidate pool for these positions.

Risk: Business Process Controls

Ongoing monitoring of business process controls identified potential risks that may require more analysis. Business processes, such as procurement, may not be operating at the most efficient level resulting in delays in resource availability for staff which, in turn, affects staff productivity. Additionally, current internal controls could be strengthened; for example, forms can be updated to ensure that certain purchases will require a second signature before they are sent to the Budget Office for processing. The current processes, without close oversight, could potentially result in purchases unaligned with Department goals and values.

Control: Business Process Re-engineering

CDI proposes to conduct a review of major business processes (e.g. business process re-engineering) that will assist in the identification of potential internal control gaps and help management implement controls that will further mitigate risk.

CONCLUSION

The Department of Insurance strives to reduce the risks inherent in our work and accepts the responsibility to continuously improve by addressing newly recognized risks and revising risk mitigation strategies as appropriate. I certify our internal control and monitoring systems are adequate to identify and address current and potential risks facing the organization.

Ricardo Lara, Insurance Commissioner

CC: California Legislature [Senate (2), Assembly (1)]
California State Auditor
California State Library
California State Controller
Director of California Department of Finance
Secretary of California Government Operations Agency