January 4, 2016

Michael Cohen, Director  
California Department of Finance  
915 L Street  
Sacramento, CA 95814

Dear Mr. Cohen,

In accordance with the State Leadership Accountability Act (SLAA), the Department of Insurance submits this report on the review of our systems of internal control and monitoring processes for the biennial period ended December 31, 2015.

Should you have any questions please contact Joel Laucher, Chief Deputy Insurance Commissioner, at (415) 538-4381, joel.laucher@insurance.ca.gov.

BACKGROUND

The California Department of Insurance (CDI) was created in 1868, but consumer protection continues to be CDI’s core mission. In 1988, Proposition 103 expanded CDI’s authority and changed the Insurance Commissioner to an elected statewide officer; Prop 103 also required prior approvals of property and casualty rates, includes personal auto and homeowner insurance.

The CA insurance industry is $259 billion, the largest nationally and the sixth biggest in the world. The CDI exercises direct oversight over over $123 billion of this market. The premium tax contribution from the CDI regulated marketplace is $2.4 billion or 1.95% in FY13/14.

The CDI’s vision "Insurance protection for all Californians" is advanced by enforcing insurance laws and regulations, assisting consumers in their dealings with insurers, and promoting innovations to improve services for insurance producers and consumers.

CDI achieves its mission “to ensure vibrant markets where insurers keep their promises and the health and economic security of individuals, families, and businesses are protected,” through six key interlinked regulatory functions:

- Financial solvency oversight.
- Licensing, certification, oversight, and discipline of companies, their agents and brokers.
- Examining premium rates and insurance products to ensure fair products, rates, and services.
- Consumer protections, includes resolving individual complaints, examining market practices, and pursuing violations of the Insurance Code.
- Premium tax collection.
- Detection, investigation, and prosecution of insurance fraud.

As a special fund agency, CDI obtains the resources necessary to guarantee insurance marketplace integrity, health, and vitality from license fees, assessments, and Proposition 103 recoupment fees. Factoring our systems of Internal Controls (IC), CDI’s return on investment, as contributions to the General Fund or consumers, during the Commissioner’s tenure include:

- $2.4 billion collected in premium taxes in FY13/14.
$100 million collected in fines and penalties, from vigorous legal and enforcement activities.

$71 million savings for consumers, from insurance rate reasonableness review and compliance with medical loss ratio requirements.

$1.3 billion in consumer rate reductions and $974 million in premium savings, from Proposition 103 review of property and casualty rate filings.

175,000 consumer calls handled by our Consumer Hotline in 2014 alone.

$266 million ($55 million in 2014) recoveries for consumers, from CDI consumer-complaint investigations and market conduct examinations.

$500 million workers’ compensation insurance fraud conspiracy investigated and prosecuted resulting in State Senator Ron Calderon’s federal indictment for public corruption, and the guilty pleas involving hospital CEO Michael Drobot and others.

780,965 insurance producer, bail agent and insurance adjuster licenses issued.

Restricted, suspended, or revoked the licenses of 2,914 insurance producers, bail agents, and insurance adjusters while denying the licenses for 1,030 applicants.

Awarded $61 million in FY14/15 to districts attorney to investigate and prosecute insurance fraud and insurance related crimes. These programs have resulted in 3,589 arrests and 6,944 convictions and similar amounts are awarded annually.

CDI has over 1,300 employees with well-defined roles and responsibilities. CDI fosters and maintains strong lines of authority, control, and communication throughout the eleven CDI branches:

Administration and Licensing Services: Provides administrative support services to all CDI programs and licenses agents, brokers, adjusters and business entities and performs financial reviews and examinations.

Communications and Press Relations: Coordinates and disseminates CDI’s message and objectives to consumers, the industry, media and CDI staff.

Community Programs & Policy Initiatives: Connects CDI with all of our stakeholders, such as community groups, consumer and industry organizations, businesses, government entities, and individuals. Analyze emerging insurance issues with policy implications and implements policy initiatives.

Consumer Services and Market Conduct: Educates consumers, mediates consumer complaints and enforces insurance laws through investigation of consumer complaints against insurers and licensees and examinations of insurer claims and underwriting files.

Enforcement: Investigates criminal and regulatory violations, including fraud. Receives and processes referrals regarding suspected fraud against insurers and others and conducts criminal investigations.

Financial Surveillance: Conducts risk-focused financial surveillance of the insurance industry to ensure it can provide the benefits and protections promised to Californians.

Health Policy and Reform: Oversee state-level efforts to implement federal health care reform in health insurance and assists in the development of health-related policy initiatives.

Legal: Ensures all insurers and licensees comply with the Insurance Code and assists with legislative and regulatory initiatives. The Corporate and Regulatory Affairs Branch functions to exercise license, oversight, and enforcement so that insurers remain solvent and conduct their affairs compliant to statute.
were merged.

Legislative: Pursues CDI's legislative agenda and represents the Insurance Commissioner on all legislative issues in collaboration with the Governor's Administration, legislators, and stakeholders.

Rate Regulation: Analyze and approve filings submitted by property and casualty insurers under statutes relating to prior approval of rates.

Special Counsel to the Commissioner: Provides independent legal advice to the Insurance Commissioner, oversight of Department Rulemaking Projects and Regulations, directs the interaction with the National Association of Insurance Commissioners, and manages special projects and Commissioner-initiatives (i.e., climate change initiatives).

**RISK ASSESSMENT PROCESS**

At CDI, risks are linked to the business objectives. The Organizational Accountability Office (OAO) facilitates the risk assessment (RA) and Enterprise Risk Management (ERM) plan processes. The Office of Strategic Planning (OSP) manages the enterprise strategic objectives and the Business Implementation Plan (BIP). Together, they assist business units to derive their strategic objectives, associated risks from their core activities, and align the risks to the strategic objectives.

The purpose of the RA is to assess the likelihood of risks, for CDI management to focus their attention on the most important threats and weaknesses, and to lay the groundwork for risk response. Also, FISMA compliance required CDI to submit a report biennially to the Department of Finance that contains identification of risks, establishment of IC’s, and a continuous evaluation of the control effectiveness.

Risk is the probability that an event will occur and adversely affect the achievement of CDI objectives. Year 2014 was a transition year from a RA Questionnaire format to an OAO user-developed RA database.

We flowchart the process by identifying the:

- Branch’s ‘core activities.’
- Business objective(s).
- Objective category: operational, reporting, and compliance.
- Associated risk(s).
- Regulatory requirement for the activity.
- Likelihood of occurrence and impact with a numeric evaluation.
- IC’s used.
- Risk strategy used: accept, avoid, transfer, or mitigate.
- Affected stakeholders.

The RA process begins after the branches complete their BIPs. Each:

- Core activity may have multiple objectives.
- Objective may have multiple risks.
- Risk may have multiple IC’s.
Risk is one record.

Business units define their core activities and document their business objectives (expectations from the core activities). The core activities and business objectives must align with the OSP Strategic BIPs. OAO meets with and interviews each Branch. The purpose of the meeting is to set protocols, identify contacts, and defines Branch deliverables: RA list, risk summary, and heat map.

Next, we document the risk(s) that may prevent the achievement of each objective. The risks are assessed a value based on likelihood of occurrence and impact and categorized into a risk strategy. If the business unit chooses to transfer or mitigate the risk, we add sufficient control(s) to reduce the risk to an acceptable level and cost.

When all the identified risks for the specific objective have gone through the RA process, including the numeric assessment of each risk, we move to the next objective and repeat the process.

To automate the RA and ERM processes, we developed the CDI RA Database. The database has restricted access controls, access and change logs, and reports function for heat map, and ERM based on risk rank(s) selected. The database information is not shared across CDI. Full access is limited to Commissioner Dave Jones, Chief Deputy Insurance Commissioner, OAO and OSP. Branch level approval is required for employee access. Branch Deputy Commissioners (DC) and employees can only view their branch information. Employees with access may add, delete, or change their Branch information. The ‘New Data Entry Form’ is for new activities formed. The ‘Branch Risk Report’ is for addition, deletion, or changes to existing information.

The RA is a DC top-down approach under the auspices of the CDC. Filtered from the RA process is the ERM, which are those risks that ranked 3 or higher on the heat map and others deemed significant by the CDC. The 2014 results were 331 risks, of which 27 were risk ranked 3 or higher, and captured on the ERM Report.

At CDI, we monitor risks; however, our focus is measuring objective accomplishment.

Similarly, the 2015 annual RA was conducted. Except, BIP completion was in conjunction with state legislative Insurance Committee request for data update. The 2015 RA is based on that BIP annual review/update conduct in March 2015.

On October 2015, OSP improved the CDI Strategic Plan by reserving the Strategic objective category for Commissioner Jones’ initiatives and the business units use the Operational, Reporting, and Compliance objective categories. The annual RA for this change is slated early 2016.

For strategic planning and risk assessment, CDI has adopted the COSO ERM Cube that has four objective categories: Strategic, Operational, Compliance, and Reporting.

**EVALUATION OF RISKS AND CONTROLS**

**Operations- Internal- Resource Management**

The Enforcement Branch is CDI’s largest branch and has the most geographically dispersed business units. In particular, the Branch is responsible for investigating criminal and regulatory violations starting with point-of-sale transactions through the claims process.

An objective of the Enforcement Branch is to:

- Procure and maintain necessary equipment and tools for staff to effectively and safely perform their assigned tasks and account for and inventory equipment.
- Conduct operations and field work in a safe and professional manner while achieving the goal of the assignment.

Therefore, the risks are:
• Staffing shortage.
• Inadequate equipment procurement, maintenance, and inventory processes.
• The presence of qualified candidates pools to eliminate staffing shortages.
• Provide the best training, quality equipment, and top-notch leadership.

To alleviate staffing shortage, starts with the hiring and retention of quality candidates. The Department of Corrections and Rehabilitation (CDCR) realignment has inflated the SROA list and this hiring priority has CDI as a layover for candidates to migrate to other desired job types. We strive to select candidates with an honest interest in investigations. Other efforts include:

• CDI’s in-house training program continues to improve in quality. This training is similar to the life-long learning approach, weaving in changes as they occur.
• Peace Officer Standard Training (POST) continues to be our primary standard for new investigators. POST is external training and has unavoidable costs, which has a nexus to the above stated SROA hiring priority.
• Up-to-date policy and procedures requires a continuous review that is offset by the benefit of governance that helps with retention.
• Sound supervision and leadership are great retention indicators.
• Participation in job fairs and using social media to widen the candidate pool.
• Consolidation of the training program with a core group of instructors who are cross-trained subject-matter-experts with teaching experience.
• Scheduled quarterly and annual firearm inspections.

Have robust equipment procurement, maintenance, inventory processes for staff to effectively, and in a safe manner, perform their tasks and assignments.

Implementation of property control database, reassignment of property control staff to one supervisor for consistency.

• Ensure robust equipment procurement, maintenance, and inventory.
• Implementation of property control database, reassignment of property control staff to one supervisor for consistency.

Operations- External- Funding—Sources, Levels

The Enforce Branch is CDI’s largest branch and has the most geographically dispersed business units. In particular, the Branch is responsible for investigating criminal and regulatory violations starting with point-of-sale transactions through the claims process.

An objective of the Enforcement Branch is to conduct operations and fieldwork in a safe and professional manner while achieving the goal of the assignment.

Therefore, the risk to being able to conduct operations and field work in a safe and professional manner while achieving the goal of the assignment is maintaining adequate resources.

The risk strategy is to accept the risk. This will result in adjusting the size of the mission capacity accordingly to the budget.

Operations- Internal- Staff—Key Person Dependence, Succession Planning

The Financial Surveillance Branch (FSB) is responsible for overseeing the financial condition of the insurance industry to ensure that it can provide the benefits and protections promised to California policyholders. FSB’s function is to assure that all insurers licensed to do business in California (as well as those insurers operating on a non-admitted or surplus lines basis) maintain the financial stability and viability necessary to provide the benefits and protection they have promised the California policyholders.
FSB pursues its mission by conducting risk focused financial surveillance of the insurance industry to ensure it can provide the benefits and protections promised to California citizens.

An objective of the FSB is to ensure the effectiveness and viability of branch operations.

Therefore, the risk is loss of institutional knowledge (people with 25+ years of CDI financial regulation experience), loss of budget resources, and retirements.

The Legal Branch ensures compliance with the California Insurance Code by all admitted insurers, insurance agents and brokers, and any other person or organization engaging in or applying to engage in the business of insurance in California. The Legal Branch serves an integral part of the CDI’s mission by litigating enforcement actions, reviewing and analyzing certain insurance policies to determine whether the policy should be approved for sale to consumers, assisting with implementation of health care reform, ensuring that rate filings comply with requirements of Proposition 103, and providing legal assistance to other branches of CDI. The Legal Branch provides legal services supporting the Fraud Division in the prevention of insurance fraud activity. The branch, in coordination with the Special Counsel also promulgates regulations implementing California statutes, and provides legal services to CDI relating to service of process and Public Records Act requests.

An objective of the Legal is to ensure compliance with California laws and Federal laws, as they pertain to California, to protect consumers and complete timely reviews.

Therefore, the risk to ensure compliance with California laws and Federal laws, as they pertain to California, to protect consumers and complete timely reviews is inadequate review, lack of necessary staff, and unqualified staff.

Identifying where the potential problem exists and training up-and-coming managers to assume a bigger role.

Develop a succession plan and implement through training of identified staff.

Hire qualified staff.

FSB is working with the Chief Deputy Insurance Commissioner to establish branch priorities and initiatives as part of their BIP.

Projects in progress as part of business implementation plans (BIP) include expanding responsibility of newer employees and ensuring participation of newer employees in the National Association of Insurance Commissioners (NAIC) processes.

Identified staff will receive mentoring/training.

In January 2106, CDI will launch Commissioner Jones’ initiative ‘CDI Forward.’ This is a robust training and development program designed to make sure all CDI staff have the skills required in 2016 and beyond to protect consumers and make sure California has a healthy and vibrant insurance market for many years to come. CDI will also institutionalize top-notch training and development for all CDI employees to encourage continued professional growth.

CDI will partner with educators at Sacramento State University to provide leadership development training for managers department wide so CDI’s leaders have a common set of tools and the necessary leadership skills to guide us forward.

Operations- External- Staff—Recruitment, Retention, Staffing Levels

The Health Policy and Reform Branch (HPARB) is responsible for implementation of the Patient Protection and Affordable Care Act (ACA), otherwise known as federal healthcare reform. HPARB is working with state and federal agencies to ensure that reforms both expand health care coverage and
protect consumers. This federal law presents the opportunity to bring health insurance coverage to millions of Californians, which is a top priority for the CDI. Starting in 2011, the Commissioner tasked the Department with working towards fully implementing the ACA in California. Many significant provisions of this federal law have already come into effect. The California State Legislature has enacted a number of laws that both mirror and exceed the requirements of the federal law, making California a national leader in ensuring more accessible and affordable health care coverage for all.

An objective of HPARB is review of individual and small group health insurance rates prior to their implementation, with the goal of preventing unreasonable rates from being charged to consumers.

Therefore, the risks are:
- Difficulty in hiring and retaining sufficient actuarial resources.
- The lack of rate regulation authority makes it difficult and sometimes impossible to achieve the goal of preventing consumers from excessive rates.

Actively recruit qualified actuarial skilled staff. Submission of packet to CalHR to:
- Change the salary scale for some actuarial positions.
- Upgrade the minimum qualifications for some classifications to reflect the necessary experience to do these jobs.

**Operations- External- Business Interruption, Safety Concerns**

The passage of Proposition 103 in 1988 required the CDI to review and approve most property and casualty lines of business before those rates are used in the market. This process, mandated by the California Insurance Code (CIC) Section 1861.05, requires the Rate Regulation Branch (RRB) to analyze filings seeking changes in rates, or related rating plans and classifications submitted by property and casualty insurers and other insurance organizations.

In addition, the RRB analyzes filings submitted by property and casualty insurers and other insurance organizations under California’s file and use statutes for a limited number of property and casualty lines of business.

An objective of the RRB is to review filing applications for completeness and basic compliance.

Therefore, the risk to reviewing filing applications is natural disasters.

Implement the Business Continuity Recovery Plan in case of prolonged power outage or natural disasters.

For natural disasters, we would transfer work from the impacted areas to the non-impacted areas for the duration of the event. To the degree that employees could work at home, we would implement telecommuting procedures. San Francisco employees could work temporarily offsite in Sacramento.

CDI management has identified this risk as an enterprise level risk and directed staff to ensure a viable and comprehensive Disaster Recovery and Resumption Plan to be tested and annually certified.

**Operations- Internal- Technology—Inadequate Support, Tools, Design, or Maintenance**

The passage of Proposition 103 in 1988 required the CDI to review and approve most property and casualty lines of business before those rates are used in the market. This process, mandated by the California Insurance Code (CIC) Section 1861.05, requires the Rate Regulation Branch (RRB) to analyze
filings seeking changes in rates, or related rating plans and classifications submitted by property and casualty insurers and other insurance organizations.

In addition, the RRB analyzes filings submitted by property and casualty insurers and other insurance organizations under California’s file and use statutes for a limited number of property and casualty lines of business.

An objective of the RRB is to provide electronic access of the company filing applications to the public. Therefore, the risk to provide electronic access of the company filing applications to the public is server overload.

All personnel would have to provide the information to each inquirer using edocs or SERFF.

**Operations-External-Staff—Recruitment, Retention, Staffing Levels**

The Corporate and Regulatory Affairs Branch’s (CARAB) two Bureaus protect California consumers by effectively exercising licensing, oversight and enforcement functions such that insurers remain solvent and conduct their affairs in accordance with the law. Program areas handled by CARAB include corporate applications, troubled companies, surplus lines, company compliance, risk retention and risk purchasing groups, conservation and liquidation of insurance companies, and providing essential legal advice and assistance in support of the Financial Surveillance Branch’s regulatory programs. The Administrative Hearing Bureau (AHB) is a bureau within CARAB. The AHB’s business office is located in San Francisco and it has hearing rooms in San Francisco and Los Angeles. The Insurance Code authorizes the Insurance Commissioner to conduct evidentiary hearings on a wide variety of insurance related matters. The duties performed by the AHB support the Insurance Commissioner’s adjudicatory responsibilities. (The AHB is not affiliated with the Department’s Legal or Rate Enforcement divisions that support the Insurance Commissioner’s regulatory responsibilities). The Department employs administrative law judges (ALJs) at the AHB to conduct impartial administrative law hearings and to prepare proposed decisions containing findings of fact and conclusions of law for the Insurance Commissioner’s consideration.

An objective of the CARAB is to ensure:
- Thorough, well-grounded written decisions.
- Fair and impartial hearings in accordance with the Administrative Procedures Act and applicable laws and regulations.

Therefore, the risks to ensure a thorough and well-grounded written decision and fair and impartial hearings are retention of qualified and talented ALJs.

Offer professional development training. Offer modernized hearing rooms. Offer modernized office furniture more conducive to professional working conditions.

**Compliance-Internal-Staff Not Adhering to Policies, Procedures, or Standards**

The Organizational Accountability Office (OAO) provides the Commissioner of the California Department of Insurance (CDI) and the Department’s management with independent, objective, accurate, and timely fact-finding and information regarding CDI’s:
- Audit function.
- Ethical compliance.
- Incompatible activity policy compliance.
- Enterprise risk assessment facilitation.
- State Leaders Accountability Act facilitation.

The OAO assists management in their efforts to increase operational and program efficiency and effectiveness by providing them with analysis, appraisals, recommendations, and technical assistance.

The OAO reports to the Chief Deputy Commissioner and collaborates with CDI Programs to provide
timely, professional, and objective services to satisfy customer needs. The OAO receives and investigates complaints of ethical or unprofessional business conduct and resolves such complaints according to statute and policy.

The OAO is composed of two distinct functions:
- Internal Audits Unit.
- Ethics Unit.

An objective of the OAO is to facilitate compliance with the State Leaders Accountability Act.

Therefore, the risk to compliance with the State Leaders Accountability Act is not having fully identified and implemented the required agency monitoring organizational structures, the roles and responsibilities of those tasked with monitoring, and professional development and training opportunities for monitors.

Develop business unit monitor training and assign business unit monitors.

ONGOING MONITORING

Through our ongoing monitoring processes, the Department of Insurance reviews, evaluates, and improves our systems of internal controls and monitoring processes. The Department of Insurance is in the process of formalizing and documenting our ongoing monitoring and as such, we have determined we partially comply with California Government Code sections 13400-13407.

Roles and Responsibilities

As the head of Department of Insurance, Dave Jones, Insurance Commissioner, is responsible for the overall establishment and maintenance of the internal control system. We have identified George Mendoza, Chief, Organizational Accountability Office, as our designated agency monitor(s).

Frequency of Monitoring Activities

CDI uses the Three Lines of Defense Model for monitoring:
- First line is management responsibility to use sufficient internal controls (IC) to reduce risk.
- Second line is oversight-owners to use and monitor IC’s over areas of responsibility.
- Third line is the internal auditors to provide assurance of compliance, mediation of risks, and reporting of CDI governance.

CDI has started control self-assessments (CSA) to evaluate CDI processes. This tool allows large participation and one facilitator. CDI has three main locations: Sacramento (HQ), San Francisco, and Los Angeles and nine regional offices. The two CSA’s provide suitable methods to comply with SLAA required monitoring:
- Network and Keycard Access. Assessed CDI’s active-directory netowrk and the facility-keycard access processes. Participants responded to an Internal Control Questionnaire and submitted their respective access data. These were reconciled with various management data to:
  - Validate data accuracy across several sources.
  - Identify weaknesses with IC’s.
  - Provide current analysis and solicit IC process improvements.
- Evidence Collection. Assess the regional offices’ evidence collection methodology, procedures, and the inventory database.

Reporting and Documenting Monitoring Activities

CDI monitoring includes:
- Working level staff monitor their processes and apply required IC’s to reduce risk. These are mostly desk procedures and supervisory review. CDI will designate Branch monitors to coordinate Branch IC’s.
- Managers at the oversight level focus on productivity with minimal risks exposure. Monthly Executive Staff meetings to discuss core activity progress and address obstacles.
• CDI uses CSAs to assess internal processes that involve all process employees and managers. Participants provide governance information and samples of the work performed. The CSA facilitator reconciles the data and analyzes the data integrity. The participants receive the analysis and reciprocate with their ideas to improve the process. The facilitator issues the CSA report with the procedures used and proposed improvements. Management is responsible to improve the process.
• CDI uses internal audit reports for data on mitigation of risk, IC weaknesses, and CDI governance.
• CDI uses process information from complaints received by our system of complaints: Ethics, Whistleblower, EEO, and HR hotlines.
• OAO, as the designated agency monitor, gathers this data to provide to and as directed by the CDC.

Procedure for Addressing Identified Internal Control Deficiencies

CDI tracks remediation of identified internal control deficiencies using a remediation log. This log is similar to the audit industry’s remediation log and modified to account for all sources of identified internal control deficiencies. The log lists:
• Who has action on the remediation?
• What is the deficiency?
• When will remediation be completed?
• Where the deficiency is located?
• Why remediation is required; regulatory citation?

The Organizational Accountability Office, CDI’s designated agency monitor per the State Leaders Accountability Act, will maintain the remediation log and keep the CDC apprised of remediation and status. CDC will use the remediation log at the Executive Staff monthly meetings.

During this reporting period, CDI has complied with all aspects of the Financial Integrity State Manager's Act (FISMA) and as we transitioned, to most of the State Leaders Accountability Act (SLAA), GC §13400 et. seq. The exception was our late implementation of Agency Monitor per DOF’s guideline, which was released late summer 2015. This internal control weakness will be remediated 1st quarter, CY 2016.

CONCLUSION

The Department of Insurance strives to reduce the risks inherent in our work through ongoing monitoring. The Department of Insurance accepts the responsibility to continuously improve by addressing newly recognized risks and revising risk mitigation strategies. I certify our systems of internal control and monitoring processes are adequate to identify and address material inadequacies or material weaknesses facing the organization.

As Insurance Commissioner, I am responsible for the establishment and maintenance of our systems of internal control, and effective and objective ongoing monitoring of the internal controls. This responsibility includes documenting the system, communicating system requirements to employees, and ensuring that the system is functioning as prescribed and is modified, as appropriate and required. Additionally, all levels of management at CDI are involved in assessing and strengthening the internal control to minimize risks. The monitoring process is centralized at the agency designated monitor level and will be further designated to the business unit level once training is developed and available, scheduled for early 2016.

Dave Jones, Insurance Commissioner

cc: Department of Finance
    Legislature
    State Auditor
    State Library
    State Controller
    Secretary of Government Operations