MICHIGAN

OFFICE OF THE AUDITOR GENERAL

AUDIT REPORT

PERFORMANCE AUDIT
OF THE

DEPARTMENT OF INSURANCE AND FINANCIAL SERVICES

March 2014

THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

651-0146-13

The auditor general shall conduct post audits of financial transactions and accounts of the state and of all branches, departments, offices, boards, commissions, agencies, authorities and institutions of the state established by this constitution or by law, and performance post audits thereof.

– Article IV, Section 53 of the Michigan Constitution

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REPORT SUMMARY

Performance Audit
Department of Insurance and Financial Services

Report Number:
651-0146-13

Released:
March 2014

The Department of Insurance and Financial Services (DIFS), formerly the Office of Financial and Insurance Regulation (OFIR) within the Department of Licensing and Regulatory Affairs, was created on January 16, 2013 by Executive Order No. 2013-1, effective March 18, 2013. DIFS is responsible for regulating Michigan's financial industries, including consumer finance, financial institutions, and insurance.

Audit Objective:
To assess the effectiveness of DIFS's efforts to appropriately and timely investigate complaints filed against licensees.

Audit Conclusion:
We concluded that DIFS's efforts to appropriately and timely investigate complaints filed against licensees were moderately effective. We noted one reportable condition (Finding 1).

Reportable Condition:
DIFS had not fully implemented a comprehensive process designed to help ensure that it investigated complaints in a timely manner (Finding 1).

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Audit Objective:
To assess the effectiveness of DIFS's efforts to appropriately and timely process appeals filed by individuals under the Patient's Right to Independent Review Act (PRIRA).

Audit Conclusion:
We concluded that DIFS's efforts to appropriately and timely process appeals filed by individuals under PRIRA were effective. However, we noted one reportable condition (Finding 2).

Reportable Condition:
DIFS needs to continue its efforts to improve its timeliness in processing PRIRA appeals (Finding 2).

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Audit Objective:
To assess the effectiveness of DIFS's efforts to ensure that Michigan surplus lines licensees accurately report and remit required surplus lines taxes.

Audit Conclusion:
We concluded that DIFS's efforts to ensure that Michigan surplus lines licensees accurately report and remit required surplus lines taxes were moderately effective. We noted one reportable condition (Finding 3).

Reportable Condition:

DIFS did not have a comprehensive process to help ensure that Michigan surplus lines licensees accurately reported and remitted the required surplus lines taxes (Finding 3).

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Audit Objective:

To assess the effectiveness of DIFS's efforts to ensure that Michigan surplus lines licensees comply with insurance policy and notification requirements in accordance with Michigan's Insurance Code.

Audit Conclusion:

We concluded that DIFS's efforts to ensure that Michigan surplus lines licensees comply with insurance policy and notification requirements in accordance with Michigan's Insurance Code were effective. Our audit report does not include any reportable conditions related to this audit objective.

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Agency Response:

Our audit report contains 3 findings and 3 corresponding recommendations. DIFS's preliminary response indicates that it agrees with all of the recommendations.

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A copy of the full report can be obtained by calling 517.334.8050 or by visiting our Web site at: http://audgen.michigan.gov

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THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

March 13, 2014

Ms. Annette E. Flood, Director
Department of Insurance and Financial Services
Ottawa Building
Lansing, Michigan

Dear Ms. Flood:

This is our report on the performance audit of the Department of Insurance and Financial Services.

This report contains our report summary; a description of agency; our audit objectives, scope, and methodology and agency responses; comments, findings, recommendations, and agency preliminary responses; and a glossary of abbreviations and terms.

Our comments, findings, and recommendations are organized by audit objective. The agency preliminary responses were taken from the agency's response at the end of our audit fieldwork. The *Michigan Compiled Laws* and administrative procedures require that the audited agency develop a plan to comply with the audit recommendations and submit it within 60 days after release of the audit report to the Office of Internal Audit Services, State Budget Office. Within 30 days of receipt, the Office of Internal Audit Services is required to review the plan and either accept the plan as final or contact the agency to take additional steps to finalize the plan.

We appreciate the courtesy and cooperation extended to us during this audit.

Sincerely,

Thomas H. McTavish, C.P.A.
Auditor General

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DEPARTMENT OF INSURANCE AND FINANCIAL SERVICES

Description of Agency

The Department of Insurance and Financial Services (DIFS), formerly the Office of Financial and Insurance Regulation (OFIR) within the Department of Licensing and Regulatory Affairs (LARA), was created on January 16, 2013 by Executive Order No. 2013-1, effective March 18, 2013. The executive order consolidated all functions related to the regulation of insurance and financial services in Michigan. All OFIR functions were transferred to DIFS, excluding the Securities Division, which remained within LARA.

DIFS is responsible for regulating Michigan's financial industries, including consumer finance, financial institutions, and insurance. DIFS carries out this responsibility through 9 program and regulatory offices:

- Office of Banking - Responsible for the safety and soundness review of State-chartered banks and business and industrial development corporations (BIDCOs).

- Office of Consumer Finance - Responsible for the licensing, regulation, and examination of entities and individuals doing business under various Michigan consumer finance statutes, including mortgage brokers, lenders and servicers, mortgage loan originators, money transmitters, deferred presentment providers, direct loan companies, motor vehicle installment sellers and sales finance companies, and other consumer finance providers.

- Office of Consumer Services - Responsible for managing consumer information and outreach, inquiries, and complaints; investigating insurance agents and entities; developing and maintaining the Web site; developing forms; and overseeing the communication center, which serves as the initial point of contact for all incoming telephone calls and visitors.

- Office of Credit Unions - Responsible for the regulation, examination, and supervision of State-chartered credit unions. The Office is also responsible for processing corporate applications filed by depository financial institutions.

- Office of General Counsel - Responsible for providing legal advice and representation to the DIFS director and personnel with respect to enforcement

actions, formal administrative hearings, orders, rules, statutes, regulations, bulletins, declaratory rulings, health benefit claims, and special projects. Also, the Office processes Patient's Right to Independent Review Act* (PRIRA) appeals. The general counsel serves as the Freedom of Information Act (FOIA) coordinator, represents the DIFS director on the Michigan State Employees' Retirement System Board, and acts as liaison with the Department of Attorney General and other State and federal agencies.

- Office of Insurance Evaluation - Responsible for all aspects of monitoring and regulation of the financial condition of risk-bearing insurance entities, including the processing of applications for licensure filed by insurance companies; on-site financial examination of domestic insurance companies; ongoing financial monitoring of licensed insurance companies; and working with insurance companies reporting negative trends to take appropriate corrective measures. The Office is also responsible for the licensing, monitoring, and examination of captive insurers*.

- Office of Insurance Licensing & Market Conduct - Responsible for licensing individual and agency insurance producers, solicitors, counselors, risk retention groups, purchasing groups, reinsurance intermediaries, and third party administrators. The Office is also responsible for market conduct review of insurers and audits of insurance agents and entities. In addition, the Office is responsible for the surplus lines tax* program.

- Office of Insurance Rates and Forms - Responsible for enforcing Michigan insurance statutes and regulations pertaining to rates and forms submitted by insurance companies and other licensed entities.

- Office of Policy - Responsible for developing and implementing regulatory policy, performing research and analysis of regulatory related issues, and handling legislative matters.

For fiscal year 2011-12, OFIR (excluding the Securities Division) revenues totaled $41.2 million and expenditures totaled $38.3 million. DIFS had 295 full-time equated employees as of March 31, 2013.

** See glossary at end of report for definition.*

Audit Objectives, Scope, and Methodology and Agency Responses

Audit Objectives

Our performance audit* of the Department of Insurance and Financial Services (DIFS) had the following objectives:

1. To assess the effectiveness* of DIFS's efforts to appropriately and timely investigate complaints filed against licensees*.

2. To assess the effectiveness of DIFS's efforts to appropriately and timely process appeals filed by individuals under the Patient's Right to Independent Review Act (PRIRA).

3. To assess the effectiveness of DIFS's efforts to ensure that Michigan surplus lines licensees accurately report and remit required surplus lines taxes.

4. To assess the effectiveness of DIFS's efforts to ensure that Michigan surplus lines licensees comply with insurance policy and notification requirements in accordance with Michigan's Insurance Code.

Audit Scope

Our audit scope was to examine the program and other records of the Department of Insurance and Financial Services. 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. Our audit procedures, which included a preliminary survey, audit fieldwork, report preparation, analysis of agency responses, and quality assurance, generally covered the period October 1, 2010 through March 31, 2013.

* *See glossary at end of report for definition.*

Audit Methodology

We conducted a preliminary survey to gain an understanding of DIFS's operations and internal control* to formulate a basis for establishing our audit objectives and for defining our audit scope and audit methodology. Our preliminary survey included interviewing DIFS personnel; reviewing applicable State and federal laws; reviewing DIFS policies and procedures; reviewing applicable executive orders and appropriations acts; analyzing DIFS revenues and expenditures; reviewing DIFS (formerly the Office of Financial and Insurance Regulation [OFIR]) annual reports; and reviewing Office of Internal Audit Services preliminary survey questionnaires and Office of the Auditor General prior audit reports. Our preliminary survey also included analyzing available records and data, including:

1. Office of Banking:
    a. Accreditation reports
    b. Examination records and data

2. Office of Consumer Finance:
    a. Examination and investigation records and data
    b. Complaint records and data
    c. Licensing and registration records and data

3. Office of Consumer Services:
    a. Complaint records and data
    b. Insurance investigation records and data
    c. Internal audit report related to the Office of Consumer Services' efforts in resolving consumer complaints

4. Office of Credit Unions:
    a. Accreditation reports
    b. Examination files and data

5. Office of General Counsel:
    a. Enforcement records and data
    b. PRIRA appeal data

* *See glossary at end of report for definition.*

6. Office of Insurance Evaluation:
    a. Accreditation reports
    b. Captive insurance and domestic monitoring
    c. Financial analysis processes
    d. Licensing records and data

7. Office of Insurance Licensing & Market Conduct:
    a. Analysis and examination records
    b. Licensing records and data
    c. Research related to surplus lines tax programs in other states

To accomplish our first objective, we interviewed Office of Consumer Finance and Office of Consumer Services personnel. We reviewed procedures and internal goals for DIFS's completion of complaint investigations. We selected a random sample of complaints referred for investigation during the period October 1, 2010 through March 31, 2013. We reviewed the investigation records and analyzed the timeliness of DIFS's investigations.

To accomplish our second objective, we interviewed Office of General Counsel personnel and reviewed procedures for processing PRIRA appeals. We identified statutorily required time frames for processing PRIRA appeals. We analyzed the timeliness of DIFS's processing of appeals in progress between October 1, 2010 and March 31, 2013. We selected a random sample and a judgmental sample of appeals, reviewed DIFS's records, and compared DIFS's efforts with the statutorily required time frames.

To accomplish our third objective, we interviewed Office of Insurance Licensing & Market Conduct personnel. We reviewed DIFS's processes, policies, and procedures. We also analyzed surplus lines tax revenue data.

To accomplish our fourth objective, we interviewed Office of Insurance Licensing & Market Conduct personnel. We reviewed DIFS's processes, policies, and procedures and compared the processes, policies, and procedures to licensee requirements in the *Michigan Compiled Laws*. We reviewed information for surplus lines licensees and information related to surplus lines taxes available on the DIFS Web site. In addition, we interviewed personnel from other states to obtain an understanding of their surplus lines tax and licensee monitoring processes performed.

When selecting activities or programs for audit, we use an approach based on assessment of risk and opportunity for improvement. Accordingly, we focus our audit efforts on activities or programs having the greatest probability for needing improvement as identified through a preliminary survey. Our limited audit resources are used, by design, to identify where and how improvements can be made. Consequently, we prepare our performance audit reports on an exception basis.

Agency Responses

Our audit report contains 3 findings and 3 corresponding recommendations. DIFS's preliminary response indicates that it agrees with all of the recommendations.

The agency preliminary response that follows each recommendation in our report was taken from the agency's written comments and oral discussion at the end of our audit fieldwork. Section 18.1462 of the *Michigan Compiled Laws* and the State of Michigan Financial Management Guide (Part VII, Chapter 4, Section 100) require DIFS to develop a plan to comply with the audit recommendations and submit it within 60 days after release of the audit report to the Office of Internal Audit Services, State Budget Office. Within 30 days of receipt, the Office on Internal Audit Services is required to review the plan and either accept the plan as final or contact the agency to take additional steps to finalize the plan.

COMMENTS, FINDINGS, RECOMMENDATIONS, AND AGENCY PRELIMINARY RESPONSES

EFFECTIVENESS OF EFFORTS TO INVESTIGATE COMPLAINTS

COMMENT

Audit Objective: To assess the effectiveness of the Department of Insurance and Financial Services' (DIFS's) efforts to appropriately and timely investigate complaints filed against licensees.

Audit Conclusion: We concluded that DIFS's efforts to appropriately and timely investigate complaints filed against licensees were moderately effective.

Our audit conclusion was based on our audit efforts as described in the audit scope and audit methodology sections and the resulting reportable condition* noted in the comments, findings, recommendations, and agency preliminary responses section.

We noted one reportable condition related to DIFS's efforts to ensure that it investigates complaints in a timely manner (Finding 1). In our professional judgment, this matter is less severe than a material condition* but still represents an opportunity for improvement in DIFS's internal control over complaint investigations.

We applied our audit procedures to all 1,141 complaints referred for investigation during our audit period. We completed an analysis of the complaints and selected a random sample for testing DIFS's processing of the complaints.

Also, we evaluated qualitative factors, such as potential risks to consumers and public perception of the DIFS investigation processes, and nothing came to our attention that had a significant impact on our conclusion.

In addition, we noted that there were no statutory requirements for DIFS to process complaints or for DIFS to establish time frames for processing complaints. Therefore, we used DIFS's established internal goals.

In reaching our audit conclusion, we considered the reportable condition related to the 61.9% rate of complaint investigations not completed timely and the lack of established

* *See glossary at end of report for definition.*

internal goals for mortgage and consumer finance industry complaint investigations. We also considered the absence of other significant qualitative factors and the lack of statutory requirements. We believe that the results of our audit efforts provide a reasonable basis for our audit conclusion for this audit objective.

FINDING

1. Complaint Investigations

   DIFS had not fully implemented a comprehensive process to help ensure that it investigated complaints in a timely manner. As a result, DIFS could not effectively ensure that it identified and resolved complaints brought against licensees in a timely manner.

   Our analysis of DIFS data identified 1,141 complaints received from consumers, licensees, and employees that DIFS referred for investigation during the period October 1, 2010 through March 31, 2013. DIFS referred 803 complaints to the Office of Consumer Services and 338 complaints to the Office of Consumer Finance.

   We randomly selected 31 complaint investigation files, including 17 nonfiduciary insurance industry complaints and 4 fiduciary insurance industry complaints that the Office of Consumer Services investigated and 10 mortgage and consumer finance industry complaints that the Office of Consumer Finance investigated. Our review disclosed:

   a. DIFS did not meet established internal goals for timely completion of insurance industry complaint investigations. DIFS's Insurance Investigations and Examination Manual states that most insurance industry complaint investigations should be completed within 60 calendar days. However, the insurance investigator performance objectives state that 80% of new insurance industry complaint investigation cases received should be concluded within 90 business days. DIFS informed us that investigators operated under the standard established in the insurance investigator performance objectives and that it had not updated the Insurance Investigations and Examination Manual to reflect the performance objectives set. Our review of the 17 selected nonfiduciary insurance industry complaint investigations disclosed that DIFS did not meet the established internal goal of

90 business days for 10 (58.8%) complaints that were processed from 10 to 315 business days late as follows:

Range of Days Late for Investigation Completion	Number of Complaints Processed Exceeding 90 Business Days
1 to 25 days late	2
26 to 50 days late	1
51 to 75 days late	0
76 to 100 days late	0
Over 100 days late	7
Total complaints processed late	10

Fiduciary related insurance industry complaints are considered critical, and DIFS informed us that its investigations of these complaints are assigned a higher priority than investigation of other complaints. Our review of the 4 selected fiduciary insurance industry complaint investigations disclosed that DIFS's follow-up on 3 (75.0%) of the 4 fiduciary complaints was not timely and ranged from 182 to 397 business days.

b. DIFS had not established internal goals for the Office of Consumer Finance to perform mortgage and consumer finance industry complaint investigations. As a result, DIFS's ability to fully assess that complaints were investigated within a reasonable time and its ability to fully evaluate its effectiveness in investigating complaints were impaired. Our review of the 10 selected mortgage and consumer finance industry complaint investigations identified complaint investigations that remained open from 16 to 846 calendar days.

RECOMMENDATION

We recommend that DIFS fully implement a comprehensive process to help ensure that it investigates complaints in a timely manner.

AGENCY PRELIMINARY RESPONSE

DIFS agrees with the recommendation. DIFS informed us that, during the audit period, it was presented with unique challenges in meeting applicable time frames, such as retirement of senior investigators, training of new investigation staff,

military leave, departmental bumping of senior staff, as well as process and documentation changes implemented by its Office of General Counsel regarding insurance investigations.

DIFS also informed us that, although time frames were not always met, it did identify and timely process cases that warranted immediate attention. DIFS stated that priority was given to cases that posed the greatest threat to consumers and/or involved violations of the law and that cases that did not meet the time frames were determined to be low priority and, after the investigation was completed, were determined to include no violations of law and were closed with a "no further action required" disposition. DIFS also stated that new reports have been created for insurance investigation staff to help them easily identify cases that are due to be reviewed and processed.

DIFS agrees that developing specific performance goals for the completion of consumer finance complaint investigations represents an opportunity for improvement. However, DIFS does not believe that its past management of these investigations has been unreasonable or represents a significant deficiency in the operation of its regulatory program. DIFS stated that the length of time needed to complete an investigation can vary widely based on a number of factors, including legal or jurisdictional considerations, prioritization of investigation assignments based on an evaluation of risk factors, and the availability of staff resources. Specifically, DIFS noted that several investigations reviewed during the audit pertained to complaints involving on-line lenders. Legal and jurisdictional issues relating to the regulation of on-line lenders exist at the federal and State levels and constrained DIFS's ability to investigate these complaints and pursue appropriate enforcement actions. As a result, these investigations remained open for an extended period of time.

DIFS further informed us that it has a process in place to review all new complaint investigation referrals when received and to determine the potential risk factors involved and the urgency of a particular investigation. DIFS stated that investigations are scheduled using a risk-based approach, with those determined to be most urgent receiving highest priority. DIFS management informed us that it reviews and approves investigation results and recommendations for appropriate action. DIFS noted that specific performance goals are being developed for the review and investigation of complaints received.

EFFECTIVENESS OF EFFORTS TO PROCESS APPEALS UNDER PRIRA

COMMENT

Background: The Patient's Right to Independent Review Act (PRIRA) (Sections 550.1901 - 550.1929 of the *Michigan Compiled Laws*) provides a system by which individuals can appeal the denial of health benefit claims. A review under PRIRA determines whether an adverse determination by a health plan is consistent with the language of the policy or certificate under which the individual received health benefits. The review also determines whether the policy provisions are consistent with State law. DIFS receives requests for external review (appeals) from individuals, or authorized representatives of individuals, who received adverse determinations of health benefit claims. If a request is accepted for external review and appears to involve issues of medical necessity or clinical review criteria, Section 550.1911(6) of the *Michigan Compiled Laws* requires DIFS to assign an independent review organization (IRO) at the time the request is accepted for external review. The IRO provides a written recommendation to DIFS on whether to uphold or reverse the adverse determination. If a request does not appear to involve issues of medical necessity or clinical review criteria, DIFS can keep the request and conduct its own review. After receipt of the IRO recommendation or completion of its own review, DIFS issues a decision to uphold or reverse the adverse determination. Expedited reviews are available when adverse determinations involve medical conditions that may jeopardize the life or health of the individual or jeopardize the individual's ability to regain maximum function.

Audit Objective: To assess the effectiveness of DIFS's efforts to appropriately and timely process appeals filed by individuals under PRIRA.

Audit Conclusion: We concluded that DIFS's efforts to appropriately and timely process appeals filed by individuals under PRIRA were effective.

Our audit conclusion was based on our audit efforts as described in the audit scope and audit methodology sections and the resulting reportable condition noted in the comments, findings, recommendations, and agency preliminary responses section.

We noted one reportable condition related to DIFS's efforts to improve its timeliness in processing PRIRA appeals (Finding 2). In our professional judgment, this matter is less severe than a material condition but still represents an opportunity for improvement in DIFS's internal control over the processing of PRIRA appeals.

We applied our audit procedures to all 1,003 PRIRA appeals received during our audit period. We completed an analysis of the appeals and selected a random sample for testing DIFS's processing of the appeals. Our sample results indicated that DIFS appropriately processed the PRIRA appeals; however, DIFS's processing of PRIRA appeals took longer than the statutory requirement.

Also, we evaluated qualitative factors, such as the percentage of appeals that resulted in a recovery amount to the beneficiary, the change in processes initiated and implemented by DIFS during our audit period, and the resulting substantial improvement in DIFS's processing time after its implementation of process changes.

In reaching our audit conclusion, we considered the opportunity for improvement related to timeliness, the implementation of process changes with the resulting substantial improvement in processing time, and the fact that nothing came to our attention to indicate that DIFS had not appropriately processed appeals. We believe that the results of our audit efforts provide a reasonable basis for our audit conclusion for this audit objective.

FINDING

2. Timeliness in Processing PRIRA Appeals

   DIFS needs to continue its efforts to improve its timeliness in processing PRIRA appeals. Without timely processing of appeals, individuals may be incorrectly denied benefits for prolonged periods of time.

   Section 550.1911(16) of the *Michigan Compiled Laws* requires that DIFS provide written notice of its decision to uphold or reverse an adverse determination not later than 7 business days after the date of receipt of an IRO's recommendation or not later than 14 days after the decision to complete its own review. In addition, Section 550.1913(9) of the *Michigan Compiled Laws* requires that DIFS provide notice of its decision to uphold or reverse an adverse determination not later than 24 hours after receipt of an IRO's recommendation for expedited appeals.

Based on our review of DIFS data for appeals in progress between October 1, 2010 and March 31, 2013, DIFS did not provide written notice of its decision to uphold or reverse the denial of health benefit claims within the statutorily required time frames for 853 (86.5%) of 986 accepted appeals. An analysis of the appeals data disclosed that DIFS did not meet the statutorily required time frames as follows:

Timeliness of Written Notice	Number of Appeals	Percent of Total Appeals
On time	133	13.5%
1 to 10 days late	180	18.3%
11 to 25 days late	124	12.6%
26 to 50 days late	103	10.4%
51 to 100 days late	169	17.1%
Over 100 days late	277	28.1%
Total appeals	986	100.0%
Total appeals provided late written notice	853	86.5%

DIFS changed its processes in January 2012 in an effort to improve timeliness. Our review of DIFS data for accepted appeals received during the first quarter of 2013 showed that these changes substantially improved DIFS's processing time. Specifically, the percentage of appeals processed on time and within 1 to 25 days late increased from 44.4% to 96.6% and appeals that took 26 days or longer to process decreased from 55.6% to 3.4%.

RECOMMENDATION

We recommend that DIFS continue its efforts to improve its timeliness in processing PRIRA appeals.

AGENCY PRELIMINARY RESPONSE

DIFS agrees that it should continue its efforts to timely process appeals filed by individuals under PRIRA. As noted in the finding, DIFS recognized a deficiency in the timely processing of PRIRA appeals and initiated efforts to address the problem, including the transfer of the PRIRA unit to the Office of General Counsel,

the temporary assignment of additional staff to assist in eliminating the backlog of cases, and the delegation of the director's signing authority to improve efficiency in the process. DIFS will continue its efforts to refine the PRIRA process and to identify and implement additional efficiencies.

EFFECTIVENESS OF EFFORTS TO ENSURE SURPLUS LINES LICENSEES ACCURATELY REPORT AND REMIT TAXES

COMMENT

Background: Surplus lines insurance* is a form of insurance in which buyers can acquire insurance from unauthorized insurance companies (unauthorized insurers*) through specially licensed insurance producers (licensees). The *Michigan Compiled Laws* require licensees to report surplus lines business written for a Michigan risk and remit surplus lines taxes on the premium amount of the insurance to DIFS. If Michigan is determined to be the home state of the insured as defined by the federal Nonadmitted Reinsurance Reform Act (NRRA) of 2010, 100% of surplus lines tax is to be paid to the State of Michigan. Michigan's tax rate is a combined 2.0% tax and a 0.5% regulatory fee on the premium amount of the insurance. The 2.0% tax is deposited into the State's General Fund, and the 0.5% regulatory fee is deposited into DIFS's Insurance Bureau Fund.

Audit Objective: To assess the effectiveness of DIFS's efforts to ensure that Michigan surplus lines licensees accurately report and remit required surplus lines taxes.

Audit Conclusion: We concluded that DIFS's efforts to ensure that Michigan surplus lines licensees accurately report and remit required surplus lines taxes were moderately effective.

Our audit conclusion was based on our audit efforts as described in the audit scope and audit methodology sections and the resulting reportable condition noted in the comments, findings, recommendations, and agency preliminary responses section.

* *See glossary at end of report for definition.*

We noted one reportable condition related to DIFS's efforts to ensure that surplus lines licensees accurately report and remit surplus lines taxes (Finding 3). In our professional judgment, this matter is less severe than a material condition but still represents an opportunity for improvement in DIFS's internal control over monitoring surplus lines licensees.

We applied our audit procedures to the surplus lines insurers licensed by DIFS. We interviewed Office of Insurance Licensing & Market Conduct personnel; reviewed DIFS's processes, policies, and procedures; and analyzed surplus lines tax revenue data, including $27.9 million in surplus lines taxes and $6.6 million in surplus lines regulatory fees.

In addition, we evaluated qualitative factors, such as the limited staffing available to the surplus lines section, the lack of a comprehensive process to help ensure that licensees are reporting and remitting taxes and fees as required, and an instance of a surplus lines licensee failing to report taxes and fees to DIFS during our audit period.

In reaching our audit conclusion, we considered the reportable condition and the current processes DIFS has in place for monitoring the reporting and remittance of surplus lines taxes and fees. We believe that the results of our audit efforts provide a reasonable basis for our audit conclusion for this audit objective.

FINDING

3. Surplus Lines Taxes

   DIFS did not have a comprehensive process to help ensure that Michigan surplus lines licensees accurately reported and remitted the required surplus lines taxes. As a result, DIFS could not ensure that it collected the full amount of surplus lines tax revenue due from licensees.

   DIFS had over 2,000 active surplus lines licensees during our audit period. DIFS collected licensee surplus lines tax reports and payments, including approximately $27.9 million in surplus lines taxes and $6.6 million in surplus lines regulatory fees,

during our audit period. Our review of DIFS's processes and documentation relating to its monitoring activities for surplus lines licensees disclosed:

a. DIFS did not have a sufficient process to help ensure that licensees accurately reported and remitted surplus lines tax amounts. DIFS's process included comparing the tax amount remitted by each licensee with the amount due as reported on the licensee's tax form and recalculating the amount due. DIFS indicated that it requested insurance declaration pages from licensees that submitted tax filings only when DIFS identified mathematical errors during the comparison and recalculation of amounts due. However, DIFS's process did not substantiate that licensees' tax forms reported all policies written and that the licensees remitted all required surplus lines tax due.

   DIFS could not provide the number of requests made but estimated that it requested selected declaration pages to follow up on errors noted and confirm premium amounts reported for 5% to 25% of reports received. However, for the remaining 75% to 95% of reports received, DIFS did not request a sample of declaration pages or perform other procedures to verify the accuracy of amounts reported by the licensees. DIFS has the authority, if the DIFS director considers it necessary, to examine the books and records of a surplus lines licensee to determine whether the licensee is conducting its business in accordance with statute. DIFS informed us that it did not consider additional examination of licensee books and records, in addition to what it already performed, necessary during our audit period.

b. DIFS did not have a process to identify and follow up with licensees that did not report and remit surplus lines taxes. Although licensees are not required by statute to file surplus lines tax reports if they did not conduct surplus lines business during the reporting period, DIFS did request that licensees file "zero" reports, indicating that no surplus lines business was conducted. However, DIFS did not identify the licensees that did not file reports and did not perform procedures to determine if it was reasonable to not expect any reports from the licensees.

   One insurer that wrote policies through a surplus lines licensee brought the licensee to DIFS's attention during our audit period because the licensee did

not report and submit surplus lines taxes. DIFS determined that approximately $26,000 in surplus lines premiums were not reported by the licensee, resulting in unpaid surplus lines taxes and regulatory fees of approximately $540 and $130, respectively. Although these amounts were not material in comparison to the total surplus lines tax revenue collected during our audit period, this instance demonstrates the need for DIFS to confirm that all surplus lines taxes were reported and remitted. This licensee had reported and remitted surplus lines taxes to DIFS in prior periods but did not submit reports for two semiannual reporting periods. Further, DIFS had not conducted any follow-up with the licensee.

DIFS has assigned one staff member to process surplus lines tax reports. DIFS informed us that it did not have the automated ability to identify licensee tax filings for which it requested insurance declaration pages to support the data reported or to identify whether tax reports are submitted for all licensees. DIFS also informed us that it did not have a dedicated audit program for surplus lines taxes.

RECOMMENDATION

We recommend that DIFS implement a comprehensive process to help ensure that Michigan surplus lines licensees accurately report and remit the required surplus lines taxes.

AGENCY PRELIMINARY RESPONSE

DIFS agrees with this recommendation. DIFS informed us that it has a surplus lines process in place which, according to DIFS, ensures that the proper amount of taxes are remitted for all premiums reported; however, DIFS agrees that the process could be better documented. DIFS stated that it conducts a review of all surplus lines tax filings to ensure that the amount of tax paid is the proper amount due based on premiums reported during the filing period. According to DIFS, when anomalies are detected, a more in-depth review of that filing is conducted. DIFS stated that, in accordance with the statute, supporting documentation on surplus lines filings is requested, as deemed necessary. DIFS informed us that it will initiate an audit when an additional examination of a licensee's records is necessary in the public interest.

DIFS stated that, short of a comprehensive on-site audit, it is difficult to substantiate that a licensee's tax form reports all policies written and remits all taxes due within the reporting period. According to DIFS, because of the complex nature of the market, there is not one central place, or even multiple places, in which to gather information to substantiate that a licensee has accurately reported all policies written within the reporting period. DIFS also stated that, frequently, one licensee procures the surplus lines insurance and another licensee collects, reports, and remits the taxes; therefore, auditing one licensee would involve auditing the records of multiple licensees. DIFS believes that, because of the nature of the industry and State and federal laws regulating the industry, the reporting and remittance of proper taxes is largely based on the integrity of the licensee.

DIFS agrees that it did not have a process to identify and follow up with licensees who did not report and remit surplus lines taxes. However, the statute only requires a licensee to file a surplus lines tax report only when insurance is procured or placed. DIFS stated that it proactively requests that licensees file a zero report, but the statute does not mandate licensees to file a zero report. DIFS stated that, because of the complex nature of the surplus lines market, it would be impractical to follow up with all licensees who do not file reports in every reporting period. However, DIFS agrees that there may be a benefit to tracking surplus lines tax filings to conduct periodic analysis on the consistency of filings.

DIFS informed us that it is in the process of developing a database that will allow for the tracking of surplus lines tax filings, reviews of filings, and requests for supporting material, individually and in the aggregate. DIFS will use this information to target periodic review of licensee filings. DIFS expects the new database to be operational within a year. DIFS also informed us that it is documenting its processes and developing a standard for the number of reviews that will be undertaken each filing period and that it is developing a surplus lines audit protocol.

EFFECTIVENESS OF EFFORTS TO ENSURE SURPLUS LINES LICENSEE COMPLIANCE

COMMENT

Background: Surplus lines insurance is a form of insurance in which buyers can acquire insurance from unauthorized insurance companies (unauthorized insurers) through specially licensed insurance brokers (licensees). DIFS publishes a list on its Web site of surplus lines insurance for which it has determined coverage is generally unavailable in the authorized market. For example, insurance may be purchased to cover items such as animal mortality, environmental impairment, kidnap and ransom or extortion, products recall, or high hazard cargo.

Audit Objective: To assess the effectiveness of DIFS's efforts to ensure that Michigan surplus lines licensees comply with insurance policy and notification requirements in accordance with Michigan's Insurance Code.

Audit Conclusion: We concluded that DIFS's efforts to ensure that Michigan surplus lines licensees comply with insurance policy and notification requirements in accordance with Michigan's Insurance Code were effective.

Our audit conclusion was based on our audit efforts as described in the audit scope and audit methodology sections. Our audit report does not include any reportable conditions related to this audit objective. We believe that the results of our audit efforts provide a reasonable basis for our audit conclusion for this audit objective.

GLOSSARY

captive insurer	A company that insures risks of its parent, affiliated companies, controlled unaffiliated business, or a combination of its parent, affiliated companies, and controlled unaffiliated business.
DIFS	Department of Insurance and Financial Services.
effectiveness	Success in achieving mission and goals.
internal control	The plan, policies, methods, and procedures adopted by management to meet its mission, goals, and objectives. Internal control includes the processes for planning, organizing, directing, and controlling program operations. It also includes the systems for measuring, reporting, and monitoring program performance. Internal control serves as a defense in safeguarding assets and in preventing and detecting errors; fraud; violations of laws, regulations, and provisions of contracts and grant agreements; or abuse.
IRO	independent review organization.
LARA	Department of Licensing and Regulatory Affairs.
licensee	A person or company licensed or required to be licensed under a specific act.
material condition	A matter that, in the auditor's judgment, is more severe than a reportable condition and could impair the ability of management to operate a program in an effective and efficient manner and/or could adversely affect the judgment of an interested person concerning the effectiveness and efficiency of the program.

OFIR	Office of Financial and Insurance Regulation.
Patient's Right to Independent Review Act (PRIRA)	Sections 550.1901 - 550.1929 of the *Michigan Compiled Laws*. PRIRA provides a system by which individuals can appeal the denial of health benefit claims.
performance audit	An audit that provides findings or conclusions based on an evaluation of sufficient, appropriate evidence against criteria. Performance audits provide objective analysis to assist management and those charged with governance and oversight in using the information to improve program performance and operations, reduce costs, facilitate decision making by parties with responsibility to oversee or initiate corrective action, and contribute to public accountability.
reportable condition	A matter that, in the auditor's judgment, is less severe than a material condition and falls within any of the following categories: an opportunity for improvement within the context of the audit objectives; a deficiency in internal control that is significant within the context of the audit objectives; all instances of fraud; illegal acts unless they are inconsequential within the context of the audit objectives; significant violations of provisions of contracts or grant agreements; and significant abuse that has occurred or is likely to have occurred.
surplus lines insurance	Insurance in Michigan procured from or continued or renewed with an unauthorized insurer.
surplus lines tax	Tax on the premium amount of surplus lines insurance written.
unauthorized insurer	An insurer not licensed by the DIFS director to transact insurance in Michigan.

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