



**Office of the Director
Arizona Department of Insurance**

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Douglas A. Ducey, Governor
Keith A. Schraad, Director

September 16, 2019

Ms. Lindsey Perry, Auditor General
Arizona Office of the Auditor General
2910 North 44th Street, Suite 410
Phoenix, Arizona 85018

Re: Department of Insurance - Performance Audit and Sunset Review

Dear Ms. Perry:

The Arizona Department of Insurance would like to thank you for the work you performed to evaluate how well the Department is fulfilling its mission, and for providing us the opportunity to respond to the recommendations and findings in your preliminary report draft of the performance audit and sunset review dated September 10, 2019.

Highlighting a few key successes for the Department:

- ADOI is very proud to be the most efficiently run department of insurance in the US based on data from the National Association of Insurance Commissioners (NAIC).
- ADOI has been fully committed to the Arizona Management System's initiative to bring never-ending improvements to the Department and has implemented numerous programs that have resulted in maximizing taxpayer dollars while better serving Arizona citizens.
- The Department brings in over \$500 million a year in premium tax payments, the third largest source of Arizona General Fund revenue.

We carefully reviewed the observations, feedback, research and recommendations you provided, and we are committed to using the report to improve our department.

Sincerely,

Keith Schraad
Director

Finding 1: Department's new fraud referral prioritization process lacks components to ensure it investigates high-priority referrals

Recommendation 1: The Department should strengthen its fraud-referral prioritization process by:

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Response explanation: The Department proposes to implement recommendations as detailed in 1a through 1f, as follows.

Recommendation 1a: Developing and implementing a referral template, reporting requirements, and/or instructions that define the specific information and level of detail that insurance companies should provide when reporting suspected instances of insurance fraud.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Response explanation: The Department is actively participating on the NAIC's Anti-fraud Task Force and the Anti-fraud Information Systems Working Group to develop a uniform standard and process by which insurance companies can report the sum and substance of information that states need to receive in order to prioritize, investigate and prosecute insurance fraud referrals. Although A.R.S. § 20-466(G) provides the director authority to prescribe a form that insurance companies must use in Arizona to report suspected insurance fraud, the director is sensitive to the fact that insurance companies must fulfill fraud reporting requirements imposed in other states and territories throughout the U.S., and believes that working with other jurisdictions to create a uniform nationwide standard and system will facilitate fraud reporting and could help streamline processes for taking in, prioritizing and assigning cases. In the meantime, the Department will evaluate the fraud reporting standards and forms that other states employ to identify best practices that the Department can incorporate into its operations and can advocate in a multi-state uniform standard.

Recommendation 1b: Developing and implementing a process to use available referral data to help identify fraud trends and prioritize fraud referrals.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Response explanation: The Department will work to identify how best to perform this activity given the resources it has at its disposal.

Recommendation 1c: Developing and implementing instructions to guide investigators' efforts to input referral and investigation information into the database completely and consistently.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Response explanation: We have already begun implementing this recommendation in two ways. First, as previously described, the Department is participating in NAIC initiatives to unify insurance fraud reporting and processing, which will improve the quality and consistency of information that is automatically loaded into the Department's fraud referral records. Second (in the meantime), our special agent supervisor and a newly hired special agent are writing a training manual that, in part, addresses how case information needs to be entered into the database.

Recommendation 1d: Developing and implementing policies and procedures to incorporate the information discussed during the outreach events it conducts into its fraud-referral prioritization process and evaluating the effectiveness of these events.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Response explanation: The Department will continue to receive information from, and will participate in education events and conferences hosted by, the National Association of Insurance Commissioners, the International Association of Financial Crimes Investigators, the Arizona Association of Chiefs of Police, the Arizona Association of Special Investigation Units, the National Insurance Crime Bureau and the Coalition Against Insurance Fraud, to remain abreast of trends in insurance fraud, both nationally and locally. The Department will formalize its current outreach efforts by establishing routinely scheduled meetings with insurance industry stakeholders and other insurance fraud opponents (National Insurance Crime Bureau, Coalition Against Insurance Fraud) to learn about trends they see developing, and their ideas for areas where we should focus our investigation resources. The insurance industry has expressed intense interest in the Department having sufficient resources to combat insurance fraud, and the Department is committed to utilizing the resources it is provided to yield the most effective results.

Recommendation 1e: Developing and implementing a risk-based supervisory review process for referrals that are not investigated to help ensure that Department staff do not inappropriately close referrals that should be prioritized for investigation.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Response explanation: The Department will continue its practice of encouraging its special agents to ask questions as needed to determine whether referrals warrant investigation, and will develop and implement a process for reviewing a sample of referrals closed without investigation to verify the appropriateness of the decisions made by the special agents, and to provide further instructions to special agents if needed.

Recommendation 1f: Developing and implementing policies and procedures for its fraud-referral prioritization system and training additional staff on these policies and procedures.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Response explanation: Our special agent supervisor and a newly hired special agent are writing a training manual that, in part, addresses how to prioritize referrals for investigation.

Recommendation 2: The Department should evaluate whether its prioritization process has facilitated the Department's ability to focus on high priority referrals and determine what changes, if any, are needed to continue to improve the prioritization process.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Response explanation: The Department shall develop as part of its policy and procedures a method to periodically review the priority levels assigned to a sampling of open referrals.

Recommendation 3: Once the Department has taken steps to evaluate and strengthen its prioritization process, the Department should assess its fraud investigative staffing needs to help ensure it investigates all the high priority fraud referrals it receives. This assessment should include a documented workload analysis that compares the Department's workload, including an estimate of future workload, with its staff resources and then identifies the level of resources needed based on workload and responsibilities. If the Department determines additional resources are needed, it should work with the Legislature to obtain these resources.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Response explanation: The Department shall apply its fraud-referral evaluation process to identify the number of fraud referrals that warrant investigation, to identify high-priority cases from among all cases warranting investigation, to develop an approach or calculation to estimate the investigation hours that would be required to investigate all the referrals, and to extrapolate the resources it would need to investigate all the high-priority fraud cases awaiting investigation and those it expects to receive annually.

Finding 2: Department's practices for managing conflicts-of-interest increase risk of nondisclosure

Recommendation 4: The Department should develop and implement a conflict-of-interest policy that (1) requires all employees to complete an annual disclosure form; (2) defines a process for managing any disclosed potential conflicts of interest to ensure the conflict will not interfere with the performance of the employee's duties; and (3) defines a process for ensuring that completed forms are maintained in the Department's separate special disclosure file for public inspection.

Department Response: The finding of the Auditor General is agreed to and a different method of dealing with the finding will be implemented.

Response explanation: In addition to the conflict of interest statutes provided in Title 38, Chapter 3, Article 8, A.R.S. § 20-149 also prohibits direct and indirect financial interests by the director, or any deputy, examiner, assistant or employee (collectively "Department employee") in any insurer, agency or other entity regulated under A.R.S. Title 20 except as a policyholder or claimant under a policy, and requires a conflict of interest disclosure from any Department employee who has a relative with certain forms of beneficial interests in entities regulated under A.R.S. Title 20. However, as the report notes, Arizona law does not require employees to complete a form on an annual basis. Instead, they require disclosure

when a public employee, or the public employee's relative, has "a substantial interest in any decision of the public agency." A.R.S. § 38-503(B). The Department of Insurance will be consolidating with the Department of Financial Institutions and the Arizona Automobile Theft Authority effective July 1, 2020. The Department shall determine the conflict of interest provisions contained in the laws applicable to the employees and contractors of the consolidating agencies, including the general provisions in Title 38. The Department shall develop a comprehensive conflict of interest policy and form that (1) is made readily and continuously accessible to Department employees, (2) requires disclosure when required, including but not limited to when an employee has, or may be perceived as having, an substantial interest in a party involved in a matter being considered by the Department, (3) defines the process for managing disclosed potential conflicts of interest to ensure conflicts will not interfere with the performance of the employee's duties or with the perception of outcomes, (4) requires each employee to complete a form, attesting to their understanding of the policy and disclosing any known conflicts of interest, (5) describes the process of maintaining and making available for public inspection the repository of completed forms, open to public inspection, (6) requires new employees to review the policy and to attest to the review, (7) requires a designated employee to periodically review the repository to ensure that it has a form from each Department employee, and (8) requires that employees are reminded at least annually about the Department's conflict of interest policy and the need to disclose conflicts of interest.

Recommendation 5: The Department should update and implement the policies and procedures for the Arizona Life and Disability Insurance Guaranty Fund Board, the Arizona Property and Casualty Insurance Guaranty Fund Board, and the Arizona Workers' Compensation Appeals Board to (1) require board members to complete an annual disclosure form; (2) define a process to allow board members to fully disclose substantial interests during public meetings, document these disclosures in the board's meeting minutes—including the name of the person with an interest (i.e., board member or board member's relative), the interest's description, and the reason the board member is refraining from discussing or otherwise participating; and (3) define a process for ensuring that completed forms are maintained in the Department's separate special disclosure file for public inspection.

Department Response: The finding of the Auditor General is agreed to and a different method of dealing with the finding will be implemented.

Response explanation: The Department shall develop a model policy and procedure that it will recommend be adopted by each of the boards into their plans of operation to be consistently administered by the board to inform each board member of the conflict of interest policy and disclosure requirements. The policy shall include the process, content, disposition and retention for a disclosure. The policy may include a provision that each meeting notice and agenda remind members of the conflict of interest policy and disclosure requirements.

Recommendation 6: The Department should update its disclosure form to require employees and public officers to comply with conflict-of-interest statutes by requiring the disclosure of both substantial financial and decision-making interests.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Response explanation: The policy that the Department develops will incorporate disclosure of both substantial financial and decision-making interests.

Sunset Factor 2: The extent to which the Department has met its statutory objective and purpose and the efficiency with which it has operated

Recommendation 7: The Department should improve its administration of long-term care insurance rate reviews by:

Department Response: The finding of the Auditor General is agreed to and a different method of dealing with the finding will be implemented.

Response explanation: The Department proposes to implement recommendations as detailed in 7a through 7c, as follows.

Recommendation 7a: Researching an appropriate time frame and then provide information to the Legislature regarding the need to revise the statutory time frame in order to allow more time to review long-term care insurance rates.

Department Response: The finding of the Auditor General is agreed to and a different method of dealing with the finding will be implemented.

Response explanation: The Department will work with the NAIC to research the long-term care review time frames established in other states' laws, and will work to collect data about the time it actually takes states to review long-term care rates. We believe this information would be useful if policymakers consider revising the statutory time frame to allow more time to review long-term care insurance rates. The Department will make itself available to respond to questions and to offer insights as to the resources and conditions needed for the Department to meet proposed time frames.

Recommendation 7b: Establishing and implementing a formal process for notifying insurance companies to waive the time frame requirement for long-term care insurance rates.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Response explanation: The Department will establish and implement a uniform communication process to notify an insurance company of the opportunity to waive the long-term care insurance rate review time frame within a specified amount of time after the Department has determined a long-term care rate filing contains all required elements.

Recommendation 7c: Implementing the NAIC long-term care insurance task force's recommendations for improving long-term care insurance rate review when available and if appropriate and helpful.

Department Response: The finding of the Auditor General is agreed to and a different method of dealing with the finding will be implemented.

Response explanation: The Department will evaluate the recommendations from both NAIC Long Term Care Task Forces, will implement appropriate recommendations to the

extent they fall within the Department's administrative authority, and will make itself available to provide information and input to policymakers as appropriate.

Recommendation 8: The Department should determine whether the Insurance Consumer Advisory Board is necessary and provides value to the Department and, based on its determination, take appropriate steps to either form this body to perform its statutory function or provide information to the Legislature regarding the need for a statutory change to sunset this body.

Department Response: The finding of the Auditor General is agreed to and a different method of dealing with the finding will be implemented.

Response explanation: The purpose of the Insurance Consumer Advisory Board ("Board") as specified in A.R.S. 20-400.08(D) is to "...advise and counsel with the director on matters relating to the condition of the insurance marketplace in terms of competition and compliance with [Article 4.2, Chapter 2, Title 20]." Article 4.2 applies to commercial property and casualty insurance. It does not apply to personal lines automobile, dwelling and homeowner insurance policies, mortgage guaranty insurance, title insurance, disability or life insurance, hospital service or medical service corporations, investment companies, mutual benefit associations or fraternal beneficiary associations. A.R.S. § 20-400. We believe this specification is important because without reading A.R.S. § 20-400.08(D), one may infer from its name that the Board would have similar functions as the type of consumer advisory boards or committees that other states may have to provide advice to the state's insurance regulatory agency. The Department actively participates as a member of the NAIC, which facilitates discussions, analysis and consideration of key issues involving insurance consumers, industry members, prospective vendors to the industry or regulators, and regulators. We agree that the usefulness of this board is questionable, given that the director already has broad discretion to establish task forces, committee, and advisory groups. The Department established a Commercial Lines Markets Task Force in 2002, which recommended that the Legislature consider repealing this board. The Department will make itself available to respond to questions and to offer insights if policymakers consider pursuing a statutory change to sunset the Board.

Recommendation 9: The Department should determine whether it is necessary to reconvene the Continuing Education Review Committee. If the Department determines it is not necessary to reconvene this body, it should provide information to the Legislature regarding the need for a statutory change to sunset this body.

Department Response: The finding of the Auditor General is agreed to and a different method of dealing with the finding will be implemented.

Response explanation: We agree that the usefulness of this committee is questionable, given that the director already has broad discretion to establish task forces, committees, and advisory groups. The Department will make itself available to respond to questions and to offer insights if policymakers consider pursuing a statutory change to sunset the Committee and to provide the director the authority to create and update standards that apply to continuing education courses and course providers that Arizona insurance producers may use to satisfy their continuing education requirements.

Recommendation 10: The Department should update and finalize its policies and procedures manual for the Arizona Property and Casualty Insurance Guaranty Fund and the Arizona Life and Disability Insurance Guaranty Fund.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Response explanation: The Department shall review and update its policies and procedures manual for the guaranty funds, and shall present the draft policies and procedures to each guaranty fund board for comment and approval.

Recommendation 11: The Department should ensure that all required reconciliations are completed and that a monthly financial review is being performed and subsequently verified by Department leadership, consistent with SAAM requirements.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Response explanation: An appropriate member of the Department's accounting team shall prepare reconciliations, and shall present them to the administration division manager, deputy director or director for review. The division manager, deputy director or director shall ask questions about any information that is unclear or appears incorrect, and shall signify approval of clear and correct reconciliations.

Recommendation 12: The Department should conduct a risk assessment to evaluate, document, and prioritize the areas in the Department's IT systems with the highest security risks, and use the results of its risk assessment to guide its efforts to develop and implement all required IT security program policies and procedures in line with ASET requirements and credible IT standards, focusing on high-risk areas first.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Response explanation: The Department will work with ASET to conduct a risk assessment to evaluate, document and prioritize the areas in the Department's IT systems that have the highest security risks, and shall use the results to develop and help implement IT security program policies and procedures for the Department.

Recommendation 13: Once it has developed and implemented all required IT policies and procedures, the Department should provide training to its employees on these policies and procedures.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Response explanation: The Department shall provide training to its employees pursuant to ASET policies and recommendations.

Recommendation 14: The Department should work with ASET to define and document the scope of IT security services provided by ASET to the Department and ensure that ASET provides these services.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Response explanation: The Department will continue to ask ASET to define and document the scope of IT security services it provides, and will work with ASET to devise a method by which the Department can verify that ASET is providing those services

Sunset Factor 4: The extent to which rules adopted by the Department are consistent with the legislative mandate

Recommendation 15: The Department should conduct rulemakings to adopt or revise rules it has identified that need to be established, amended, or repealed.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Response explanation: The report recognizes that the Department must determine how best to apply its limited resources to promulgate rules that Arizona law requires the director to adopt, to promulgate rules that will help ensure the Department maintains NAIC accreditation, and to eliminate rules that are antiquated, redundant or otherwise no longer necessary for the operation of state government. The Department will continue to publish its regulatory agenda as a means for keeping the public informed as to the Department's rulemaking priorities, and will continue to apply resources toward improving or eliminating outmoded rules.

Sunset Factor 5: The extent to which the Department has encouraged input from the public before adopting its rules and the extent to which it has informed the public as to its actions and their expected impact on the public

Recommendation 16: The Department should ensure that it makes board meeting minutes or a recording of board public meetings for the boards it supports available for public inspection 3 working days following a meeting as required by statute.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Response explanation: The Department shall post minutes to its Internet website or make a recording of each meeting available for public inspection within 3 working days following each board meeting.