

# Final Draft Report



## California Department of Insurance Surplus Lines Association Triennial Examination for 2016 – 2018

June 5, 2020



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Licensing Services Division  
California Department of Insurance  
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Mr. Ben McKay, Executive Director  
The Surplus Line Association of California  
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Dear Ms. Ferguson and Mr. McKay:

The Surplus Line Association is subject to a triennial compliance examination. The California Department of Insurance, Licensing Services Division, requested that Macias Consulting Group, Inc., conduct the examination. As agreed, our objectives were to (1) determine the extent to which the Surplus Line Association complies with applicable sections of the California Insurance Code and its Plan of Operation; (2) evaluate the Surplus Line Association's internal controls; (3) determine the extent to which the Surplus Line Association has complied with the recommendations made in the previous performance audit report; and (4) assess the reasonableness of the Stamping Fee at 0.200 percent of premiums and the Stamping Fee increase that took effect January 2020. Our examination period was January 1, 2016 through December 31, 2018. We have provided our findings and offer recommendations for operational improvements. The examination was conducted between December 2019 and March 2020.

Respectfully submitted,

Kenneth A. Macias, D.P.A., CPA  
President and CEO  
Macias Consulting Group, Inc.

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# Opinion

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We have examined the SLA's compliance with applicable sections of the California Insurance Code and its Plan of Operation and compliance with the recommendations made in the previous performance audit report; evaluated the Surplus Line Association's internal controls; and assessed the reasonableness of the Stamping Fee at 0.200 percent of premiums during the period January 1, 2016 to December 31, 2018, and the Stamping Fee increase that took effect on January 1, 2020. Management of the SLA is responsible for SLA's compliance with the specified requirements. Our responsibility is to express an opinion on SLA's compliance with the specified requirements based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the examination to obtain reasonable assurance about whether the SLA complied, in all material respects, with the specified requirements referenced above. An examination involves performing procedures to obtain evidence about whether the SLA complied with the specified requirements. The nature, timing, and extent of the procedures selected depend on our judgment, including an assessment of the risks of material noncompliance, whether due to fraud or error. We believe that the evidence we obtained is sufficient and appropriate to provide a reasonable basis for our opinion.

Our examination does not provide a legal determination on SLA's compliance with specified requirements.

In our opinion, the SLA complied, in all material respects, with the specified compliance requirements; that the level of stamping fee was reasonable during the period January 1, 2016 to December 31, 2018; and that the level of stamping fee is reasonable as of January 1, 2020.

# Executive Summary

## WHY THIS COMPLIANCE EXAMINATION WAS CONDUCTED

The Surplus Line Association of California (SLA) is the California Department of Insurance's (CDI's) designated statutory surplus line advisory organization and, as such, it must comply with the applicable sections of the California Insurance Code (CIC). Its responsibilities include monitoring and processing surplus line brokers' placements of insurance with nonadmitted insurers. CIC Section 1780.58 authorizes CDI to require SLA to obtain an independent examination of its operations every three years. This report meets this requirement.

CDI requested that Macias Consulting Group, Inc. (MCG), conduct this triennial examination, which includes:

- 1) Determining the extent to which SLA complies with applicable sections of the CIC and its Plan of Operation
- 2) Evaluating the SLA's internal controls
- 3) Determining the extent to which SLA has complied with the recommendations made in the previous performance audit report
- 4) Assessing the reasonableness of the Stamping Fee at 0.20 percent of premiums and increase in Stamping Fee that took effect January 2020.

The methodology for this engagement included:

- Reviewing department policies and procedures related to receiving, recording, and processing surplus line broker filings;
- Reviewing key monitoring and reporting processes and comparing them to written policies and procedures;
- Reviewing and assessing compliance with the California Insurance Code's (CIC) sections related to the surplus line market (CIC Sections 1760-1780);
- Evaluating management tools, business processes, and internal controls;
- Reviewing the prior triennial performance audit report and determining the status of the recommendations;
- Meeting with SLA staff and member brokers to discuss how compliance requirements are carried out and the responsiveness of SLA's service;
- Selecting a haphazard sample of 216 broker filings to test for receipt, review, recording, tagging, and other processing effectiveness to verify implementation and adequacy of efforts;
- Selecting a haphazard sample of 25 Security Summary Reviews (SSRs) to test for thoroughness, overall compliance with CIC and Plan of Operation guidelines, the addressing of required and non-required criteria, and other processing effectiveness to verify the adequacy of SLA's financial reviews;

- Reviewing the continuing professional education (CPE) classes and seminars provided for appropriateness and variety of topics, attendance, and certificates issued to participants;
- Reviewing the internal control environment of SLA's information management systems, processes, and policies, including the security of the physical environment, security of the data environment, prevention of unwarranted intrusions, and adequate policies and procedures covering all SLA system users;
- Analyzing budget documents and audited financial statements from Fiscal Years (FY) 2016 to FY 2018, and other relevant financial documents;
- Reviewing documentation supporting the setting of the Stamping Fee throughout the examination period, assessing SLA staff and subcommittee assumptions used in stamping fee determinations, and performing a high-level analysis of SLA's fiscal health;
- Conducting financial analyses to assess the reasonableness of increasing the stamping fee to 0.25 percent.

## WHAT THE EXAMINATION FOUND

We found that the SLA adhered to the requirements set forth in both the applicable CIC sections and its Plan of Operation from January 1, 2016 to December 31, 2018. Specifically, we found:

- The SLA's Financial Analysis Department's monitoring of current and prospective surplus line insurance companies adhered to CIC Sections 1780.56(a)(2) and (3) and SLA's Plan of Operation. We found no exceptions in our review of 25 haphazardly selected surplus line insurers. Specifically, all SSRs were organized in the prescribed fashion, addressed all required aspects of the insurer's business and financial statements, provided evidence of thorough financial research, and were presented in the prescribed format for CDI's review.
- The SLA's Data Analysis Department adhered to CIC Sections 1780.56(a)(1) and (5) based on our review of 216 haphazardly selected batches of broker filings. We found all filings to be in compliance. Specifically, all submissions included evidence that: the cover sheet information provided by the broker was complete; the necessary review criteria were documented by the SLA analyst; the stamping fees and relevant taxes were calculated and confirmed; and filings that were incomplete or contained errors were properly "tagged" and appropriately addressed.
- Regarding educating brokers, we found that the Education & Compliance Department (Education) fulfilled its responsibilities as outlined in CIC Section 1780.56(a)(7). Education held seminars and conferences to enable brokers to fulfill their continuing education requirements, established itself as the point of contact within SLA, and effectively provided training and support for brokers, particularly new brokers and new broker staff. Monthly continuing education classes in Northern and Southern California averaged roughly 130 attendees throughout the period.

Additionally, SLA continues to have strong controls for monitoring current and prospective surplus line insurance companies, data processing activities, education services, and information management systems. There was turnover at the manager position within the Data Analysis and

Education and Compliance Departments. The Executive Director actively consulted with the CDI and provided comment and representation of the industry on proposed legislation. The Administration Department (Administration), under the leadership of the Director/COO, effectively managed SLA during the examination period. Finally, we found SLA's continuation of the stamping fee at the same level throughout the examination period and the increase from 0.20 to 0.25 percent in 2020 to be reasonable for a fiscally healthy organization.

Our report concludes that SLA is well positioned to adapt to any changes that may occur in the marketplace or in laws or regulations that would impact its key functions. We provide a recommendation relating to information technology to continue to enhance the well-managed organization.

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# Section 1: Overview of the Surplus Line Association

## BACKGROUND

The origins of the Excess & Surplus Line market go back to the 1800's, when a broker — unable to find American insurers to provide full coverage for his client — could export the business to British insurers to cover the additional or unique coverage needed. Though initially only a small percentage of the insurance business done in the state, the demand for “Excess” or “Surplus” insurance grew, and state regulatory authorities soon realized that they had inadequate controls over this market and additional regulations were needed.

Traditionally in the United States, an **admitted carrier** is an insurance company licensed by the state to write specific and fairly common lines of insurance, such as auto, home, life, health, etc. In contrast, **nonadmitted carriers** are eligible to write insurance when there is a special need that admitted carriers cannot or will not cover, such as liability insurance for amusement parks, hurricane losses, and other unusual risks that require specialized insurance policies or risks that have very poor loss experience. These nonadmitted carriers are referred to as "surplus" or "excess lines insurers."

In the early 20<sup>th</sup> century, the California Insurance Commissioner (Commissioner) lacked the authority and facilities to effectively police the activities of brokers who placed insurance with nonadmitted carriers. As a result, in 1937 the Commissioner recommended, and the Legislature drafted and passed, regulations that the Legislature:

1. Create a committee to help the CDI draft new laws to properly regulate nonadmitted insurers providing coverages which the admitted market did not readily provide, and;
2. Encourage surplus line brokers to form an association, to keep members informed and to cooperate with the CDI regarding current and new regulations.

From these efforts the California Legislature revised the Surplus Line Law to provide for better regulation of the surplus line market. As California started to address the nonadmitted market in more depth, it soon became apparent to the CDI that it was not able to handle the large volume of work generated by these new provisions. The solution was to enlist the help of, and further empower, the surplus line broker community, leading to the formation of the SLA. In 1938, the Commissioner requested that the newly formed SLA establish a Stamping Office, initially to review broker filings. The Stamping Office was allowed to charge a fee on the filings they reviewed as a means of covering their expenses. *California's SLA was the first association of its kind and soon became a model for other surplus line associations throughout the country.*

Today, California's Surplus Line Law is still based on the theory that the right of the buyer to make a contract outside of the State cannot be denied by the State:

*A home state insured, as defined in subdivision (f) of Section 1760.1, may negotiate and effect insurance to protect himself, herself, or itself against loss, damage, or liability with any nonadmitted insurer.*

*CIC Section 1760 (a) (1)<sup>1</sup>*

However, the home state insured often wants and needs *the advice and services of a qualified representative to negotiate such insurance*. Under California law, such representatives — Surplus Line Brokers — are subject to license and regulation by the State, and may place insurance with surplus line insurers only in those instances where the insurance for a risk is not available from qualified admitted insurers who are actually writing such insurance.

In 1994, Assembly Bill (AB) 865 formally authorized SLA to act as the surplus line advisory organization to the CDI to help ensure that California insurance consumers had access to financially sound and reputable nonadmitted insurers. Among its delegated duties, SLA directs and monitors broker insurance placement with nonadmitted insurance companies. SLA operates as a private, non-profit 501(c)(6) organization that ensures that surplus line insurance is placed with organizations or individuals who are licensed (“member”) surplus line brokers in California, and that these brokers submit stamping fees to SLA for each policy that they sell.

The CDI approves foreign and alien surplus line insurers and maintains a list of these insurers approved to enact business in California. This *List of Approved Surplus Line Insurers* (LASLI) also includes:

- **Foreign insurers** — insurance companies that are licensed in their state of domicile, but not licensed in California.
- **Alien insurers** — insurance companies licensed in a foreign country, but not licensed in California.

SLA monitors the companies on the LASLI to ensure their financial strength and capacity requirements while they serve the California surplus lines market.

Per the CIC and the SLA’s Plan of Operation, the CDI and SLA also serve the admitted market by requiring that brokers first ensure that the specific coverage cannot be provided by California’s admitted carriers.

- A surplus line broker may solicit and place insurance for a home state insured [...] with nonadmitted insurers only if that insurance cannot be procured from insurers admitted for the particular class or classes of insurance and that actually write the particular type of insurance in this state.<sup>2</sup>

In general, each broker filing must include a declination (Form SL-2) from three admitted carriers in the specific category being insured. In recognition of the fact that certain types of insurance

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<sup>1</sup> Effective January 1, 2013.

<sup>2</sup> CIC 1763(a)

coverages, or classes of risks, are almost always placed in the surplus line market, an Export List was created by CDI pursuant to CIC Section 1763.1(a). The Export List includes insurance categories such as kidnap and ransom, amusement parks and carnivals, explosives manufacturers, hot air balloon companies, and others. The Export List greatly facilitates surplus line placements by not requiring brokers to complete a diligent search resulting in at least three declinations by admitted insurers. The Export List is reviewed and updated at least annually by the CDI to reflect changes in market conditions. Further, pursuant to CIC Section 1763.1(a), CDI holds an annual public hearing regarding the Export List. During the annual hearing, testimony is taken to determine whether any items should be added to or removed from the list.

During the examination period, SLA membership increased steadily. As of January 1, 2016, SLA was serving 4,689 member brokers; three years later membership stood at 5,654.<sup>3</sup>

California's Surplus Line Association serves its members and the CDI in an advisory role, while working to maintain a healthy, fair, and competitive surplus lines marketplace in California. SLA is delegated duties by the Insurance Commissioner to assist in the regulatory oversight of nonadmitted insurers and surplus brokers. SLA carries out its dual roles as an advisory organization and private non-profit — governed by member brokers — by separating responsibilities in the administration of operations. General policy issues, programs, and advocacy roles are addressed by the Executive Director and committees, while day-to-day operations are managed by the Chief Operating Officer (Director/COO).

## ORGANIZATIONAL RESPONSIBILITIES

SLA is organized and delegates responsibility departmentally as follows:

- SLA is governed by a thirteen-member Executive Committee that is responsible for carrying out and enforcing the SLA Constitution and Plan of Operation. In addition, there is a five-member Stamping Fee Committee. Seven sub-committees, such as the Information Technology Committee, are convened to perform special studies or address special concerns.
- Administration is comprised of the Executive Director, the Director/COO, Human Resources (HR), Communications, and other administrative support including accounts receivable and collections.
  - The Executive Director reports to the Chair of the Executive Committee, interfaces with CDI, is responsible for carrying out SLA's policies and programs, and oversees all operations.
  - The Director/COO reports to the Executive Director and serves as the Chief Operating Officer responsible for organizational administration. The Director provides oversight to the Education and Compliance, Financial Analysis, and Data Analysis Departments. The Director heads Administration and performs the day-to-day financial management activities of SLA.

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<sup>3</sup> Per Education and Compliance, at year-end 2019 there were 5,959 broker members.

- The Financial Analysis Department (FA) conducts Security Summary Reviews, which are the documented analyses of financial filings submitted by each insurance company listed on, or applying to, the LASLI. Each financial analysis contains (1) observations about the insurer and their environment, and (2) confidential recommendations on whether or not any foreign or alien nonadmitted insurer should be approved pursuant to Section 1765.2<sup>4</sup>. CDI makes the final decision as to the status of surplus line insurers, based on SLA's recommendations. FA also serves as the point of contact or liaison with the carriers, collects documents from them, and notifies them of errors or incomplete or missing information in their filed submissions.
- The Data Analysis Department (DA) receives, reviews, records, and stores surplus lines policy filings submitted by brokers pursuant to the Plan of Operations. This department also generates broker invoices for the stamping fees in accordance with CIC Section 1780.56(b). Data Analysis staff notify the surplus line broker of any errors, discrepancies, missing information, or other problems found in submitted documents via "tag" letters.
- The Information Technology Department (IT) oversees all IT operations pursuant to CIC Section 1780.54(a)(2) and (3). One key task is to ensure that SLA has the administrative capabilities and the record keeping facilities to process all surplus line filings in California. Additional tasks include creating and maintaining the network infrastructure and information management systems, web site, and security procedures, including backup of data.
- The Education and Compliance Department (E&C) informs and educates members and retail brokers on current surplus line laws, regulations, procedures, and topics of import to brokers, while continuing to provide professional education. Education does this by conducting site visits; offering periodic conferences, seminars/webinars, and professional education classes; and providing direct phone support to broker firms. These duties are outlined in CIC section 1780.56(a)(7).

The organizational responsibilities and department titles changed after the examination period. This examination of calendar years 2016-2018 was conducted in early 2020, and our examination included meetings with current staff and senior staff. Meetings with representatives from each function included staff who worked in that department during the 2016-2018 examination period. The organization of these departments as of the beginning of the examination period (1/1/2016) and the end of the examination period (12/31/2018) is summarized in the following organization charts.

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<sup>4</sup> Per CIC Section 1780.56.(a)(3)

Figure 1.1: SLA Organization Chart as of January 2016:

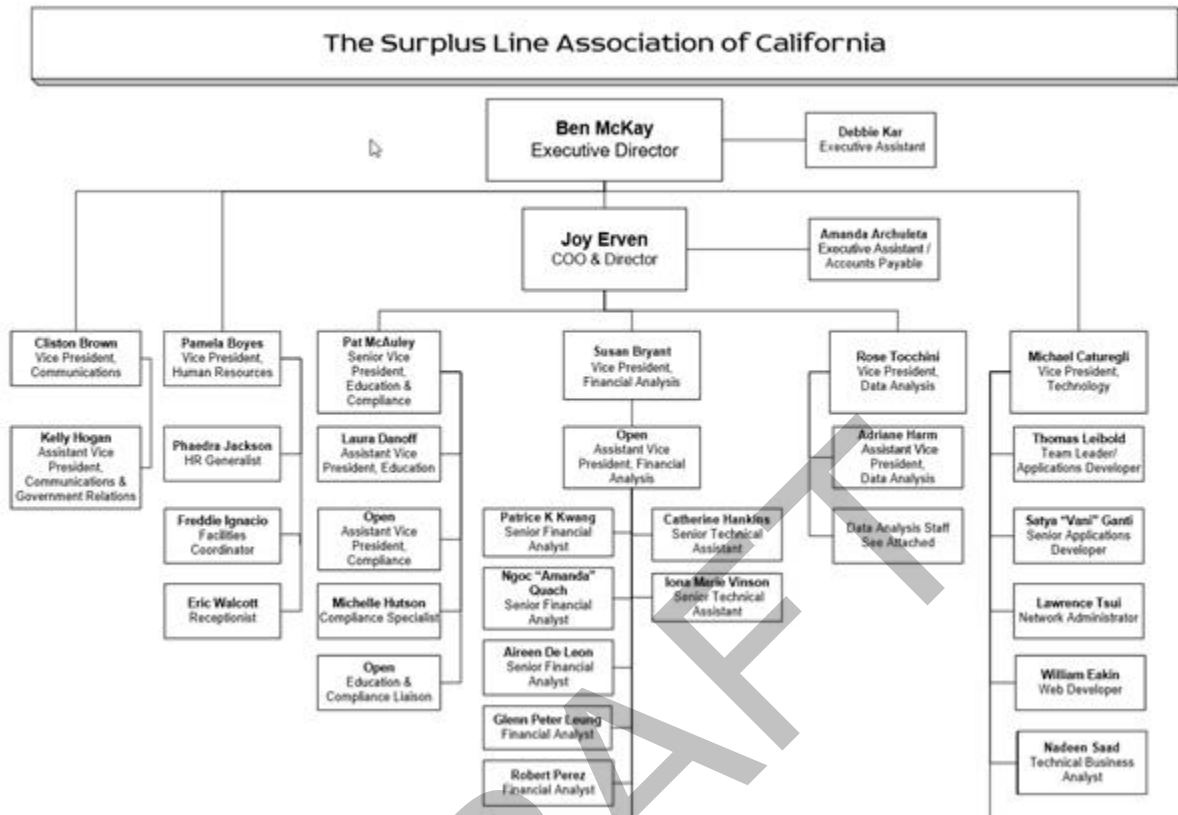
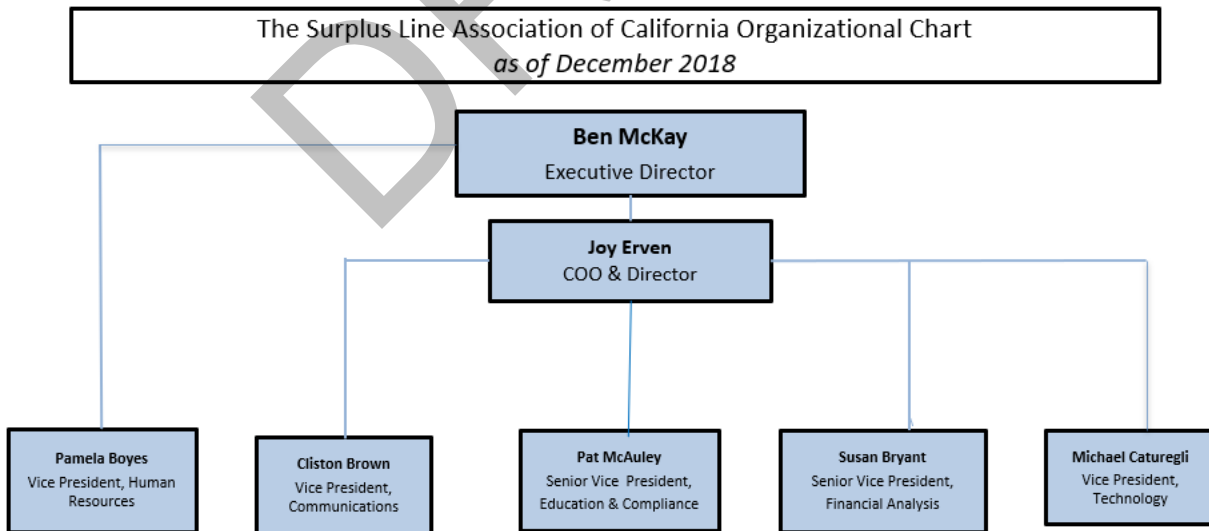


Figure 1.2: SLA Organization Chart as of December 31, 2018:



**FEW CHANGES SINCE THE PRIOR PERFORMANCE AUDIT**

For the years 2016 through 2018, SLA experienced few changes in the surplus lines environment. Premiums continued to rise, and SLA increased its staff over the three-year period of examination.

In October 2017, AB 1641 was signed into law. This legislation offered and lobbied by the SLA gives the Department of Insurance more flexibility in deciding which coverages to add to the Export List. This new law is crucial in ensuring coverage for commercial consumers and also for emerging new technologies in which California is at the cutting edge, including high-speed rail and autonomous vehicles, as well as other large commercial projects, and new risks such as legal, recreational cannabis and cybersecurity risks. AB 1641 promotes innovation and brings the old insurance economy closer in step with the new digital economy. There was no other significant legislation passed that impacted broker filings or insurer requirements.

The largest organizational impacts during 2016-2018 included water damage from a flood in 2016 of the SLA’s server room; in 2017 the SLA office moved from its office on California Street to two new office locations; and the discovery of a significant backlog in processing policy filings. Details of these events can be found in Section 2, Data Analysis and Section 2, Information Technology.

**SLA HAS IMPLEMENTED THE PRIOR AUDIT RECOMMENDATIONS**

In 2017, SLA conducted a triennial performance audit covering the 2013-2015 time period. This prior audit identified four recommendations related to information system improvements, IT policies, and high surplus reserves.

A summary of the status of the prior recommendations is provided in Table 1.1, below.

**Table 1.1: Status of Prior Performance Audit Recommendations**

Prior Performance Audit Recommendations (2017)	Status
<p><b>1. <i>The Information Technology Department should work with the IT Subcommittee to establish a more robust cyber security program. SLA should consider regular vulnerability assessments and the possible need for cyber insurance.</i></b></p> <p>This issue continues to be addressed. Cyber security has been upgraded as part of the transition to new offices and the infrastructure shift to the cloud. While intrusion monitoring continues, full intrusion detection and disaster recovery tests are planned once the SLA has moved to the Amazon cloud in 2020.</p>	<p>Adequately Addressed</p>
<p><b>2. <i>The Human Resources Department should obtain signature page sign-off from all employees for the current Employee Manual - including sign-off on IT Policies and Procedures - and maintain these in each employee’s file.</i></b></p>	<p>Fully Addressed</p>

<p>This issued has been addressed. The Employee Handbook was updated in 2019 and employee signature acknowledging receipt is included in personnel file.</p>	
<p><b>3. SLA Administration, including the Stamping Fee Director/COO and Executive Director, should work with the Board and its subcommittees to review and monitor the continuing high level of surplus reserves. The Board and Executive staff should continue to discuss whether such high reserves represent the optimal service to the members and their clients.</b></p> <p>This issue has been addressed, as the reserves have decreased significantly as they funded the operating deficits in each year of the three-years during this examination period and the reserves are no longer considered high.</p>	<p>Fully Addressed</p>
<p><b>4. As CDI considers requiring insurers to file financial statements electronically, such as with the OASIS, now called CDI LASLI system, SLA should prepare to upgrade their information systems to accommodate this change.</b></p> <p>This issued has been addressed. The SVP and AVP of Financial Analysis actively collaborated with the CDI to create the now functional online LASLI portal.</p>	<p>Fully Addressed</p>

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## Section 2: Compliance Assessment and Operational Controls

This section of the report contains the analysis of SLA's compliance with delegated duties as set forth in the Plan of Operation. CDI delegates duties to the SLA pursuant to CIC Section 1780.50 et seq. The Plan of Operation, most recently updated and approved by the CDI in May 2013, is organized according to these duties. As shown in Table 2.1, SLA has complied with each of the requirements for the 2016 - 2018 calendar years.

**Table 2.1: Plan of Operation Compliance Requirements: Results**

Plan of Operation Requirement – CIC Sections	Responsible Department	Compliance
Section 1780.56.(a)(1) Receive, review, and record required document filings	Data Analysis	Yes
Section 1780.56.(a)(2) Conduct security reviews and analyses	Financial Analysis	Yes
Section 1780.56.(a)(3) Make confidential recommendations re: insurers	Financial Analysis	Yes
Section 1780.56.(a)(4) Report fraudulent or illegal insurance activity	All	Yes
Section 1780.56.(a)(5) Maintain and report information supporting insurance premium taxes	Data Analysis	Yes
Section 1780.56.(a)(6) Comment on proposed legislation or regulations	Executive	Yes
Section 1780.56.(a)(7) Inform and educate members on surplus line law and regulations	Education & Compliance	Yes
Section 1780.56.(a)(8) Communicate with organizations of admitted insurers	Administration/ Executive	Yes
Section 1780.58 (a) – (d) Provide annual reports and conduct audits	Administration/ Executive	Yes
All employees sign confidentiality agreement	Administration	Yes

**ADMINISTRATION AND HUMAN RESOURCES*****Administration provided strong overall management***

Administrative and operational oversight of SLA is appropriately conducted by an experienced Director/Chief Operating Officer who also performs the day-to-day financial management activities of SLA, including:

- Budgets
- Stamping Fee revenue and cash flow
- Accounts Payable
- Accounts Receivable
- Payroll
- Financial Audits
- Committee Liaison
- Association Events, including Board Meetings and the Annual Meeting

The Director reports to the Executive Director and is also responsible for the oversight of the Financial Analysis, Data Analysis, and Education & Compliance Departments. These departments carry out the primary activities delegated by the CDI for regulating the surplus lines market. Communications, IT, and HR continue to report to the Executive Director.

Leadership within the Administration function remained stable through the examination period. In 2016 a new head of Human Resources came aboard. There were also changes to the leadership of Data Analysis. A copy of SLA's organization chart as of 2019 is included in Figure 1.1 above and reflects minor changes since the prior audit.

SLA previously established a standard progression for Board service, whereby brokers are invited to serve first on subcommittees, then on the Stamping Fee committee, then on the Executive Board. To further define the progression of Board service, the Stamping Committee Chair also serves as the Board's Vice Chair. The time serving on subcommittees provides valuable experience for future work at the Stamping Committee and Board levels. There is an understood timeframe for committee members rolling off each committee or board, including having the past chair of the Executive Committee remain on that board for one year.

***Overall human resource controls are sound***

During the examination period the human resources function was led by an experienced HR Manager by providing oversight to personnel activities, payroll and benefits administration, and the activities of the receptionist and administrative clerk functions, while reporting to the Executive Director. The HR Manager shared the support of a Senior Administrative Assistant with the Director. In 2019, a Vice President of Human Resources joined SLA and reports to the COO & Director.

Regarding payroll processes, managers review and approve their respective employee's timesheets. SLA continues to use a web-based payroll system hosted by ADP, though as of late

2019 SLA is considering alternatives to the use of ADP. The HR Manager oversees the payroll process, administers the ADP Employee Web Portal, and serves as the first responder to employee benefit questions. The Director/COO approves payroll after reviewing reports of variances.

We found sufficient general controls in regard to maintaining and storing employee files, and improved checklists. The employee files were appropriately locked in cabinets in the HR Manager's office. We found controls related to the maintenance of employee files, and the distribution of employee handbooks, to be good, with the following exception:

- It was noted that since the prior examination period the Employee Handbook was updated to include an expanded statement of IT policies and procedures. As of that update and going forward, a signed signature page of the Employee Handbook will serve as addressing employee sign-off on IT policies and procedures.

During the examination period HR actively assisted the COO in addressing three significant challenges to the SLA:

- Flooding of the California Street office provided a disruption to operations and to staff personally
- The move from the California Street office to two locations meant a level of personal upheaval for some staff
- The discovery of a significant backlog in processing policy filings was addressed by:
  - Exploiting all possible worker incentives, such as performance incentives and overtime
  - Hiring temporary and permanent analysts
  - Consideration of employees needing to telecommute
  - Dealing with high turnover at the data analyst position, where only three out of ten new hires remained through the three-month training program.

The addition of so many new staff has meant adding more levels and job titles. Where the prior org chart was relatively "flat," the Data Analysis Department now reflects more of a team approach with the added position of Lead Analyst – three levels per team.

### ***Internal financial controls are sound***

Our examination of the internal controls currently in place in Administration, including the controls of financial management activities carried out by the Director, found them to be generally sound.

The HR Manager manages the payroll process, with the Executive Director providing final approvals. The Controller function, outsourced to Burr, Pilger and Mayer (BPM), serves as the primary backup for this process, while the Director/COO serves as a secondary backup. In late 2019 the SLA hired an in-house controller, with plans to move payroll processes from HR to the Accounting Department.

Financial management controls over journal entries and financial reporting continued as all financial management activities performed by the Director/COO were reviewed and reconciled by the part-time, contracted Controller. On a monthly basis the Controller reviewed the financial journal entries and made necessary adjustments. The Controller also prepared financial statements, reconciled bank statements to the general ledger, and verified the forecasts made by the Director/COO regarding premium volume and associated stamping fee revenue during the budget process.

***The Public Affairs and Digital Communications Departments push relevant industry information to members***

The Public Affairs Department drives SLA's outreach efforts to legislators and legislative staff in Sacramento and Washington, D.C., and is responsible for media relations and executive communications. The SLA has recently hired a lobbyist in Sacramento to further represent SLA and the industry to legislators.

The Digital Communications Department is responsible for ensuring that SLA members receive high-quality digital information on a regular basis about the marketplace and how it affects them. The department also supports SLA's digital efforts at its various meetings and events throughout the year while compiling an ongoing visual history of the association and the industry.

Improvements to the SLA website include a chat room feature focused on emerging risks confronting the industry and a Learning Center allowing brokers to track their continuing professional education and Continuing Education (CE) credits. In California, the SLA is responsible for both oversight and service to the non-admitted insurance industry. The executive team continues to shift the organization's "brand" toward an emphasis on broker support and industry advocacy. The ongoing changes to the website support such a shift.

***There were few legislative or regulatory changes during this period***

The Executive Director, SLA Board Members and the SLA's General Counsel interfaced with the CDI on proposed or current legislation related to surplus lines business throughout the examination period as required by Section 1780.56 (a)(6) of the CIC. This section requires SLA "to respond to any request by the Commissioner for comments on any proposed legislation or regulation affecting the placement of insurance pursuant to the surplus lines law." SLA has continued to engage in this activity throughout the examination period. Our examination recognized some changes to the CIC regulations governing the SLA which took effect in 2017, most notably AB 1641, discussed previously. There were no other major legislative changes impacting the SLA during this examination period.

***Current Legislation: Pandemic and Wildfires***

Management of SLA is closely watching any legislation that may arise on the issue of pandemic exclusions within business interruption insurance policies. As of the date of this examination report, we are not aware of legislation has been introduced in California on this issue, but there

have been a couple of proposals mentioned at the federal level. SLA management is watching that issue very closely.

SLA management are also keeping tabs on any wildfire-related bills that may impact its members, as well as regulations on insurance coverage for wastewater facilities, and the California Department of Insurance's Export List, on which an annual hearing is held.

### ***SLA focus is changing from the need for internal efficiencies to one of industry support***

Examples of SLA's work with the Board to address industry issues include:

#### **A. Improving communication and relationships among Board and subcommittee members**

The SLA has weekly operation calls with the Chairman to discuss state of affairs. The board meets quarterly to review SLA internal financials and hear updates from SLA staff and Committee chairs. Every two years there is a Board Retreat where SLA provides educational opportunities to its board members, such as how to read financial statements or what is the role of a board member.

#### **B. Improving the Export List as a Service to Brokers**

The Export List speeds the process of broker filings by including categories of coverage that the admitted market has consistently declined to address. The list is maintained and published by the CDI, and also continually available on the SLA's website. Filings falling into the Export List's categories do not require a diligent search to confirm that admitted carriers have declined to provide coverage; that is, completion of a SL-2 form is not required.

The Export List is reviewed and updated at least annually – not more than twice annually – and the SLA provides input to that discussion with information on industry changes that should be considered. The list represents relatively mature products, if only because of the time to be certain that the admitted market has no interest in providing such coverage. Of course, surplus line brokers would appreciate the time saved by having as many coverages as possible on the list. The issue for surplus line brokers is that certain *relatively new coverages can represent a high volume of their business*, such as:

- The ***cannabis industry*** is exploding, and there is a large need to cover growers, distributors, wholesalers, and retailers. The industry is expanding beyond medical marijuana to include recreational availability and use in more states, and the differing laws between states and the Federal government impacts banking procedures, making it a high-cash industry needing insurance.
- Companies like AirBnB, an ***online marketplace and hospitality service***, enable people to lease or rent short-term lodging including vacation rentals, apartment rentals, homestays, hostel beds, or hotel rooms. Private owners require insurance beyond the standard property and casualty coverage, which typically falls to the surplus line market.

- As business and life becomes ever more online, and the threat of cyber-crime expands daily, the need for **cyber-insurance** is rapidly expanding. Such coverage calls for specialized knowledge and specialized insurers to provide businesses of all types – including the SLA itself – to seek protection.
- Companies are starting to utilize **drones** as part of their operations. The increased use of unmanned aircraft could create new risks while also recognizing their potential value as a risk-mitigation tool. The longer a drone is in the air, the greater the likelihood that it will crash, lose or damage its payload, or in some other way cause injury. Conversely, the ability of drones to take the place of people engaging in dangerous tasks—say, inspecting power lines—might generally be viewed as reducing risk.
- **Ride-sharing services** have now become commonplace. With that, most large ride-hailing companies carry insurance but with million-dollar limits. The potential risks to companies and to employers who utilize the services for their employees create emerging considerations for the surplus line industry.
- The topic of **Autonomous vehicles** is evolving and as such there is a question of determining who is liable and what will be the impact on the surplus line industry.

As new businesses such as the above become more commonplace, and the surplus line industry comes to routinely provide such needs, the SLA continues to stay on the cutting edge

and provide objective information to the discussion – serving both the CDI and SLA’s members.

***Prior audit recommendations related to Administration have been addressed***

**Finding #3:**

While the goal of minimizing the frequency of changes to the stamping fee represents a benefit to the members, the healthy growth of premiums has resulted in ever-growing revenues and high-than-previous levels of undesignated assets – surplus reserves.

**Recommendation #3:**

SLA Administration, including the Stamping Fee Director/COO and Executive Director, should work with the Board and its subcommittees to review and monitor the continuing high level of surplus reserves. The Board and Executive staff should continue to discuss whether such high reserves represent the optimal service to the members and their clients.

**SLA Response:**

SLA Administrative leadership works closely with the Board throughout the year to maintain an optimal level of financial reserves, and to manage the organization in such a manner as to minimize changes to the Stamping Fee. One recent change to SLA’s reserves, subsequent to this review period, includes the elimination of the Computer System Reserve Fund, as those targeted systems have been implemented.

**Update:**

We observed that the surplus reserves decreased significantly over the three-year examination period, as expenses exceeded revenues in each of the three years. The surplus reserve was used to fund the operating deficits.

**FINANCIAL ANALYSIS*****Financial Analysis Department Security Summary Reviews are sound***

CDI has requested, per CIC Section 1780.56 (a)(2) that the SLA assist in the financial review of approved surplus line carriers and those applying to be approved surplus line carriers for insureds in California. Pursuant to CIC Section 1780.56 (a) (3) and the Plan of Operation, CDI requests the FA Department to communicate confidential recommendations regarding nonadmitted insurers. The primary purpose of these functions is to ensure that nonadmitted insurers which place business in California meet the requirements of CIC Section 1765.1 and 1765.2. **SLA Bulletin #1278** provides a summary of the CIC changes effective January 1, 2013:

*Following the enactment of Assembly Bill 2303 on September 29, 2012, California Insurance Code (CIC) Section 1765.1(c) has been repealed. As a result, effective January 1, 2013, the File and Use Recognition System no longer exists. Companies that previously appeared on the File and Use System List may still be used for California placements provided the broker has verified or determined eligibility. Effective January 1, 2013, nonadmitted insurers are only eligible to place business in California if the insurers have met the requirements established under CIC 1765.1 or CIC 1765.2. As such, brokers must ensure that the nonadmitted insurer with whom the broker is making the placement for California home state insureds would qualify under the following:*

**CIC 1765.1 (Eligible Carriers)** – *Brokers may make placements with a nonadmitted insurer provided at the time of placement the broker has determined that the carrier has met the following:*

- *For a Foreign (US domiciled) insurer, the insurer must:*
  - ✓ *be licensed in its domiciliary jurisdiction to write the type of coverages being placed in California, and*
  - ✓ *maintain a minimum capital and surplus or its equivalent of at least \$45 million (unless excepted).*
- *For an Alien (non-U.S. domiciled) insurer, the insurer must:*
  - ✓ *be on the current International Insurers Department Quarterly Listing of Alien Insurers (IID List) maintained by the National Association of Insurance Commissioner (NAIC).*

*Please note that there is NO published list of eligible foreign carriers under CIC 1765.1.*

**CIC 1765.2 (LASLI Carriers)** – These are carriers on the California **List of Approved Surplus Line Insurers (LASLI)**. The LASLI is an optional listing of nonadmitted insurers that the California Department of Insurance (CDI) has approved for use by California surplus line brokers. These carriers have voluntarily provided the CDI with specific documents for review and have been determined to have met the financial stability, reputation and integrity requirements as set forth in CIC 1765.2.

The LASLI is updated and posted on the CDI and SLA websites.

**Nonadmitted Carrier Ineligibility:** If the Commissioner determines that a carrier is not eligible, the Commissioner may issue an order and notify all surplus line brokers (or ask the SLA to notify brokers) that the carrier is no longer eligible.

Using the regulations detailed in CIC, the FA Department appropriately, and in compliance with the requirements, conducts Security Summary Reviews (SSRs) which are in-depth, ongoing documented financial and non-financial analyses of the financial filings submitted by current and prospective carriers that desire to place Surplus Lines Insurance business in California.

As of December 2018, of the total premiums processed by the SLA, 73.7% were from foreign or alien insurers on LASLI, while 21.6% were Lloyd’s syndicates on the NAIC IID list. In summary, all LASLI insurers are subject to the SSR process to assure their financial stability.

The FA also reviews filing materials as required by CDI with respect to insurers not otherwise eligible to provide coverage based on the criteria specified in CIC Section 1765.1 (f) - “Gap provisions” or “Gap providers.” The broker has the responsibility to check and submit to the CDI any information relied upon to determine the financial stability, integrity, and reputation of the Gap provider. The FA completes a cursory review of the filings submitted by the broker to confirm that they have complied with this code section; that the interests of the insured are adequately safeguarded.

#### **Financial Analysis Department activities are compliant with the CIC**

To assess compliance, we examined a haphazard sample of 25 nonadmitted carriers, or about 7.81 percent of the total companies that the Financial Analysis Department monitored between 2016 and 2018. We found no exceptions in our examination. Reports were organized in the prescribed fashion, contained the necessary information, and included evidence that financial reviews were conducted. Our sample included 20 Foreign carriers and 3 Alien carriers that we identified on LASLI as of March 21, 2020. Our sample also included 1 Alien carrier that was eligible but not listed on LASLI, as well as 1 Alien carrier that was removed from LASLI on February 10, 2020. Currently there are 127 non-admitted insurers on LASLI. The Alien carrier, listed on the National Association’s Quarterly List of Alien Insurers, dated January 2020, met the requirement of maintaining a United States Trust Account of at least \$5.4M. All carriers in the sample met selected critical requirements:

- A. Capital/Surplus listed was equal to or greater than \$45M,
- B. Assets of cash/readily marketable securities was at least \$25M, and

- C. The SSR was reviewed and signed as approved by a Senior Financial Analyst/Financial Manager/Senior Vice President and a CDI representative.

Each financial analyst reviewed the following to determine financial stability, reputation, and integrity of the insurer.

1. Company background, including its related corporate group
2. Company operations
3. External environmental considerations, such as legal proceedings, catastrophic conditions or product concentrations, if applicable
4. Assets
5. Loss reserves and other liabilities
6. Income statement
7. Reinsurance
8. U.S. Trust Account, if applicable
9. Adjustments to surplus
10. Updates on solvency, as applicable
11. Insurance Regulatory Information System Ratios (IRIS)
12. Risk Based Capital Ratios (RBC)
13. Conclusion with the Financial Analyst's recommendation as to SLA's priority code status for the insurer.

#### ***Financial Analysis Department makes good use of automated tools***

We determined that the Financial Analysis Department continues to utilize effective tools that allow it to be in compliance with statutory requirements. These tools include:

1. The Company Assignment Worksheet, to track and prioritize the assignment of companies to specific analysts;
2. The Early Warning Checklist, which provides the analyst a notice of issues the carrier may be having that SLA needs to monitor and address in the next formal review;
3. The SSR Log tracks the status of each SSR and the priority level of each company.
4. Financial data from A.M. Best, an Insurance Credit Rating Organization
5. Financial data from the National Association of Insurance Commissioners
6. Financial data from Standard & Poor's, a Financial Market Rating Organization

The Early Warning Checklist process includes a guideline with questions, the checklist in the Regulatory Administration Platform for Insurance Data (RAPID) System, an excel file with automated calculations. The Early Warning Checklist covers a number of possible issues for each category related to the SSR as noted above. The Financial Analyst assigns a finding ranging from "no adverse finding" to "problem area." We examined a completed Early Warning Checklist for one of the SSRs included in our compliance test work. The checklist addressed the multiple categories, including company background, capital and surplus, operations, external environmental considerations, assets, liabilities, income statement, and reinsurance.

As part of the oversight and review of staff, the Senior Vice President of Financial Analysis conducts monthly meetings with the analysts to follow up on the review progress of high priority, or high risk, companies. In addition to the Senior Vice President of Financial Analysis, we also interviewed a Senior Financial Analyst.

***Financial Analysis systems capture and maintain insurer's documents electronically.***

*If a required document is available from the National Association of Insurance Commissioners ("NAIC"), the insurer need not file that document with the CDI. However, the insurer will have to submit a statement to the CDI attesting to that fact and identifying the document(s) that is available from the NAIC along with the appropriate filing fee.*

California LASLI Filing Requirements Guide  
for Surplus Line Insurers; 4-23-12

The Guide further notes that, under the LASLI requirements, all financial documents still need to be certified or verified. However, if the documents are available from the NAIC, certification or verification of documents is no longer required.

Some insurers still prefer to submit hard copy documents. The FA receives and checks these hard copy documents, and scans and saves them on the network.

***Financial Analysis Department Staff***

As of October 2019, one Assistant Vice President, ten Financial Analysts and two Technical Assistants report to Susan Bryant, Senior Vice President Financial Analysis.

Two of the Financial Analysts hold designations as an Associate of Surplus Line Insurers (ASLI). One analyst has obtained the Chartered Property Casualty Underwriter (CPCU) designation.

Training is provided to Financial Analysts within the constraints of the budget. Training during the period from 2016 through 2018 related to statutory statements and standard accounting practices from several sources:

- a. *The Institutes –Risk and Insurance Knowledge Group offers Continuing Education for a variety of insurance designations, such as Chartered Property Casualty Underwriter (CPCUs), and Associate Surplus Lines.*
- b. *NAIC (National Association Insurance Commissioners) conferences.*
- c. *Booke Insurance Seminars*

The Financial Analysis Department communicates regularly with CDI representatives on an informal basis, with formal meetings at least annually. The CDI Representatives review and approve SLA's SSRs.

Processing enhancements during the examination period included the CDI system upgrade called LASLI project, which now allows SLA and CDI to share financial data and documents more

efficiently and securely and expedites SLA's financial reviews and filing of annual renewal documents.

### ***Prior audit recommendations related to Financial Analysis***

The previous audit included no recommendations related to Financial Analysis or SSR operations.

## **DATA ANALYSIS**

### ***Data Analysis reviews of policy filings are sound***

CIC Section 1780.56.(a)(1)<sup>5</sup> and the SLA Plan of Operation direct the Data Analysis Department to *receive, review, and record all documents required [...] with respect to foreign and alien nonadmitted insurers and any insurance placed with nonadmitted insurers.*

Overall, the filing process did not change, as brokers continued to use SLIP v2.0<sup>6</sup> to upload information on policy transactions. As well, brokers could still provide this data via electronic documents, such as in the popular PDF format, or in paper format via US mail.

The filing process continued to shift toward electronic submission and the use of SLIP, while the process of reviewing and registering those policy filings shifted from the previous Electronic Automated System (EAS) system to RAPID. DA leadership estimates that about half of all broker filings were received through SLIP in 2016 and now up to 98% in 2020, which stores the documents in a database shared with RAPID. For submissions apart from SLIP, whether received electronically or as hard copy, clerical staff continue to enter the relevant documents to the database so that analysts can review all transactions online. In 2016 RAPID was implemented as the core software application supporting DA analysts, replacing the EAS system. The implementation was admittedly problematic and required a good deal of training for DA staff.

Each submission must still include a cover letter with specific batch information summarizing information such as the total dollar value of all the premiums included, as well as the calculated stamping fee and tax. The basic policy information provided for each item in the batch includes:

- **Confidential Report of Placement: Form SL-1.** This form is a summary of the pertinent policy information, and brokers must also include a copy of the *Declarations Page* of the policy or the surplus line broker's certificate or binder, and any other pertinent information reasonably required by the Commissioner.
- **Diligent Search Report: Form SL-2.** This form includes basic information about the type of insurance provided, and evidence of at least three admitted brokers who are currently providing insurance in this category who declined this specific opportunity. Exemptions from having to submit a completed SL-2 include coverage that meets the Export List

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<sup>5</sup> This section of the California Insurance Code was last updated in 2011

<sup>6</sup> SLIP is an acronym for Surplus Line Information Portal

requirements, a California Automobile Assigned Risk Plan ("CAARP") Determination of Ineligibility or, since Non-admitted and Reinsurance Reform Act (NRRRA) guidelines became effective, submission by a Commercial Insured broker.

When information is missing, incorrect, or provided outside of the required timeframe, the system or the analyst will issue a "tag" clarifying the particular error or omission. The system generates monthly letters to any broker with outstanding tags. DA leadership estimates that through the 2016-18 examination period about one third of all filings were issued a tag, but by mid-2019 that number had dropped to around 28%. One factor that may lead to what seems to be a high incidence of tags is that SLIP flags filings that are more than 60 days past the policy's effective date; SLIP requires an explanation for the delinquency yet still issues a tag even if the explanation is deemed valid. Per DA leadership, most explanations for late filings are accepted as valid, so the number of *significant* tags would appear to be inflated, especially since late filings are by far the most common reason for a tag. There are many reasons for tags, mostly for errors or omissions, but also including policies apart from errors and omissions that still require special attention by the CDI. These policies are assigned specific reason codes, and the matter is forwarded to the CDI.

#### ***Data Analysis staffing and responsibilities have shifted***

Rose Tocchini served as Vice President of Data Analysis from late 2014 until late 2017 when Mike Caturegli became the Sr. Vice President of Data Analysis and Technology. Data Analysis leadership also includes two other Vice Presidents with more direct oversight of Data Analysis operations.

Staffing levels were increased to address a significant backlog in processing discovered in 2017. Between 2016 and 2018 the Data Analysis Department grew from 40 to 60 staff, including four Quality Control staff and four clerical staff. The department's organization shifted away from a relatively "flat" organizational structure by emphasis on teams and more distributed supervisory responsibilities. Team Leads meet with their teams weekly; the V.P. and Assistant V.P. meet regularly with the Team Leads; Department meetings are held as needed and at least quarterly.

The Data Analysis Department continued to be responsible for Accounts Receivable (A/R) during the audit period, assigning a dedicated employee with specific A/R tasks. While RAPID interfaces with QuickBooks to generate invoices, A/R staff receive and post the money received in the system upon receipt. At the beginning of our examination period brokers would generally pay their balances monthly by hard-copy check, but SLA now supports electronic payments. Given the large number of submissions, brokers tend to take advantage of this feature, so far fewer paper checks are received and fewer trips to the bank are made with deposits. Also, SLA can now receive credit card payments via PayPal, an online payment service. These tend to be for smaller standalone transactions; the head of Data Analysis estimates that only about \$1,000/month is received through PayPal. While Burr, Pilger, and Mayer (BPM) continues to serve as the outside controller, during our examination SLA hired an internal controller to take on these responsibilities.

***Implementing system upgrades seems to have caused a significant backlog for a significant period***

Based on our testing of broker submissions, it appears that growth in the backlog of pending filings began in early 2016 and was back to normal in early 2019:

- In late 2015 the lag between submission and registration was about 15-20 days<sup>7</sup>
- RAPID was implemented in 2016
- In 2017 the data analytics provided by RAPID identified a significant backlog of unprocessed submissions
- Between 2016-18 the lag ranged from 90 to 120 days or more<sup>8</sup>
- The stated goal of reviewing all submissions within 10 days was reached in July 2019, and the backlog was at 6 days as of December 2019<sup>9</sup>

The SLA response to the discovered backlog appears to have been reasonable. The first effort was to increase the pace of reviews by offering incentives, including overtime and incentives, to existing staff. Subsequently, a large number of analysts were hired and trained as temporary staff, increasing the department head count from 40 to 60. As the backlog came under control SLA sought to retain the better workers by identifying pathways for professional growth, including the possibility of transferring to the other departments.

SLA continues toward a paperless environment, while continuing to support those brokers who wish to submit copies of the paper documents. DA leadership estimates that roughly 50% of filings are via SLIP; 48% are submitted as electronic documents (e.g., PDF, etc. with SLA cover sheet); and perhaps 1-2% are received as hard copy or e-mail.

- As of the beginning of 2016 it was estimated that 20% of filings were still received as hard copy, in batches. At one-point SLA issued a memo to brokers suggesting that SLIP was now *required* for policy submissions. The message/requirement was subsequently rescinded upon advice from CDI that use of the SLIP portal could not be mandated. However, the message apparently served to get non-SLIP users to try the system; apparently the system proved its ease of use as the 10% of paper filings dropped to about 2%.

DA leadership also estimates that, of the roughly 6,000 SLA broker/members, the top 50 brokers provide roughly 90% of the filings. These larger brokerage firms tend to be more technologically savvy, supporting the move to a paperless environment, while the rare hard copy submissions tend to come from smaller firms with standalone or unique policies.

### ***Data Analysis activities are compliant with the CIC***

Our examination found SLA to be in compliance with prescribed requirements. To assess compliance against processing requirements stipulated in CIC Section 1780.56, the Plan of Operation Exhibits I and II, and the Data Analysis Training Manual, we examined a haphazard sample of 216 broker filings. We found that all transactions were properly registered, including a

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<sup>7</sup> Cursory estimate based on random sampling from Q4 2015

<sup>8</sup> Based on data collected during compliance testing

<sup>9</sup> Per the SLA COO, confirmed by spot checks within RAPID

small number that required clarification for us. For policies that were incorrect or incomplete, the submission was properly tagged. Other characteristics of this sampling included:

- 72 filings from each year, 2016-18, selected by judgmental sampling to include:
  - 50 different brokers/brokerage firms
  - 56 different SLA data analysts
- 53 tags (26%), 6 distinct tag categories
- Of the tags generated:
  - ✓ 30 (56.6%) were for late filings
  - ✓ 14 (26.4%) were for missing documentation
  - ✓ 4 ( 7.5%) were for Declarations Page errors
  - ✓ 3 ( 5.7%) were for multiple or other errors
  - ✓ 2 ( 3.8%) were for an SL-2 error and a note regarding the Export List

### ***Data Analysis procedures demonstrate sufficient controls***

Regarding quality control (QA), four dedicated staff within Data Analysis randomly select and review 50 transactions per analyst per month. Each analyst's productivity and error rate serve as input to their promotion and pay increases. Regarding productivity, the standard work week for SLA staff remains at 37.5 hours. As well, QA distinguishes analyst registration issues from A/R or broker payment issues. While broker payments are tracked based on 30/60/90-day payment windows, the small number of brokers who are late constitute a minor overall concern and are addressed on a case-by-case basis.

The shift to teams of data analysts at the journey, senior, and lead levels is likely to improve quality in the registration process, providing additional opportunities to escalate questions regarding anomalies and complex policies. The tools in use include checklists and reference notes that are clear and not overly complex and are tied to the State regulations and the DA training manual.

### ***Prior audit recommendations related to Data Analysis***

The previous audit included no recommendations related to Data Analysis or filing operations.

## EDUCATION AND COMPLIANCE

***Education and Compliance offerings and activities adequately address brokers' needs***

Each California-resident surplus line broker is required to be licensed by CDI *as a property/casualty broker-agent*, which requires 24 Continuing Education (CE) hours every two-year license term, three of which must satisfy the ethics requirement. In other words, there are no specific education requirements for a property/casualty broker to receive their Surplus Line license. However, CIC Section 1780.56 (a) (7) and the SLA Plan of Operation require that SLA disseminate information and provide professional education offerings to surplus line brokers. Additionally, CIC Section 1765(f) requires each surplus line broker which acts as a business entity to appropriately train their employees – a minimum of two hours every five years - and for SLA to provide the curriculum for such training. As such, SLA education offerings serve both the individual broker and those brokerage firms serving the nonadmitted market.

Education and Compliance (E&C Department) carries out these duties by: (1) providing CE courses via both live classroom and online formats; (2) providing seminars, webinars, and presentations on current issues and concerns impacting the non-admitted market; and (3) training brokers regarding current filing guidelines and online filing processes. We examined information on courses, seminars, conferences, and broker visits conducted by SLA, including the number of attendees and continuing education units provided. We also met with a broker who serves on the Board's Education and Compliance committee. Our examination found Education and Compliance to be in compliance with these requirements.

Education and Compliance completes its delegated duty by effectively coordinating all aspects of broker seminars and conferences, providing many education opportunities throughout the state on a variety of topics ranging from ethics to specific surplus line coverage. Course instructors include insurance professionals, such as SLA senior staff and managers, as well as SLA Board Members, accountants, and attorneys. Department staff work with the trainers and with CDI to ensure thorough, accurate and replicable curricula.

Our examination of the seminar schedule shows that training is frequent, regular (generally monthly), and easily accessible to brokers:

- Live courses are offered in the major metropolitan areas of Los Angeles and San Francisco. We understand that efforts are underway to expand access by offering classes in Orange County, San Diego, and Sacramento.
- The courses are publicized on the SLA website, through the SLA Quarterly Newsletter, and via mailings, and the website allows brokers to register for those courses.
- Brokers can also attend SLA courses online via WebEx, an internet-based presentation service.
- In 2019 SLA launched the Learning Center, allowing brokers to create an education account and track their continuing education certification as Surplus Line professionals.

Once conferences, seminars, or continuing education courses are completed, SLA issues certificates and enters the attendee information into the CDI's Education Provider System. This

system tracks the continuing education hours for each licensed broker, and also provides information on a broker's standing to the general public and those shopping for insurance services.

Continuing Education topics are generally suggested by Education and Compliance Committee members. During the audit period there were no major legislative changes that required education courses. In 2017, AB 1641 amended the requirements for SLA membership and the process of updating the Export List, but these changes did not require educational offerings.

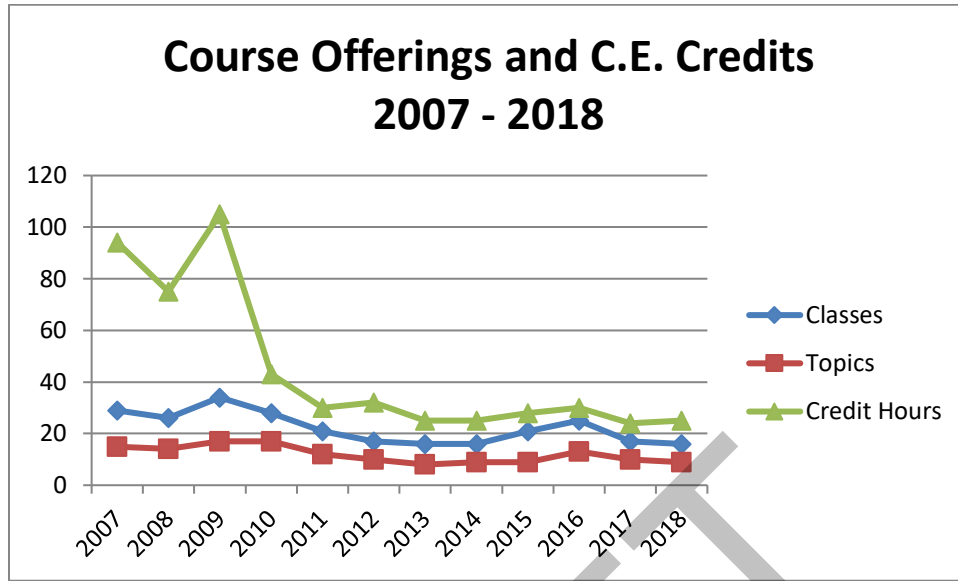
The Education and Compliance Department included 4-6 staff during the examination period. In 2016 the head of the Data Analysis Department became the Senior V.P. of Education, and the department's title was changed to Education and Compliance. During the process of our examination in early 2020 that Senior V.P. retired, and an individual was hired to take her place. Other issues impacting Education and Compliance during this examination period include:

- Implementation of the new RAPID system (used by SLA staff) and SLIP enhancements (used by brokers for their required filings) was problematic both internally and with brokers, and Education and Compliance staff devoted significant time to internal and external training on these systems.
- The system upgrades provided new analytics, including the time between a policy's effective date, submission, and registration by SLA staff. Discovery of lengthy backlog in reviewing and registering policies caused SLA to hire additional data analysts; E&C staff dedicated time to assist with their training.

### **Education and Compliance Activities**

SLA has experienced healthy broker participation in its training programs. During this three-year period, SLA registered a total of 7,297 attendees and provided certificates to 4,855 upon successful completion. A total of 58 continuing education classes were offered in Northern and Southern California, covering 32 topics, with an average registration of 128 members of the broker community. The charts below reflect the increased attendance at systems-related training in 2016, as well as a slight diversion of E&C staff toward systems training of new staff in 2017.

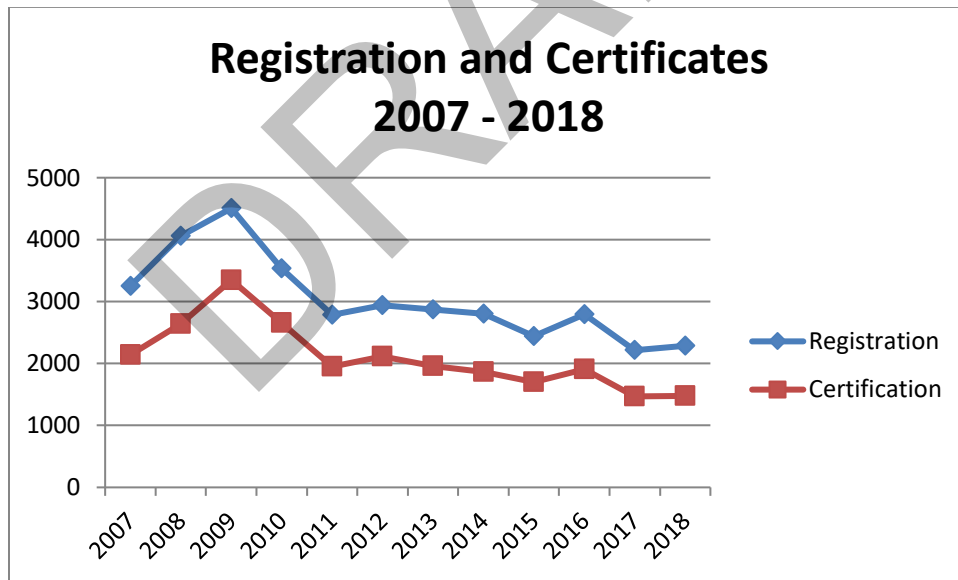
Figure 2.1: Course Offerings and Continuing Education Credits



Source: SLA Education & Compliance Department (unaudited)

Figure 2.1

Figure 2.2 Continuing Education Registration and Certificates



Source: SLA Education & Compliance Department (unaudited)

Figure 2.2

Education and Compliance is also responsible to establish SLA as a point of contact for new brokers, to provide new broker training, to respond to broker questions, to provide training to brokerage houses whose filings demonstrate significant problems, and to ensure that broker licenses are kept up to date. Table 2.2 below shows some of the growth in the broker community addressed by Education and Compliance.

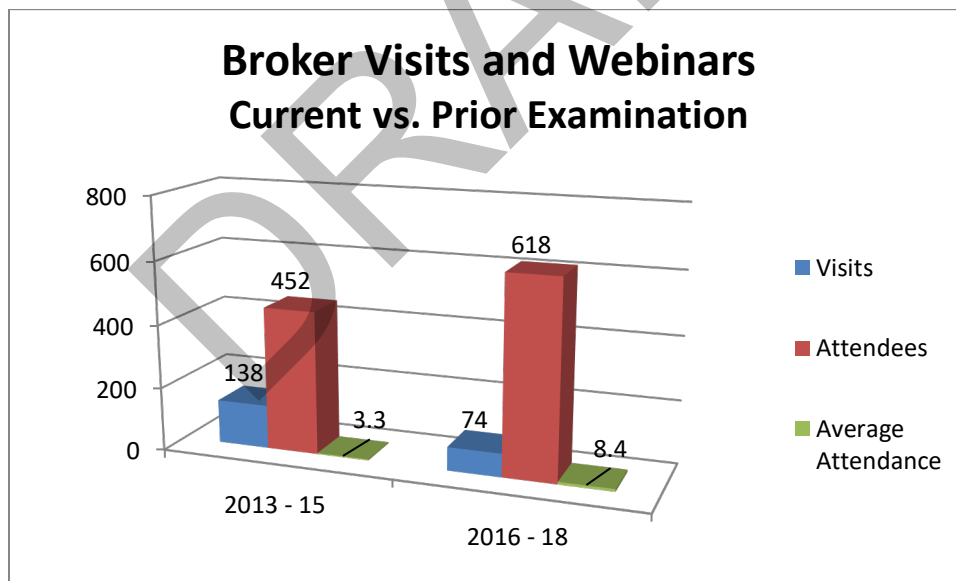
As of Year End	Total Licensees	New/Year	Average New/Month
2016	5,192	502	42
2017	5,348	552	46
2018	5,654	540	45
2019	5,959	578	48

Source: SLA Education & Compliance Department (unaudited) Table 2.2

Education and Compliance identifies brokers with high numbers of filing errors through quarterly tagging reports generated by Data Analysis, researches the likely causes for such errors, and identifies the best means of addressing the problem. Meetings with SLA senior staff confirmed that excessive problems or tags – apart from late filings – are most often the result of employee turnover within brokerages, and replacement staff who haven’t been adequately trained in-house on SLA procedures, broker requirements, and SLA’s information systems.

**Figure 2.3: Broker Visits and Attendees**

The most notable change in outreach by Education and Compliance might be reflected in the chart below, as the overall number of events – visits to brokerage firms and hosted webinars – declined since the prior audit period. At the same time, the total number of brokers served increased. The use of webinars as a means of targeted training seems to be expanding the reach of SLA’s education efforts.



Source: SLA Education and Compliance Department (unaudited)

Figure 2.3

**Prior audit recommendations related to Education and Compliance**

The previous audit included no recommendations related to Education and Compliance.

**INFORMATION TECHNOLOGY*****IT supports internal departments and external clients***

The Information Technology Department (IT) oversees all information technology operations in support of CIC Section 1780.54 (a)(2) and (3) and the Plan of Operation. The key responsibilities directed to IT include:

- Ensuring that SLA has the administrative capabilities and the record keeping facilities to process all surplus line filings in California
- Ensuring that SLA has the data processing capability...to perform appropriate security review of all nonadmitted insurers.

To carry out these responsibilities during the examination period, IT maintained and provided upgrades to the primary systems used by the Data and Financial Analysis departments. Examples include the SLIP portal for broker filings, the EAS system to store policy filings, and the RAPID system to support the financial reviews of nonadmitted insurers. Perhaps of most significant importance, during the examination period, RAPID was significantly upgraded in its functionality and as a database to store and support the registration of broker filings, replacing the EAS system.

IT also maintained the SLA website, a key resource for surplus line brokers. Our examination found they met the above responsibilities and expanded the website's functionality to further support surplus line brokers. Further, as of the time of this examination our team recognized significant improvements in the appearance and content provided via the SLA website. The site provides links to support online filing, such as to SLIP, SL-1 and SL-2 forms, and LASLI and Export List lookups. The site has also added a Learning Center where members may access online courses and track their continuing professional education.

***IT maintains a strong internal control environment***

To assess the control environment of SLA's information management systems, we assessed the general control environment and associated controls during the examination period. From 2016 through 2018, SLA initially maintained its own internal network, including a secure server room to host the EAS systems, the vendor-maintained SLIP and RAPID systems, and IT security policies and procedures. The SLA website continued to be hosted on Rackspace. In 2017, in conjunction with the RAPID upgrade, SLA worked with Infinity, its software vendor, to transition to a cloud-based architecture hosted by Rackspace. We found the new environment to be secure, including controls related to data, physical, and intrusion security, and IT policies and procedures.

Regarding data security:

Initially in 2016:

- SLA had a hot site in Scottsdale, Arizona that included full network backup on dedicated servers.
- EAS was backed up continuously on three redundant servers: two local sites in the Bay Area, one at the Scottsdale hot site.
- Secondary backups occurred nightly with the network/AS400.
- SLIP and Rapid were backed up daily to warm servers at the Scottsdale/SunGard site. The greatest “date exposure” included one day of SLIP/EAS and RAPID data.

Beginning in June 2016:

- Much of SLA’s system infrastructure was shifted to the cloud. Further, the shift to a cloud-based infrastructure provided a more secure approach to the telecommuting that was needed during the rapid hiring related to the backlog, as workspace was completely full in San Ramon.
- The move away from local servers included SLA’s core systems, and the previous offsite data backup scheme noted above is no longer used
- Data storage and processing on dedicated servers hosted by Rackspace includes continuous backups – data written to multiple databases at the same time - redundant processing, and load sharing between distinct servers. Specifically, the primary database in Texas would fail over to that in Virginia. As such, the risk of potential data loss might be roughly a minute or two.

Regarding physical security:

Initially in 2016, and noted in the prior audit:

- The SLA’s offices were secured from entry via elevator and stairway by card key and camera-supported buzz-in locks.
- The prior examination noted that the server room was secure, including being windowless with a locked door and password security. Items that were less than ideal included: fire suppression based on a water-based sprinkler system rather than some form of gas-based system; the floor was not raised; and there was only one cooling unit.
- When operations were primarily hosted internally, disaster recovery was a high priority. The Disaster Recovery Plan had been tested and came into play with the flooding of the server room. With the shift to cloud-based computing, much of that responsibility has been shifted to Rackspace.
- In 2016 the SLA’s server room flooded, causing water damage to several subsequent floors to the ground, including the 18<sup>th</sup> floor SLA offices and its server room. While staff were removed from the office, the server room continued to function, providing uninterrupted service to brokers submitting their filings. While the server room was under repair, the SLA was able to successfully fail over to its disaster recovery site in Arizona and

operations resumed with little downtime. While this incident presented a significant disruption to local operations, it served to confirm that SLA's physical security measures were adequate. Concerns about similar incidents in the future have been mostly addressed by moving operations to the cloud.

2017 brought significant changes and challenges to the SLA:

- The SLA office moved from its office on California Street to two new office locations:
  - One a few blocks away on Battery Street in San Francisco, primarily housing Financial Analysis and E&C staff
  - Another primary site in San Ramon housing Data Analysis operations and all administrative and executive functions
  - System administration and support staff are deployed at both locations
  - Both new facilities demonstrate appropriate physical security
- IT operations shifted from local to cloud-based support, with primary database computing hosted by Rackspace and other functions hosted by Amazon Web Services (AWS). While SLA plans to move all operations to AWS in 2020, there are advantages associated with outsourcing much of the IT infrastructure, including:
  - The risks associated with local disasters, such as the known risk of earthquakes in San Francisco or even the office flooding noted above, have largely been removed or mitigated. The Rackspace locations used to host SLA are in Texas (primary) and Virginia (secondary) and offer state-of-the-art security, cooling, and fire protection. That the hardware at Rackspace is dedicated to SLA means that the equipment is not shared with other entities.
  - Onsite network hardware has downsized from an entire room to the equivalent of a closet at each location. The cloud-based infrastructure also provides a relatively secure telecommuting environment, which was needed during the staffing increase in 2017-18. During our examination in March 2020, SLA moved all employees to telecommuting status in response to the COVID-19 pandemic.
- IT plans another disaster recovery test after transitioning from Rackspace to AWS in 2020.

Regarding intrusion security:

- The system and network architecture in place includes firewall layers to Rackspace to guard against malicious intrusion. As well, the Virtual Local Area Network (VLAN) design includes various protected "zones" – designated as Infrastructure, Security, and Peer Levels – to effectively sequester data.
- Rackspace also hosts the SLA website with appropriate controls. SLA plans to transition the website to AWS along with its core systems.
- Virus protection is in place regarding the desktop environment, primarily using Kaspersky, a top provider. Along with the broker and insurer data that must be protected, the most common hacking events target personally identifiable information (PII). It appears that the data collected and maintained by SLA does not contain a large volume of PII. For instance, one such risk is when an individual broker uses their social security number (SSN) in lieu of an IRS-provided company identifier (FEIN); the association between a

name and a SSN exposes that broker to personal risk. SLA is aware of such risks and continues to monitor for malicious intrusions.

- IT plans a thorough intrusion detection test along with its disaster recovery test, after transitioning to Amazon in 2020.

Regarding IT policies and procedures:

- Onboarding and termination procedures are in place, resulting in up-to-date network access and password listings. Termination processes include revoking all access to SLA operations.
- SLA has a strong and relatively thorough electronic media policy statement, included in the Employee Handbook.
- Password policies are in place and have been upgraded to match the requirements in place with Rackspace. Desktop passwords include mandatory updates every 90 days, and complexity requirements are fairly strong. Members using SLIP must update their passwords every six months.

### ***The implementation of a new information system was problematic***

SLA implemented a new core information system supporting the Data Analysis Department in June of 2016. The new system represented a significant expansion and upgrade to the RAPID system, already used by the Financial Analysis Department, as well as a replacement of the EAS system used by Data Analysis to review policy filings submitted by brokers.

The new system was developed and implemented in conjunction with Infinity Software Development, Inc., of Tallahassee, Florida. Recognizing needed improvements to the prior EAS system, working with Infinity made sense because SLA was already using their proprietary RAPID system to support FA functions, and other states, particularly in the Western U.S., were already working with Infinity to expand the functionality of RAPID to review and store policy documents. Implementation of RAPID in California followed that of other states, and included more, and more complex, system specifications.

Following the system implementation, SLA was confronted with a 4-month backlog of submitted policies. This backlog represents a delay in registering important tax and stamping fee data, as well as a delay in invoicing brokers for the policies they submit.

Discussions with IT suggest a few causes of, and lessons learned from, the system upgrade:

- Geographic distance hindered SLA's efforts to closely monitor the progress of system development. While there was a level of continuous contact by SLA's project management, and Infinity project managers would be on site at SLA for key project milestones, offsite development presents a challenge for clients such as SLA to track and verify true project progress, and to be made aware of minor delays that can become significant problems. Working with developers across the country is not the same as working those across town.

- Turnover within Infinity’s project management team as the “go-live” date approached disrupted the established communication channels. While SLA appreciated the expertise of the initial system architect and project manager, turnover while approaching a key juncture in the project appears to have resulted in diminished communication regarding implementation issues. Of course, in the role of a client, SLA is largely unable to control the departure of vendor staff.
- Prior to the new system the backlog was largely unknown. Previous business processes were primarily paper-based, and included managing a relatively huge inventory of paper needing to be scanned prior to review by data analysts. As well, processing was previously based on batch submissions. A batch submission might include anywhere from 1 – 70 policies. As such, a visual scan of rooms full of boxes of paper could not be accurate since registering a single box might require a few days or a few weeks.
- The prior system did not online data to accurately measure any backlog. Further, the delay between a broker’s submission and their receipt of the relevant invoice was not a significant problem or concern raised by brokers.
- Before going live DA staff invested time to scan the inventory of policies received using high speed scanners. This investment of staff time may have added to the backlog - delay in processing – as time was taken away from reviewing and registering the submitted policies. The need to scan paper submissions continued as SLA worked to encourage the use of SLIP for online submission, though now virtually all submissions – estimated at 98% - are digital in nature, either through SLIP or in an electronic format such as PDF.
- Once live, DA staff would face a learning curve in their use of the new system. Even the smoothest system implementation includes delays as staff learn new business processes.

Enhanced data in the new system allowed SLA to accurately measure its backlog. To some degree the new system both discovered and added to a significant delay in SLA’s processing of surplus line policies, as high as 120 days between receipt and registration. See Finding #1.

#### ***IT continues to support filing and security review processes***

When SLIP 2.0 went live in September 2013, as a replacement of the broker extranet, electronic filings were estimated at roughly 10%. In other words, seven years ago 90% of the broker filings were hard copy. As of early 2020 paper filings are estimated at less than 2%. Electronic filing, especially the use of SLIP but also the acceptance of electronic documents in PDF format, reduces the need for data entry and clean-up, and allows Data Analysis efforts to more appropriately focus on reviewing and registering filings. While electronic filing remains voluntary for brokers, some (i.e., the 1-2%) continue to submit paper documents. As noted above for Data Analysis, the rare hard copy submissions tend to come from smaller firms with standalone or unique policies.

RAPID continues to provide support to Financial Analysis, including checklists to ensure a thorough review of each insurer. IT helps manage the FA subscription to A.M. Best and provides online access to NAIC for data not otherwise available. SLA’s financial analysts continue to rely on Excel and Word templates, and their research and analysis data and the actual SSRs are stored locally apart from RAPID.

The RAPID upgrade allowed SLA to expand its data analytics capability, supporting data warehousing via the use of Tableau software. This is a significant improvement since the previous system, EAS, did not effectively validate data submitted by brokers. For instance, the varying use of “Avenue” “Ave” or “Ave.” might generate a duplicate record instead of finding and updating an existing record. RAPID’s validation capabilities support the efficient database needed for effective research and analytics. As well, the database now includes NAIC codes, provided by Experian, which allow policies to be categorized for additional analysis.

The desktop infrastructure is upgraded on an on-going, as-needed basis. In general, hardware is replaced at the end of its depreciated life cycle. The desktop hardware of Data Analysis staff was significantly upgraded with the move to Bishop Ranch, including dual monitors to support the simultaneous assessment of forms, policies and supporting documents.

***Prior audit recommendations related to Information Technology have been addressed***

Three of the four recommendations of the prior audit, published in 2017 and addressing the 2013-2015 time period, involved information technology. The SLA and its IT Department have substantially addressed those concerns.

**Finding #1:**

There was no external cyber security assessment during this review period, nor was one conducted during the prior period. Worldwide the incidence of large corporate and organizational data “hacks” and ransom is increasing at an alarming rate. The SLA stores valuable and sensitive financial data on insurers, and also some sensitive business and personal data included in policy filings.

**Recommendation #1:**

The Information Technology Department should work with the IT Subcommittee to establish a more robust cyber security program. SLA should consider regular vulnerability assessments and the possible need for cyber insurance.

**SLA Initial Response:**

With the recent significant upgrades to the SLA’s technology platform, plans addressing cyber security will be restructured when the SLA is 100% in the Cloud and/or hosted environments, and the new offices are fully operational.

**Update:**

Cyber security has been upgraded as part of the transition to new offices and the infrastructure shift to the cloud. While intrusion monitoring continues, full intrusion detection and disaster recovery tests are planned once the SLA has moved to the Amazon cloud in 2020. One reason provided for delayed testing is that full intrusion detection testing

is expensive, costing \$100K or more, and would not represent the best use of SLA resources for what is planned to be the brief remaining time with Rackspace.

**Finding #2:**

The Employee Manual was updated during this review period and includes a thorough summary of SLA's IT policies and Procedures. This review could not confirm a uniform workforce commitment to SLA policies in general and in particular SLA IT policies.

**Recommendation #2:**

- The Human Resources Department should obtain signature page sign-off from all employees for the current Employee Manual - including sign-off on IT Policies and Procedures - and maintain these in each employee's file.

**SLA Response:**

- HR and IT will review the files with missing signed IT Policy statements and distribute to the pertinent employees for signature and submission to their respective files.

**Update:**

- The Employee Handbook was updated in 2019 and contains sections on the Use of Electronic Media (Section 8.6) and the handling of confidential information (Section 3.1). Both sections are clearly and strongly worded, and the employee sign-off page is saved in each personnel file.

**Finding #4:**

The CDI is considering requiring insurers to file financial statements electronically and is working to establish an automated system to support electronic filings, such as the LASLI project. At present the CDI is taking the lead on these system improvements, developing a system that will include both admitted and non-admitted insurers.

**Recommendation #4:**

SLA should actively work with CDI to ensure that:

- The functionality supports insurers in the non-admitted market
- Functional flaws and bugs are identified and corrected prior to user implementation, minimizing the negative impact on processing
- System implementation and roll-out includes a significant organizational change management strategy and component to train and prepare users for the new system.

**SLA Response:**

- SLA recognizes that allowing insurers to file all required financial documents electronically will benefit not only insurers but the SLA and the CDI as well. The CDI continues to move toward a system which would allow or require insurers to file financial documents electronically, and has restarted the OASIS project with the SLA, now called the CDI-LASLI project. This project is expected to be completed in 2017.

**Update:**

- As the emphasis of this recommendation was on functionality and planning for change, the SVP and AVP of Financial Analysis (Susan, Glenn) have been actively involved and working with the CDI to create this online portal, now called CDI-LASLI, which appears to be functional. FA staff confirm its use and that they also still receive hard copy submissions from insurers as allowed. The CDI website supporting CDI-LASLI includes a summary statement:

*The LASLI Portal is a web-based portal that allows applicants and insurers (or their representatives) to optionally submit and pay for their statutory-required [...] and supporting documentation on-line for initial application, annual renewals, updates and amendments [...] Once submitted, the (portal) will allow sensitive information to be securely shared and reviewed by the LASLI review team, including CDI and the Surplus Lines Association of California (SLA). Applicants will still have the option to file the original applications, annual renewals, and updates in physical form (hard copy).<sup>10</sup>*

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<sup>10</sup> <https://cdi-lasli-portal.zendesk.com/hc/en-us/articles/115002532474-LASLI-Portal-Overview>

## Section 3: Stamping Fee Analysis

**MAINTAINING THE STAMPING FEE AT 0.20% DURING EXAMINATION PERIOD AND INCREASING THE STAMPING FEE TO 0.25% ON JANUARY 1, 2020 WERE REASONABLE.**

Pursuant to CIC Section 1780.56.(b)<sup>11</sup>, the CDI has delegated the SLA authority to charge a stamping fee for each policy, declarations page, cover note, or other premium-bearing document submitted. It further states, “the stamping fee shall be established from time to time by the governing body of the advisory organization, shall reflect all reasonable costs associated with the services provided by the advisory organization, and may be reviewed by the commissioner for reasonableness as part of the commissioner’s examination of the advisory organization.” This section of the report serves as that function.

The stamping fee is calculated as a percentage of the premium charged on each item filed. The specific stamping fee rate is determined by the Director/COO and the Stamping Committee and is approved by the Executive Committee. The stamping fee is set by estimating the total dollar amount of premiums to be processed, and then calculating the percentage required to meet the SLA’s anticipated expenses. The Stamping Committee is comprised of five member brokers that meet four times a year, including Committee Day, and includes reviewing the stamping fee during the annual budget process. The Stamping Fee Committee also reviews the SLA’s budget to analyze the reasonableness of operating costs. To determine if the stamping fee needs to be changed, the Director/COO and Controller present scenarios with various expected premium levels, operating expenses, and stamping fee rates.

Revenues generated from stamping fees are the primary source of income to support SLA’s operating costs, special projects including new computer systems, and maintenance of reserve funds from year to year. The history of the stamping fee’s specific rate includes:

Schedule of Past/Present Stamping Fee Rates			Rate
January 1, 2020	to	Present	0.25%
January 1, 2013	to	December 31, 2019	0.20%
February 1, 2010	to	December 31, 2012	0.25%
January 1, 2009	to	January 31, 2010	0.35%
January 1, 2008	to	December 31, 2008	0.25%
January 1, 2007	to	December 31, 2007	0.23%
January 1, 2006	to	December 31, 2006	0.13%
January 1, 2004	to	December 31, 2005	0.13%
January 1, 2003	to	December 31, 2003	0.18%
January 1, 2001	to	December 31, 2002	0.23%
January 1, 1996	to	December 31, 2000	0.13%

**Table 3.1**

<sup>11</sup> Except as otherwise provided in the CIC, the stamping fee may not exceed three-fourths of one percent (0.750%) of the premium for the insurance. It has never exceeded this threshold.

During the prior performance audit (2013—2015), SLA experienced a rather small (3%) increase in stamping fee revenues over the three-year period. The market trends showed faster growth during this examination period (2016—2018): the number of policies and the total amount of premiums increased, as did stamping fee revenues.

Historically, when SLA's undesignated reserve funds have exceeded 20 percent of the Board's designated assets, SLA has decreased the stamping fee and drawn from these prior excess revenues to finance operations. SLA policy continues to require that the stamping fee be adjusted when total reserve funds vary by more than 50% of the Board-designated levels. That is, adjustments to the stamping fee would be based on both the operations budget and the amount of reserve funds desired to be drawn down. Table 3.2 shows how premiums processed and stamping fee revenues have increased during the examination period, while the stamping fee remained stable at 0.20%. However, since the SLA has committed to stabilizing the stamping fee, and is more actively managing expenses, that historic approach has not held during this examination period, as the undesignated assets (surplus reserves) were 23-27% above the Board designated totals – see Figure 3.5, below. The premium values processed, stamping fees, and associated revenues for 2016 through 2018 are shown in Table 3.2.

#### Premiums Processed and Stamping Fee Revenues

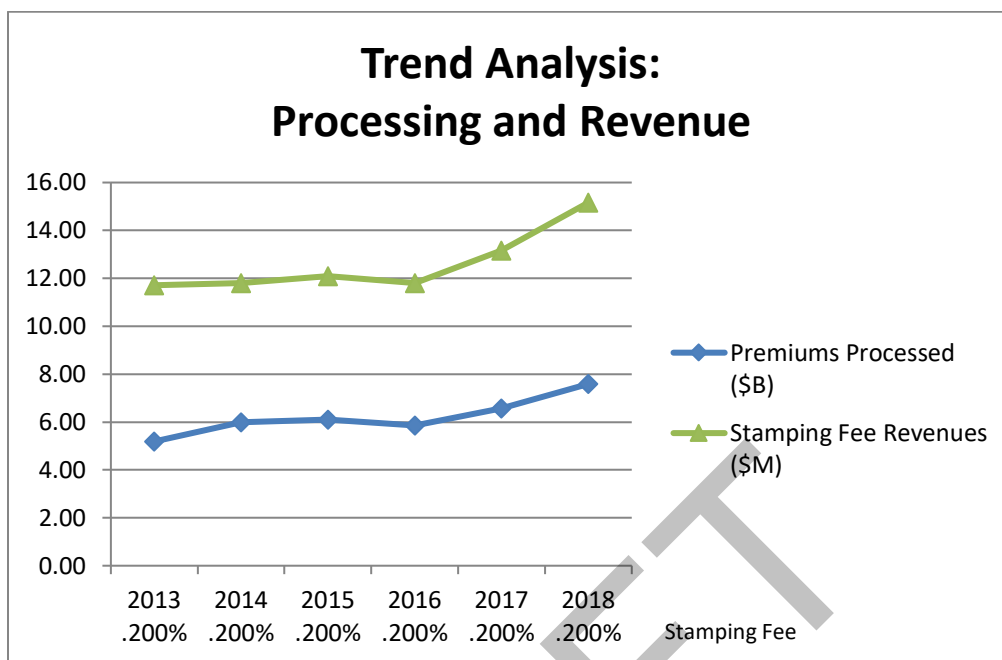
Premiums Processed and Stamping Fee Revenues			
	2016	2017	2018
Premiums Processed	\$5,854,354,375	\$6,573,446,567	\$7,587,853,048
Stamping Fee	0.20%	0.20%	0.20%
Stamping Fee Revenues	\$11,795,883	\$13,150,096	\$15,161,685

Source: SLA Financial Statements

**Table 3.2**

Figure 3.1 below shows how premiums processed and stamping fee revenues have increased over the examination period at a faster rate than the prior period.

Figure 3.1: Trend Analysis: Processing and Revenue



Source: SLA Financial Statements

Figure 3.1

**The process used to assess the Stamping Fee is sound**

As the stamping fee is the primary source of income to support SLA’s operations as a non-profit, we approached the assessment of a “reasonable” fee as one that is determined by a sound process supporting the fiscal health of the organization. Therefore, the fee should generate revenue to address both expenses and the reserves necessary to maintain the financial stability of the organization in an unforeseen event. It should also be consistent with best practices and with current reserve policies.

One key component in determining the appropriateness of the stamping fee is the revenue assumptions and projections used, particularly projected operating costs and projected premium volume. To understand and assess the methodology used to set the stamping fee, we met with the Director, confirmed our understanding with a member of the committee, and examined documentation supporting the economic projections and the resulting revenues and expenses for each year.

Perhaps the most significant change within the SLA during this period was the commitment to a goal of minimizing changes to the stamping fee – to manage the SLA based on revenues tied to a 0.20% fee as much as possible. As of 2018 the fee remained stable at 0.20% and was increased as of January 1, 2020 to 0.25%. When the stamping fee is set at a stable rate, revenues are determined by total premiums on policies and items filed. As such, this requires the SLA to manage expenses closely. As shown below in Table 3.3, *Revenues, Expenses and Assets for 2014 through 2018*, and in Figure 3.3, *Revenues vs. Expenses*, expenses exceeded revenues for all three

years in the examination period, as during this period expenses were more volatile than revenues.

The Stamping Fee Committee continues to meet three-four times per year to discuss environmental changes and determined that adjustments to the current fee were needed as of January 1, 2020. The Board has established reserve fund limits: when the total amount of reserve funds varies by fifty percent from board-designated amounts, the Committee must take immediate action to correct the surplus or deficit. Between meetings, committee members track market trends and events that may impact policies written or premiums collected. When the budget for the upcoming year is discussed, the Director and the Controller present varying scenarios. The Committee votes and reaches consensus on the predicted premium levels. One tool used by the Committee is a Stamping Fee Worksheet correlating processed premiums against proposed budget and expenditures, to simplify the calculation of the desired stamping fee. The Committee's process/methodology for setting and changing the fee is sound, including a thorough examination of SLA past and anticipated revenues and expenses, and regular environmental scans for industry trends and anticipated volumes and premiums.

### ***Financial statement analysis supports a stable stamping fee for the period***

Another key component in assessing the reasonableness of the stamping fee is an assessment of the fiscal health of the organization. A financial statement analysis is important to boards, managers, and stakeholders who make decisions on fee increases. Our analysis shows SLA experienced a steady increase in revenues during the three-year examination period. However, as mentioned above, the expenses increased by a larger margin in each of the three years, primarily from increases in salaries and benefits. The SLA realized a sharp decrease in surplus for the examination period, from \$2.5M in 2016 to \$488,459 in 2018. While the overall level of net assets hovered around \$14M prior to this examination period, between 2016 and 2018 total net assets averaged closer to \$11M. The Board designates that reserves be maintained for specific categories, displayed in Figure 3.4. These reserves represent the firm's total assets and are held and invested in various certificates of deposit and agency and corporate bonds – conservative, interest-bearing instruments.

### **Revenues, Expenses and Assets for 2014 through 2018**

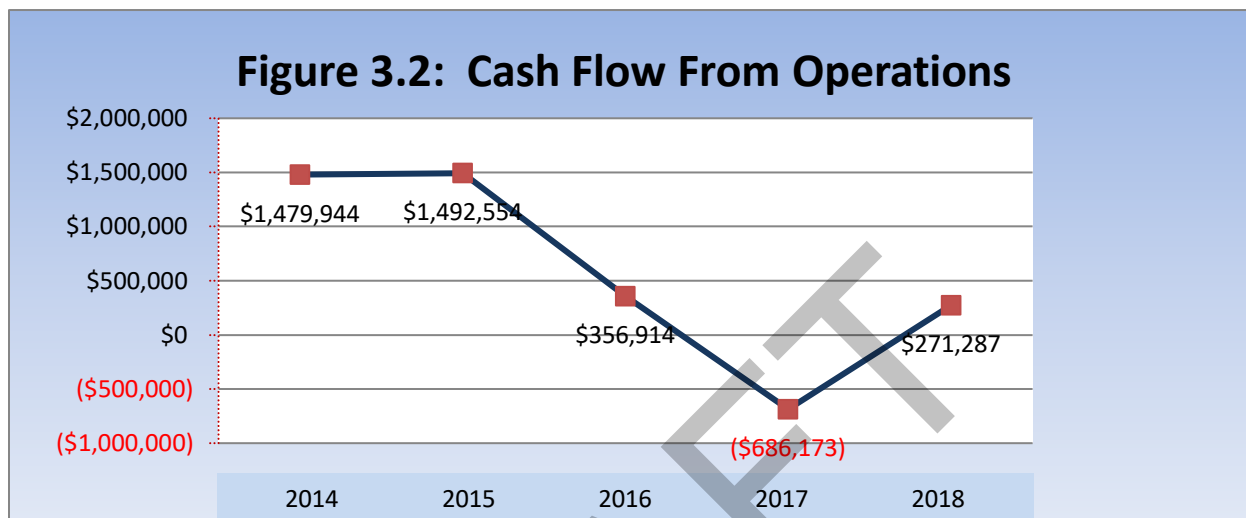
	Fiscal Year				
	2014	2015	2016	2017	2018
Total Revenue	\$11,791,910	\$12,081,286	\$11,975,883	\$13,150,096	\$15,161,685
Total Expenses*	\$11,194,971	\$13,099,107	\$12,526,266	\$14,506,146	\$17,880,376
Change in Net Assets	\$596,939	(\$1,017,821)	(\$550,383)	(\$1,356,050)	(\$2,718,691)
Beginning Fund Balance	\$14,034,465	\$14,631,404	\$13,613,583	\$13,063,200	\$11,707,150
Ending Fund Balance (Net Assets)	\$14,631,404	\$13,613,583	\$13,063,200	\$11,707,150	\$8,988,459

Source: SLA Audited Financial Statements for Years 2016 - 2018; prior report for 2014-2015

**Table 3.3**

\* Total Expenses = Total Operating Expenses - Other Income

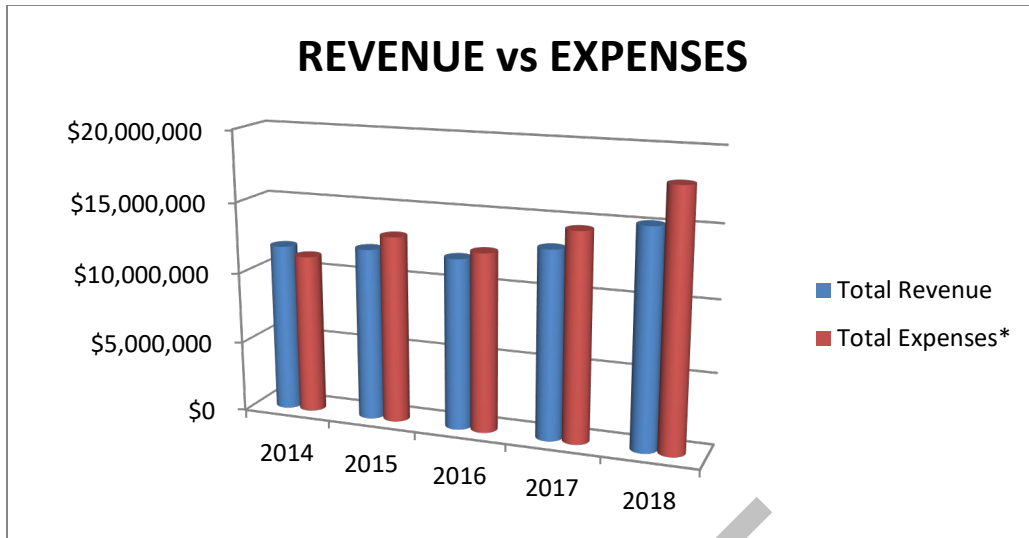
Small deficits may not be significant if an organization has adequate expendable assets, but large deficits or losses are usually a warning signal that major program or operational adjustments should be made. While SLA’s revenues increased during the examination period, Figure 3.2 shows that the operating expenses during the same period increased exponentially, most notably in salaries and benefits and professional services. Figure 3.2, below, shows that cash flow from operations fluctuated but remained generally significantly lower than in the prior period.



Source: Audited Financial Statements for 2016-2018.

Figure 3.2

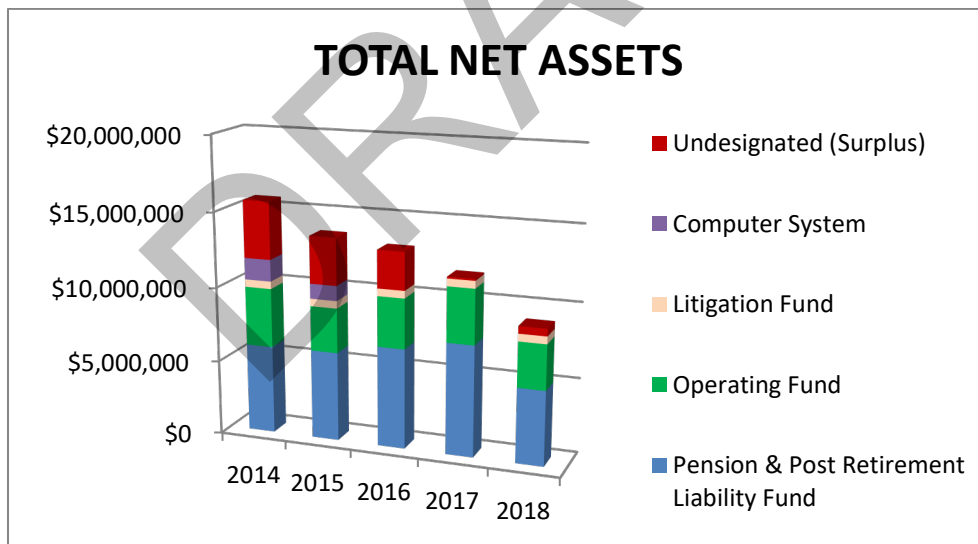
As shown above and in Figure 3.3 below, SLA’s revenues increased each year during the period, however in each year expenses exceeded revenues. SLA was able to weather this surge in expenses because the reserve fund balance had grown significantly during 2013 – from roughly \$11 million to just over \$14 million. Figure 3.3 below displays the results of the Stamping Committee’s efforts to match revenue to expenses during the examination period, as well as the years preceding the current examination period. Understanding that total revenue is based on the stamping fee and is somewhat predictable, and that expenses can be managed throughout the year, for the fiscal year ended November 30, 2018 the SLA is operating with both higher revenue and higher expenses.



\* Total Expenses = Total Operating Expenses - Other Income.  
Source: SLA Financial Statements

Figure 3.3

Figure 3.4 below shows how the SLA’s reserve fund is actually three different designations (four in preceding years) plus undesignated surplus funds and has generally decreased each year of the examination period. The undesignated assets have not been earmarked for a specific purpose or activity.

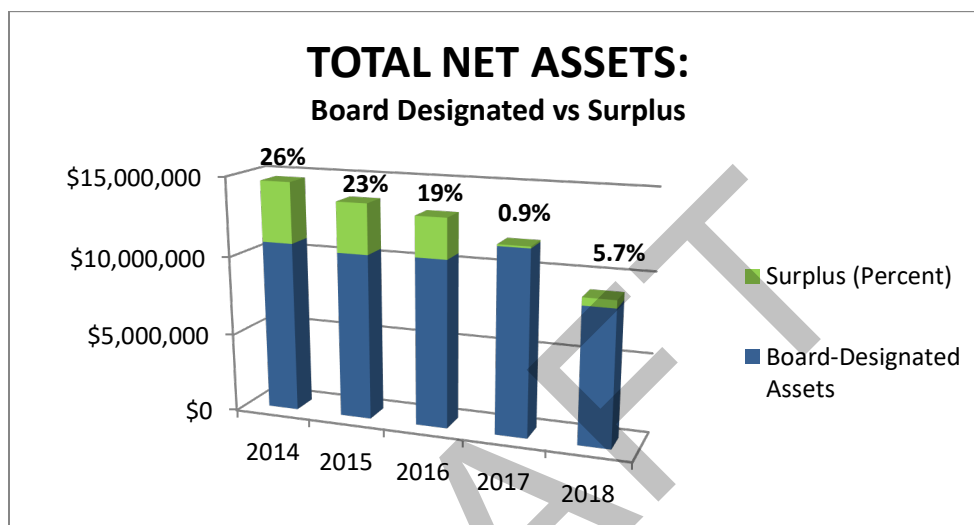


Source: SLA Financial Statements

Figure 3.4

Figure 3.5 below summarizes the designated and undesignated assets for 2014 through 2018 (the examination period plus two years prior). In years when there is a deficit, SLA funds any operational expenses that exceed revenues from undesignated net assets. Thus, in the three-year examination period, when expenses exceeded revenues, this deficit could be funded from undesignated/surplus funds without significantly impacting the operating fund. The growth of the SLA reserves in prior periods, including both designated and undesignated assets, included

an increase in the overall surplus, not more than 20%. These reserve funds, retained as cash and short-term investments, generate income. As the SLA stamping fee approach changed from one of (A) *setting and adjusting* the fee to cover SLA operating costs plus reasonable reserve funds, to (B) *attempting to maintain* the stamping fee at a reasonable level that will cover SLA operating costs, it allowed for healthy and sufficient reserve and contingency funds to apply to periods of higher than normal and unexpected expenses. However, the steady increase in expenses exceeding revenues has significantly decreased the undesignated surplus over the examination period.



Source: SLA Financial Statements

Figure 3.5

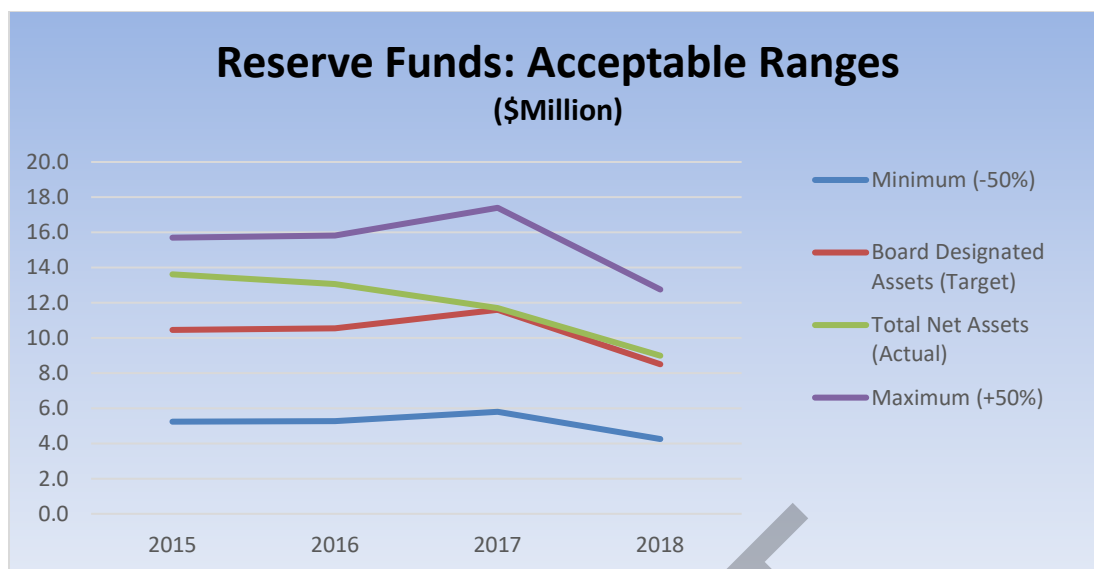
### ***Operating reserves were maintained within Board-designated ranges***

The Executive Committee has designated a target amount for total net assets, including each reserve fund, and has also designated an acceptable range within which the actual reserve funds must fall. This policy states that the reserve fund is established by setting aside:

1. Operating fund: three months of average expenses
2. Contingency fund: six months of average expenses
3. Litigation fund: \$500,000

Management's objective is to maintain current net assets within 50 percent of the three funds as calculated. Should the level of current net assets rise or fall outside the acceptable range, the Stamping Fee Committee is charged with proposing immediate changes to the Executive Committee, so that the Stamping Fee might be changed to ensure a proper level of reserve funds.

We assessed whether the SLA's level of net assets exceeded or fell below the prescribed range, as required by SLA Board Policy. We performed calculations to show the acceptable range of the reserve funds based on the reserve policy. For all years in our examination, the reserve funds remained within the designated range, as shown in Figure 3.6 below.



Source: SLA Financial Statements

Figure 3.6

### FINANCIAL ANALYSIS INDICATES THAT SLA IS FISCALLY SOUND

Beyond assessing the specific process, assumptions, and financial indicators underlying the stamping fee, another concern is the organization's general fiscal health, typically assessed via ratio analysis<sup>12</sup>. In this case we reviewed financial indicators to assess revenues and expenses, and their impact on the organization in order to provide additional evidentiary support for maintaining the stamping fee.

- One important ratio that would indicate a decline in the health of the organization is the Viability Ratio. As a basic indicator of financial strength, this ratio was well above benchmark levels for all three years examined.
- A second important indicator is the Net Income Ratio, which assess whether the organization was able to live within its means for the year. For each of the three years examined, expenses significantly exceeded revenues, which can be a cause for concern when continued over multiple years as it impacts cash flow and cash on hand.

Overall, in our analysis of financial indicators we found that SLA is healthy in certain current ratios but has averages of financial indicators regarding cash and net income well below the targets for non-profit organizations<sup>13</sup>. The Net Income ratio, as noted above, is the sole indicator that

<sup>12</sup> Careful judgment must be taken when interpreting financial ratios. On their own, financial ratios do not always provide a complete picture of the organization's performance. However, when used in conjunction with other quantitative and qualitative measures, it can provide valuable insights into the organization's operations.

<sup>13</sup> Mark Krawczyk and Jim Washam, *Using Ratio Analysis to Improve Performance*, presentation to the Treasury Institute for Higher Education, 2004. Clyde P. Stickney, Roman L. Weil, Katherine Schipper, and Jennifer Francis, *Financial Accounting: An Introduction to Concepts, Methods and Uses*, 2010, pp. 265-272. Dr. Marian W. Boscia, *Guidance for Using Financial Ratios to Analyze Financial Statements*, King's College, 2007, p. 2.

showed below-target levels in any single year. The specific financial ratios identified in Table 3.4 are defined and illustrated in Figures 3.7 through 3.11.

#### Key Financial Ratios Used for Non-Profit Financial Assessments

Key Ratio	2016	2017	2018	Benchmark	Above/ Below Target	2016- 2018 Average
Viability Ratio	1.82	0.88	0.40	>.40	↑	1.03
Net Income Ratio	-0.05	-0.10	-0.18	0.03–0.05	↓	-0.11
Cash Flow from Ops to Current Liabilities	0.25	-0.49	0.17	> 0.40	↓	-0.02
Cash Flow from Ops to Total Liabilities	0.07	-0.13	0.04	> 0.20	↓	-0.01
Current Ratio	7.14	6.64	4.90	> 1.0	↑	6.23
Acid Test	2.31	1.87	1.69	> 1.0	↑	1.96
Days Cash on Hand	50	10	19	> 90	↓	26

Table 3.4

These ratios show SLA has current assets that exceed current obligations, but that the obligations are being funded through the reserve surplus. These ratios support that an increase in stamping fee would enable the SLA to meet its immediate obligations and be financially stable. The Days Cash on Hand was below the target range for all three years in the examination period.

The Viability Ratio is a basic indicator of financial strength, measuring the organization's availability of liquid assets to meet financial obligations as they come due. Total net assets have decreased steadily in each of the three years as the net assets are being used to meet financial obligations. SLA's low level of long-term debt in comparison to expendable assets indicates they are able to pay their debt with available liquefiable assets, and for this ratio were well above the target ratio.

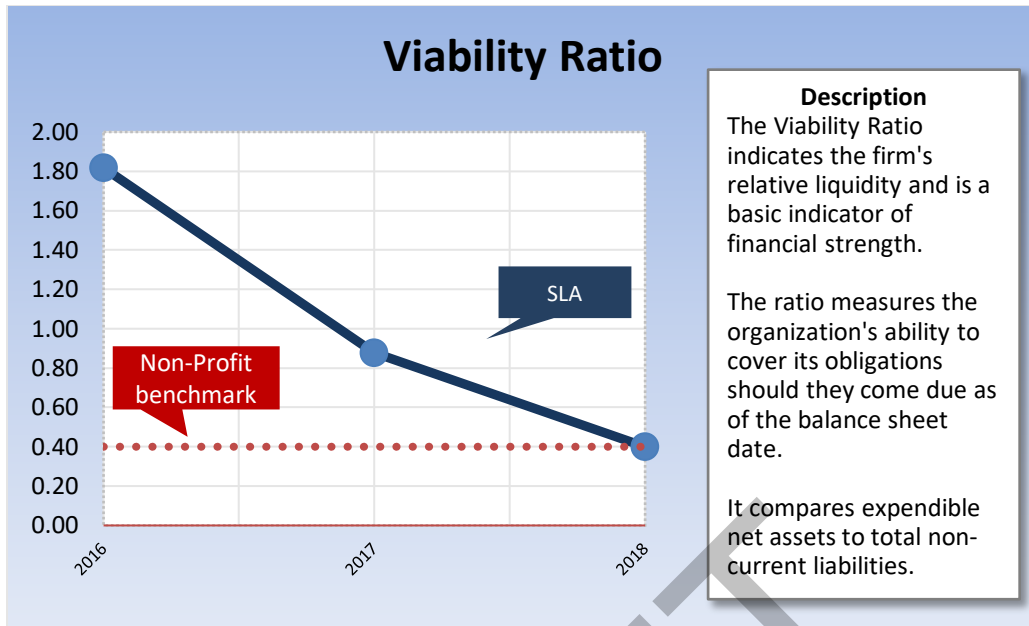


Figure 3.7

Due to fluctuating asset levels from one year to the next, SLA experienced negative net income in each of the three years, as shown in Figure 3.8. The Net Income ratio is a comparison of the change in unrestricted net assets against total unrestricted income. The target range for net income for a non-profit organization is from 0.03 to 0.05. A negative ratio indicates a deficit or loss for the year. Small deficits may not be significant if the institution has large expendible undesignated net assets, but large deficits or losses are usually a warning signal to be heeded. The three-year average for this ratio was -0.11, well below the target range, suggesting that the organization did not live within its means.

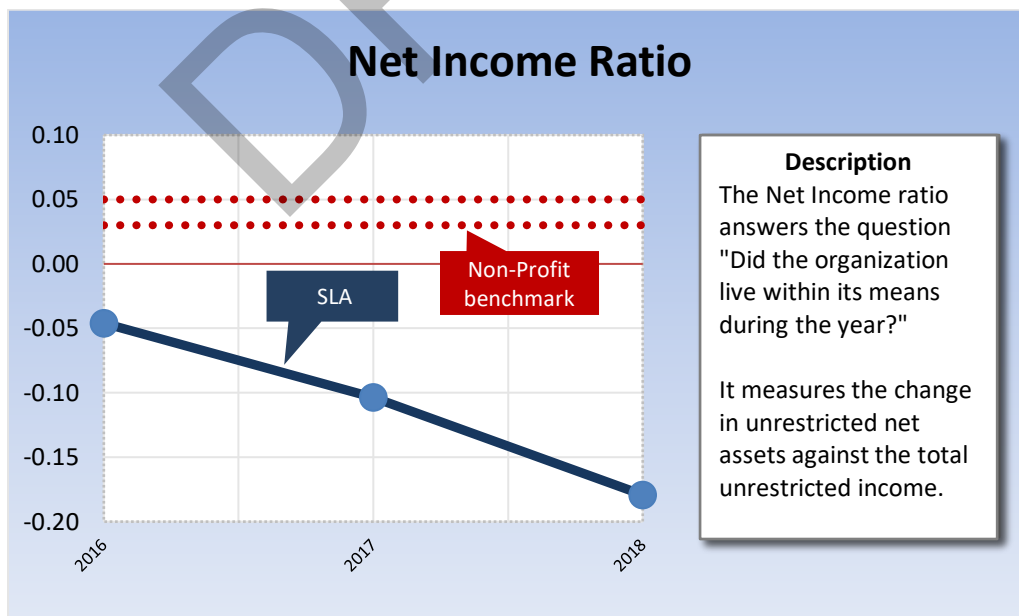


Figure 3.8

The Current ratio depicts the organization's ability to meet its short-term obligations with available assets. Ratios ranging from 4.90 to 7.14, and averaging 6.23 for the period, as shown in Figure 3.9, show that SLA has the ability to meet its short-term obligations, such as account payables and payroll, and remained well above the target level of 1.0 for the three-year period.

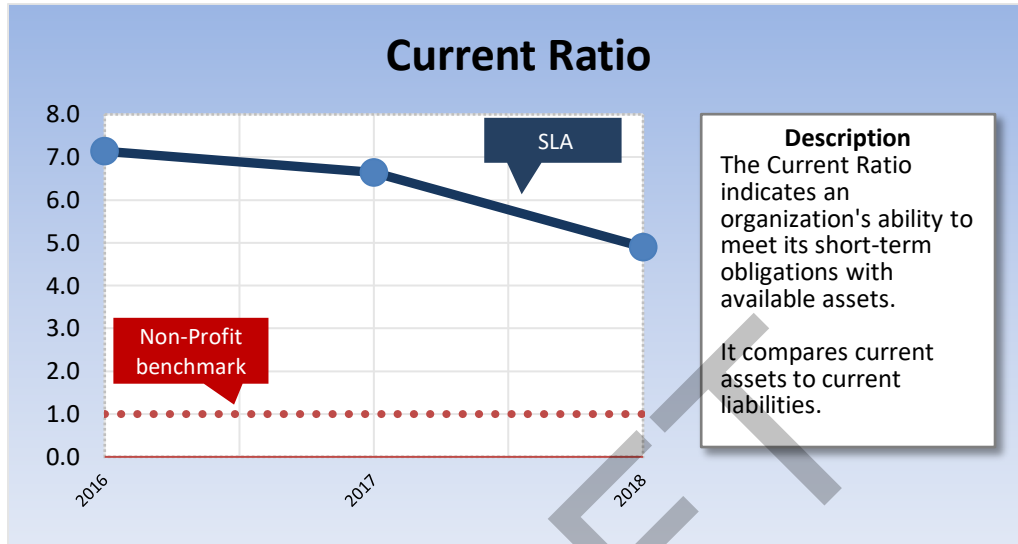


Figure 3.9

The Acid Test ratio, a more stringent indicator than the Current ratio, also indicates the organization's ability to meet short-term obligations, as seen below in Figure 3.10. As with the Current Ratio, it is well above the target of 1.0 for all three years under examination and ranged from 1.69 to 2.31. Instead of considering all available assets, the Acid Test ratio only considers available assets that can be quickly converted into cash.

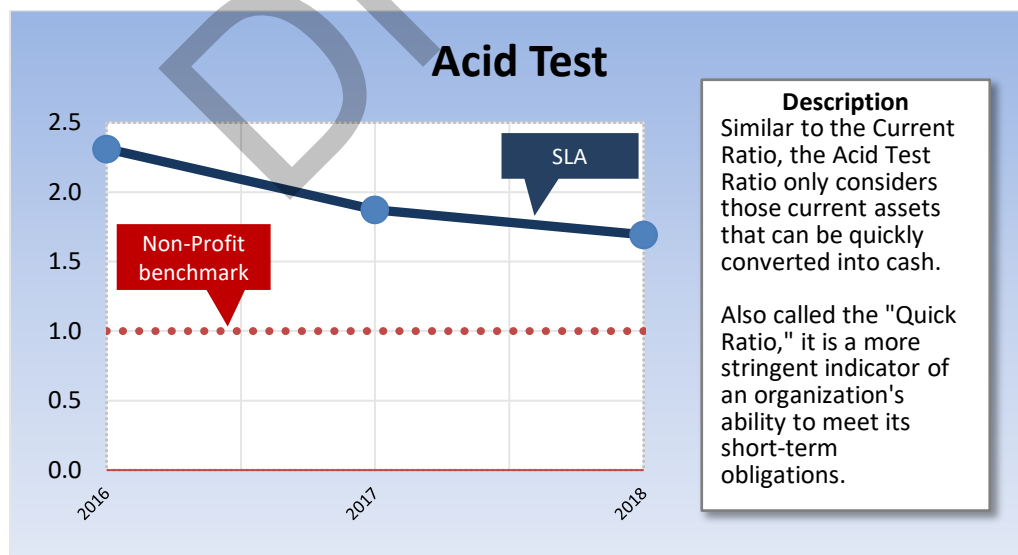


Figure 3.10

The Days Cash On Hand ratio measures the number of days of average expenses that the organization maintains in cash and is a measure of total liquidity, short and long-term. As shown

in Figure 3.11, during each of the three years of examination SLA fell below the *optimal* level of available cash on hand to pay expenses. Overall, for the current examination period, cash and equivalents were maintained at *half* that of levels from prior periods. The interpretation is that overall expenses in 2016-2018 meant care regarding operating expenses such as accounts payable and payroll.

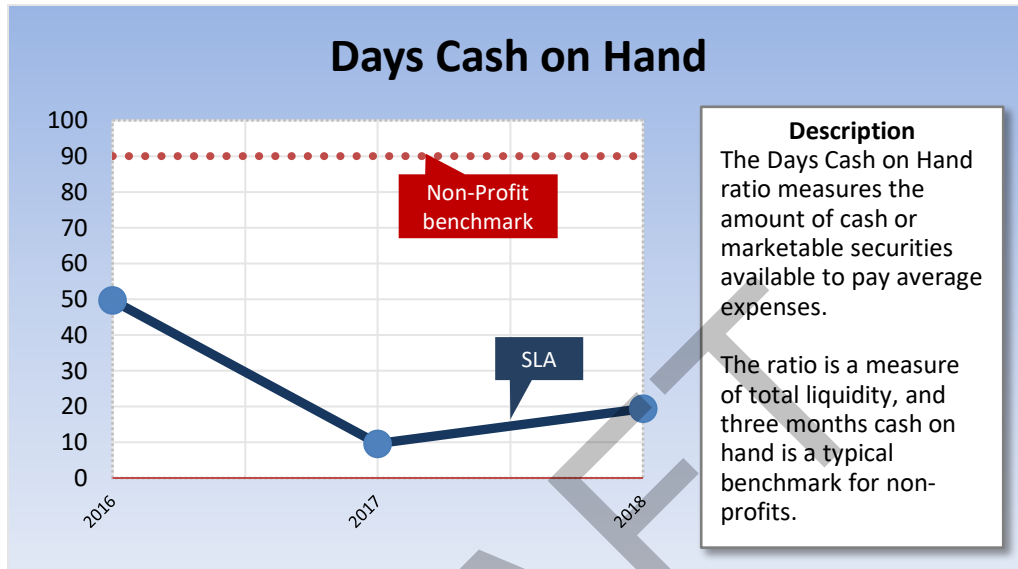


Figure 3.11

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## Section 4: Conclusions

As in prior years, SLA has continued to maintain compliance with governing CIC sections and its own Plan of Operation. SLA has implemented each of the prior recommendations that remained applicable. SLA continues to implement more automated technologies and systems and is well positioned to continue serving the surplus line market in California. SLA has implemented upgrades to systems, software, and hardware continuously throughout the examination period including a significant cutover from the prior EAS system to an expanded and cloud-based RAPID system. The SLA has made significant improvements to the content, style, and functionality of the SLA's web site, making it more user-friendly and useful to members as well as to the general public.

From a management perspective, SLA has knowledgeable, experienced department vice presidents with extensive institutional knowledge of their respective areas and back-up staff able to perform all functions. Transitions at the vice president level of key departments, including Financial Analysis, Data Analysis, Education & Compliance, Public Affairs and Digital Communications appear to have been managed well.

SLA continues to inform and represent the broker community regarding pending legislation, advises the CDI on surplus line issues, and regularly interfaces with other SLAs, federal and state legislators, and the admitted market.

In 2013 the SLA heard from its members that the *level* of the stamping fee was less important than the *frequency* of changes: members were clear that fewer changes to the fee level would be greatly preferred. At the same time, during this examination period the economy continued to recover from its recession, and the forecasts of premium volumes were accurate. SLA continued to demonstrate strong fiscal health while maintaining the same level of service to members. We found the continuation of the stamping fee at 0.200 percent throughout the examination period to be reasonable based on the financial conditions SLA experienced, however that an increase in the stamping fee to 0.250 percent as of January 1, 2020 was reasonable to address expenses exceeding revenues in each of the three years examined. SLA successfully maintained reserves at levels consistent with the Board Policy, showing strong financial management. Changes in asset levels were correlated to management of the pension fund, which was frozen during the period and continues to be managed and discussed by the Board and the Executive Committee.

## Section 5: Findings and Recommendations

### Finding #1:

During the review period SLA discovered and addressed a significant backlog in the processing and registering of policy filings received from brokers.

### Recommendation #1:

SLA should continue to actively work with its system vendor, Infinity, by identifying a specific project manager to manage the relationship as well as ongoing improvements to the system. SLA should continue to meet with other states' SLAs using RAPID to identify and cooperatively coordinate improvements to the system. Principles of IT and organizational change management should be incorporated into SLA's strategic IT plans.

**SLA Response:** In 2019, the SVP, DA and Technology promoted a senior developer to Assistant Vice President and specifically assigned her that role. The AVP is a graduate of Stanford University's PMP program and a certified project manager (CPMP). The AVP closely manages all Technology projects with external vendors, as well as develops scope, schedule, and costs for each initiative.

# Appendix A: Objectives, Scope, and Methodology

The objectives of this report were to (1) determine the extent to which SLA complies with applicable sections of the CIC and the SLA's Plan of Operation; (2) evaluate the SLA's internal controls; (3) determine the extent to which SLA has complied with the recommendations made in the previous triennial performance audit report; and (4) assess the reasonableness of the Stamping Fee at 0.200 percent of premiums and the increase in 2020 to 0.250 percent of premiums.

Based on this work, we were asked to develop recommendations to increase operational efficiency and effectiveness.

The scope of this examination included SLA operations during calendar years 2016 through 2018. Our assessment of the stamping fee and the SLA's fiscal health are based on the SLA's financial statements for each fiscal year; the SLA's fiscal year is December 1 – November 30.

To assess SLA's adherence to its Plan of Operation and the relevant CIC sections, and to examine the internal control environment, we reviewed the CIC, SLA's Plan of Operation, and prior triennial performance audit reports. We interviewed the manager in charge of each service line along with other staff as needed, and also the Director/COO, the Executive Director, the HR and Communications Managers, and the Chair of the Stamping Fee Committee. We reviewed existing policy and procedure manuals for Accounting, Data Analysis, Financial Analysis, and the Employee Handbook, and compared them to the appropriate CIC sections. For these same departments, we documented our understanding of their internal controls, and then tested these controls to ensure that the departments carried them out according to SLA's Plan of Operation:

- For Data Analysis, we collected a haphazard sample of 216 batch filings, across all three years examined. We reviewed each batch for compliance with the specific CIC sections guiding the examination of Data Analysts.
- For Financial Analysis, we examined a haphazard sample of 25 SSRs for consistency, completeness, organization of information gathered in annual, interim and quarterly financial documents as they were assessed for compliance with applicable filing and eligibility standards.
- For Education and Compliance, we examined the listing of CPE classes and seminars provided for appropriateness and variety of topics, attendance, and certificates issued to participants, as well as staff visits to and online meetings with brokers.
- For IT, we reviewed the internal control environment to assess SLA's information management systems, processes, and policies. We reviewed control elements that together ensure a secure physical environment, a secure data environment, prevention of unwarranted intrusions, and adequate policies and procedures covering all SLA system users.

To assess the reasonableness of the stamping fee, we viewed the process in place to determine the fee, forecasted premium volumes at various stamping fee rates, and conducted an independent fiscal health analysis by reviewing the SLA's audited and other financial statements to assess whether the revenues associated with the continued fee level, together with forecasted and actual premiums, provided sufficient operating reserves to ensure financial stability of the organization. We assessed the extent to which SLA financial indicators changed, which provided additional justification to the fee. As part of the fiscal health analysis, we reviewed the operating reserve levels to ensure they were aligned with best practices for non-profits and with SLA's reserve policy.

Our examination was conducted between the Entrance Meeting on December 12, 2019 and receipt of management representation letter signed June 5, 2020. A draft version of this report was provided to SLA on April 20, 2020. SLA has accepted our conclusions and recommendations.

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