



Office of the Internal Auditor



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AUDIT REPORT

Traditional Reinsurance Audit

November 16, 2016

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Executive Summary

Background

To manage the financial impact of large weather events, Citizens has utilized traditional reinsurance, together with capital markets risk transfer, as an integral component of the risk transfer strategy. Traditional reinsurance is a historically proven financial tool that can help Citizens manage large and difficult to predict financial impacts by transferring losses to other organizations which can free up capital or provide additional stability to manage potential shocks. Simply stated, reinsurance is insurance for insurance companies.

From the inception of Citizens, the practical consideration of traditional reinsurance has been required by statute to “make its best efforts to procure catastrophe reinsurance at reasonable rates, to cover its projected 100 year probable maximum loss as determined by the Board of Governors”. Citizens overall risk transfer strategy also contemplates Citizens’ surplus in the Coastal, Personal lines and Commercial lines accounts, coverage provided through the Florida Hurricane Catastrophe Fund (also known as the CAT Fund) and catastrophe bonds issued through Everglades Re Ltd. With all components of risk transfer strategy in place for 2016 Citizens is prepared to cover a 1 in 100-year probable maximum loss event within each of its three accounts.

State wide hurricane assessments from catastrophe hurricane events of 2004 and 2005 were eliminated in 2015. Decreasing the likelihood of hurricane assessments going forward is a high priority for management. Citizens’ use of traditional reinsurance in addition to capital markets risk transfer, during the lull in hurricane activity from 2005 through 2015 and management taking advantage of historically low reinsurance rates contributed to Citizens’ improved financial stability. In turn this reduced the likelihood, and in fact eliminated the likelihood in 2015, that a probable maximum loss from a 1 in 100 year storm will cause a state wide assessment.

As of September 2016 Citizens’ traditional reinsurance agreements provide \$443 million in single event coverage for commercial and personal residential losses and \$221 million in single event coverage for commercial non-residential losses. The traditional reinsurance agreements are single year excess of loss contracts applied specifically to risks from a named storm which includes wind, hail, rain, tornado, cyclone and hurricane to policies in the Coastal account across the State of Florida. The Coastal account, in comparison to the Personal and Commercial lines accounts, bears the greatest potential wind risk and is the account in which traditional reinsurance is utilized. The risk transfer strategy is reviewed annually to adjust for market conditions and strategic goals.

The following chart illustrates risk transfer trends since 2012 and how overall market pricing declines has assisted Citizens in purchasing increased coverage. This chart includes both traditional reinsurance and capital markets risk transfer.



Executive Summary

Audit Objectives and Scope

The objective of this audit was to review and assess processes and procedures by which traditional reinsurance agreements are administered and verify Citizens' compliance with those agreements. In addition we will review basic assumptions for reinsurance program to assess alignment with Citizens strategic objectives. Our scope included a review of the following areas:

- Review the traditional reinsurance process and assess its alignment with management's objectives.
- Review the traditional reinsurance process and assess compliance with Florida statutes.
- Review the traditional reinsurance process and verify that process oversight, operational controls, and documentation are sufficiently incorporated to mitigate process risks.
- Review traditional reinsurance contracts conformance to industry standards and norms.

Audit Opinion

The overall effectiveness of the processes and controls with regards to the Traditional Reinsurance evaluated during the audit is rated as **Satisfactory**.

The Finance department is managing the traditional reinsurance program and provides Citizens management and the Board of Governors with quarterly and annual updates. The goals and execution of the reinsurance program is directly in line with corporate strategy and has adjusted to meet corporate needs with market conditions. Though Citizens has not experienced a storm of sufficient magnitude to trigger reinsurance in over 10 years, the administration of claims from the 2005 hurricane season is performed accurately and timely. In addition, the traditional excess of loss contracts terms and conditions are in line with industry standards.

During the audit we shared some minor process documentation observations with Management. Management has considered the observations and provided an action plan to address.

We would like to thank Finance Management and staff for their cooperation and professional courtesy throughout the course of this audit.

Appendix 1

Definitions

Audit Ratings

Satisfactory:

The control environment is considered appropriate and maintaining risks within acceptable parameters. There may be no or very few minor issues, but their number and severity relative to the size and scope of the operation, entity, or process audited indicate minimal concern.

Needs Minor Improvement:

The number and severity of issues relative to the size and scope of the operation, entity, or process being audited indicate some minor areas of weakness in the control environment that need to be addressed. Once the identified weaknesses are addressed, the control environment will be considered satisfactory.

Needs Improvement:

The audit raises questions regarding the appropriateness of the control environment and its ability to maintain risks within acceptable parameters. The control environment will require meaningful enhancement before it can be considered as fully satisfactory. The number and severity of issues relative to the size and scope of the operation, entity, or process being audited indicate some noteworthy areas of weakness.

Unsatisfactory:

The control environment is not considered appropriate, or the management of risks reviewed falls outside acceptable parameters, or both. The number and severity of issues relative to the size and scope of the operation, entity, or process being audited indicate pervasive, systemic, or individually serious weaknesses.

Appendix 2

Issue Classifications

Control Category	High	Medium	Low
<i>Financial Controls (Reliability of financial reporting)</i>	<ul style="list-style-type: none"> Actual or potential financial statement misstatements > \$10 million Control issue that could have a pervasive impact on control effectiveness in business or financial processes at the business unit level A control issue relating to any fraud committed by any member of senior management or any manager who plays a significant role in the financial reporting process 	<ul style="list-style-type: none"> Actual or potential financial statement misstatements > \$5 million Control issue that could have an important impact on control effectiveness in business or financial processes at the business unit level 	<ul style="list-style-type: none"> Actual or potential financial statement misstatements < \$5 million Control issue that does not impact on control effectiveness in business or financial processes at the business unit level
<i>Operational Controls (Effectiveness and efficiency of operations)</i>	<ul style="list-style-type: none"> Actual or potential losses > \$5 million Achievement of principal business objectives in jeopardy Customer service failure (e.g., excessive processing backlogs, unit pricing errors, call center non responsiveness for more than a day) impacting 10,000 policyholders or more or negatively impacting a number of key corporate accounts Actual or potential prolonged IT service failure impacts one or more applications and/or one or more business units Actual or potential negative publicity related to an operational control issue An operational control issue relating to any fraud committed by any member of senior management or any manager who plays a significant role in operations Any operational issue leading to death of an employee or customer 	<ul style="list-style-type: none"> Actual or potential losses > \$2.5 million Achievement of principal business objectives may be affected Customer service failure (e.g., processing backlogs, unit pricing errors, call center non responsiveness) impacting 1,000 policyholders to 10,000 or negatively impacting a key corporate account Actual or potential IT service failure impacts more than one application for a short period of time Any operational issue leading to injury of an employee or customer 	<ul style="list-style-type: none"> Actual or potential losses < \$2.5 million Achievement of principal business objectives not in doubt Customer service failure (e.g., processing backlogs, unit pricing errors, call center non responsiveness) impacting less than 1,000 policyholders Actual or potential IT service failure impacts one application for a short period of time
<i>Compliance Controls (Compliance with applicable laws and regulations)</i>	<ul style="list-style-type: none"> Actual or potential for public censure, fines or enforcement action (including requirement to take corrective actions) by 	<ul style="list-style-type: none"> Actual or potential for public censure, fines or enforcement action (including requirement to 	<ul style="list-style-type: none"> Actual or potential for non-public action (including routine fines) by any regulatory body

Appendix 2

Control Category	High	Medium	Low
	<p>any regulatory body which could have a significant financial and/or reputational impact on the Group</p> <ul style="list-style-type: none"> • Any risk of loss of license or regulatory approval to do business • Areas of non-compliance identified which could ultimately lead to the above outcomes • A control issue relating to any fraud committed by any member of senior management which could have an important compliance or regulatory impact 	<p>take corrective action) by any regulatory body</p> <ul style="list-style-type: none"> • Areas of non-compliance identified which could ultimately lead to the above outcomes 	<ul style="list-style-type: none"> • Areas of noncompliance identified which could ultimately lead the above outcome
<i>Remediation timeline</i>	<ul style="list-style-type: none"> • Such an issue would be expected to receive immediate attention from senior management, but must not exceed 60 days to remedy 	<ul style="list-style-type: none"> • Such an issue would be expected to receive corrective action from senior management within 1 month, but must be completed within 90 days of final Audit Report date 	<ul style="list-style-type: none"> • Such an issue does not warrant immediate attention but there should be an agreed program for resolution. This would be expected to complete within 3 months, but in every case must not exceed 120 days

Appendix 3

Distribution

Addressee(s) Jennifer Montero, Chief Financial Officer
Andrew Woodward, Senior Director - Controller

Copies **Business Leaders:**
Barry Gilway, President/CEO/Executive Director
Dan Sumner, Chief Legal Officer & General Counsel
John Rollins, Chief Risk Officer
Christine Turner Ashburn, VP-Communications, Legislative & External Affairs
Bruce Meeks, Inspector General

Audit Committee
Juan Cocuy, Citizens Audit Committee Chairman
Bette Brown, Citizens Audit Committee Member
Jim Henderson, Citizens Audit Committee Member

Following Audit Committee Distribution
The Honorable Rick Scott, Governor
The Honorable Jeff Atwater, Chief Financial Officer
The Honorable Pam Bondi, Attorney General
The Honorable Adam Putnam, Commissioner of Agriculture
The Honorable Andy Gardiner, President of the Senate
The Honorable Steve Crisafulli, Speaker of the House of Representatives

The External Auditor

Audit Performed By

Auditor in Charge Anthony Huebner

Audit Director John Fox

Under the Direction of Joe Martins
Chief of Internal Audit
