

# STATE COMPENSATION INSURANCE FUND STATUS REPORT, AUGUST 23, 2007

In late March of this year, State Fund's Board of Directors reported interim findings made by a team of outside counsel retained to review State Fund's group administrative fee program and related internal controls. This report outlines the actions taken as a response to issues raised by this evaluation. At the same time, these steps also stem from the Board's ongoing review of State Fund's operations.

State Fund has been cooperating actively with the task force assembled to investigate whether any criminal conduct has taken place at State Fund or in connection with its operations. The existence of this investigation, in fact, constrains State Fund's ability to give more information now about what the team found during its review. This report focuses instead on the changes that have been made during the past five months. State Fund has taken decisive steps in the critical areas of management personnel, internal controls and corporate governance. Other management initiatives, including a new group administrative program, also are proceeding rapidly.

## I. Personnel Actions

Changes at State Fund began with the removal of President James C. Tudor and Executive Vice President A. Renee Koren on March 18, 2007. These personnel actions were unprecedented in State Fund's history and in part reflected the Board's judgment that the administrative fee program as operated by senior management was unacceptable. The Board later determined that a new General Counsel also was needed.

Following the removal of Mr. Tudor and Ms. Koren, the Board immediately appointed Lawrence E. Mulryan, former president of the California Insurance Guarantee Association, as interim president. He came to State Fund as a universally respected insurance executive with no previous connection to State Fund. Mr. Mulryan began work on March 20, 2007 and is expected to serve until mid-October 2007. Many of the positive changes taking place at State Fund are a direct result of his leadership and the close involvement of the Board.

As part of his first actions, Mr. Mulryan hired an experienced temporary Chief Financial Officer, Stephen C. Kolakowski and a highly regarded management consultant, Marjorie Berte. Mr. Kolakowski was charged to assist Mr. Mulryan in evaluating and coordinating all financial and accounting activities. He also has been advising State Fund management and staff in the following departments: Fiscal and Investment Services, Internal Audit, Management Information and Budget, Business Services and Information Technology. Mr. Kolakowski has met regularly with State Fund management and staff from these departments. Among the actions resulting from his work are comprehensive changes in expenditure authorization and oversight, and budgeting and internal financial reporting. These steps are described in more detail in Sections II and IV. His work is ongoing.

Ms. Berte focused on other management and operational issues and has completed her assignment. She gave high marks to State Fund in its core areas: claims, safety and health, and loss control services. At the same time, she highlighted a need for improvement in the areas of risk management, human resources, internal audit and internal communication. She also suggested a comprehensive review of management structure. While the areas of human resources, internal communications and management structure primarily are for State Fund's new

permanent management to address, the Board and State Fund's interim team have been focusing intensively on risk management, internal audit, internal controls and corporate governance.

Changes in those areas are described in sections II and IV of this report.

More recently, Mr. Mulryan retained Neal Conolly to assist with ongoing operational changes at the Fund. Mr. Conolly is a well-known expert in workers' compensation insurance management. He is intimately familiar with State Fund having led an earlier review of its operations on behalf of the Board. His 2005 report to the Board was widely received as an excellent big picture study of State Fund. Mr. Conolly will now assist with operational matters and recommendations at a greater level of detail.

As part of the planned transition to a new, permanent management team, Mr. Mulryan will be replaced by Janet Frank as permanent President. Ms. Frank has had a long and successful career in the insurance industry. Most recently she held the position of Executive Vice President of North American Field Operations for CNA Financial. CNA Financial is the fifth largest insurance company in the United States. Ms. Frank's areas of responsibility generated \$6.5 billion in premiums. In the Board's view, she is exactly what State Fund needs: a talented senior executive from the private sector with a track record of achievement in a complex and demanding environment. While the Board does not anticipate continuing its current extraordinary degree of involvement with State Fund's operations necessitated by the circumstances of this review and the transition in management, it will work closely with Ms. Frank to evaluate her performance regularly with objective contractual performance metrics. This is a new approach to working with senior management that will provide much-needed support and guidance to State Fund's management team.

Currently, the president is the only exempt position available to State Fund. State Fund has determined that there is a critical need for at least six more exempt positions: Chief Financial Officer; Chief Information Technology Officer; Chief Investment Officer; Chief Operating Officer; Chief Underwriting Officer; and General Counsel. These additional exempt positions will provide State Fund with the flexibility to attract both internally and externally the talent necessary for successful execution of these critical positions' responsibilities. State Fund is working with the Governor's office and strongly advocating necessary legislation that will authorize these new exempt positions.

Particularly pressing is the need for a permanent Chief Financial Officer. Until now, State Fund has relied on a combination of outside consultants and internal staff. A permanent Chief Financial Officer, however, will be much better positioned to implement and monitor enhanced internal controls, accounting, budgeting and financial reporting. A permanent Chief Financial Officer will take charge of all of these functions.

The importance of the Chief Information Technology Officer also bears special emphasis. Information technology is critical to State Fund. At the same time, the pace and complexity of change in technology can outstrip State Fund's internal resources. The magnitude of this challenge and the importance of top notch performance – accomplished to the greatest degree possible with internal resources – call for an outstanding, highly qualified executive with a deep technical and management background. Until a new senior technology manager can be added to State Fund's executive team, a current State Fund vice president has recently assumed direct management of information technology.

## II. Internal Controls

The Board and Interim President determined that identifying and closing gaps in internal controls were as critical for State Fund as the personnel actions outlined above. A first fundamental step in closing internal control gaps has been to separate approvals of expenditures from the requesting manager in accordance with generally accepted best business practices. At the same time, the final approval for all payments must come from the Fiscal Services Department. This department now requires more extensive supporting documentation and is intensifying scrutiny of all expenditures. Interim contract payments must be supported with the same level of documentation as is required for the contract's initial review. State Fund's requisition system has been programmed to block any payment not adhering to this check and balance process.

New policies and procedures are being added to State Fund's organizational and governance documents to provide clear direction and allow for documentation necessary for auditing. Until these new controls are fully integrated into State Fund's electronic systems and audited, Mr. Mulryan or Mr. Kolakowski will continue to review all significant expenditures.

In addition, the consultant contracting process is being strengthened to ensure thorough review and analysis throughout the process. State Fund has adopted new contract requirements recommended by outside counsel. All significant contracts are now reviewed by the Legal Department. Especially rigorous attention is being given to information technology consultant contracts. As with all expenditures, the Business Services Department must approve any payments both at the inception of a consultant contract and throughout its performance. In short, consultant contacts begin with an enhanced baseline of contractual requirements, proceed

through legal review, and end with an objective evaluation by the Business Services Department. The Fiscal Department also has an expanded role in the expenditure approval process. This department now performs all calculations of fees or commissions and issues checks directly. No other department can make these calculations or issue its own checks.

This process of analysis, evaluation and improvement will continue both on a formal and informal basis.

### III. Administrative Fee Programs

The initial focus of State Fund's internal review was the administrative fee program's operation. State Fund has made fundamental changes in this program following a rigorous review of both operational and legal issues as well as a complete analysis of the business case for the program. As a first step in the review process, State Fund immediately stopped all fee payments as well as payments to several vendors. Second, led by outside counsel State Fund began evaluating the groups' performance. The Department of Insurance has actively participated and assisted in the process. Third, responsibility for group programs was assigned to a vice president with a broad base of experience at State Fund but no previous connection to administration of the group programs. Fourth, the business merits of the program were thoroughly analyzed by highly qualified outside consultants.

State Fund has concluded that the group insurance program and group administrators are important for State Fund. These programs help balance State Fund's business portfolio and improve safety. When properly administered and refocused on safety services, administrative fees are a worthwhile investment for State Fund. Outside counsel have worked with State Fund to draft new proposed contracts for the program. These contracts have carefully defined

expectations, performance metrics, mandatory audits and financial incentives for safety program participation. The new program will continue to be managed by State Fund executives entirely new to management of group insurance. Throughout this process State Fund is keeping the Department of Insurance closely informed of these changes so that the Department has an opportunity to make suggestions or raise questions about this newly revamped program.

Another key aspect of the new program will be the groups' past performance as evaluated by State Fund's audit program. In the new program, State Fund will work to include groups that have performed well. Groups that have not met all of their contractual obligations will not be offered participation unless they can demonstrate conclusively their willingness to revamp their operations and meet the standards of the new program.

#### IV. Corporate Governance

State Fund has strengthened its corporate governance to keep pace with the industry's evolving best practices. The Board has established an Audit Committee and a detailed charter that spells out the committee's duties and responsibilities. The charter requires that the Audit Committee: (1) independently monitor State Fund's financial processes and internal controls, (2) review the work of State Fund's independent auditor, (3) review Internal Audit's work and (4) ensure that an adequate system of risk evaluation exists in the organization. Currently, Chairperson Jeanne Cain, Director Vincent Mudd and newly appointed Director Sheryl Chalupa are the members of this committee.

The Internal Audit department now reports directly to this Audit Committee and presents reports at every Board meeting without State Fund management staff present. The Board's Audit Committee will work closely both with Internal Audit and the permanent Chief Financial Officer

to ensure that key financial functions, expenses and internal controls are audited, monitored and reported to the Board regularly and in detail.

The Board has approved a charter for Internal Audit that details Internal Audit's responsibilities and mandates unrestricted access to all records and personnel at State Fund. This charter is an adaptation of the Institute of Internal Auditors' model charter. Internal Audit reports to the president only for administrative matters. Functionally, Internal Audit reports to the Board and the Audit Committee. Internal Audit now has a direct line to the Audit Committee for reporting its findings to the Board. With these structural changes in place, the Board will receive the benefit of independent, unfiltered findings from Internal Audit.

Internal Audit has added additional personnel to assure adequate staffing for its expanded functions. A new unit has been created specifically for complex audits. Another important aspect of Internal Audit's expanded coverage is its supervision of a new whistleblower hotline that is operated by an outside company. All complaints are reported to Internal Audit, and then assigned to the appropriate department for investigation and resolution. Internal Audit evaluates the department's response and determines when a direct report to the Audit Committee is necessary. To date, Internal Audit has handled 131 complaints and is due to make a report to the Board in September.

State Fund management, closely assisted by Mr. Kolakowski, is developing a risk management committee to work in conjunction with Internal Audit. This committee is charged to continually review business risks. Its first task will be to commence a full operational risk analysis and further evaluation of internal controls. Through the work of this committee, State Fund will pursue best practices in these areas as part of its regular operations.

A code of ethics is being developed for board members, officers and employees. This code will include, among other provisions, articles related to financial conflicts of interest and procedures for investigations of directors and officers concerning ethics complaints. Also, an employee incompatibility activities policy is in progress. The Board is scheduled to review and adopt these policies this fall.

Finally, the Board will be making a recommendation to increase its size. The average number of members serving on boards today is 11. State Fund's Board expansion should reflect what is typically seen in the private sector, and should allow for an appropriate mix of policy holders and non-policy holders. Expanded membership also will provide the Board with greater technical expertise and the ability to maintain an audit committee, corporate governance committee, ethics committee, and investment committee.

#### V. Other Management Initiatives

As noted earlier, a highly experienced outside consultant has completed a review of management operations and governance issues. Following Ms. Berte's recommendations, State Fund's governance documentation will be redrafted so as to make completely clear and transparent all policies, procedures and lines of authority – including the changes described in this report. Another project, already under way, will be enhancing the human resources function with special emphasis on training and performance metrics. Other key initiatives include providing professional oversight for State Fund's investment managers; and requiring more formal quarterly reviews of budgets and expenses. As part of the latter process, the Fiscal Department will review and report all significant budget line items for variances between budgeted and actual expenses. They will report these results on a quarterly basis. Additionally,

the accounting department will ensure that all of the general ledger accounts accurately reflect the kinds of expenses included in them.

While not an exhaustive description, this report should make clear the magnitude and pace of positive change at State Fund. These initiatives are far-reaching and effective. State Fund is committed to continuing the process and working closely with the Department of Insurance, Legislature and Governor's Office to ensure its success. State Fund will continue to provide further reports as additional timely changes are made.