Department of Insurance

Former Executive Life Insurance Company Policyholders Have Incurred Significant Economic Losses, and Distributions of Funds Have Been Inconsistently Monitored and Reported

REPORT NUMBER 2005-115.2, JANUARY 2008

California Insurance Commissioner's, California Department of Insurance's and the Conservation and Liquidation Office's responses as of January 2009

The Joint Legislative Audit Committee (audit committee) directed the Bureau of State Audits to review the California Department of Insurance's (department) management of the Executive Life Insurance Company Estate (ELIC estate) and related litigation. Specific audit objectives included the following:

- Analyze the funds paid into and out of the ELIC estate since April 11, 1991.
- Determine how much money policyholders have received.
- Determine the percentage of policyholders who have received all of the payments they would have received if ELIC had not become insolvent.
- Determine the amount policyholders will receive in the future.
- Determine how the department has used the litigation proceeds that it has received, including payments made to policyholders, the national guaranty organization, and others.
- Determine the percentage of the department's projected $4 billion loss to policyholders that was recovered by litigation including settlements, relating to the ELIC estate, after subtracting amounts distributed to policyholders and the national guaranty organization and others.

Finding #1: The California Insurance Commissioner (commissioner) has not consistently ensured that Aurora National Life Assurance Company (Aurora) complies with ELIC agreements.

The commissioner entered into agreements specifying how ELIC's insurance policies would be transferred to Aurora, how the former ELIC policies would be restructured, and how assets that remained under the commissioner's control and future litigation proceeds that he received would subsequently be distributed to policyholders.

The commissioner, Aurora, and the National Organization of Life and Health Insurance Guaranty Associations (national guaranty organization) are party to the ELIC agreements.

Audit Highlights . . .

- *When the California Insurance Commissioner (commissioner) conserved the Executive Life Insurance Company (ELIC) on April 11, 1991, he reported the company's assets to be $8.8 billion. Later, losses from the liquidation of ELIC investment securities reduced this amount by $1.3 billion. Through December 31, 2006, the remaining $7.5 billion has been increased by investment income, litigation proceeds, and other income, resulting in $10.2 billion in total available assets.*
- *Of the $10.2 billion, the commissioner transferred $6.7 billion to Aurora National Life Assurance Company for use in its role as successor insurer to ELIC and to pay policyholders who did not continue with the company. The commissioner has paid a total of $2.7 billion to policyholders and other beneficiaries of the estate and has used $528 million for administering the ELIC estate.*
- *About $325 million remained in the estate as of December 31, 2006. In 2007 the commissioner transferred $311 million of these remaining funds to Aurora, most of which it reports as disbursed to policyholders and others in October 2007.*
- *In August 2005 the department estimated policyholder losses at $936 million, which equates to policyholders recovering 90 percent of their original policy rights.*

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» *Including factors not considered by the department, we estimated policyholder economic losses of $3.1 billion as of August 2005, with policyholders recovering 86 percent of their expected ELIC account values.*

» *The commissioner has not consistently monitored, reported on, or accounted for the distribution of the assets of the ELIC estate.*

Key provisions of the ELIC agreements require Aurora to add interest to the funds it receives from the ELIC estate; calculate distributions to policyholders who opted to continue coverage with Aurora (opt-in policyholders) and other ELIC estate beneficiaries, such as the national guaranty organization, according to complex formulas; and determine the amount of ELIC funds that it pays to third-party companies that offset some policyholders' losses.

The commissioner, as trustee of the ELIC estate, has not consistently ensured that Aurora adds the proper amount of interest to the funds it receives from the ELIC estate, or that it accurately calculates the amounts that it distributes to policyholders and others based on provisions in the ELIC agreements. Between September 1993, when Aurora assumed ELIC's policies, and October 2007, one external examination has been conducted, and an internal examination by the commissioner's Conservation and Liquidation Office (CLO) is in the process of being conducted, to verify Aurora's compliance with some of the provisions of the ELIC agreements. However, the commissioner did not monitor other distributions that occurred from 1998 through 2006 for such compliance and therefore cannot provide policyholders and others the same level of assurance that the $225 million Aurora distributed during this period of time was handled in accordance with the ELIC agreements.

To increase assurance that Aurora follows key provisions in the ELIC agreements, we recommend that the commissioner seek the right to review Aurora's future distributions of ELIC estate funds and review those distributions to ensure that it adds the proper amount of interest to the funds, and distributes the funds correctly.

Commissioner's Action: Corrective action taken.

The CLO sent a written request seeking the right to review future distributions to Aurora and the national guaranty organization on February 27, 2008. Although discussions with Aurora continue, Aurora has not made a commitment to fulfill the CLO's request. There have been no subsequent distributions for the CLO to review. Future distributions, if any, are dependent on the outcome of pending litigation.

Finding #2: Managers of the ELIC estate have not consistently reported on the disposition of ELIC's assets.

During the period from 1990, before the commissioner conserved ELIC, through 2006, we found that there is a lack of available information on ELIC's operations and the disposition of ELIC's assets. The commissioner has assigned various parties the responsibility of managing the ELIC estate since he conserved ELIC in April 1991. We found that the level of information varied depending on the entity managing the estate or trust at the time. Some of the reports that are either authorized by the insurance code or required by individual trust agreements have not been produced, and audits of the ELIC estate have not been consistently performed. Similarly the extent of audited financial statements available showing the disposition of ELIC's assets, including the receipt and distribution of ELIC funds, is related to which entity was managing the estate. We found that audited financial statements were not available during the 1991 through 1993 period, and while the ELIC estate was extensively audited during the 1994 through 1996 period, it has not been consistently audited since 1997. Overall, inconsistent reporting has contributed to a lack of information available to former ELIC policyholders and other parties who have an interest in the ELIC estate.

In order to ensure that information is available to policyholders and other parties interested in the disposition of ELIC's assets, we recommended that the commissioner, as soon as practical after the end of each year and upon the termination of any trust, complete a report that includes the assets and liabilities; the amount of all distributions, if any, made to the trust beneficiaries; and all transactions materially affecting the trust and estate.

Commissioner's Action: Corrective action taken.

The CLO has placed summarized financial information along with a brief narrative of the ELIC estate and grantor trusts for the year ended December 31, 2007, and December 31, 2008, on its Web site. The CLO will continue to update this information after the end of each year.

Finding #3: Managers of the ELIC estate have not consistently audited the estate.

In settling the ELIC estate, the commissioner established a series of trusts to receive and distribute funds to policyholders. Auditing requirements have been met for some of the trusts but not for others. For example, the consolidated audits performed of the ELIC estate from 1997 to 2000 are not comprehensive, and no audits were performed from 2001 to 2004. The purpose of the audits is to ensure that reported financial information is accurate.

By not producing the audits, the commissioner had no way to ensure that ELIC's financial statements were accurate and further reduced the amount of publicly available information on the disposition of the ELIC estate's assets.

In 2006 the CLO's chief financial officer requested the Department of Finance (Finance) to conduct a separate review of the ELIC estate and each of its trusts covering the 2005 and 2006 period. He stated that he plans to continue these reviews yearly until the trusts are closed.

In order to ensure that the financial information reported by the CLO is accurate, we recommended that the commissioner continue the practice of auditing the ELIC estate, and any trusts that remain open, on a periodic basis as implemented by the current chief executive officer in 2006.

Commissioner's Action: Corrective action taken.

Finance's reviews for the year ended December 31, 2007, and December 31, 2008, have been completed and are available on the CLO's Web site. The CLO will continue the practice of having Finance auditors review the ELIC estate and grantor trusts.

Finding #4: Inconsistent accounting practices and inconsistent availability of supporting documents hinder a complete accounting of the ELIC estate.

Since ELIC was first conserved in 1991, a variety of methods have been used to account for the estate. For example, from 1991 to 1993, the available financial information is primarily contained in unaudited financial statements prepared by outside contractors and unaudited financial statements included in the annual report to the governor. For the 1994 to 1996 period, audited financial statements exist for the various trusts; however, for the ELIC estate in 1994, only a balance sheet was included in the audit report. Financial reporting was not consistent from 1997 through 2006. For example, in 1998 a $75 million indemnity payment was paid to Aurora pursuant to the rehabilitation plan.

While the 1998 ELIC Trust audit reports a $55.5 million expense for its portion of this amount, the CLO's general ledger does not report a $19.5 million expense for the remaining portion that it paid from the ELIC estate. Additionally, the cash-flow statements prepared from 1991 through 1996 were not prepared during the period from 1997 through 2006.

Various trust agreements identify the recipients of ELIC estate distributions as opt-in and opt-out policyholders, Aurora, and the national guaranty association. Although the notes to the financial statements for the 1994 to 1996 period identified the amount of funds paid to opt-in and opt-out policyholders and refer to opt-in and opt-out accounts, the CLO accounting system does not maintain separate accounts to record distributions to these recipients. In addition, it does not maintain separate accounts to record payments made to the national guaranty organization or Aurora. Although there is no specific requirement for structuring the accounting records, maintaining subsidiary accounts that separately track payments to each category of trust recipient would aid the timely reporting of payments to recipients of ELIC estate distributions.

The lack of maintaining separate accounts for tracking the payments made to the four recipients of the trusts may have contributed to the delayed identification of a $90 million posting error to the CLO general ledger distribution account in 1997 and a $62 million posting error to the CLO general ledger distribution account in 2002, which the CLO did not correct until September 2007. Another reason that the distribution account errors may not have been promptly identified during the 1997 through 2006 period is that, although the CLO reconciles its cash account to subsidiary databases for distributions to maintain control of cash, it did not reconcile the distributions reported in its general ledger to the subsidiary databases in order to maintain control for correct financial reporting.

In order to ensure that it accurately records distributions in its primary accounting system, and ensure correct financial reporting, we recommended that the CLO periodically reconcile the distributions reported in its general ledger to its subsidiary databases.

Commissioner's Action: Corrective action taken.

The commissioner stated that the CLO will continue its practice of reconciling distributions to the Trust Administration System subsidiary databases and to the general ledger, and stated that the CLO has reformatted the financial presentation of the ELIC financial statements and has established separate accounts in the ELIC estate general ledger for each future distribution.