

# **Audit Follow-Up**

*As of November 30, 2014*



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City Auditor

## **Acquisition of Commercial Insurance Coverages**

*(Report #1404 issued December 12, 2013)*

**Report #1502**

**December 22, 2014**

### **Summary**

*As directed by the City Commission, the Office of the Treasurer-Clerk has taken appropriate steps to revise the process for the City's acquisition of commercial insurance coverages. To date, those actions show the City should realize meaningful savings from the Treasurer-Clerk's actions. Other actions are in process to complete the remaining planned changes.*

In audit report #1404, we recommended the Office of the City Treasurer-Clerk's Risk Management section consider revising its methods for acquiring commercial insurance coverages. Instead of using the "Defined Coverage Method" and "Appointment Method," we recommended consideration be given to using the "Broker of Record Method" or an appropriately modified version of that method. We reported that (1) the existence of a limited carrier (insurer) market for many of the City's coverages, (2) the practice of other local governmental entities, and (3) the potential for reducing and better controlling broker fees/compensation all indicated that changing methods may be to the City's benefit.

In response to the resulting audit recommendations, the Treasurer-Clerk's Risk Management section established an action plan to obtain subsequent coverages using the Broker of Record Method for property coverages and a modified version of the Broker of Record Method for other coverages (e.g., liability coverages).

Based on those planned actions, a Request for Proposal (RFP) for broker services regarding non-property coverages (e.g., various liability coverages) was issued on March 6, 2014, with the intent of selecting two brokers and then having the two selected brokers compete for the right to obtain coverages through carriers on behalf of the City. That process represented a modified version of the

Broker of Record Method. At the direction of the City Commission on July 9, 2014, the Treasurer-Clerk's Office was directed to award the contract to just one of the two highest ranked brokers (i.e., as would be done under the unmodified Broker of Record Method). That broker has obtained various non-property coverages (e.g., liability coverages) on behalf of the City.

As of the time of this follow-up engagement, the Treasurer-Clerk's Office was in the process of finalizing negotiations with the selected broker so a contract could be executed. Because the City Commission direction in essence resulted in the unmodified Broker of Record Method being used, the Treasurer-Clerk's Office Risk Management section is negotiating a contract to provide for a fixed (flat) fee for those broker services. (NOTE: A fixed or flat fee instead of a commission fee [based on a percentage of the total premium] is appropriate under the unmodified Broker of Record Method so as to eliminate the incentive for the broker to recommend carriers with higher premiums, as those higher premiums would provide the broker a greater fee.) As of this follow-up, the Treasurer-Clerk's Risk Management section indicated the broker had agreed to a fixed annual fee that was equivalent to approximately 5% of the premiums paid for the current coverages and that they were in the process of finalizing the contract.

We recommend those efforts to finalize negotiations and execute a contract with the selected broker be expedited and completed given that that broker is currently providing services to the City.

Our analysis of broker fees paid for recent liability and statutory death benefit coverages acquired under the revised process shows the City should realize meaningful savings. Specifically, our analysis shows savings of \$10,963 as a result of the change in process. (Note: As the City and broker are

currently negotiating the final compensation and contract for brokerage services as described above, the fees may be adjusted to some extent. However, significant differences are not anticipated.)

In accordance with the planned actions, the Treasurer-Clerk's Risk Management section issued a RFP for broker services on November 17, 2014, regarding property coverages needed by the City. The Office of the Treasurer-Clerk Risk Management section plans to select the best broker and award the contract for services using the Broker of Record Method. Accordingly, the Treasurer-Clerk's Office Risk Management section indicates that once responses are received and evaluated and the best broker identified, a recommendation will be made to the City Commission for award of broker services in January 2015. We will address those efforts and results in a subsequent follow-up engagement.

**Table 1** within this report more fully addresses the completed and remaining actions.

We commend the Office of the Treasurer-Clerk for the actions taken to date to complete the action plan steps. We appreciate the assistance and cooperation from the Treasurer-Clerk's Risk Management staff during this audit follow-up.

### *Scope, Objectives, and Methodology*

We conducted this audit follow-up in accordance with the International Standards for the Professional Practice of Internal Auditing and Generally Accepted Government Auditing Standards. Those standards require we plan and perform the audit follow-up to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit follow-up objectives.

### *Report #1404*

The audit inquiry resulting in report #1404 was conducted as directed by the City Commission (Commission) to address the City's process for acquiring commercial insurance coverages. Those coverages are maintained to mitigate certain City risks relative to property loss and liability. Concerns were expressed by the Commission that the methods currently and historically used by the City

to acquire commercial insurance coverage did not provide sufficient competition among potential providers (insurance brokers and carriers). As a result, concerns were expressed that the City may be paying too much for the purchased coverages.

To address those concerns, we performed procedures to answer the following six questions:

1. What are the standard industry practices for selection of insurance brokers and carriers?
2. How many years has the City used the current insurance brokers and how much has the City paid those brokers during that period?
3. For each time the City acquired commercial insurance coverages, was a competitive process (e.g., Request for Proposals, or RFP) used; and when used, how many proposals/responses were received?
4. What methods are used by other governmental entities in their acquisition of commercial insurance coverages?
5. Is the City paying too much for its commercial insurance coverages because its acquisition methods do not provide for effective competition?
6. What can be done to improve the methods used by the City in the acquisition of commercial insurance?

To answer those questions, we performed the following audit procedures:

- We identified laws, rules, policies, and procedures governing the City's acquisition of commercial insurance coverages.
- We reviewed available industry literature and met with knowledgeable City staff (Risk Management section within the Office of the Treasurer-Clerk) and industry professionals regarding the methods for acquisition of commercial insurance.
- We identified the types of commercial insurance coverage purchased by the City (exclusive of health insurance and other insurance coverages pertaining to employee benefits and performance bonds).
- We determined the amount of insurance premiums and broker fees/commissions paid by

the City for commercial insurance coverages over the last decade.

- We identified the insurance brokers (and carriers) from whom the City acquired insurance coverages and how long those brokers have been used by the City.
- We identified the methods used by the City's Office of the Treasurer-Clerk Risk Management section to acquire the commercial insurance coverages.
- We identified and evaluated the individual purchases of commercial insurance coverages by the City over the last decade.
- We surveyed ten other local government entities within the state of Florida to determine their methods for acquiring commercial insurance coverages.

Through completion of the described audit procedures, we developed a recommendation to be considered by management for enhancing and improving the City's method for acquiring commercial insurance coverages.

### Report #1502

This is our first follow-up on action plan steps identified in audit report #1404. The purpose of this follow-up is to report on the progress and status of efforts to complete action plan steps due for completion as of November 30, 2014. To determine the status of the action plan steps, we interviewed staff, made observations, and reviewed relevant documentation.

### Background

**Overview:** Insurance is a mechanism used by an entity to control and mitigate the risk of loss of property or loss resulting from liability for specific events or circumstances. An entity may be "self-insured" for part or all such risks and may purchase commercial insurance for those risks not covered through self-insurance.

Under the concept of self-insurance, an entity generally establishes a separate fund for the purpose of setting aside resources to pay claims (e.g., property or liability) as they occur. On the other hand, when acquiring commercial insurance

an entity in essence pays a fee (insurance premium) to transfer that risk to a separate commercial entity. When events occur (losses), claims are filed with that commercial entity (insurer) to obtain funds to cover losses incurred by the insured entity as the result of the insured event.

The City of Tallahassee is self-insured for some risks and acquires commercial insurance for other risks. Specifically, the City maintains reserve funds to self-insure for:

- Workers' Compensation up to \$1 million per event.
- General Liability (includes premises liability, operational liability, employment practice liability, police civil liability, etc.)
- Automobile Liability.

Commercial insurance coverage is obtained by the City to cover remaining risks, to include:

- Workers' Compensation for events in excess of \$1 million.
- Property damage or loss.
- Airport Liability.
- Statutory Death Benefits for police and firefighters.
- Professional Liability for City personnel providing basic and advanced lifesaving services (e.g., firefighters and emergency medical technicians, or EMTs).
- Fiduciary Liability for City Pension Advisory Boards.

The original audit inquiry only addressed the City's acquisition of commercial insurance coverages. The City's self-insurance programs were not included in the scope of that audit.

### **Governing Laws, Policies, and Procedures:**

City Commission Policy 242 and the City's Procurement Manual provide for competitive acquisition/procurement of goods (commodities) and services for which the cost is expected to exceed certain thresholds. Under the City's procedures, the specific competitive procurement method that should be used depends on the amount of the expected costs. For purchases where the expected costs are between \$1,000 and \$25,000, quotes should be obtained from at least

three vendors. For purchases with expected costs greater than \$25,000, written formal proposals/bids should be solicited by the City through either the "Request for Proposals (RFP)" process or the "Invitation for Bid (IFB)" process. The RFP process should be used for purchases where the selection of the vendor is dependent on factors in addition to costs/fees, such as experience and ability of the potential vendors to provide the desired services.

Pursuant to the noted City policy and procedures, all City acquisitions of insurance coverages addressed in the original audit inquiry were in amounts that required application of one of the described competitive procurement methods.

### *Original Inquiry Results and Current Status*

Question No. 1: In the initial audit inquiry we identified several methods that an entity may use to acquire commercial insurance coverages. As reported, some involved solicitation of competitive proposals and some did not involve competition. As reported, the appropriate method depends on various circumstances, such as the number of carriers willing and capable of providing the specific coverages and the nature of relationships between brokers and carriers.

Question No. 2: We reported over the last ten years the City had acquired the vast majority of its coverages through one broker, J. Smith Lanier & Co. and its predecessor companies. Broker fees/compensation for the last ten years totaled approximately \$3.24 million, or 9.1% of total premiums paid.

Question No. 3: As reported, the City primarily used a competitive method (Defined Coverage Method) in the acquisition of coverages. Under that method, the broker and carriers are selected as part of one unified process. Specifically, the entity to be insured (e.g., City) requests proposals for coverages when determinations are made that insurance coverages are needed. Interested brokers go to the insurance market and find and obtain commitments from carriers willing to underwrite those coverages. Those brokers that are successful in obtaining such commitments then submit a proposal to the City. The submitted proposals include a combination of

brokerage services as well as specific insurance coverages from individual carriers. The insured entity then evaluates all proposals and selects the broker and carrier(s) with the most favorable proposal(s).

In addition, we reported that in some instances the City used a non-competitive method (Appointment Method) to acquire insurance coverages.

Question No. 4: In contrast to the two methods used by the City, our surveys of ten other local governments showed the Broker of Record Method was the method used by those entities for acquiring commercial insurance coverages. Under that method, the broker is competitively selected (through a RFP process) separate from the acquisitions of the desired insurance coverages. Criteria used in the selection of brokers under this process generally include consideration of broker fees/compensation as well as the experience and ability to provide the needed brokerage services.

Question No. 5: Broker fees/compensation paid by nine of the ten surveyed local governments, each using the Broker of Record Method, averaged 5.11% of total premiums paid for purchased coverages. In comparison, the broker fees/compensation for City policies in place at the time of the initial audit and acquired under the Defined Coverage Method and Appointment Method represents 8.8% of total annual premiums. As reported, if the City had paid 5.11% in broker fees/compensation, it would have paid approximately \$150,000 less annually in broker fees/compensation for coverages in place at the time of the original audit inquiry. The larger portion of those savings would be attributable to property coverages.

Question No. 6: In the initial audit inquiry we recommended the Treasurer-Clerk's Risk Management section consider revising its methods for acquiring commercial insurance coverages. Specifically, instead of using the Defined Coverage Method and Appointment Method, consideration should be given to using the Broker of Record Method or a modified version of that method. As reported, there is no guarantee that changing to another method will result in savings to the City. However, (1) the existence of a limited carrier market for many of the City's coverages, (2) the practices of other local governmental entities, and (3) the potential for reducing and better controlling

broker fees/compensation all indicate that changing methods may be to the City’s benefit.

In response to our audit inquiry and recommendations, the Treasurer-Clerk agreed that a change in methods would be made. Accordingly, an action plan was developed to acquire future coverages under a revised method. As shown in **Table 1** below, the Office of the Treasurer-Clerk

Risk Management section has implemented a revised method for certain coverages and has started the process for using a revised process for the other coverages.

**Table 1  
Action Plan Steps from Audit Report #1404  
Due as of November 30, 2014, and Current Status**

Action Plan Steps Due as of November 30, 2014	Current Status
<ul style="list-style-type: none"> <li>- Using a version of the “Broker of Record Method,” issue a RFP for broker selection for the following coverages: (1) excess workers’ compensation, (2) aviation liability, (3) pension fiduciary liability, (4) EMS professional liability, and (5) statutory death benefit for police &amp; fire with an October 2014 inception date.</li> <li>- Engage consultant to prepare RFP specifications, evaluation criteria, and RFP document.</li> <li>- Release RFP.</li> <li>- Receive and evaluate responses to RFP and identify broker(s) for recommendation to City Commission for approval.</li> <li>- Obtain City Commission approval for broker selection.</li> </ul>	<ul style="list-style-type: none"> <li>➤ On March 6, 2014, the Treasurer-Clerk’s Office released a RFP for broker services for coverages other than property (i.e., a Broker of Record Method). Four brokers provided responses that were evaluated. The Treasurer-Clerk’s Office prepared and presented a City Commission agenda item on July 9, 2014, recommending the selection and awarding of contracts to the two brokers whose proposals were ranked the highest by the City’s evaluation committee. The Treasurer-Clerk recommended negotiation of fees and awarding contracts with/to those two brokers, with the intention of assigning specific markets to each selected broker (a modified version of the Broker of Record Method).</li> </ul> <p>The City Commission provided alternative direction. Specifically, the Commission directed the Treasurer-Clerk’s Office to award the contract to just one of the two highest ranked brokers.</p> <p>As of the date of our follow-up fieldwork in mid-November 2014, the Treasurer-Clerk’s Office Risk Management section had used that broker to obtain the applicable coverages (e.g., (1) excess workers’ compensation, (2) aviation liability, (3) pension fiduciary liability, (4) EMS professional liability, and (5) statutory death benefit for police &amp; fire).</p> <p>As of our follow-up fieldwork in mid-November 2014, the Treasurer-Clerk’s Office Risk Management section was in the process of finalizing negotiations with the selected broker regarding fees and a contract. The applicable coverages were acquired prior to finalization of those negotiations and execution of a contract so as to ensure the City did not have any lapses in coverages.</p> <p>Because the unmodified Broker of Record Method is, in essence, being used the Treasurer-Clerk’s Office Risk Management section is negotiating a</p>

	<p>contract to provide for a fixed (flat) fee for those broker services. (NOTE: A fixed or flat fee instead of a commission fee [based on a percentage of the total premium] is appropriate under the unmodified Broker of Record Method so as to eliminate the incentive for the broker to recommend carriers with higher premiums, as those higher premiums would provide the broker a greater fee.) As of this follow-up, the Treasurer-Clerk’s Risk Management section indicated the broker had agreed to a fixed annual fee that was equivalent to approximately 5% of the premiums paid for the current coverages and that they were in the process of finalizing the contract.</p> <p><u>We recommend</u> the Treasurer-Clerk’s Office Risk Management section continue efforts to complete the negotiations and execute an appropriate contract with the selected broker.</p>
<ul style="list-style-type: none"> <li>- Using a version of the “Broker of Record Method,” issue a RFP for broker selection for the following property coverages: (1) commercial property and boiler &amp; machinery, (2) Renaissance Building, (3) fine arts, and (4) Neighborhood Stabilization Program properties with an April 2015 inception date.</li> <li>- Engage consultant to prepare RFP specifications, evaluation criteria, and RFP document.</li> <li>- Release RFP.</li> <li>- Receive and evaluate responses to RFP and identify broker(s) for recommendation to City Commission for approval.</li> <li>- Obtain City Commission approval for broker selection.</li> </ul>	<ul style="list-style-type: none"> <li>➤ Through the City’s Purchasing Division, the Treasurer-Clerk’s Office Risk Management section released a RFP for broker services for property coverages under the Broker of Record Method. The RFP was released November 17, 2014. The Treasurer-Clerk’s Office Risk Management section plans to evaluate responses to that RFP and make a recommendation to the City Commission for award of broker services in January 2015. We will address those efforts and results in a subsequent follow-up engagement.</li> </ul>

**Table Legend:**

- Issue to be addressed from the original audit.
- Actions taken and in progress to complete the action plan step.

***Additional Analysis***

As part of this follow-up engagement, we compared for applicable coverages the fees chargeable by the former broker under the prior contract and method (Defined Coverage Method) to the fees charged for those coverages by the current broker (being contracted under the Broker of Record). The purpose of the comparison was to ascertain any cost savings likely realized from changing methods. This analysis is shown below in **Table 2**.

**TABLE 2  
BROKER FEE COMPARISON**

	<u>Coverage</u>	<u>Current Premium (Note 1)</u>	<u>Brokers Fees based on commissions of former broker used under the Defined Coverage Method (Note 2)</u>	<u>Broker fees based on current broker acquired under Broker of Record Method (Note 3)</u>	<u>Difference</u>
1.	Excess workers' compensation	\$144,650	\$21,697.50	\$14,465.00	\$7,232.50
2.	Aviation Liability	\$42,507	\$6,376.05	\$4,250.70	\$2,125.35
3.	Pension Fiduciary Liability	\$23,255	\$3,488.25	\$1,162.75	\$2,325.50
4.	EMS Professional Liability	\$65,978	\$6,597.80	\$8,282.26	(\$1,684.46)
5.	Statutory Death Benefits for Police and Fire	\$9,642	\$1,446.30	\$482.10	\$964.20
<b>TOTAL</b>		<b>\$286,032</b>	<b>\$39,605.90</b>	<b>\$28,642.81</b>	<b>\$10,963.09</b>
Note 1:	These are the premiums excluding commissions paid by the City for the coverage awarded and effective October 1, 2014.				
Note 2:	These would be the commissions based on the rates charged by the former broker. It is assumed the commissions would be all inclusive; i.e., they include any commissions also paid intermediary brokers.				
Note 3:	These are the commissions paid by the City for the current coverages; these include commissions paid to both broker (5%) and intermediary brokers. <b>As the City and primary broker are currently negotiating the final compensation and contract for the brokerage services, these fees may be adjusted to some extent. However, significant differences are not anticipated.</b>				

As shown, the described comparison shows the City will likely realize a savings of \$10,963. (Note: As noted in **Table 2** and also previously within this report in **Table 1**, the City is in the process of negotiating final fees for these services but anticipates the final fees will not differ significantly from those shown in **Table 2**.)

We also compared total costs for the applicable coverages. Total costs are comprised of premiums including broker commissions and state assessments. That comparison is shown in **Table 3** that follows.

**TABLE 3  
TOTAL PREMIUM COMPARISON**

	<u>Coverage</u>	<u>Prior Premium and Commission and Fees (Note 1)</u>	<u>Current Premium and Commissions and Fees (Note 2)</u>	<u>Difference (Note 3)</u>
1.	Excess workers' compensation	\$170,090	\$146,530	\$23,560
2.	Aviation Liability	\$41,004	\$43,060	(\$2,056)
3.	Pension Fiduciary Liability	\$21,927	\$23,767	(\$1,840)
4.	EMS Professional Liability	\$62,562	\$66,871	(\$4,309)
5.	Statutory Death Benefits for Police and Fire	\$9,758	\$9,642	\$116
TOTAL		\$305,341	\$289,870	\$15,471
Note 1:	These are the premiums including commissions and state assessments paid by the City for the coverage in effect <u>prior to</u> October 1, 2014.			
Note 2:	These are the premiums including commissions and state assessments paid by the City for the coverage awarded and <u>effective</u> October 1, 2014.			
Note 3:	Premiums inherently fluctuate due to changes in market conditions, coverages, and/or policy structure.			

As shown in **Table 3**, the total costs for the five applicable coverages decreased in some instances and increased in the other instances. When aggregated, the changes resulted in a net decrease in costs of \$15,471. As explained in the last note within **Table 3**, premium costs fluctuate based on market conditions, changes in needed coverages (e.g., the number of City employees impacts the coverages in the excess workers' compensation policy), and/or policy structure. Accordingly, changes in broker fees and commissions are only one factor that impacts total premium costs. Nonetheless, the City should realize a net savings of \$15,471 for the coverages addressed, which is at least partially attributable to a decrease in broker fees.

- Finalizing the contract and related fees with the new broker selected to assist the City in obtaining coverages other than property coverage.
- Selecting a broker to assist the City in obtaining property coverages.

As described in **Table 1** in this report, the Office of the Treasurer-Clerk's Risk Management section is in the process of completing those remaining actions. We will follow up on those efforts in a subsequent follow-up engagement.

We appreciate the assistance and cooperation from the Treasurer-Clerk's Risk Management staff during this audit follow-up.

**Conclusion**

The Office of the Treasurer-Clerk as directed by the City Commission has taken positive actions to revise the City's process for acquiring commercial insurance coverages. Actions taken to date should result in meaningful savings to the City.

Actions remaining to be completed include:

**Appointed Official's Response**

**City Treasurer-Clerk:**

We are pleased with the progress made to date as we continue to implement the steps outlined in the action plan resulting from the initial inquiry. We continue to appreciate the diligence of the City Auditor in his follow-up regarding acquisition methods for commercial insurance coverages.

Copies of this audit follow-up #1502 or audit report #1404 may be obtained from the City Auditor's website (<http://talgov.com/auditing>) or via request by telephone (850 / 891-8397), by FAX (850 / 891-0912), by mail or in person (Office of the City Auditor, 300 S. Adams Street, Mail Box A-22, Tallahassee, FL 32301-1731), or by e-mail ([auditors@talgov.com](mailto:auditors@talgov.com)).

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