COMMONWEALTH OF VIRGINIA
STATEWIDE SELF-INSURANCE REVIEW

2004

Auditor of Public Accounts
COMMONWEALTH OF VIRGINIA

AUDIT SUMMARY

The Commonwealth of Virginia operates a variety of self-insurance programs to cover risk loss exposures such as health, workers compensation, general liability, property and casualty, disability and life. The Departments of Accounts, Corrections, Human Resource Management, Juvenile Justice, Treasury, and the Virginia Retirement System administer these programs. This report provides general information about the programs, their administration, and funding. During the course of this study we identified a number of issues that the Commonwealth should consider to improve their operations.

Line of Duty

Due to new upcoming accounting standards that may require an actuarial valuation of the Line of Duty program, the Commonwealth should consider moving the entire program to another agency.

Monitoring Third Party Administrators

The Department of Human Resource Management, Office of Health Benefits requires the actuary review Anthem's third party administration services; however, the most recent valuation covers the period April 25 through June 15, 2001. Monitoring the operations of a third party administrator is an essential best practice that allows program managers to ensure internal controls over program transactions are effective. Program managers can achieve this control by requiring the third party administrators to have an independent review of operations performed by their independent auditor. The Office of Health Benefits should ensure a consistent and timely review of third party claim administration for health care claims is performed and the results reviewed by program management.

Funding Policies

Events such as premium holidays, premium reductions, and transfers to the General Fund create long-term solvency issues for the Commonwealth's self-insurance programs. These events coupled with the programs' inability to avoid the rising costs of services and administration may lead to decreased benefits and increased premiums. Further analysis of the Health Insurance Fund and Workers Compensation Fund revealed that the funds did not meet standard ratio tests for liquidity. In addition, the funds have increasing negative net assets, fund balances that cannot cover current claims payable. As a result, the Commonwealth should develop policies that protect the funding and any future reserves of self-insurance programs to minimize the severity of cost increases and benefit decreases. The policies should also include setting adequate premium revenues, monitoring and managing liquidity levels, and funding progress.

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CHAPTER 1

OVERVIEW AND ADMINISTRATION

Introduction

Prior to the mid-1980's, the Commonwealth of Virginia used commercial insurance to cover the risk of losses. Today the Commonwealth administers a variety of self-insurance programs to meet the insurance needs of state and local agencies and institutions. For most insurance coverage needs, the Commonwealth uses self-insured funds or hybrids consisting of a self-insured fund and a commercial insurance policy. The primary benefit of these self-insured funds, when properly managed and maintained, is their cost effectiveness. This report will discuss the purpose, administration, and financial position of the Commonwealth of Virginia's self-insurance programs.

The Departments of Human Resource Management, Treasury, Accounts, Corrections, and Juvenile Justice and the Virginia Retirement System administer these activities. Each agency has developed processes to address its programs. Generally, the Commonwealth maintains the Workers' Compensation, Health Benefits, and Risk Management programs in separate state funds. Separate healthcare and risk management programs exist for local governments. The Commonwealth established these pools to make coverage available to localities and political subdivisions at affordable rates. Below is a description by agency of the programs they administer.

Overview of Programs

Department of Human Resource Management

The Department of Human Resource Management (DHRM) manages the Office of Workers' Compensation and the Office of Health Benefits in addition to other centralized personnel services.

Office of Workers' Compensation (OWC)
The Workers' Compensation Fund pays all state employees for financial loss due to lost work, medical expenses, and other costs associated with a work-related injury or occupational disease. In addition to the claims administration, the program also has a large safety and loss control consulting component that provides on-site review of agencies compliance with OSHA regulations and best practice recommendations to reduce/eliminate workplace injuries.

Office of Health Benefits (OHB)
The Health Insurance Fund pays claims, administrative costs, contractual costs, and other necessary expenses related to the administration of the state health benefit program. Over 200 state agencies and independent authorities provide the program to approximately 89,182 active employees, retirees, and extended coverage contract holders and their dependents. DHRM also administers the Local Choice Health care fund for 220 local government units.

Department of Treasury

The Department of Treasury manages the Division of Risk Management in addition to other centralized services for the Commonwealth and the Division of Unclaimed Property. DRM administers a variety of insurance programs using a combination of risk retention (self-insurance) and risk transfer (commercial insurance) to pay for or offset the cost of the Commonwealth's public, professional, and tort liability claims. DRM administers the following programs:

Medical Malpractice
This program provides liability coverage for state agencies and employees of the Department of Health; Department of Mental Health, Mental Retardation, and Substance Abuse Services; Department of Corrections; Woodrow Wilson Rehabilitation Center; The University of Virginia-Health Sciences Center; Department of General Services; Department of Juvenile Justice; and the Virginia Veterans Care Center. The program also covers the community colleges and four-year colleges and universities, which have medical and nursing training or student health services.

General Liability
This program provides liability claim and legal protection to the Commonwealth, its institutions, boards, commissions, and authorities, as well as all officers, employees, agents, and volunteers. This program also provides legal defense for judges appearing before the Judicial Inquiry and Review Commission.

Constitutional Officers
This program provides liability protection to all Constitutional Officers, their deputies, employees, and agents as well as all regional jails, their officers, and employees.

Local Government
This program provides voluntary liability coverage to political subdivisions, various public boards, commissions, authorities and instrumentalities, health care professionals providing pro bono medical care at free clinics, free clinics, court-appointed attorneys, pro bono attorneys, receivers, and guardians.

Property and Boiler
This program provides property insurance for all state agencies. The property insurance program covers state-owned buildings, and their boilers and machinery; owned contents in owned and non-owned buildings; and non-owned buildings contractually under the state's care, custody, and control. The property program also provides boiler and machinery inspections for operation certification in owned buildings.

Fidelity Bond
This program provides surety for the faithful performance of duty for all state employees required by statute to be bonded. Agency heads may request surety for other agency employees that handle state funds. DRM also provides surety for the faithful performance of duty for those constitutional officers, and superintendents and officers of regional jail facilities required by statute to be bonded. This includes general receivers and clerks.

Automobile Liability and Property Damage
This program covers liability claims arising from the operation of motor vehicles including owned, hired, or borrowed vehicles. Plan members may also purchase optional physical damage coverage for non-liability losses. The plan offers the same comprehensive and collision coverage found in most commercial automobile insurance policies.

Watercraft/Hull and Aviation
This program provides coverage for state agencies and institutions with aircraft and/or watercraft. Depending on the availability and cost of commercial insurance, these programs may vary between

commercial coverage and self-insurance or a combination of the two. Currently, the state has aviation and watercraft/hull coverage underwritten through a commercial insurance policy.

Commuter Rail
This program provides liability coverage for the Virginia Rail Express commuter railroad.

Department of Accounts

The Department of Accounts (DOA) currently administers the Line of Duty program in addition to other centralized services.

Line of Duty Act
This program provides benefits to public safety employees, or their beneficiaries, who are disabled or who die in the line of duty. Eligible employees include those receiving workers compensation benefits under the heart/lung presumption. They also include those who experience disability or death as the result of a disability or death in the line of duty. DOA pays Line of Duty claims as they arise from the General Fund; however, there are no other claims adjudication programs administered by DOA.

Virginia Retirement System

The Virginia Retirement System (VRS) manages the Virginia Sickness and Disability Program for eligible State employees and the Group Life Insurance self-insurance programs. The group life insurance program also offers coverage to teachers and nonprofessional employees of public school boards, and employees of participating political subdivisions. The VRS maintains a trust fund for the payment of long-term disability claims, administrative costs, case management, cost containment and other expenses associated with the program. VRS also administers the state and local government retirement programs.

Virginia Sickness and Disability Program (VSDP)
The Virginia Sickness and Disability Program (VSDP) provides eligible state employees with up to 125 days of disability benefits during active employment as well as long-term disability benefits. The Virginia Retirement System maintains a trust fund for the payment of long-term disability claims, administrative costs, case management, cost containment, and other expenses associated with the program.

Group Life Insurance Program
The Group Life Insurance Program (Group Life) provides all eligible active state employees, teachers and nonprofessional employees of public school boards, and employees of participating political subdivisions life insurance and accidental death and dismemberment insurance. Retirees continue coverage under the group life insurance program with coverage reducing annually until reaching 25 percent of original coverage amount at retirement. Accidental death and dismemberment coverage cease at retirement.

Departments of Corrections and Juvenile Justice

The Departments of Corrections (DOC) and Juvenile Justice (DJJ) must provide medical care regardless of an inmate's ability to pay. The DOC and DJJ administer self-insured inmate medical care programs. These programs differ from the programs listed above in several ways. The programs provide on-site primary care physicians and nurses, as well as off-site services contracted with external health care providers. The departments do not collect premiums and the departments pay expenses when incurred with the respective agency's general fund appropriation. This review does not include DOC and DJJ, but our audit of these departments will review their financial management of their programs.

Exceptions/Recommendations

Finding: Line of Duty (LOD) Program

While conducting research for this report, auditors found that the Line of Duty program is misplaced.

Background:

The Line of Duty program is the only self-insurance program that is not large enough to necessitate full-time staff. The Department of Human Resource Management (DHRM) and DOA were directed to conduct a joint study (June 2002 Line of Duty Report) of the Line of Duty Act program. The study's results were reported to the Director of the Department of Planning and Budget, and included recommendations regarding the transfer of the health insurance benefit portion of the Line of Duty Act program from DOA to DHRM.

The state police investigate each Line of Duty case for legitimacy prior to sending the case to DOA. Incidents of Line of Duty claims are steadily raising, according to the joint study' the State Police investigations have increased from 6 in 2000 to 40 in 2002. The joint study concludes that the administrative burden for the LOD death benefit at DOA is minimal. The number of claims can vary considerably but average about 12 per year. Barring a catastrophic incident, processing only the death benefit portion of LOD claims currently requires 40 - 60 hours per year.

The Auditor of Public Accounts issued a report entitled "Review of the Financial Accounting and Control Operations of the State Comptroller, Interim Report, December 1, 2004." This report to the Governor and the Chairman of the Joint Legislative Audit and Review Commission agrees with the recommendation of the joint report that administration of the Line of Duty death benefit remain at DOA and administration of the LOD health insurance benefit be transferred to the Department of Human Resource Management. However, with the impending implementation of new accounting standards governing the accounting for post employment benefits other than pensions (OPEB's) the Line of Duty program, which accounts for both the death benefit and the health insurance benefit, may require an actuarial valuation. Moving the entire LOD program to one agency could allow the Commonwealth to benefit from cost savings attributed to procuring the required actuarial valuation, as well as accounting and reporting the fund in compliance with the new standard. During the 2005 General Assembly session, legislation was introduced that would move the Line of Duty program to the Virginia Retirement System. The legislation was not successful. Because the Line of Duty program is not a formal self-insurance program, it is not included in the following review and analysis of the Commonwealth's self-insurance programs.

Line of Duty

Due to new upcoming accounting standards that may require an actuarial valuation of the Line of Duty program, the Commonwealth should consider moving the entire program to another agency.

CHAPTER 2

PROGRAM ADMINISTRATION

Introduction

Though the Commonwealth manages self-insurance programs with a number of agencies, all of them use similar risk management techniques to cover identified risk exposures. Each agency employs a dedicated staff responsible for the administration of each of the self-insurance programs. The program director, with other staff members, identifies, analyzes, and evaluates potential risk exposures using historical experience data as well as industry trends. Risk financing techniques cover the identified risk exposures and program staff evaluate the risk exposures, trends, and financing techniques annually and adjust the program as needed.

The Commonwealth uses risk financing techniques as a way to obtain funds to pay for or offset day-to-day losses that occur. All catastrophic losses are either commercially insured or self-insured. The *risk financing techniques* the Commonwealth uses to cover day-to-day losses are as follows:

- The Commonwealth employs a loss *retention* technique for its self-insurance funds, which means keeping records of losses and maintaining a formal system to pay for them with its own resources.

- The Commonwealth *transfers* the risk of loss to another organization by using commercial insurance to offset losses.

- The Commonwealth employs a *hybrid* technique to combine elements of both loss *retention* and *transfer*, such as large deductible commercial insurance or retention, to a specific stop-loss.

Table A below depicts the diverse placement of the risk financing programs by Secretariats and the commercial providers under contract.

Table A

<table>
<tr><th>Agency</th><th>Program</th><th>Risk Financing Technique*</th><th>Actuary</th><th>Commercial Insurer</th></tr>
<tr><td rowspan="3">Secretary of Administration – Department of Human Resource Management</td><td>Workers Compensation</td><td>Retention</td><td>Mercer (joint contract)</td><td>N/A</td></tr>
<tr><td>State Health Insurance</td><td>Retention</td><td>AON</td><td>N/A</td></tr>
<tr><td>Local Health Insurance</td><td>Retention</td><td>AON</td><td>N/A</td></tr>
<tr><td rowspan="11">Secretary of Finance – Department of the Treasury Division of Risk Management</td><td>Medical Malpractice</td><td>Retention</td><td rowspan="11">Mercer (joint contract)</td><td>N/A</td></tr>
<tr><td>General Liability</td><td>Retention</td><td>N/A</td></tr>
<tr><td>Constitutional Officers</td><td>Retention</td><td>N/A</td></tr>
<tr><td>Local Government</td><td>Retention</td><td>N/A</td></tr>
<tr><td>Property and Boiler</td><td>Hybrid</td><td>Aon/
Hartford
Steam Boiler</td></tr>
<tr><td>Fidelity Bond</td><td>Transfer</td><td>Travelers</td></tr>
<tr><td>Automobile Liability</td><td>Retention</td><td>N/A</td></tr>
<tr><td>Automobile Property Damage</td><td>Retention</td><td>N/A</td></tr>
<tr><td>Watercraft/Hull</td><td>Transfer</td><td>Hilb,
Rogal & Hamilton</td></tr>
<tr><td>Aviation</td><td>Transfer</td><td>AIG</td></tr>
<tr><td>Commuter Rail</td><td>Hybrid</td><td>Lloyd’s of London</td></tr>
<tr><td rowspan="2">Independent Agency – Virginia Retirement System</td><td>VA Sickness & Disability</td><td>Retention</td><td>Palmer & Cay[1]</td><td>N/A</td></tr>
<tr><td>Group Life Insurance</td><td>Hybrid</td><td>Palmer & Cay[1]</td><td>Minnesota Life</td></tr>
</table>

1 *As of January 1, 2005. Prior actuary was Gabriel, Roeder, Smith & Co.*

Regardless of a program’s method of financing, program administrators are required to perform specific functions including: development of premiums and investment income; claims processing and monitoring; management of program expenses; and accounting and reporting.

Program Revenue

Once program staff identify risk exposures and the risk financing technique, the program must generate premium revenue. All of the self-insured funds within the scope of this project contract with an actuary who provides annual or biennial experience-based premium recommendations. This additional analyses includes long- and short-term claims liabilities, which we discuss in the Accounting and Reporting section of this chapter as well as in Chapter Three. Program staff review the actuarial analysis in addition to analyzing historical data and trends to develop a premium recommendation.

Generally, the self-insurance program directors concur with the premium recommendations provided by the actuary. The directors of the Workers’ Compensation, Health Benefits, and Risk Management Programs discuss recommended premiums with the Department of Planning and Budget (DPB). The VRS program actuary recommends premium rate changes to the VRS Board of Trustees who in turn report the Board certified rates to the Governor. Typically, the recommended premiums result from negotiations involving program administrators, the Department of Planning and Budget or the VRS Board of Directors, and the Senate Finance and House Appropriations Committees. However, DPB submits the final proposed premiums for the Governor's consideration in the budget. These premiums are subject to the Governor and the General Assembly's consideration in the development of the Appropriation Act.

Historically, both the Governor and the legislature have changed the recommended premiums. The changes have followed two actions, either a "premium holiday" or a direct reduction in the recommended premium. A premium holiday is a time in which the Commonwealth agencies and employees do not have to pay their monthly premium. While premium holidays or premium reductions may appear on the surface reasonable, the long-term effects can impact the future financial solvency of a self-insurance fund.

A second source of income for a self-insurance fund is interest income on investments. With the exception of the Virginia Retirement System, which is responsible for investing the self-insurance funds for the programs under the System's management, the self-insurance funds of the Commonwealth invest program reserves with the Treasurer of Virginia. The General Assembly may exercise the right to withhold interest on cash held with the Treasurer. Chapter Three – Funding Polices discusses investment interest in detail.

Claims Administration and Monitoring

In exchange for paying a premium, the insured expect an insurance program to provide specified services including: financial indemnification for loss exposures; claims adjudication services; and monitoring of the program to eliminate unnecessary expenses that contribute to rising premiums. The insured expect that from the filing of a claim to final payment or denial of payment, the claims administrator will function as a liaison between the claimant and the insured, and will efficiently handle all administrative tasks involved in adjudicating the claim.

The agencies administering the Commonwealth's self-insurance programs are responsible for providing payment for monetary damages as well as providing claims administration services. The program may provide administration services by contract with a third party administrator (TPA) or by having a dedicated in-house claims adjudication staff. Third party administrators provide claims processing services for the programs with the exception of the Division of Risk Management (DRM) that employs a dedicated staff to adjust claims. However, a TPA provides claims adjudication for the automobile programs and the Commuter Rail program administered by DRM.

Claims administrators, whether TPAs or in-house staff, should undergo an annual review of controls and tests of operating effectiveness. This review is performed on contracting TPAs by an accounting firm using the Statements on Auditing Standards (SAS) No. 70 *Service Organizations*, No. 78 *Consideration of Internal Control in a Financial Statement Audit* and No. 88 *Service Organizations and Reporting on Consistency* issued by the American Institute of Certified Public Accountants. In-house dedicated claims operations should receive an internal audit using standards equivalent to the SAS 70. Claims administration programs that comply with set standards and operate effectively produce cost efficiencies. These cost efficiencies will aid in keeping premium at an acceptable level without compromising the services provided by the self-insurance programs.

Program Expenditures

Each program incurs administrative expenses including actuarial service fees, third party administration (TPA) fees, personal services fees, and cost containment fees for claim payments. The agencies responsible for administering the Commonwealth's self-insurance programs collect premiums, administer claims, and pay all expenses associated with the operations of the program. *Table B* summarizes the total program and claim expenses as percentages of total operating expenses for fiscal year 2004. In general, these expenses are reasonable. Commercial insurance premiums paid for the commuter rail program result in higher administrative expenses as a percentage of claims in the Local Risk Management program. Commercial insurance premiums paid for the property, watercraft/hull and aviation programs result in higher administrative expenses as a percentage of claims in the State Risk Management program.

Table B – 2004 Data

Program	***Risk Financing Technique***	***2004 Total Operating Expenses (millions)[1]***	***2004 Administrative Expenses (millions)[2]***	***Administrative Expenses as % of Operating Expenses***	***2004 Claims Expenses (millions)[3]***	***Claims as % of Total Operating Expenses***	***Administrative Expenses as Percent of Claims***
Workers' Compensation	Retention	$75.1	$8.46	11.26%	$66.64	88.74%	12.70%
Local Health Insurance	Retention	$131.16	$6.27	4.78%	$124.89	95.22%	5.02%
State Health Insurance	Retention	$643.98	$30.82	4.79%	$613.12	95.21%	5.03%
Local Risk Management	Retention/ Transfer	$7.86	$4.21	53.56%	$3.65	46.44%	115.34%
State Risk Management	Retention/ Transfer	$22.47	$7.60	33.82%	$14.87	66.18%	51.11%
VA Sickness & Disability	Retention	$24.51	$.67	2.73%	$23.84	97.27%	2.81%
Group Life Insurance	Hybrid	$107.02	$.99	0.93%	$106.03	99.07%	0.93%

[1] "Total Operating Expenses" includes all expenses incurred to run the program. The figures in this column are directly from program financial statements with the exception of Line of Duty. "Total Operating Expenses" includes claim payments, premium taxes, legal services, actuarial service fees, third party administration (TPA) fees, personal services fees, cost containment fees as well as any miscellaneous fees incurred in the administration of the program as reported in the financial statements.

[2] "Administrative Expenses" is the sum of "Total Operating Expenses" less claim payments.

[3] "Claims Expenses" equal total expenses for claims as reported in program financial statements. "Claims Expenses" are all expenses incurred for payment of claims including reimbursement to third party administrators who pay claims directly.

In addition to these normal operating expenditures, the self-insured funds have also had to transfer funds to the General Fund. The Appropriation Act has directed these transfers from the fund, which are not a normal operating expense of the program's administration. *Non-operating* transfers from the funds have a negative impact on the ability to develop reserves.

Premium revenue and interest income contribute to the development of claims reserves, which serve to stabilize the increases in premium over time and provide a reserve for unusual, but not catastrophic losses. With the exception of the Virginia Retirement System programs, all the self-insured funds are subject to these transfers to the General Fund. These transfers, like premium holidays, deplete reserves, threatening the solvency of the funds and potentially resulting in negative cash flows.

<u>Accounting and Financial Reporting</u>

Each agency administering self-insurance funds employs a fiscal staff responsible for fund accounting and reporting. Each fiscal unit maintains the day-to-day revenue and expenditure functions for the fund.

Additionally, the fiscal unit creates year-end reports for inclusion in the Commonwealth's Comprehensive Annual Financial Report.

Accounting functions include the collection of premiums. The self-insurance programs accounting units individually bill each program participant (insured agency or local entity) at the beginning of the fiscal year with the exception of the health insurance funds. Insured typically pay the total annual premiums in full to the self-insurance programs within the first quarter of each fiscal year. Participants in the health insurance programs pay premiums on a monthly basis. The accounting staff track receivables to ensure that participants have remitted accurate premium payments. If there are discrepancies, the individual accounting units must collect the premiums due.

As mentioned previously, all of the self-insurance funds within the scope of this project contract with an actuary to perform an annual or biennial valuation to forecast program funding requirements. Using historical claims data, the actuary projects cash flow based on anticipated receipt of funds (premium) and the payment of probable future financial obligations (short and/or long-term claims payable). Upon completion of the valuation, depending upon contract requirements, the actuary provides the current and long-term claim liability and may provide an analysis of the overall fund position. The short-term claims liability figure represents claims that will be payable within one year. The long-term claims liability figure represents claims that have been incurred but will be payable in more than one year. Accounting standards require agencies to report claims payable liabilities on financial statements. Refer to Chapter Three – Funding Policies, Fund Balance Analyze for more information regarding actuarial reporting.

Exceptions/Recommendations

Finding: Program Revenue

While conducting research for this study, we found that the Department of Human Resource Management experienced a series of premium holidays and a premium reduction. The tables below represent the history of the fund.

<table>
<tr><th>Fiscal Year</th><th>State Health Insurance Fund</th><th>Legislative Action</th><th>Purpose/Effect</th></tr>
<tr><td>1994</td><td>$41.3 million surplus</td><td></td><td></td></tr>
<tr><td>1995</td><td>$1.2 million surplus</td><td></td><td></td></tr>
<tr><td>June 1995</td><td></td><td>Premium Holiday</td><td rowspan="4">Purpose: to return surplus to agencies by depleting fund

Effect: Deficit with long-term negative impact</td></tr>
<tr><td>June 1996</td><td></td><td>Premium Holiday</td></tr>
<tr><td>July 1996</td><td></td><td>8.5% Premium reduction</td></tr>
<tr><td>FYE 1996</td><td>$26 million deficit</td><td></td></tr>
</table>

The premium holidays and reduction returned the surplus to the agencies; however, they created a long-term financial solvency issue within the program. The Office of Health Benefits, Department of Planning and Budget, and legislators took the following action to preserve the viability of the fund.

Fiscal Year	*Legislative Action – State Health Insurance Fund*
May 1997- June 1998	$27 million infusion to fund through surcharge on agencies' share of premium
1999	$19 million Appropriation
2000	5 percent Premium increase
2002	4 percent Benefit reduction
2003	Employee premium, co-pay and deductible increases
2004	Agency and Employee premium increase

Short-term cost savings to the agencies, such as reallocation of funds or premium holidays, causes hardships to agencies and employees in the long run. Many factors dictate the health of each fund. The programs cannot avoid the rising costs of services and administration; however, restricting the use of the funds can protect their solvency.

Recommendation*: The Commonwealth should develop policies that protect the funding and any future reserves of self-insurance programs to ensure that the increasing liabilities can be satisfied.*

Finding: Claims Administration and Monitoring

We found that the Department of Human Resource Management, Office of Health Benefits requires, by contract with the actuary, a review of Anthem's third party claims administration (TPA) services including payment, processing, and procedural administration. However, the most recent evaluation covers the period of April 25 through June 15, 2001.

Recommendation: *The Office of Health Benefits should ensure that they receive a consistent and timely SAS 70 review of the third party claims administration for health care claims of the Commonwealth. Reviews ensure the TPA's statistical, systems, and procedural compliance with standards. They also provide assurances on workflow, management, and quality control.*

CHAPTER 3

FUNDING POLICIES

Funding Standards

A successful risk management program operates based on specific funding policies. Funding policies include the establishment of accepted standards to determine whether a fund is healthy, in recovery, or in need of review and revision. Established standards may include fund balance and net asset minimums, liquidity measures, and investment policies. Without uniform funding policies and objectives, it is difficult to identify the health of a self-insurance fund. Often, funding policies uphold the expectation that the fund balance be equal to or greater than the current claims liability (claims due within one year). Many funding policies require a reserve for long-term claims payable (claims due to be paid in greater than one year).

None of self-insurance funds have funding policies, and therefore, we could not measure the fund performance with internally established standards. However, to determine the health of each fund when performing our analyses of net assets, working capital, and liquidity measures we used the American Institute for Chartered Property Casualty Underwriters (AICPCU) Liquidity Ratio and the actuarial calculation of the National Association of Insurance Commissioners" Risk-Based Capital Formula.

Fund Balance Analyses

The most significant expenses for insurance funds that affects fund balance are claims. A self-insured organization must recognize its claims on its financial statements as they are incurred rather than as they are paid out of the fund. Some losses may have occurred but the pending claim remains unreported to the program. The industry refers to these claims as "incurred-but-not-reported (IBNR) losses." A self-insured organization should include reserves for its IBNR losses if they can be reasonably determined.

The IBNR losses of self-insurance funds can be reasonably determined because each program has a significant history of relevant claims data. An actuary uses this data to project the IBNR based on the history of claims experience for the program and the actual claims reported in a given year. The actuary uses IBNR to determine necessary funding (which is a variable in the formula for the recommended premium calculation). *Table C* below indicates the claims payable liabilities, short- and long-term, reported on the financial statements for each fund as well as the fund balance for each program.

Table C – 2004 Data (in millions)

Program	***Fund Balance[1]***	***Current Claims Payable [2]***	***Long-term Claims Payable [3]***	***Total Net Assets [4]***	***Restricted Fund (Trust)***	***Line of Credit FY04***
Workers' Compensation	$ 30.8	$ (41.6)	$ (150.7)	$ (161.5)	None	$10.0
Local Health Insurance	30.6	(15.2)	-	15.4	None	$25.0
State Health Insurance	60.9	(85.7)	(53.2)[5]	(24.8)	None	
Local Risk Management	32.4	(10.7)	(4.3)	21.7	None	$15.0
State Risk Management	19.4	(27.2)	(13.2)	(7.8)	None	
Line of Duty Act [5]	-	Note[5]	$-[5]	-	None	None

VA Sickness & Disability	105.4	(2.1)	(112.5)[5,6]	103.3	Restricted	None
Group Life Insurance	813.3	(34.9)	$ (1,637.4)[5,6]	$ 778.4	Restricted	None
Collective Fund Balance	$1,095.6	$ (197.1)				

[1] Actual Fund Balance at fiscal year end 6/30/04. The fund balance reflects the status of the fund before subtracting the short- and long-term claims payable from the year-end total net assets of the fund as reported in agency financial statements. The actuarial valuations provided for Workers' Compensation and Treasury Division of Risk Management use this method to calculate the fund balance. For consistency, this report uses the described method for all funds reviewed.

[2] An actuary determines Current Claims Payable (short-term claims payable) for each fund and long-term claim for Workers Compensation as reported in the Commonwealth's financial statements. Based on fiscal year 2004 valuations.

[3] An actuary determines Long-term Claims Payable for each fund. Based on fiscal year 2004 valuations unless otherwise noted.

[4] Total Net Assets at fiscal year end June 30, 2004 represents the balance in the fund as if claims payable were paid.

[5] Though currently only the Workers' Compensation Fund books long-term claims payable on financial statements, implementation of "Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions" (OPEB) *will require certain funds to account for long-term claims payable in their financial statements.*

[6] Long-term claims payable figures for Sickness and Disability and Group Life Insurance programs based on fiscal year 2003 actuarial valuations as these are the most current valuations available for long-term liabilities.

We found that in comparing the actual fund balances to the current claims payable liability for each fund, it is apparent that the Workers' Compensation Fund, State Risk Management, and the State Health Insurance Fund at fiscal year end June 30, 2004, do not have adequate assets to cover the current claims liability. If the self-insured program ceased operations today, the claims incurred but not reported (IBNR) would continue to be payable, though with the cessation of the program, premium revenue would cease. Historical analyses of the Workers' Compensation and State Health Insurance Funds indicate a steady decline in total net assets for each fund.

Net Assets (in millions)

	2000	***2001***	***2002***	***2003***	***2004***
Workers' Compensation Fund	($109)	($107)	($116)	($131)	($161)
State Health Insurance Fund (HIF)	$35	$17	($18)	($21)	($25)

** The Workers' Compensation Fund transferred to the Department of Human Resource Management (DHRM) from the Department of General Services (DGS). Data from 2001-2004 was obtained from DHRM; 2000 data obtained from DGS financial statements.*

While the Workers' Compensation Fund and the State Health Insurance Fund have significant negative fund balances, they operate from year to year, by striving to collect premium revenue equal to total program and claims expenses. Since 2001, both programs have had to utilize their inadequate reserve funds to satisfy total program expenses and claims resulting in a yearly decrease in net assets. This is evident when determining the liquidity of each program.

The implementation of the new accounting standards governing the accounting for post employment benefits other than pensions (OPEBs), will require some of the self-insured funds of the Commonwealth to show long-term liabilities (claims payable in greater than one year) on fund financial statements. This will further reduce the affected program's fund balance and net assets, increasing the need for fund reserves.

Industry Liquidity Measures

An organization's measures of liquidity are working capital and its current ratio. Current assets provide an economic benefit to an organization. They consist of cash and other items that can convert to cash within one year. Included are marketable securities and accounts receivable. Current liabilities are an organization's obligations due in cash within one year and include accounts payable, other expenses payable, and short-term debt. For an organization that retains (self-insures) its losses, current liabilities also include reserves for losses that have occurred but not reported (IBNR) and are expected to be paid within one year.

Working capital is a measure of a firm's overall liquidity calculated by subtracting current liabilities from current assets. Working capital is the amount left over if current assets fund all the cash demands of the firm's current liabilities. As long as its working capital is a positive number, an organization has readily available cash to fund losses from unforeseen events, such as higher-than-expected payments for retained losses.

Table D – 2004 Data

Program	***Current Assets***	***Current Liabilities***	***Working Capital***
Workers' Compensation	$ 74,084,371	$ 85,595,238	$ (11,510,867)
Local Health care	35,982,410	20,820,585	15,161,825
State Health care	74,485,981	100,153,639	(25,667,658)
Local Risk Management	25,130,000	16,646,000	8,484,000
State Risk Management	44,071,071	51,839,531	(7,768,460)
Virginia Sickness & Disability	13,090,000	9,366,000	3,724,000
Group Life Insurance	83,350,000	92,879,000	(9,529,000)

A second liquidity measure is the current ratio, which shows the size of a fund's current assets relative to its current liabilities. Per the American Institute for Chartered Property Casualty Underwriters (AICPCU), and the Insurance Institute of America (IIA) the higher the level of an organization's risk retention, the greater its need for liquidity. In general, a current ratio of 2.0 or higher indicates that a firm has a strong level of liquidity. Alone, a current ratio of less than 2.0 does not indicate that a fund is in distress, nor is a current ratio of less than 2.0 inadequate. Liquidity requirements vary among programs. The Commonwealth's programs operate on a pay-as-you-go basis. They rely on each current dollar coming into the fund to cover a dollar that must go out of the fund. In the event of an unforeseen increase in the number claims or an unpredicted trend in rising program costs, the liquidity of the fund is a crucial factor.

Table E below illustrates the Commonwealth's risk financing programs and their respective liquidity measures.

Table E – 2004 Data

Program	***Current Assets***	***Current Liabilities***	***Current Ratio***
Workers' Compensation	$74,834,371	$ 85,595,238	0.87
Local Health care	36,092,410	20,820,585	1.73
State Health care	74,485,981	100,153,639	0.74
Local Risk Management	25,130,000	16,646,000	1.51
State Risk Management	44,071,071	51,839,531	0.85
Virginia Sickness & Disability	13,090,000	9,366,000	1.40
Group Life Insurance	83,350,000	92,879,000	0.90

The final liquidity measure is the National Association of Insurance Commissioners' (NAIC) Risk Based Capital Formula. The State and Local Health Insurance programs are the only programs where actuaries apply this formula. The formula represents the minimum capital an insurance company should have to support the types of risks assumed by the Commonwealth in connection with the plan. The formula serves as an industry benchmark for minimum funding. Using the actuary's calculation of the minimum capital requirement the table below shows the State Health Insurance Fund $78 million under-funded.

FY04 Figures (in millions)

Program	**Actuary Minimum Capital Requirement**	**Fund Balance (per financial statements)**	**Unfunded Liability**
Local Health Insurance	15.4	30.6	15.2
State Health Insurance	138.9	60.9	(78.0)

The Workers' Compensation, State Health Insurance, State Risk Management and Group Life Insurance funds fail to meet the benchmark liquidity tests. The current ratios for these funds are below 1.0, and the working capital for each of these funds is negative. However, liquidity ratios alone are not indicative of deterioration of the fund. The Workers' Compensation Fund and the State Health Insurance Fund (HIF) are particularly at risk and share the following characteristics:

- Continued decline in funds resulting in increasing negative net assets;
- Fund balances cannot cover current claims payable;
- Failed current ratio test;
- Negative working capital; and
- Transfers from reserves.

In addition, the State Health Insurance Program does not meet the NAIC minimum capital requirements for funding. This program and the State Risk Management fund have also experienced transfers from their reserves to the General Fund in the recent past having a severely negative impact on the funds. Refer to Chapter Two – Program Administration, Exceptions/Recommendations for findings regarding these transfers.

Return on Investments

Currently, the Department of Treasury manages the entire cash reserve balances of the self-insurance programs, with the exception of the Group Life Insurance and the Virginia Sickness and Disability programs, in the Treasurer's General Account Portfolio. The purpose of the Treasurer's General Account Portfolio is to meet the daily cash flow demands of the Commonwealth by investing in short-term, high liquid investments with durations of one to five years. Each of the cash reserve balances receives an allocation of interest earnings based on their balance as a ratio of the total funds invested. However, in prior years to meet the Commonwealth's overall budget shortfalls, the programs have had their interest earnings transferred to the General Fund.

Though the self-insured funds listed in the table below received fourth quarter interest from cash invested with the Treasurer of Virginia in 2004, total fiscal year 2004 interest paid for four quarters averaged 36 percent *less* than prior year interest paid for only three quarters due to a downturn in the market. *Table F* below illustrates interest income for fiscal years 2003 and 2004 for the five funds invested in the General Account Portfolio.

Table F – Composite Data

Program	***Fund Interest Paid on Cash w/Treasurer of VA***			
	2004*	***2003*****	***Variance***	***Interest Income Increase/Decrease***
Workers Compensation Fund	$1,254,280	$2,161,536	($907,256)	-41.97%
Local Health Insurance Fund[1]	367,926	249,334	118,592	47.56%
State Health Insurance Fund	1,032,570	1,871,973	(839,403)	-44.84%
Local Risk Management	1,248,762	1,796,623	(547,861)	-30.49%
State Risk Management	770,774	1,201,624	(430,850)	-35.86%

** Interest revenue includes 1st-4th quarter interest.*

** Includes only 1st-3rd quarter interest. 4th quarter interest not paid.*

1 Local fund interest revenue increase is due to increased premium revenue in fiscal year 2004.

The self-insurance programs have a combined fund balance of over $1.1 billion as shown in Table C. The Virginia Retirement System (VRS) Virginia Sickness and Disability Program and Group Life Insurance program account for over $918.8 million of that total and VRS actively invests those dollars in a variety of investment instruments. Collectively, the remaining fund balances outside of VRS (included in Table D above) total $189 million.

A more aggressive investment policy may yield higher returns for the collective non-VRS administered self-insurance funds. The analysis below reflects the effects of changes in interest and expected losses over a five-year investment period using a simplified version of a five-year fund balance calculation. Exhibits one through three below summarize the tables based on the following mutual assumptions:

- The beginning balance of the fund is $ 0.00 (zero);
- A simple interest calculation is based on the sum of the beginning balance plus the annual premium revenue multiplied by the annual interest rate (1 percent or 5 percent for models);
- To simplify the illustration, administrative/program fees are not included;
- Loss payments increase by 5 percent each year; and
- Premium revenue is constant ($100,000,000)

In the true financial marketplace, the premium revenue will not remain constant. However, this assumption allows the models to illustrate the impact of increasing the rate of return on investments as well as the effect of a 1-year freeze on premium revenue collection (called a "premium holiday".)

Exhibit 1:

Premium revenue remains constant		
Rate of Return	Investment Income 1 percent	Investment Income 5 percent
Ending Fund Balance Year 5	$8,340,603	$33,213,469

Exhibit 2:

Premium holiday in year 2		
Rate of Return	Investment Income 1 percent	Investment Income 5 percent
Ending Fund Balance Year 5	($95,719,798)	($88,337,156)

Exhibit one indicates that when premium revenue remains constant, the ending balance in year five shows a $25 million gain over a fund invested at one percent interest. In exhibit two, a premium holiday in year two causes a deficit fund balance that projects through to year five at alarming levels.

Exhibit 3:

Premium revenue remains constant Unpredicted additional loss of 5 percent in year 2		
Rate of Return	Investment Income 1 percent	Investment Income 5 percent
Ending Fund Balance Year 5	$9,268,606	$34,439,344

Exhibit 3 illustrates the effect of an unexpected rise in claims payments in the second year of the five-year analysis. All other assumptions remaining equal, a 5 percent return on investments yields nearly $25 million in additional funds.

A greater yield on investments, along with stable interest earnings, will aid in the development of financially sound self-insurance funds. Although, the model above shows one theoretical alternative, actual market conditions will probably result in lower returns.

Exceptions/Recommendations

Finding: Funding Analyses

Our analysis found that all self-insurance funds lack funding policies in order to monitor the ongoing health of each fund and assist in ensuring impending accounting standards do not adversely effect the Commonwealth's financial position.

***Recommendation**: The Commonwealth should develop and implement formal funding policies for all self-insurance funds including setting adequate premium revenues, and monitoring and managing the liquidity levels and funding progress. In addition to safeguarding the self-insurance funds, the Governor and General Assembly may wish to consider segregating these funds in a dedicated fiduciary trust fund.*

Finding: Investment Policies

We found that factors that may threaten the heath of the self-insurance funds include the current investment strategy for reserves. Investing the self-insurance programs cash and developing a more aggressive investment strategy can provide higher yields that will allow the Commonwealth to manage more effectively the day-to-day risk of loss. It is important to recognize that liquid investments are appropriate for portions of the funds that cover current liabilities (liabilities payable within one year or less). The short-term portion of the self-insurance funds can grow in traditional capital market securities. A revised investment strategy can include maturities greater than one year to correlate with the long-term claims payable associated with the funds.

Recommendation: *If the Governor and General Assembly choose to segregate the self-insurance funds, it should consider investing assets with external investment managers and using the Local Government Investment Pool for daily cash management. Another alternative is authorizing the Treasurer of Virginia to segregate the funds within the General Account, use existing investment managers and establish separate investment objectives that provide the maximum benefit to operations.*

Commonwealth of Virginia

Walter J. Kucharski, Auditor

Auditor of Public Accounts
P.O. Box 1295
Richmond, Virginia 23218

April 1, 2005

The Honorable Mark R. Warner
Governor of Virginia
State Capitol
Richmond, Virginia

The Honorable Lacey E. Putney
Chairman, Joint Legislative Audit
and Review Commission
General Assembly Building
Richmond, Virginia

We have completed our review of the operations of the **Self-Insurance Funds** for the year ended June 30, 2004. The objective of our review was to discuss the purpose, administration and financial position of the Commonwealth of Virginia's self-insurance programs.

Scope and Methodology

In conducting our review we made inquiries of appropriate personnel, inspection of documents and records, and observation of the Department of Treasury Division of Risk Management, Department of Human Resource Management Office of Health Benefits and Office of Workers Compensation, and the Virginia Retirement System self-insurance operations.

We have discussed this report with management at the Department of Treasury, Department of Human Resource Management and the Virginia Retirement System and have included their responses at the end of this report.

AUDITOR OF PUBLIC ACCOUNTS

SHW:whb
whb:

COMMONWEALTH of VIRGINIA

SARA REDDING WILSON
DIRECTOR

Department of Human Resource Management

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April 13, 2005

Auditor of Public Accounts
P.O. Box 1295
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Subject: Agency comments to Statewide Self-Insurance Review

The Department of Human Resource Management (DHRM) administers three of the programs included in this review and will be impacted by any ongoing actions resulting from this review. In general, we are in agreement with the overall findings however would like to include the following comment from the two areas within DHRM that operate the programs. The comments are shown by the responsible office areas.

Office of Worker's Compensation (OWC)

In reviewing the audit report, there are several broad comments that may not accurately reflect the Workers' Compensation Program. They are:

- Events such as premium holidays, reductions and fund transfer coupled with the rising costs of services and administration cannot lead to decreased benefits for Workers' Compensation because the workers' compensation benefits are statutorily mandated.
- The Workers' Compensation Program has had a cash flow funding policy in place since 1998. As required by the Appropriations Act, cash flow experience based premium recommendations are submitted to the Governor and the General Assembly September 1 in advance of the biennium. The Governor, the Department of Planning and Budget, and the General Assembly have consistently supported those recommendations.
- If the Workers' Compensation Program ceased operations today, premium revenues would not cease, they would continue. The Program operates on a cash flow basis, and is funded similar to a commercially insured paid loss retro policy or a cash flow program without the minimum and maximum premium guarantee.

Office of Health Benefits (OHB)

In reviewing the final report on the Statewide Self-Insurance Review (2004), we note that items contained in the preliminary report and addressed by this office on March 25, 2005, were not updated on the final report. Per conversation between T. J. Clayton, Department of Human Resource Management (DHRM), and Sherri Wyatt, Auditor of Public Accounts, these items will not be corrected in the final report. DHRM feels these items are relevant and have a bearing on the final report, and we are, therefore, reiterating them below. As noted earlier, these comments pertain basically to the two health insurance programs operated by DHRM, although some comments may have a bearing on statements pertaining to other programs.

We would like to note that the report is very comprehensive and addresses many items of concern to this Agency. We have found no material differences in the numbers used and calculated and any discrepancies are likely due to timing and differences in the way that different individuals look at the data being addressed. Our points primarily address written items. The are listed by Chapter and page number as follows:

1) Chapter 1, Page 1: The state employee count does not include the 25,638 Medicare Retirees although most of your table data includes the Medicare Retirees portion. In the same paragraph, the TLC programs covers over 230 groups.

2) Chapter 1, Page 3 - DOA Line of Duty Act. DOA does not pay claims in the normal sense, but pays the premiums to employers for the continuing insurance on the participants.

3) Chapter 1, Page 4 - Background on LOD program. LOD is not a true self-insurance program, rather than an unfunded program. The report refers to it as a self-insurance program in the first paragraph but backs off that statement in the last paragraph.

4) Chapter 2, Page 8 & 9 - Accounting & Financial Reporting. Paragraph 2 addresses collection of funds and describes the method used by Workers Compensation and Risk Management. However, under the health insurance programs, agency and employer premiums are billed and collected monthly for the current month. This is not reflected in the discussion, which may be confusing to the uninformed enrollee who knows their premiums are deducted from each payroll or retirement check.

5) Chapter 2, Page 10 - Finding: Claims Administration and Monitoring. The report is correct in that the last formal on-site audit of Anthem covered the claims for the period noted. There are, however, substantial control functions that continue on which were not mentioned for the time period since that formal audit. They are: (1) AON's claims history file that they operate by contract for the Office of Health Benefits and has the built in audit functions which are applied to paid claims from all vendors including claims paid for eligible enrollees, duplicate claims payments, filing timeliness, and is being enhanced to perform case and disease management functions based upon all vendors claims. This is a substantial and on-going audit function that cannot be discounted in this report. (2) Anthem performs a SAS 70 audit of their entire system. Anthem's most recent SAS 70 audit has been completed and is in our contract files; and (3) during the 2004 procurement, we performed and extensive review of all claims processing and administrative systems for each finalist. Our in-house policy is to perform an on-site audit of vendors' systems every 3-4 years or as needed in our opinion. We extended our formal audit period due to the systems review that went into the procurement. On-site audit of vendors' systems will be scheduled beginning early in 2006.

6) Chapter 3, Page 13 - Table D. Under the current assets, the prepaid item of deposits with carriers was not handled consistently between the two health insurance programs. This is not a material difference but may be confusing to an accountant attempting to verify numbers against the CAFR.

We appreciate the work that has gone into this study to consolidate information on all of the programs involved. It provides a basis which will allow a high level overview of the state's self insurance business.

Sincerely,

Sara R. Wilson

Sara R. Wilson
Director

COMMONWEALTH of VIRGINIA

Department of the Treasury

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April 13, 2005

Walter J. Kucharski
Auditor of Public Accounts
James Monroe Building
101 North 14th Street
Richmond, Virginia 23219

Dear Mr. Kucharski:

Thank you for the opportunity to respond to the suggestions and policy recommendations contained in the Audit Report on the Statewide Self-Insurance Review 2004. Your efforts to examine and improve the self-insurance programs of the Commonwealth are commendable. We welcome your comments and suggestions for improvement as they pertain to the Department of the Treasury (Treasury) and will take them under consideration as we continue to evaluate the investment policies and other improvements to our programs. Our response focuses primarily on investment policy.

Investment Policies for Self-Insurance Funds

Invest Assets with External Investment Managers – The recommendation to invest the self-insurance funds in a more aggressive strategy may be problematic unless it is accompanied by stable funding. We agree that opportunities for improvement do exist. Our observations and concerns follow:

- At present, 25% of the General Account portfolio is already invested in an extended duration strategy. Accordingly, 25% of the self-insurance funds are invested in this manner. Six external portfolio managers, under contract with the Treasurer of Virginia, have been engaged since January 1, 1995 and have generated substantial additional returns to the participants of the General Account portfolio. Beginning on July 1, 2005, our external portfolio managers will have authority to invest up to 10% of the assets under their management in BBB rated securities. Over time, this will add additional value to the monies that are invested within the General Account.

- In the example presented in the audit report, the interest rate assumptions, and the spread between short-term returns and extended duration returns may be misinterpreted. While a spread of 400 basis points may occur, it is more realistic to assume a spread of 150 to 200 basis points over a long term. Even then, only a portion of funds would be invested in an extended strategy.

- While the external management program of the General Account portfolio has been very successful since its inception, it was also one of the primary causes for the interest income decline shown in Table F. Since interest rates have now been rising for almost one year, professional portfolio managers have been selling portfolio holdings at losses, resulting in a sizable negative impact on the earnings of the General Account. A more aggressive approach during this period would have had an even greater negative impact on the earnings of the self-insurance funds. Even if no unscheduled liquidations are required, longer duration separately managed portfolios will have to be marked to market on a regular basis that might have a detrimental impact on the performance of the assets.

- The proposal to utilize the Local Government Investment Pool (LGIP) as a vehicle for short-term transactions may create inefficiencies since it would involve frequent transfers into and out of the LGIP. We urge that all efforts be made to protect the self-insurance funds while allowing the short-term funds to be invested in the General Account.

Treasury will, with its investment consultant, reevaluate current investment policies, with the objective of enhancing the returns on the self-insurance funds. However, we believe any enhancements must be tied to the development and implementation of formal funding policies. Without dependable cash flow projections, the integrity of such enhancements would likely be at risk if unexpected liquidation of the portfolio were required during difficult market environments.

Please contact me if you have any questions or comments related to our response.

Sincerely,

Jody M. Wagner

Jody M. Wagner

JMW:gas

c: The Honorable John M. Bennett
Secretary of Finance