

REPORT BY THE
AUDITOR GENERAL
OF CALIFORNIA

**THE DEPARTMENT OF VETERANS AFFAIRS
HAS NOT ADEQUATELY MONITORED THE
GROWTH OF THE RESERVE FUND BALANCE**

REPORT BY THE
OFFICE OF THE AUDITOR GENERAL
TO THE
JOINT LEGISLATIVE AUDIT COMMITTEE

P-361

THE DEPARTMENT OF VETERANS AFFAIRS
HAS NOT ADEQUATELY MONITORED
THE GROWTH OF THE RESERVE FUND BALANCE

NOVEMBER 1983



Telephone:
(916) 445-0255

Thomas W. Hayes
Auditor General

STATE OF CALIFORNIA
Office of the Auditor General
660 J STREET, SUITE 300
SACRAMENTO, CALIFORNIA 95814

November 14, 1983

P-361

Honorable Art Agnos, Chairman
Members, Joint Legislative
Audit Committee
State Capitol, Room 3151
Sacramento, California 95814

Dear Mr. Chairman and Members:

The Office of the Auditor General presents its report concerning the Department of Veterans Affairs' monitoring of the reserve fund balance for the life and disability insurance provided under the California Veterans Home Protection Plan.

Respectfully submitted,


THOMAS W. HAYES
Auditor General

TABLE OF CONTENTS

	<u>Page</u>
SUMMARY	i
INTRODUCTION	1
AUDIT RESULTS	5
CONCLUSION	13
RECOMMENDATION	14
OTHER PERTINENT INFORMATION	15
RESPONSE TO THE AUDITOR GENERAL'S REPORT	
Secretary, State and Consumer Services Agency	19
APPENDIX	
LIFE AND DISABILITY INSURANCE PROGRAM RESERVE FUND INCOME AND EXPENSES, 1978-1983	A-1

SUMMARY

The Department of Veterans Affairs (department) has not adequately monitored the growth of the reserve fund balance for the life and disability insurance provided under the California Veterans Home Protection Plan. From 1977 to 1983, the reserve fund balance grew from \$57 million to \$115 million. During 1983, the reserve fund was \$50 million to \$74 million larger than necessary. The department and the insurance companies could have reduced the premium rates charged to California veterans to decrease the size of the reserve fund earlier but did not do so until 1982.

The department contracts with two private insurance companies to provide life and disability insurance for California veterans. The department and the insurance companies agree that the reserve fund balance is significantly higher than what is required to meet expected insurance commitments. The department's actuary estimated that the fund could be as low as \$41 million, while an insurance company actuary estimated that the fund should be between \$55 million and \$65 million. Any amount over what is required to meet expected insurance commitments is considered excess reserve funds.

The department and the insurance companies could not agree on a method to stop the growth. Thus, the department and the insurance companies did not reduce total premium income until September 1982. As a result, California veterans were paying unnecessarily high premiums, thereby further increasing the size of the reserve fund balance. Moreover, the department paid the insurance companies more fees than necessary. If the premiums had been reduced by 50 percent in 1981, the department would have paid the insurance companies approximately \$65,553 rather than \$131,106 in premium profit charges.

Because the department and the insurance companies have disagreed on how to reduce the reserve fund balance, the department notified the insurance companies on August 22, 1983, that the contract would be terminated effective December 31, 1983. Department officials will employ the competitive bidding process in procuring the next insurance contractor.

INTRODUCTION

The Department of Veterans Affairs (department) offers long-term, low-interest loans to California veterans so that they may purchase homes or farms. California veterans, with some exceptions, have 25 years following their release from active military service to apply for loan benefits. Since 1921, the department has made loans to over 363,000 California veterans. All California veterans applying to the department for home or farm loans must also apply for life and disability insurance under the California Veterans Home Protection Plan.* The life insurance coverage will pay off the outstanding loan balance upon the death of the insured veteran. The disability coverage will pay the insured veteran's monthly loan installment if that veteran becomes disabled. Between 1938 and 1982, the insurance companies paid \$185.9 million in death benefit claims; between 1955 and 1982, the insurance companies paid \$80.1 million in disability benefit claims. In December 1982, 115,614 veterans had life insurance coverage, and 90,769 veterans had disability insurance coverage. Veterans were insured for a total of \$2,737,500,901 in life and disability insurance.

The Military and Veterans Code authorizes the department to contract with one or more insurance companies to provide life or disability insurance to California veterans who purchased homes or farms

*Throughout this report, we refer to the life and disability coverage provided to California veterans as the "life and disability insurance program."

through the department. In 1938, the State contracted with two insurance companies, California-Western States Life Insurance Company and Occidental Life Insurance Company of California, to provide life insurance to California veterans qualifying for home and farm loans. The State originally awarded the contract on a sole-source basis. The contract has been modified several times, but it has never been competitively bid. In 1955, the department added disability insurance to the program. Supplemental life and accidental death benefits were added in 1960, but discontinued for new loans after 1981. In August 1983, the department notified the insurance companies that it will terminate the contract effective December 31, 1983. The two insurance companies have had the insurance program for over 44 years.

The department collects monthly premiums for life and disability insurance coverage from veterans with home and farm loans. The department pays the total amount collected to the insurance companies. The insurance companies maintain a reserve fund to pay life and disability insurance claims. The department and the insurance companies can moderate the size of the reserve fund balance by adjusting the premium rates. If the amount paid for benefit claims is greater than the amount of the reserve fund balance, the department and the insurance companies could increase future premiums. Likewise, if the amount paid for benefit claims is lower than the amount of the reserve fund balance, the department and the insurance companies could either decrease future premiums or maintain the excess in the reserve fund.

As part of their contractual responsibilities, the insurance companies review applications for insurance, process benefit claims, and invest the reserve funds. The department reimburses the insurance companies for their administrative and investment expenses and pays them three "profit charges." These profit charges are not related to the costs incurred by the insurance companies; instead, they are based upon the premiums received or the average size of the reserve fund. During 1982, the insurance companies' reports showed that the department paid \$1,094,521 to the insurance companies. Of this total, \$734,230 represented administrative and investment expenses, while \$360,291 represented profit charges. In addition, the department reimburses the insurance companies for premium taxes. In 1982, the department paid \$541,178 in premium taxes.

When the insurance companies make investments, they commingle monies from the reserve fund for the department's life and disability insurance program for California veterans with their own investment portfolios. Since 1976, the insurance companies have determined the interest on the department's portion of the investment based upon the department's share of the actual market place earnings on the various assets that the insurance companies purchase each year.

SCOPE AND METHODOLOGY

We focused on the Department of Veterans Affairs' management of the program that provides life and disability insurance to California veterans. We limited our review to the reserve fund balance that the insurance companies maintain, but we did not conduct this audit to determine how large the reserve fund balance should be. We reviewed actuarial reports, correspondence between the department and the insurance companies, and annual accounting reports that the insurance companies provided to the department. We interviewed personnel from the Department of Veterans Affairs, from the Department of General Services' Office of Insurance and Risk Management, and from the California-Western States Life Insurance Company. We also interviewed a representative from the actuarial consulting firm under contract to the department.

AUDIT RESULTS

The Department of Veterans Affairs (department) has not adequately monitored the growth of the reserve fund balance for the life and disability insurance program. Between 1977 and 1983, the reserve fund balance grew from \$57 million to \$115 million. According to the department, this fund balance only needs to be \$41 million. Although the reserve fund balance has been increasing, the department and the insurance companies did not reduce the size of the reserve fund balance by reducing the premium rates charged to California veterans until 1982. As a result, California veterans paid higher premiums than necessary, and the department paid unnecessarily high profit charges to the insurance companies.

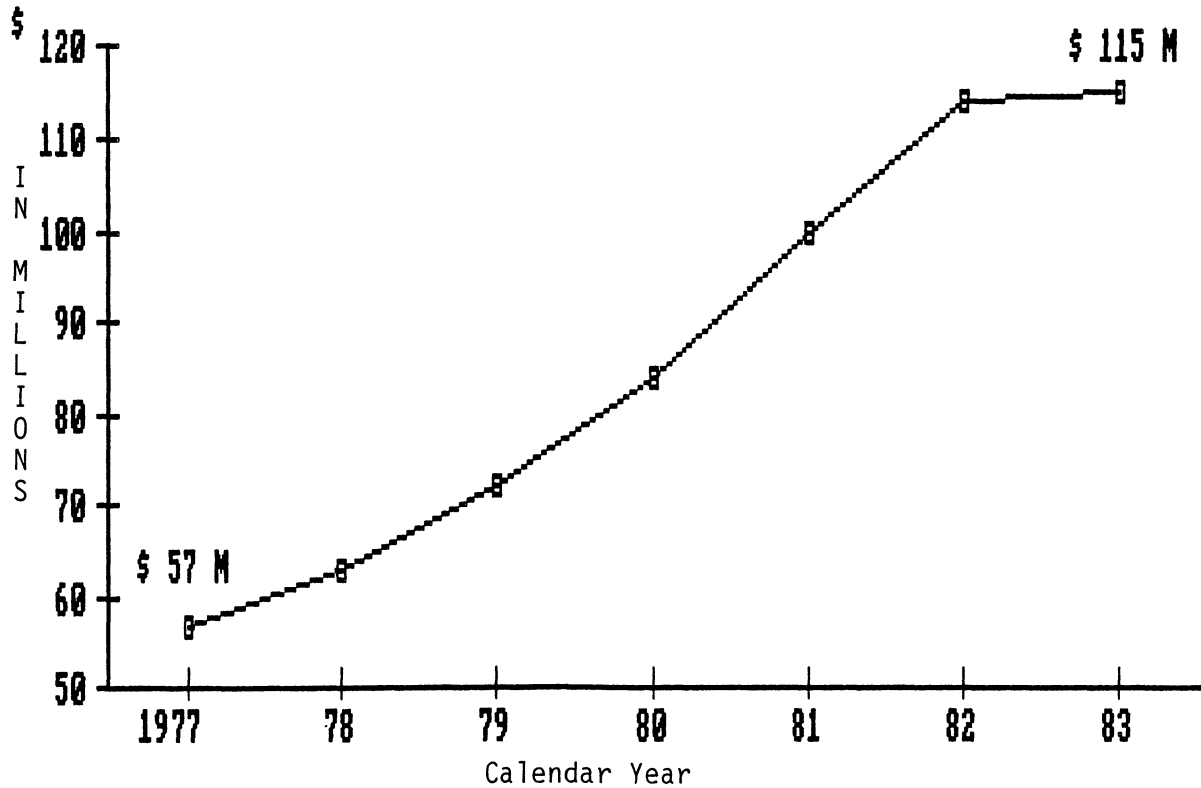
The Reserve Fund Balance Is Higher Than Necessary

Under the terms of their contract with the State, the insurance companies maintain a reserve fund that, when combined with premiums, is sufficient to pay life and disability claim benefits to California veterans. The insurance companies provide the department with annual accounting reports that present information on the reserve fund balance. The ending reserve fund balance equals the beginning fund balance plus premium income and investment interest, less total expenses (paid benefits, administrative and investment expenses, and premium taxes) and profit charges. We reviewed these accounting reports from 1978 to 1982 and found that total income reported in the reserve fund has increased

disproportionally to total expenses and profit charges. In 1977, the department's reserve fund had a total of \$22,181,304 in premium and investment interest income and a total of \$15,943,413 in expenses and profit charges (see Appendix A). In 1982, the total premium and investment interest income increased by 54 percent to \$34,266,125, and the total expenses and profit charges increased by 25 percent to \$19,931,405. This disproportional growth in income relative to expense has further increased the size of the reserve fund balance. As shown in Chart 1 on the following page, the reserve fund balance has grown since 1977 from \$57 million to \$115 million.

CHART 1

LIFE AND DISABILITY INSURANCE PROGRAM
RESERVE FUND BALANCE
1977-1983



Source: Unaudited annual accounting reports from the insurance companies.

Until recent enactment of new legislation, the Military and Veterans Code did not specify how large the reserve fund balance should be. Moreover, the contract between the department and the insurance companies does not specifically limit the size of the reserve fund balance, and it does not have provisions, other than for termination, for refunding excess reserve funds to the department.

According to the department's actuary, the reserve fund balance must be large enough to pay off all existing disability claims if the life and disability insurance program were to terminate suddenly. Any amount over the minimum reserve fund balance is considered excess reserves. The department's actuary stated that meeting this requirement would necessitate a reserve fund balance of approximately \$41 million. The California-Western States Life Insurance Company estimated, however, that the reserve fund balance should be between \$55 million and \$65 million. Thus, the reserve fund balance is from \$50 million to \$74 million higher than necessary. These estimates differ because the department's actuary and the insurance company's actuary may have used different assumptions to calculate the reserve fund balance requirements.

The department and the insurance companies could moderate the size of this reserve fund balance by adjusting the premiums charged to veterans. Although premiums have been adjusted in the past, the department did not agree with the insurance companies on how to reduce the reserve fund balance, and thus, the department and the insurance companies did not lower the total premium income until 1982. Consequently, California veterans paid unnecessarily high premiums, further increasing the size of the reserve fund. If the premiums had been reduced by 50 percent in September 1981 rather than September 1982, for example, California veterans would have paid \$13 million less.

In addition to charging California veterans higher premiums than necessary, the department paid the insurance companies profit

charges that were higher than necessary. Under the contract with the State, the insurance companies receive three profit charges based on the average reserve fund balance and on premiums received. Because the reserve fund balance was unnecessarily large, the department paid more fees than necessary to the insurance companies.

One of the profit charges that the department pays the insurance companies is based on premiums; the other two are based solely on the average size of the reserve fund balance. The premium profit charge is 1/2 of 1 percent of all premiums received each calendar month. The flat asset charge is determined by multiplying by .0015 the average reserve fund balance for an accounting period. The graded asset charge is also based on the average reserve fund balance, but the multiplying factor varies according to the amount of money that constitutes this average balance. Table 1 shows how the graded asset charge is calculated.

TABLE 1
GRADED ASSET CHARGE

<u>Average Reserve Fund Balance</u> <u>Per Accounting Period</u>	<u>Multiplying</u> <u>Factor</u>
First \$ 50,000	1/2 of 1%
Next \$ 100,000	1/3 of 1%
Next \$ 350,000	1/5 of 1%
Next \$ 1,000,000	1/7 of 1%
Next \$ 3,500,000	1/9 of 1%
Next \$10,000,000	1/12 of 1%
Excess	
Over \$15,000,000	1/15 of 1%

Table 2 shows the total profit charges credited to the insurance companies since 1977.

TABLE 2
 PROFIT CHARGES EARNED BY
 THE INSURANCE COMPANIES*
1977-1982

<u>Calendar Year</u>	<u>Fund Balance At Year's End</u>	<u>Profit Charges</u>
1977	\$ 57,258,419	\$209,334
1978	\$ 63,496,310	\$228,252
1979	\$ 71,553,656	\$248,588
1980	\$ 83,722,474	\$295,134
1981	\$100,139,137	\$340,384
1982	\$114,473,857	\$360,291

*Does not include payment for administrative or investment expenses.

Since the reserve fund balance has been higher than necessary, the department has paid more profit charges than necessary to the insurance companies. For example, if the premiums had been reduced by 50 percent in 1981, the department would have paid the insurance companies approximately \$65,553 rather than \$131,106 in premium profit charges. Reducing the premiums would lead to a lower average fund balance in subsequent years. If the average fund balance in 1982 had been \$55 million instead of more than \$107 million, the department would have paid the insurance companies approximately \$124,101 rather than \$242,629 in flat and graded asset charges.

Although changes in the economy and the real estate market affected the growth of the reserve fund balance, the most significant effect on this growth occurred in 1976 when the method of crediting investment interest to the reserve fund was changed. In 1976, the department and the insurance companies negotiated a change in the interest rate applied to the reserve fund balance because the department believed the reserve fund was not earning enough interest. In return for increasing the interest rate, the insurance companies were given additional protection against contract termination. The interest rate that the insurance companies credited to the department was increased from about 4 percent to about 10 percent. This new interest rate was based on each insurance company's investment portfolio; it ranged from about 8 percent to about 10 percent between 1978 and 1982. As discussed in the preceding section, the reserve fund balance increased from \$57 million in 1977 to \$115 million in 1983.

Efforts to Reduce Reserve Fund Balance

The department's Chief Deputy Director acknowledged that the department has made efforts to reduce the reserve fund balance only in the last two years. Both the department and the insurance companies agreed that the reserve fund balance can be moderated by adjusting the premium rate. However, the department has not routinely assessed the size of the reserve fund balance, and until 1983, the insurance companies did not provide the department with any reports stating how large the reserve fund balance should be. The insurance companies notified the

department in 1978 that premiums for life insurance were higher than necessary and recommended a decrease in monthly premiums of \$.08 per \$1,000 loan value. At the same time, however, the insurance companies recommended increasing the veteran's monthly payment because the premiums for disability insurance were too low. The insurance companies proposed that the premiums be increased between 3.9 and 4.5 percent. The department decided not to implement either of the recommendations.

Thus, even though the reserve fund balance grew significantly between 1977 and 1982, the department began taking action specifically to reduce the reserve fund balance only in late 1981. The department and the insurance companies did not reduce total premium income by 50 percent until September 1982. The department and the insurance companies restructured the premiums so that coverage for disability and life insurance would be based on an applicant's age. In April 1983, the department and the insurance companies eliminated all premiums on life and disability insurance policies for California veterans. The department and the insurance companies estimate that, without the premium income, the reserve fund balance will decrease by only \$4 million per year.

Recent Action by
the Department and
by the Legislature

Because the department and the insurance companies have disagreed on how to reduce the reserve fund balance, the Director of the

Department of Veterans Affairs notified the two insurance companies on August 22, 1983, that the contract would be terminated effective December 31, 1983. However, the unnecessarily large reserve fund balance means that the State will have to pay the insurance companies more than necessary to terminate the current contract. The contract between the State and the insurance companies allows the insurance companies to keep 5 percent of the market value of the reserve fund balance upon termination of the contract. In December 1983, when the contract terminates, the market value of the reserve fund balance will be approximately \$88 million. Thus, the insurance companies will retain approximately \$4.4 million.

In addition, legislation signed into law in September 1983 will give the department greater control over the reserve fund. This legislation limits the size of the reserve fund balance to 20 percent more than what is needed to meet insurance commitments. This legislation also allows the department to use the excess funds for veteran-related purposes.

CONCLUSION

The Department of Veterans Affairs should have more closely monitored the reserve fund balance for the life and disability insurance program. The reserve fund balance grew from \$57 million in 1977 to \$115 million in 1983. As of June 1983, the reserve fund balance was from \$50 million to \$74 million

higher than necessary. Because the reserve fund balance is larger than needed, California veterans have been paying unnecessarily high premiums, and the department has been paying unnecessarily high profit charges to the insurance companies.

RECOMMENDATION

Recent action by the department and recent legislation should alleviate many of the current problems with the excess reserve fund balance. However, to ensure that similar problems do not occur in the future, the Department of Veterans Affairs should do the following:

- Develop a program to routinely monitor the insurance companies' records;
- Ensure that the insurance companies are providing the department with prompt and accurate reports;
- Review the adequacy of the reserve fund balance quarterly;
and
- Adjust premiums promptly to reflect changes in the life and disability insurance program.

OTHER PERTINENT INFORMATION

As mentioned in the preceding section, the Department of Veterans Affairs notified the two insurance companies that the contract would be terminated effective December 31, 1983. The department intends to use a competitive bidding process to procure the next insurance contractor. This section provides information on the department's progress in obtaining a new contractor to administer the life and disability insurance program.


The department has considered three alternatives for administering the life and disability insurance program: (1) having the State administer the program and manage the program's investments; (2) having the State manage the program's investments and contract for administration; and (3) having the State contract for administration and investment management. Department officials informed us that they have chosen the third alternative.

The department's staff is working with the State Insurance Officer from the Department of General Services' Office of Insurance and Risk Management in writing new contract specifications. As of October 14, 1983, the department and the Department of General Services had established dates for the following major milestones for procuring a new contractor: (1) release of the final bid specifications, November 4, 1983; (2) bid responses from potential contractors, November 28, 1983; (3) contract award, December 12, 1983; and (4) full operation of the next contractor, January 1, 1984.

Because of the problems that the department has had with the current contract, it intends to make significant changes in the new contract. The major changes will address the size of the reserve fund balance, the termination penalties, and the profit charges paid to the contractor. Specifically, department representatives said that they will require that assets of the reserve fund be maintained in a separate account rather than commingled with the insurance company's investments. The new contract will require annual studies to review the adequacy of the reserve fund balance and will require that the premiums be adjusted to keep the reserve fund balance at an appropriate level. The bid specifications will also require that proposed expenses and profits be explicitly stated in the bid, and the department will not authorize a premium profit charge. In addition, the department intends to enter into the new contract for a fixed number of years, and it will not allow penalties for contract termination.

We conducted this review under the authority vested in the Auditor General by Section 10500 et seq. of the California Government Code and according to generally accepted governmental auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,



for THOMAS W. HAYES
Auditor General

Date: October 31, 1983

Staff: W. Michael Zimmerling, CPA, Audit Manager
Bernice D. Ericksmoen



State and Consumer Services Agency

OFFICE OF THE SECRETARY
915 Capitol Mall, Suite 200
Sacramento, CA 95814

October 27, 1983

Mr. Thomas W. Hayes
Auditor General
660 J Street, Suite 300
Sacramento, California 95814

Dear Mr. Hayes:

The report on the life and disability insurance reserve fund of the Department of Veterans Affairs points out a serious problem which was not addressed by the previous administration. The rapid growth of the reserve fund was quickly recognized by this administration as a problem area and we have moved, as you point out in your report, to address this problem.

Specifically, the Department has terminated the contract with the insurance carriers administering the fund so that the excess reserve can be repaid to the Department to be used for purposes consistent with the Military and Veterans Code and for the benefit of veterans. The Department has also established specifications for future contracts and internal control procedures to assure that the fund will not grow unreasonably in the future.

With regard to your specific recommendations, the Department has taken or will take the following actions:

- . A proper monitoring and reporting program will be developed in conjunction with the new master insurance agreement scheduled for January 1, 1984.
- . A follow-up procedure has been established for receipt and review of reports.
- . As a result of the termination of the existing master agreement, the reserve fund will be reduced to an appropriate level and

Mr. Thomas W. Hayes
Page Two

October 27, 1983

will be reviewed for adequacy on a quarterly basis.

- . Premium adjustment procedures are in place and will be implemented as needed, on the basis of periodic actuarial analyses.

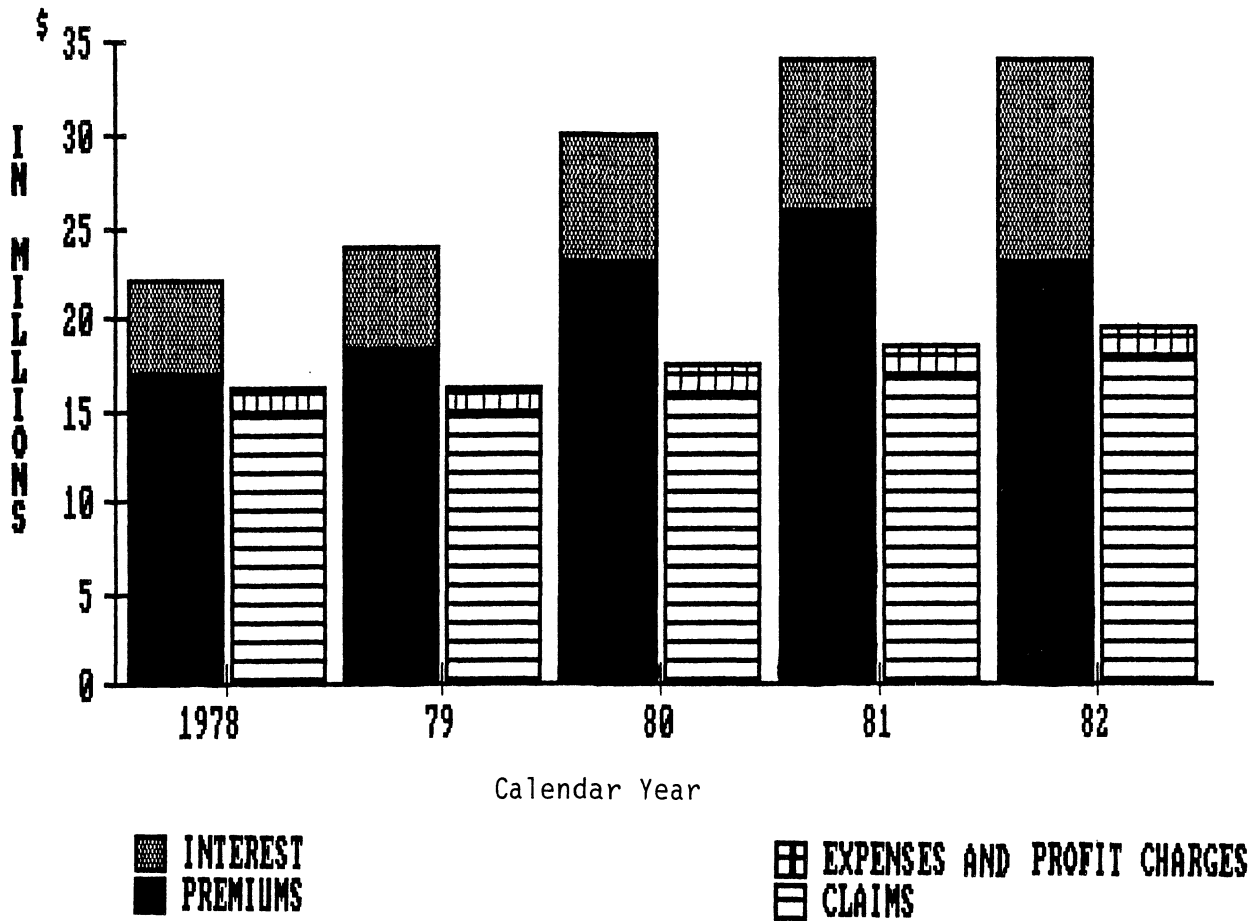
Sincerely,



SHIRLEY R. CHILTON
Secretary of the Agency

SRC:jk

LIFE AND DISABILITY INSURANCE PROGRAM
 RESERVE FUND INCOME AND EXPENSES
1978-1983



Source: Unaudited annual accounting reports prepared by the insurance companies.

cc: Members of the Legislature
Office of the Governor
Office of the Lieutenant Governor
State Controller
Legislative Analyst
Director of Finance
Assembly Office of Research
Senate Office of Research
Assembly Majority/Minority Consultants
Senate Majority/Minority Consultants
Capitol Press Corps