California State Auditor

BUREAU OF STATE AUDITS

California Department of Veterans Affairs:

Its Life and Disability Insurance Program, Financially Weakened by Past Neglect, Offers Reduced Insurance Benefits to Veterans and Faces an Uncertain Future

March 2001
2000-132

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March 28, 2001

2000-132

The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As requested by the Joint Legislative Audit Committee, the Bureau of State Audits presents its audit report concerning the Department of Veterans Affairs' (department) management of the Life and Disability Insurance Program (insurance program), which is part of the California Veterans Farm and Home Purchase Program (loan program).

This report concludes that the changes the department made to reduce its financial liabilities for the insurance program resulted in reduced benefits for veterans. Further, even though the department's consultants repeatedly warned it of funding shortfalls in the insurance program, it used a significant amount of a 1984 refund for its loan program rather than the insurance program. Although the department is currently seeking to increase insurance benefits for veterans, the long-term costs and funding for these increased benefits are uncertain. However, in the short-term, the department could fund increased benefits through a limited use of loan program funds and a modest increase in premium rates charged to veterans. Finally, the report concludes that improvements in the department's procedures are necessary to effectively manage the insurance program and safeguard its assets.

Respectfully submitted,

Elaine M. Howle

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SUMMARY

RESULTS IN BRIEF

The California Department of Veterans Affairs (department) currently helps about 34,000 veterans afford homes by offering low-cost loans through its California Veterans Farm and Home Purchase Program (loan program). In turn, the department's Life and Disability Insurance Program (insurance program) offers life and disability insurance to qualified veterans in the loan program so that injury or illness will not stop them from making loan payments and so their surviving spouses can pay off some or all of the mortgage. However, the financial health of this insurance program has been in jeopardy for over a decade because the department has regularly failed to pursue long-term strategies to financially stabilize the program. In 1996 the insurance program's funding for its estimated liabilities became so uncertain that the department purchased a group policy from a commercial insurer, resulting in reduced disability benefits for most veterans and higher life insurance premiums for some older veterans. The department is now working to improve California veterans' benefits by soliciting bids from other commercial insurers and examining funding alternatives. However, many solutions available to the department will be costly because the insurance program's liabilities for benefits to veterans are increasing as the population of veterans ages. For example, the estimated costs for options include an immediate cash contribution of $67 million to restore benefits over the next 30 years to veterans who were in the insurance program prior to June 1, 1996, and as much as $270 million to convert the insurance program from a commercial plan to a self-funded plan.

Audit Highlights . . .

Our review of the California Department of Veterans Affairs' (department) Life and Disability Insurance Program (insurance program) revealed that:

- ☑ ***Changes made in the insurance program to reduce its financial liabilities also reduced the program's benefits to veterans.***
- ☑ ***Although within its discretion, the department's decision to use a substantial part of a refund from the 1983 cancellation of its contracts with previous insurance administrators mainly for the department's California Veterans Farm and Home Purchase Program (loan program) purposes contributed to the insurance program's lack of funds.***
- ☑ ***It is currently seeking to increase the insurance program's benefits, but the long-term costs and funding for increased benefits are uncertain.***

continued on the next page . . .

The financial problems of the department's insurance program are long-standing. As far back as 1986, the department's actuary reported a shortage of cash, pointing out that the premium rates that participating veterans paid were too low to sustain the program without other sources of money. At that time, the department chose a short-term solution: to sustain the reserve fund only through 1990 by covering an almost $10 million shortfall between cash and estimated liability. Over the next 10 years, the reserve fund's shortfall soared as the department repeatedly ignored consultants' advice that it was charging inadequate premiums and failing to maintain enough cash to

☑ *In the short term, it could fund increased benefits for veterans by using a limited amount of loan program funds and a modest increase in the premium rates it charges to veterans.*

☑ *Improvements in its procedures are necessary to effectively manage the insurance program and safeguard its assets.*

cover the program's estimated liabilities. Also, the department decided not to cover the insurance program's growing shortfall with a 1984 refund from the cancellation of its contracts with previous insurance administrators. Although within its discretion, the department's decision to use this refund mainly for loan program purposes contributed to the insurance program's lack of funds.

By June 1996, facing a significant shortfall, the department made sweeping changes to its insurance program to avoid the large liabilities from future claims and restore the program's financial stability. Closing the existing self-funded insurance program, under which it was responsible for paying all veterans' claims, the department purchased a commercial group policy under which the commercial insurer is responsible for most future claims. Although the department's decision significantly lowered the disability premiums for veterans, life insurance rates for veterans age 60 and older doubled. Most veterans also experienced drastic reductions in how long they receive benefit payments from their disability insurance, and the amount of life insurance proceeds that go to beneficiaries of some veterans age 60 and older can be substantially lower than under the previous self-funded plan.

Presently, the department is exploring ways to improve veterans' benefits. Although the department plans to seek competitive bids from commercial insurers, the long-term costs of increased benefits are not predictable because these insurers generally will not contract to provide a group insurance policy for more than five years at fixed premium rates. The department has also established the Strategic Life and Disability Committee to advise it in selecting the best alternative for increasing the insurance program's benefits without greatly increasing the costs to veterans. The department's goal is to identify possible funding sources to pay for the increases and select the best option for the veterans and the future of the loan program by the end of 2001.

Finding the best option is complicated because future participation in the loan program is unpredictable for reasons that are out of the department's control, such as federal eligibility restrictions and uncertainties over funding. Because only veterans who qualify for the department's loan program can purchase the life and disability insurance, uncertainty in the loan program complicates the department's decisions on the future of the insurance program. Over half of the veterans now in the loan program are 50 to 59 years old, and the supply of funds for which younger veterans qualify is dwindling. The changing demographics of California's veterans and federal restrictions on the tax-exempt money available for home loans makes veterans' future participation in the loan and insurance programs unpredictable.

Further complicating the search for solutions, funding to cover increased benefits in the insurance program is scarce. The only ready source of funds now available within the department to subsidize the insurance program is the loan program's unrestricted funds. The department estimates it can transfer about $1.5 million each year in unrestricted funds to the insurance program for up to 10 years without adversely affecting its ability to meet the loan program's bond payments. Another source of funding for the insurance program is modest increases in veterans' premiums, increases the department has so far been unwilling to impose. In addition, when it implements recommendations from the report we issued in May 2000, the department could use the savings in its operational costs, as much as $1.3 million annually, as additional funding for the insurance program.

Finally, the department's administration of the insurance program contains flaws that weaken its ability to manage the insurance program and safeguard assets of the department and the veterans. For example, the department does not ensure that its contract practices comply with state guidelines. The department also needs to ensure adequate separation of duties for staff handling cash receipts for its insurance program. In the absence of adequate controls, the department cannot minimize the risk of errors or theft relating to veterans' premiums.

RECOMMENDATIONS

When choosing an option for the future, the department should establish a long-term strategy for the insurance program that does not adversely affect the loan program.

Further, any long-term strategy that it develops should include consideration of the following:

- The aging population of veterans in the loan program.

- The uncertainty of future funding for loans to younger veterans.

- The future costs of the insurance program beyond the five years any group insurance policy will cover.

To obtain funds to increase veterans' benefits, the department should do the following:

- Continue exploring its options for transferring unrestricted funds to the insurance program.

- Consider increasing premiums at a modest, appropriate rate.

- Complete the implementation of recommendations from our May 2000 report and use the savings to improve the insurance program.

To improve its contracting procedures, the department should follow the guidelines set forth in the State Contracting Manual.

To adequately safeguard the cash receipts for its insurance program, the department should ensure it establishes and maintains an adequate system of internal controls as set forth in the State Administrative Manual.

AGENCY COMMENTS

The department believes the options and analysis presented in our report will be helpful in determining the future direction of the insurance program. It also agrees with our recommendations and is taking steps to comply. ■

INTRODUCTION

BACKGROUND

Since its inception in 1921, the California Department of Veterans Affairs (department) has helped thousands of California military veterans buy farms and homes by providing low-cost loans through its California Veterans Farm and Home Purchase Program (loan program). The loan program is administered by the department's Farm and Home Purchases Division and governed by the California State Veterans Farm and Home Purchase Act of 1974. In conjunction with these farm and home loans, the department has also offered life insurance coverage to qualified veterans since 1938 and disability insurance since 1955. The Life and Disability Insurance Program (insurance program) allows veterans the following benefits: the disability insurance allows a veteran who gets sick or injured to remain current on loan payments; the life insurance allows the veteran's surviving spouse to pay off all or part of the loan balance. For example, the current disability benefit allows veterans to receive an amount equal to their monthly loan payments for up to 24 months for a physical disability. A surviving spouse can receive a life insurance payment equal to the lesser of the unpaid loan balance or the principal and interest payments for up to 5 years.

Currently, the department requires all veterans under age 62 who enter the loan program to apply for this life insurance, but it does not require them to apply for the disability insurance. As the number of veterans in the loan program increases or decreases so does the number of veterans in the insurance program. Therefore, enrollment in the department's insurance program is directly related to the success of its loan program. As of January 2001, 70 percent of the 34,000 veterans in the loan program had life insurance and 42 percent had disability insurance.

HISTORY OF THE LIFE AND DISABILITY INSURANCE PROGRAM

Before June 1, 1996, the insurance program was self-funded: the department was responsible for paying all current and future liabilities. From 1938 through 1983, the department contracted with California-Western States Life Insurance Company (Cal-West) and Transamerica Occidental Life Insurance Company of California (Transamerica) to review applications, process claims, and invest the insurance program's cash. In 1983 the auditor general, using the department's and the insurance company's actuarial recommendations, reported that the department had not adequately monitored the growth of the insurance program's reserve fund balance, which was estimated then to be between $50 million and $74 million larger than necessary. Because of disagreements surrounding the proper level for the reserve fund balance, the department canceled its long-standing agreements with Cal-West and Transamerica in December 1983. In January 1984 it entered into an agreement with Pacific Mutual Group Life Insurance Company, currently Pacific Life and Annuity Company (Pacific Life). Under the agreement, Pacific Life had responsibilities similar to those of Cal-West and Transamerica, and the department continued to retain responsibility for paying current and future liabilities.

In July 1993 the department's risk management consultant, who was hired to thoroughly review the insurance program, concluded that the insurance program was underfunded and could not be run successfully in its current form. Almost a year later, that same consultant concluded that the department's best option was to discontinue the insurance program. On January 1, 1995, the department placed a moratorium on the insurance program by ceasing to offer life and disability coverage to new loan applicants, as well as to those loan program participants who were not already covered.

During 1995 the department unsuccessfully attempted to implement a group life and disability insurance policy from Pacific Life. However, due to numerous complaints from veterans, particularly about the higher rates that older veterans might face under Pacific Life's group policy, the California Veterans Board (board) advised the secretary of the department to postpone making any further changes to the insurance program until it had further reviewed and studied its options. The department's secretary followed the board's advice and formed the Veterans Insurance Advisory Group (advisory group) to identify alternative solutions to the problem of increasing premiums for older veterans while maintaining the solvency of the program for younger veterans and future program participants. The advisory group was composed of loan program participants, representatives from veterans' organizations, and two members of the board.

On February 9, 1996, the advisory group submitted its findings and recommendations to the department's secretary. In order for the department to provide insurance coverage to veterans at reasonable costs and eliminate future losses, the advisory group recommended that the department remove itself from the life and disability insurance business by transferring the insurance program to a commercial carrier.

On June 1, 1996, the department entered into a group insurance policy with Pacific Life, under which Pacific Life assumed the risk for funding future claims. However, the department did continue a small self-funded plan, retaining responsibility for paying the claims for about 1,700 California veterans who were receiving disability insurance benefits before June 1, 1996. On February 1, 1998, the department entered into a new five-year group life and disability insurance policy with Pacific Life. Unfortunately, both the 1996 and 1998 commercial plans increased premiums and reduced benefits for older veterans.

ADMINISTRATION OF THE LIFE AND DISABILITY INSURANCE PROGRAM BY THE DEPARTMENT'S FARM AND HOME PURCHASES DIVISION

The home protection unit of the Farm and Home Purchases Division administers three different types of insurance: fire and hazard, disaster indemnity, and life and disability. The home protection unit has four full-time and four part-time employees. Three full-time employees assist with the Life and Disability Insurance Program, performing duties such as billing and collecting premiums from veterans and remitting these payments to Pacific Life, which handles the bulk of the administrative duties for life and disability insurance.

To administer the Life and Disability Insurance Program for fiscal year 1999-2000, the department spent about $2.5 million, which includes costs for the administration of the self-funded plan and the commercial plan, personnel, and any payments to consultants. Of that amount, Pacific Life received more than $1.7 million for administering the commercial plan.

SCOPE AND METHODOLOGY

The Joint Legislative Audit Committee (audit committee) requested the Bureau of State Audits to conduct an audit of the department's insurance program. The audit committee was specifically concerned about the department's management of the insurance program, including, but not limited to, the use of funds, the amount of premiums paid and coverage received by the veterans, and future options for the program. The audit committee also requested we review a study released in February 2001 by a certified public accountant (CPA) on the department's use of mortgage bond proceeds from 1980 to 1996. Further, the audit committee asked us to determine whether Pacific Life changed its corporate structure from a mutual insurance company, which pays any surplus to policyholders directly or in the form of lower insurance premiums, to a strict for-profit insurance company, which pays dividends only to stockholders. If Pacific Life had changed its corporate structure, the audit committee wanted to know the effect on veterans insured under the program. We determined that Pacific Life had indeed changed its corporate structure, but we found, after reviewing Pacific Life's application for this change, the Department of Insurance's approval of its application, and Pacific Life's policies before and after the change, that the change did not affect program participants.

To gain insight on how the loan program affects the insurance program, we reviewed our May 2000 report, entitled *California Department of Veterans Affairs: Changing Demographics and Limited Funding Threaten the Long-Term Viability of the Cal-Vet Program While High Program Costs Drain Current Funding.* We also interviewed the staff of the department's bond finance division and its financial consultant to update certain information cited in that report.

To understand the insurance program, we reviewed and evaluated the relevant laws, regulations, contracts, and group policies. We also interviewed department staff and interested parties, and attended meetings of the Strategic Life and Disability Committee (strategic committee). The department created this strategic committee—composed of department staff, representatives for the Departments of Insurance and General Services, and two members of the board—to explore ways to increase benefits for certain veterans.

To evaluate the propriety of the department's use of any insurance program funds for other purposes, we searched for withdrawals from the department's reserve account by reviewing Pacific Life's detailed transaction reports for January 1989 through June 2000. Because records for those dates were past the retention period for both Pacific Life and the department, we were not able to assess withdrawals for January 1984 through December 1988.

To assess the department's use of surplus reserves refunded by Cal-West and Transamerica in 1984, we reviewed available department memorandums, letters, and accounting records. We also interviewed department staff who were either responsible for or associated with decisions on how to use the surplus reserves.

To determine whether the department's fiscal controls are sufficient to prevent fraud and other abuses in the insurance program, we reviewed the department's procedures for billing and collecting veterans' premiums and remitting payments to Pacific Life, and interviewed key staff involved in these processes. Also, we reviewed Pacific Life's internal controls for claim administration and its internal quality control review procedures. To gain further assurance concerning Pacific Life's operations, we examined its audited financial statements and reviewed minutes of its audit committee meetings for calendar years 1997, 1998, and 1999. Finally, we reviewed the department's oversight of Pacific Life's process for administering the insurance program.

To determine whether the department provided its actuarial consultant with accurate information to conduct its January and December 2000 studies of the insurance program, we obtained the information provided to the department's consultant. With our consultant's assistance, we were able to assess the completeness and accuracy of the data and determine its impact on the methodologies and conclusions in the consultant's studies. Our consultant also assisted us in evaluating the feasibility of various options for revising the insurance program.

To assess whether the CPA used appropriate methodologies in his analysis of the department's bond issues from 1980 to 1996 and whether his conclusions were sound and reasonable, we reviewed the report and interviewed the CPA. We also compared the information contained in the report to the audited financial statements and the official bond statements. We present our determination of the CPA's methodologies and conclusions in the Appendix.

Finally, to determine whether the department has any money available, from other than the State's General Fund, to subsidize the insurance program, we reviewed financial records and interviewed the department's key staff and financial consultant. ■

CHAPTER 1

The Department's Decisions Created Financial Woes for the Life and Disability Insurance Program and Reduced Insurance Benefits to Most California Veterans

CHAPTER SUMMARY

In June 1996 the California Department of Veterans Affairs (department) radically changed its Life and Disability Insurance Program (insurance program), aiming to reduce that program's exposure to substantial estimated liabilities and restore its financial stability. The department partly achieved those aims by terminating the insurance program in which it was responsible for paying claims (self-funded plan) and purchasing a group policy under which the future claims are mostly the responsibility of a commercial insurer (commercial plan). Although the commercial plan significantly lowered the disability premiums for veterans, it also doubled life insurance premium rates for veterans age 60 and older. In addition, most veterans suffered drastic reductions in how long they receive benefit payments from their disability insurance, and beneficiaries of some veterans who are age 60 and older receive substantially lower amounts of life insurance than they would have been entitled to under the department's original self-funded plan.

Because the insurance program was not a top priority for the department between 1986 and 1993, it did not react sufficiently to the program's needs. Not until 1993 did the department understand there was an imminent financial crisis. Meanwhile, the department failed to develop a long-term strategy for the insurance program and to heed the advice of its consultants who repeatedly warned in 1986, 1990, 1991, and 1993 that the insurance program's premiums were too low and that more cash should be set aside to fund liabilities. Moreover, although it was within the department's discretion to use a substantial part of a refund from the 1983 cancellation of its contract with previous insurance administrators for other California Veterans Farm and Home Purchase Program (loan program) purposes, the department's decision not to use the refund to cover the insurance program's mounting liabilities was partly responsible for the program's funding shortfalls.

ALTHOUGH CHANGES IN THE INSURANCE PROGRAM SUCCESSFULLY LOWERED THE DEPARTMENT'S LIABILITY, THEY ALSO REDUCED VETERANS' BENEFITS

Since 1996, when the department reduced its future liabilities by transferring the majority of its insurance risk to a commercial insurer, veterans enrolled in the commercial plan have generally lost ground. Life insurance premiums have decreased slightly for most younger veterans, but have doubled for veterans over 60 years of age. Life insurance benefits remain unchanged for many veterans who entered the insurance program before June 1996; however, benefits have decreased significantly for veterans who entered the commercial plan after January 1998. Disability insurance premiums are substantially less, but so are the benefits offered to veterans under the commercial plan.

The insurance program presently has two separate and distinct components: the self-funded plan and the commercial plan. Figure 1 shows the evolution and structure of the insurance program.

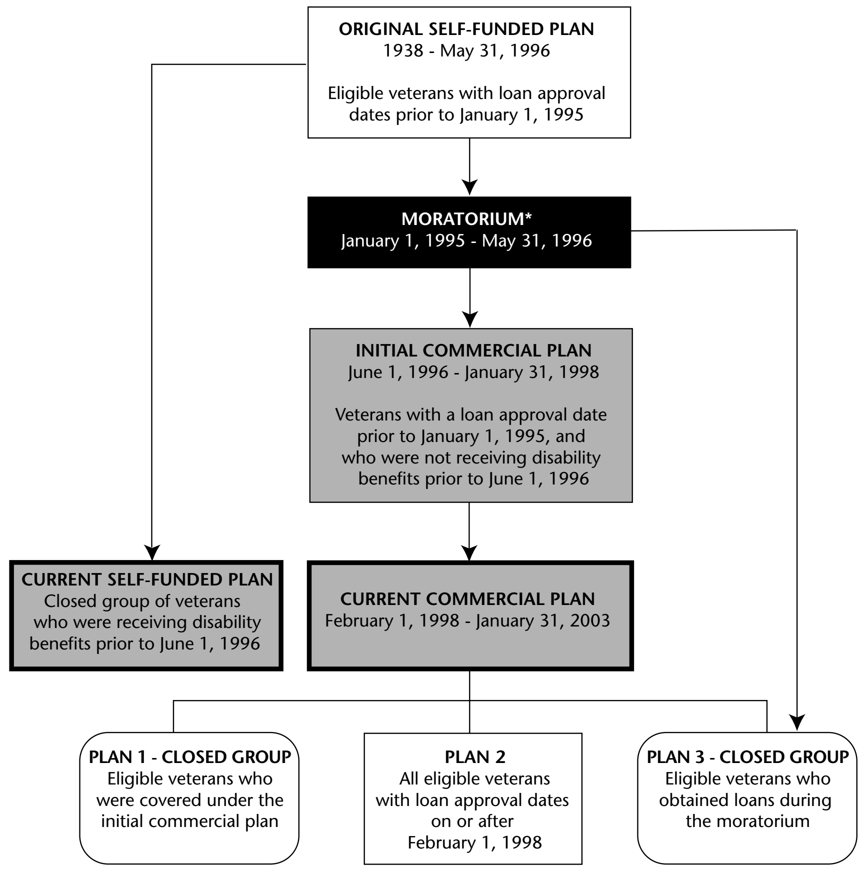
The current self-funded plan is closed to new participants and covers only those participants who were receiving disability benefits before June 1, 1996. In this plan, the department assumes all risks for paying claims and maintaining enough cash to cover the cost of claims and administration. Both the number of participants and the associated liability have steadily declined during the past four years, with enrollees decreasing from about 1,700 as of June 30, 1996, to about 840 in February 2001 as the veterans or surviving spouses have paid off their loans. Consequently, the associated liability for the program has decreased from $85 million on June 30, 1996, to $35 million on June 30, 2000. The department estimates that the self-funded plan will wind down within the next 15 to 20 years.

Under plan I of the commercial plan, the life insurance monthly premium rate for 60-year-old veterans is $.86 per $1,000 of their loan balances as opposed to $.43 under the self-funded plan. Furthermore, under plan I, benefits are limited.

The remaining 24,000 or so veterans in the insurance program receive coverage under the commercial plan in which Pacific Life assumes all the risk for paying claims as they become due. As shown in Figure 1, the current commercial plan has three separate plans depending on the date of the veteran's loan approval.

FIGURE 1

Evolution and Structure of the Insurance Program



* The department did not offer life and disability insurance to new loan program applicants or to veterans not enrolled in the insurance program as of January 1, 1995. After June 1, 1996, the department gave veterans who had obtained loans between January 1, 1995, and May 31, 1996, the option of participating in the initial and current commercial plans.

About 70 percent of the veterans in the insurance program participate in the current commercial plan 1, almost 29 percent participate in plan 2, and the remaining veterans are plan 3 participants. Table 1 on the following page shows a comparison of the life insurance rates and coverage for the current self-funded and commercial plans (these rates are for regular life insurance, which is basic insurance with no attached options). For example, under plan 1 of the commercial plan, a 60-year-old veteran pays a premium of $.86 for every $1,000 of his or her loan balance, whereas a veteran of the same age in the self-funded plan pays $.43 for every $1,000 of the loan balance.

Furthermore, under plan 1, the life insurance benefit is limited. The beneficiary of a veteran in plan 1 would receive the lesser of two amounts: the unpaid loan balance or a maximum benefit schedule, which ranges between $5,000 and $75,000 for veterans age 60 and older at the date of death; in contrast, the self-funded plan pays the beneficiary the entire loan balance at the time of the veteran's death. For example, the beneficiary of a 60-year-old veteran with an outstanding loan balance of $115,000 would receive only $75,000 under the current commercial plan 1 instead of $115,000 under the self-funded plan.

TABLE 1

Comparison of Regular Life Insurance Premiums and Benefits for Participants in the Department's Self-Funded and Commercial Plans

	Self-Funded Plan*		Current Commercial			
			Plan 1*		Plan 2*	
Age	Rates†	Benefit	Rates†	Benefit	Standard Rates†	Benefit
< 30	$.10	Payoff of loan balance at the time of death	$.09	Payoff of loan balance at the time of death	$ .09	Lump sum equal to 1, 3, or 5 years of principal and interest payments depending on the veteran's risk classification
30 - 34	.10		.09		.09	
35 - 39	.17		.19		.13	
40 - 44	.28		.34		.22	
45 - 49	.43		.46		.32	
50 - 54	.43		.50		.35	
55 - 59	.43		.80		.52	
60 - 62	.43		.86	**60 and older**	.83	
63 - 69	.43		.86	The lesser of loan balance payoff or maximum benefit schedule	1.54	
70 - 74	.43		.86		N/A	
75 - 79	.43		.86		N/A	
80 - 84	.43		.86		N/A	
85 - 89	.43		.86		N/A	
90 - 94	.43		.86		N/A	
95 - 99	.43		.86		N/A	

Sources: Pacific Life Policy #20001; self-funded plan Master Agreement between the department and Pacific Life.

Note: The current commercial plan also has a plan 3. The rates for plan 3 are the same as plan 2, however, the benefit is equal to the payoff of the loan balance at the time of death. For both plans 2 and 3, coverage ceases at age 70.

* The department's self-funded plan rates are determined by the entry age of the plan participant; rates do not increase as the participant ages. Commercial plan rates are determined by the attained age of the participant; rates generally increase as the participant ages.

† Maximum monthly rate per $1,000 of the loan balance (determined annually).

Table 2 compares the disability insurance premium rates and benefits. In contrast to life insurance rates, disability premium rates for veterans in the current commercial plan are considerably lower than the self-funded plan rates. However, veterans in the current commercial plan no longer receive disability benefit payments equal to their monthly loan payments for the duration of the disability. Instead, they receive disability benefits only up to two years. A relatively small percentage of veterans have been severely affected by this reduction because they have remained disabled beyond two years. As of January 2001, 210 disabled veterans in the current commercial plan 1 had exceeded the maximum disability benefit period of two years and no longer receive benefits. Although most have managed to remain current on their home loans or pay off their loans, 28 were delinquent in their payments.

TABLE 2

Comparison of Disability Insurance Premiums for Participants in the Department's Self-Funded and Commercial Plans

		Current Commercial	
	Self-Funded Plan*	Plan 1*	Plan 2*
Age	Rates†	Rates†	Rates†
< 30	$1.40	$1.14	$1.08
30 - 34	1.96	1.14	1.08
35 - 39	2.96	1.37	1.30
40 - 44	3.85	1.67	1.58
45 - 49	3.85	2.03	1.92
50 - 54	3.85	2.54	2.42
55 - 59	3.85	3.13	2.97
60 - 62	3.85	3.13	2.97

Source: Pacific Life Policy #20001, self-funded plan Master Agreement between the department and Pacific Life.

Note: Under the self-funded plan, benefits are the monthly loan payment for the duration of the disability. Benefits under all of the commercial plans are a maximum of two years for physical disabilities and one year for a psychiatric condition. The rates under the commercial plan 3 are the same as under commercial plan 2. Coverage is not available for veterans more than 62 years old.

* The department's self-funded rates are determined by the entry age of the plan participant; rates do not increase as the participant ages. Commercial plan rates are determined by the attained age of the participant; rates generally increase as the participant ages.

† Monthly rate per $100 of monthly benefit (determined annually).

A few veterans participating in plan 1 have expressed dissatisfaction with the reduced disability insurance and advocated the restoration of the self-funded plan's disability insurance benefits. In 1999, to comply with state law, the department hired an actuarial consultant to evaluate its insurance program. The department's consultant estimated that the premium rate structure that would be required to extend disability insurance benefits for the life of the loan would be three to four times the current commercial plan rate. The consultant also estimated that the department would need an immediate cash contribution of $48 million or would have to provide $79 million over the next 30 years to restore the self-funded plan's benefits for the almost 20,000 veterans who were in the current commercial plan 1 as of September 30, 1999. Our review of this consultant's actuarial study found the conclusions to be reasonable given the limited amount of claims experience data that was available.

THE DEPARTMENT MADE A SERIES OF DECISIONS THAT HAVE HAD AN ADVERSE IMPACT ON THE INSURANCE PROGRAM

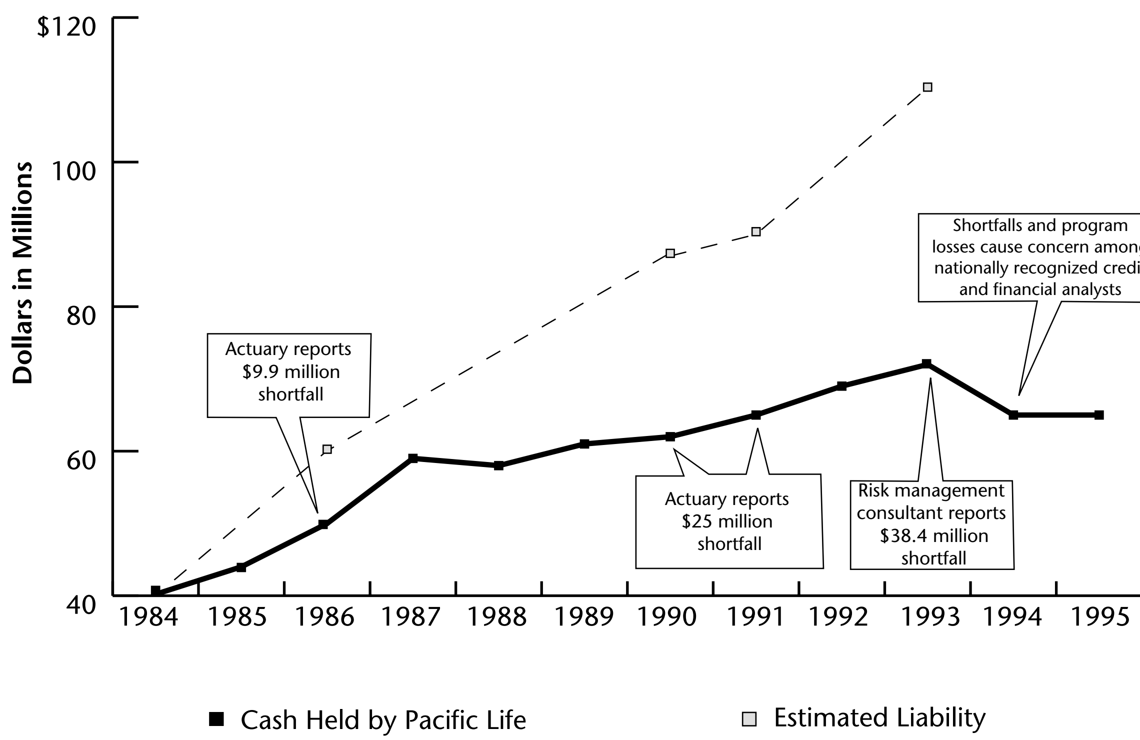
Its failure to develop a strategy for the program's long-term solvency led the department to drastically alter the insurance program, thereby reducing veterans' life and disability insurance benefits. Despite repeated warnings from its consultants, the department did not adjust the premium rate structure and maintain sufficient reserves in the insurance program. In 1993 independent auditors advised the department to recognize its estimated liability for the insurance program, an action that required the department to record an expense of almost $14 million in its financial statements. This recorded expense caused bond rating agencies to recognize that changes to the insurance program were necessary to ensure that the loan program as a whole remained solvent. Bond rating agencies are financial watchdogs that help investors analyze the credit risks associated with fixed-income securities such as the bonds issued by the department. Further, the department's decision not to use a substantial portion of a 1984 refund to cover the insurance program's estimated shortfall ultimately contributed to the shortage of cash that exists in the current self-funded plan.

The Department Did Not Develop a Long-Term Strategy or Heed Early Warnings to Properly Maintain the Self-Funded Plan

Since 1986 the department has lacked a long-term strategy to ensure that sufficient funds were available to pay the life and disability insurance claims for veterans participating in its insurance program. Despite repeated warnings from its consultants, the department did not develop a long-term plan to increase premium rates gradually and to adequately fund the insurance program's reserve. During that time, according to the department's former secretary, the insurance program was not the department's top priority. The department did not act until the insurance program's financial shortfalls became too large to ignore and nationally recognized credit analysts began to notice the losses during their municipal credit reviews. Figure 2 shows the level of cash the department maintained for the insurance

FIGURE 2

Early Warning Signs of Reserve Shortfalls in the Self-Funded Plan



Sources: Market value of cash held by Pacific Life for 1984 through 1995 as reported by Pacific Life.
Actuary reports from 1986 through 1993 provided by the department.
Credit review reports for 1994 and 1995 provided by the department.

Note: The department was unable to provide the estimated liability for 1994 and 1995.

program between 1984 and 1995 and warnings the department received from its consultants and outside parties about the adequacy of the reserve.

The first indication that the insurance program's future solvency was in jeopardy came in 1986 when the department asked its actuary to summarize the financial results of the insurance program for the two previous years and project the results for the next five years. The actuary advised the department that a severe drop in interest earnings and an inadequate premium rate structure were hindering its ability to maintain a sufficient reserve. Ideally, premiums should be sufficient to cover all estimated claims and administrative costs. The actuary recommended three possible options to increase the insurance program's reserve: (1) immediately increase premiums, (2) contribute $9.9 million to sustain the reserve fund through 1990, or (3) fund the shortfall incrementally for a period of five years at a projected cost of $13 million. Rather than choosing the long-term solution of gradually raising premiums to cover program costs, a solution that it believes would have brought an adverse reaction from participating veterans, the department contributed a lump sum of $9.9 million to the insurance program in 1987.

Actuarial reports from 1990 and 1991 also identified a reserve fund shortfall. The actuary again noted that a change in premiums was required to ensure the long-term solvency of the program. In each report, the actuary recommended that the department either increase the insurance program's reserve fund by $25 million or adjust the premium rate structure. Further, during this period, the department's former assistant bond director and former chief of the Farm and Home Purchases Division both recommended adjustments to the premium rate structure. However, the department's directors at that time did not act on either of the actuary's recommendations.

A consultant's 1993 report marked the first time the department understood the seriousness of the insurance program's inability to support itself.

In 1993 the department hired a risk management consultant to thoroughly review the insurance program. The consultant reiterated the findings of the previous actuaries that the premium rate structure was inadequate to support the program. The consultant also estimated that the program's reserve fund had a shortfall of about $38.4 million, which he attributed to numerous factors, including insufficient premium rates and the department's failure to provide adequate funding for future liabilities. According to the office chief for the Department of General Services' Office of Risk and Insurance Management, who has worked with the insurance program since at least 1990, the consultant's 1993 report marked the first time the department understood the seriousness of the insurance program's inability to support itself.

In 1994, after further review and analysis, the consultant presented three options to the department for addressing the insurance program's financial crisis: (1) do nothing and continue to allow the gap between the reserve and the liabilities to grow at an accelerating rate, (2) raise rates, either gradually or at once, or (3) discontinue the insurance program. Recognizing that raising rates was not a viable option and that the department's past approach of doing nothing was partially responsible for the dilemma, the department's consultant recommended that the department discontinue the insurance program. At the same time, the department increased its liabilities by almost $14 million in its financial statements to properly reflect the insurance program's estimated liabilities; this alerted nationally recognized credit analysts to the effect the program's liability was having on the overall solvency of the loan program. If the department were to receive a lower bond rating, implying a lower creditworthiness for its bonds, investors in the loan program would require more interest income to offset the higher likelihood of default, and veterans would have to pay higher interest rates for their loans. One credit analyst also suggested that the department consider two possible solutions for the insurance program: raise rates or discontinue the program.

In its haste to establish a commercial plan, the department failed to properly inform the program participants of the changes to the insurance program.

The department was unwilling to substantially increase premium rates or allow losses stemming from the insurance program to jeopardize the overall health of the loan program. However, rather than develop a long-term strategy for the self-funded plan to gradually increase premiums, the department chose to establish a commercial plan, which resulted in reduced disability benefits for most veterans and doubled life insurance premium rates for veterans over age 60. Also, in its haste to establish a commercial plan, the department failed to properly inform program participants of the changes to the insurance program, causing an excessive amount of criticism.

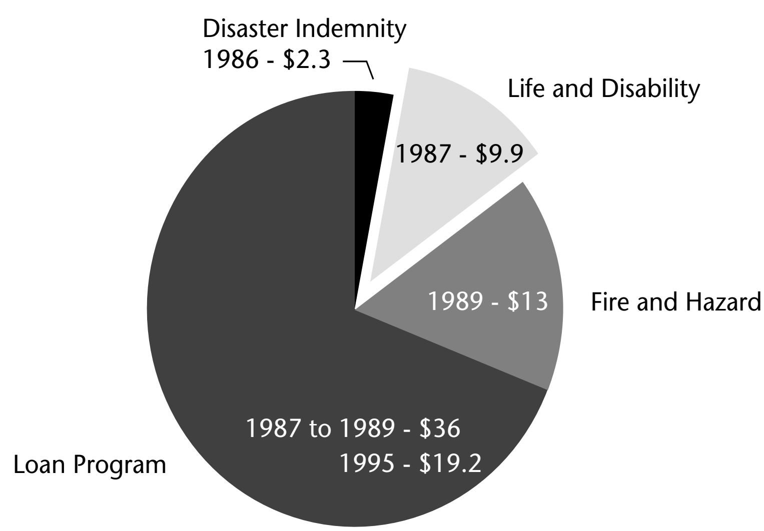
The Department Had Surplus Cash It Chose Not to Use for the Self-Funded Plan's Future Liabilities

In April 1984 the department received slightly more than $90 million in cash as a refund from the 1983 cancellation of an agreement with its previous insurance administrators, California-Western States Life Insurance Company (Cal-West) and Transamerica Occidental Life Insurance Company of California (Transamerica). With that refund, the department deposited $38.5 million, the cash necessary to pay for the majority of the estimated liabilities of $41 million calculated by the department's consultant, with its new administrator, Pacific Life. It chose to use most of the remaining refund for other loan program purposes. Although the department's use of about $70.5 million (including interest) for these purposes was within its discretion, the decision ultimately harmed the insurance program.

As shown in Figure 3, between 1986 and 1995, the department used most of the remaining $51.5 million, along with interest of $28.9 million, to fund other loan program purposes, such as lower interest rates on home loans. The department used only $9.9 million, or 12 percent, of the remaining refund to support the insurance program.

FIGURE 3

Use of the Remaining Reserve Refund Plus Interest Earned During 1986 Through 1995 (Dollars in Millions)



State law allows the department to use any insurance reserve surplus, returns, or refunds for any purpose consistent with the loan program. Veterans participating in the department's farm and home loan, disaster indemnity, and fire and hazard programs are essentially the same veterans who participated in the life and disability program and have benefited from the uses of the refund.

By 1990, the department had dwindled the remaining refund down to $14 million, and it chose not to use even these funds to address the $25 million life and disability insurance program reserve shortfall reported by its actuary.

However, by continuing to use the remaining refund for the department's other programs without evaluating the sufficiency of the Life and Disability Insurance Program reserves, the department jeopardized the long-term solvency of that program. Between 1987 and 1989 the department used $36 million of the refund to provide a temporary interest rate reduction to an average of 62,000 loan program participants and $13 million to increase cash necessary to fund liabilities for the fire and hazard insurance program. Although state law requires the department to make an annual determination of the sufficiency of the reserves for the insurance program, we found no evidence that it did so between 1987 and 1989. By 1990 only $14 million of the refund was left, and the department chose not to use even these funds to address the $25 million shortfall in the Life and Disability Insurance Program reserve that its actuary had reported. In 1993 the department's risk management consultant cited its past use of the remaining refund as one factor contributing to the $38.4 million life and disability reserve fund shortfall shown in Figure 2, but the department again did not act to increase cash held by its insurance administrator. Instead, in 1995 the department used the remaining refund of $19 million, which includes interest earnings, to provide home loans to veterans while it continued to search for a solution to the insurance program's financial shortfalls.

The Department Continues to Underfund Its Current Self-Funded Plan

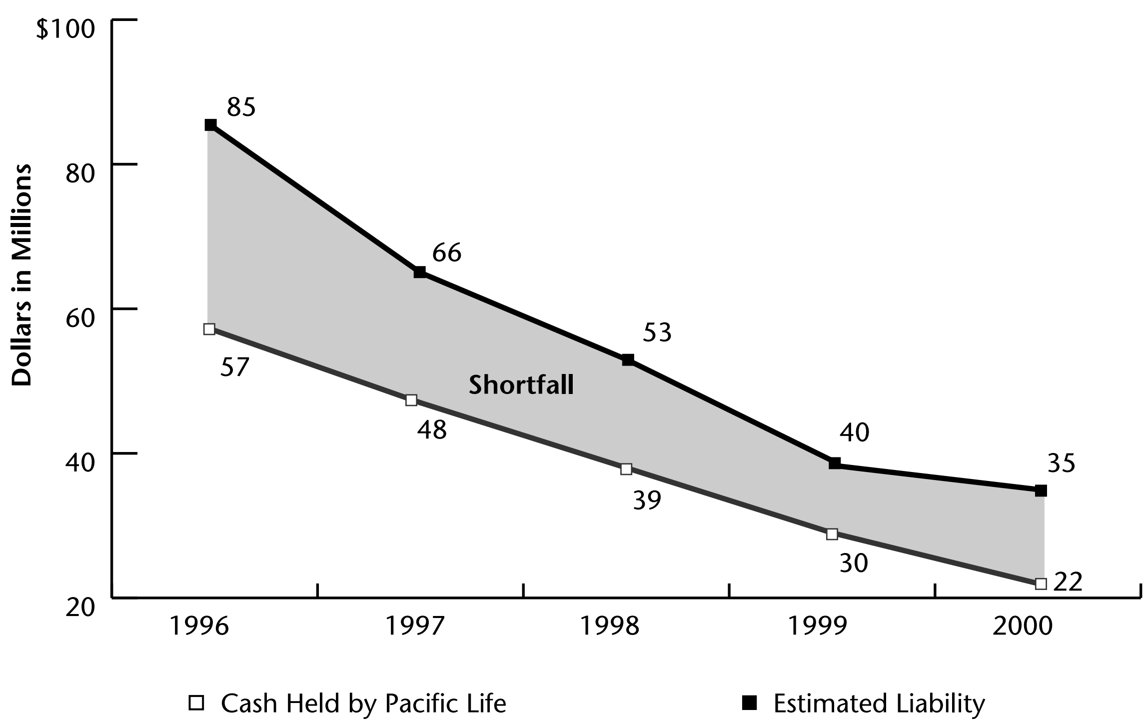
The department continues to exhibit a lack of long-term vision for its self-funded plan by not making annual determinations of its liabilities and not setting aside enough cash to pay for future liabilities.

The department does not procure an annual actuarial study of its liabilities for the self-funded plan. Instead, it estimates its liability each year by adjusting a 1997 actuarial report using the number of loans and projected averages of outstanding loan balances for disabled veterans. However, this methodology does not adequately address changes in actuarial assumptions relating to death rates, frequency of disabilities, and the number of participants leaving the program for reasons other than death or disability. Without updated actuarial projections of these and other pertinent factors, the department cannot be certain its liabilities estimate is sound.

As of June 30, 2000, the department's estimates of liabilities for the self-funded plan were $35 million, but data from Pacific Life indicated that only about $22 million had been set aside in cash to pay for these liabilities. This underfunding of $13 million occurred, in part, because the department did not set aside sufficient cash when it established the current self-funded plan in June 1996. Moreover, the underfunding could be higher as a result of the flaw in the methodology used by the department. As Figure 4 shows, the department has had shortfalls in the self-funded plan since June 1996.

FIGURE 4

A Shortfall in the Reserves for the Current Self-Funded Plan Continues



Sources: Actuary reports from 1997 and 1998 provided by the department.
Market value of cash held by Pacific Life for fiscal years 1996 through 2000 provided by Pacific Life.
Estimates for fiscal year 1999 and 2000 provided by the department

The department acknowledges that its current method of estimating liabilities for the self-funded plan needs improvement. However, it believes it can reliably determine its liabilities for the self-funded plan without an actuarial study. Because the group of participants in the plan is small and most veterans in the plan are not likely to recover from their disabilities, the department believes an actuarial determination of the liabilities would not be materially different from the present value of the payments for the outstanding loans for each veteran in the self-funded plan, reduced by its estimate of loans that will be paid off earlier than the term of the loan contract. Using this method, the department plans to calculate the liabilities for the self-funded plan by June 2001. The department also plans to perform a cash flow analysis to identify the timing and amount of cash to set aside to secure the payment of future liabilities.

RECOMMENDATION

The department should ensure that it is able to meet future liabilities for the current self-funded plan by revising its method for annually determining its liabilities and developing a long-term strategy to set aside sufficient cash. ■

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CHAPTER 2

The Department Seeks to Increase Program Benefits, but Long-Term Costs and Funding Are Difficult to Forecast

CHAPTER SUMMARY

The California Department of Veterans Affairs (department) is exploring ways to improve its Life and Disability Insurance Program (insurance program), which it converted on June 1, 1996, to a commercial plan that reduced veterans' benefits. The department believes it has a special responsibility to provide better benefits to veterans in its commercial plan 1 who were in the insurance program before that date. Believing that current claims data for the insurance program support the possibility of negotiating increases in benefits without significant premium rate increases, the department plans to seek competitive bids from commercial insurers. However, negotiating with commercial insurers, who generally make only short-term contracts, does not answer the insurance program's need for a long-term strategy to address its aging population and lack of funding sources. The department will also solicit advice from a newly created committee on how best to increase the insurance program's benefits to veterans, with the goals of identifying possible funding sources to pay for those increases and selecting the best option to serve veterans and the future of the California Veterans Farm and Home Purchase Program (loan program) by the end of 2001.

The department can expect to secure only a three- to five-year group policy from an insurer to provide insurance program benefits for its commercial plan, as is the common practice in the insurance industry. Thus, although it will be able to provide increases in benefits to aging veterans at a fixed cost for a relatively short period, it will not be able to reliably forecast the overall, long-term costs of insurance program benefits. Moreover, the average age of veterans participating in the insurance program is 53, and the rate at which younger veterans are entering the insurance program will decline. Consequently, the department may find that it will be more costly to insure the participants each time it negotiates a new contract. We estimate that many of the options available to the department to increase benefits for the insurance program will be costly: Estimated costs for options include an immediate cash contribution of $67 million to restore benefits over the next 30 years to veterans who were in the insurance program prior to June 1, 1996, and as much as $270 million to convert from a commercial plan to a new self-funded plan.

The department also faces challenges in securing funding to pay for future costs of an improved insurance program. Loan program funds cannot be used to any large extent without adversely affecting the financial health of the loan program. Modest increases in the premium rates that veterans pay are a possible source of funding, but the department has been reluctant to increase premium rates. The department could also gain funds for the loan program from savings in its operational costs, potentially as much as $1.3 million annually, when it implements certain recommendations from the report we issued in May 2000.

THE DEPARTMENT PLANS TO REVISE THE CURRENT INSURANCE PROGRAM, BUT THE PROGRAM'S FUTURE IS UNCERTAIN

By requiring veterans to participate in the self-funded plan it operated before June 1, 1996, the department led those veterans to expect they could rely on a certain level of future life and disability insurance benefits. Therefore, the department believes it must find a way to increase benefits for those veterans who were in the original self-funded plan and are now in its current commercial plan 1. To assist it in exploring ways to increase benefits for those veterans, the department has formed the Strategic Life and Disability Committee (strategic committee). However, unpredictable future costs and the changing demographics of California's veteran population may prove to be obstacles for the department when selecting options for its insurance program.

Members of the Strategic Life and Disability Committee

- Department staff
- Advisors from the Department of Insurance and the Department of General Services' Office of Risk and Insurance Management
- Two members of the California Veterans Board

Planning to seek competitive bids from commercial insurers to obtain a large range of options and associated costs, the strategic committee believes that the department can use the insurance program's claims data to negotiate an increase in benefits with only a slight increase in premium rates. Options the strategic committee has discussed include extending disability benefits for currently insured veterans from two to five years and eliminating disability insurance coverage to veterans who enter the insurance program after February 1, 1998.

Potential Commercial Insurers Will Propose Insurance Costs Based on Short-Term Agreements

The department cannot ensure that future premiums under the commercial plan will be affordable in the long term.

Seeking competitive bids from commercial insurers is only a short-term solution, because any proposals the department receives will most likely be based on short-term agreements. According to the office chief of the Department of General Services' Office of Risk and Insurance Management, it is doubtful that the department will be able to obtain a group insurance policy with a term of more than 5 years. He also told us that if the department were to obtain a group insurance policy with a term of 10 years, the price would be expensive and the insurers would probably want to renegotiate the rates for the policy at 5 years or some other point during the term. In any event, the department would have to negotiate rates for the same group of veterans, who will be older and more costly to insure. Clearly, the department needs to develop a long-term strategy that addresses the future of the insurance program beyond increments of 5 years.

For example, as of January 2001 the current commercial plan 1 contained about 17,200 veterans of which most had enrolled in the insurance program before June 1996. These veterans averaged 55 years of age and had an average home loan of about $50,000. Using the current plan 1 rate schedule (see Table 1), the average veteran with an average loan will pay $28 per month for regular life insurance coverage, almost $482,000 per month for the group. In five years, the 60-year-old average member will pay $43 per month for the same life insurance benefit, with the group cost going to nearly $740,000 per month. We were unable to determine the effect that veterans' mortgage loan payments may have on reducing the average loan balance during the five-year period, yet the example shows the department needs a strategy for covering the insurance program's future costs.

Funding Options for the Insurance Program Depend on Younger Veterans Qualifying for Loans

The insurance program's financial viability will depend on the loan program's providing loans to younger veterans. Aging veterans in the loan program and a dwindling supply of funding for home loans to younger veterans will drive up the costs of providing life and disability insurance to veterans in the loan program. The average age of veterans in the loan program is increasing, and the department may have difficulty lowering the average age by attracting younger veterans. Federal tax law limits the department's ability to make loans to younger veterans by requiring veterans to have wartime experience prior to 1977 to qualify for the most plentiful source of tax-exempt bond proceeds the department uses to fund home loans. Currently, more than 52 percent of the veterans in the loan program are 50 to 59 years old.

The loan program can offer below-market mortgage rates to qualified veterans because the federal government allows the department to sell tax-exempt bonds to interested investors who are willing to accept a lower rate of return on investments that are not subject to state and federal income taxes. As shown in Table 3, the department has three sources of funding for loans to veterans: qualified veterans mortgage bonds (QVMBs), unrestricted funds, and qualified mortgage bonds (QMBs).

TABLE 3

Distinguishing Eligibility Requirements for Each Program Funding Source

Eligibility Requirements	QVMBs	QMBs	Unrestricted Funds
Must be a first-time homebuyer		✓	
Must have separated from service less than 30 years ago	✓		
Must have service prior to January 1, 1977	✓		
Must be a wartime veteran	✓		✓
Must meet certain income limits based on region		✓	
Must not exceed certain property purchase price limits based on surrounding area		✓	

Although the department can seek voter approval to obtain an ample supply of proceeds from QVMBs, only older veterans qualify for these loans. Current eligibility restrictions in the federal tax law require veterans who qualify for loans from QVMBs to have wartime experience in the military before January 1, 1977, and a service discharge date of less than 30 years prior to the date they apply for their loan. We estimate that veterans meeting these criteria will significantly diminish in 8 to 10 years. Along with veterans' representatives from four other states with similar loan programs, the department is trying to change the federal tax law to make younger veterans eligible, but past attempts to change the law have not been successful.

Because the population of veterans in the insurance program is aging, the future viability of the program depends on the ability of the department to obtain funds to make loans to younger veterans.

Unrestricted funds, consisting of proceeds from the refinancing of high-cost tax-exempt debt issued prior to January 1, 1981, are also used to make loans. The limitations on these funds are less stringent, allowing the department more leeway in determining eligibility for loans backed by these funds. The department reserves its unrestricted funds for veterans who have wartime experience but do not qualify for loans from QVMBs. These younger veterans are important to the future viability of the insurance program because their premium rates more than offset their expected cost of benefits. Unfortunately, the department faces a shortage of unrestricted funds, which come from monthly loan principal and interest payments and loan payoffs from veterans selling their homes or refinancing with another lender (recycled funds)—almost $10 million per month—that exceed its bond payments. Furthermore, according to the department's consultant, within 12 to 15 years the department will have to use these funds to pay for bonds instead of providing new loans.

The department uses the proceeds from QMBs primarily for loans to veterans who are first-time homebuyers with no wartime experience, typically younger veterans, who do not qualify for loans from its two other funding sources. Restrictions on loans from QMBs include income and purchase price limitations. However, the department substantially used the last of its authority to sell QMBs in 2000. To sell additional QMBs, the department must have permission from the California Debt Limit Allocation Committee (debt allocation committee), which was created in 1985 in response to the federal 1984 Tax Reform Act's requirement of an annual dollar limit on tax-exempt, private activity bonds issued in a state. The debt allocation committee allocates California's share of QMBs to housing agencies throughout the State, including the department. The federal government has increased the annual limit on private activity bonds commencing in 2003. However, according to the chief of the department's bond finance division, any future increase in the department's ability to sell additional QMBs is uncertain, and its current supply of QMBs will probably expire after 2002.

We estimate the number of new loans to veterans each year could shrink 52 percent during the next 10 years. Unless the department can make more loans to younger veterans, the insurance program will suffer, because the cost of insurance benefits to all veterans in the loan program will continue to increase as the ages of the participating veterans increase.

MOST PROPOSED ALTERNATIVES TO THE CURRENT INSURANCE PLAN HAVE SUBSTANTIAL COSTS

In exploring ways to improve its insurance program, the department faces a wide range of costs for alternative plans. Options for changing the current program range from returning to a self-funded plan to terminating the insurance program. We estimate the 30-year up-front costs for these options range from almost $270 million to no cost to the department, but most cost estimates do not include the $35 million liability for those veterans who were receiving disability benefits prior to June 1996, now covered under the current self-funded plan. Our estimates are calculated using original or variations of actuarial models developed by the department's consultant, and do not include the small group of veterans in the current commercial plan 3, who received loans during a period between 1995 and 1996 in which a moratorium on new entrants to the insurance program was in effect (see Figure 1). Our estimates use claims data from November 1998 to November 2000 for the insurance program and assumptions regarding the loan program's future lending activity level.

Funding limitations for the loan program that are out of the department's control will greatly affect the future costs of the insurance program.

As just discussed, factors out of the department's control will affect its ability to make loans to veterans using proceeds from QVMBs and QMBs. Neither the department nor we can predict with certainty the outcome of such factors. Our cost estimates for various options to the existing insurance program are based on three possible funding scenarios for the loan program. Under all three scenarios, the $10 million per month of unrestricted funds that the department currently uses for loans to younger veterans expires in 2015, when it must use those funds to retire its bonds. Further, although the department is considering introducing more costly taxable bonds to fund the loan program, we did not factor this into our estimates because the department is unsure of its ability to market these types of loans. The three scenarios are as follows:

- **The highest future enrollment in the loan program is optimistic.** This scenario assumes the federal government will amend its tax laws and allow the department to use up to 50 percent of its future QVMBs for loans to younger veterans. It also includes an assumption that the department will obtain the authority from the debt allocation committee to sell $100 million in QMBs each year. Using these assumptions, we estimate the department will be able to provide an annual average of 1.13 percent fewer new home loans to veterans through 2014, at which time new loans will drop sharply when unrestricted funds are no longer available for loans.

- **The lowest future enrollment in the loan program is pessimistic.** This scenario assumes the federal government will not amend its tax laws for QVMBs and that the number of California veterans meeting its existing criteria will dwindle in 8 to 10 years. It also assumes the department's funding from QMBs will expire after 2002 because the department will not obtain additional authority from the debt allocation committee to sell QMBs. Using these assumptions, we estimate that new loans will fall from the current average yearly rate of about 2,300 to roughly 1,100, or 52 percent, by 2003, and the department will be able to provide fewer than 100 new loans per year by 2015.

- **The most likely enrollment in the loan program is realistic.** This scenario, which we believe is most likely to occur, assumes that the federal government will not amend its tax laws for QVMBs, so that the number of California veterans meeting its existing criteria will dwindle in 8 to 10 years. Although we believe it will obtain additional authority from the debt allocation committee to sell QMBs, the department's current lending history supports only $40 million per year instead of $100 million in authority it plans to seek from the debt allocation committee. This scenario produces an average of almost 10 percent fewer new loans each year, declining from about 2,150 in 2001 to around 800 in 2010, with a drastic drop after 2014.

To Return the Insurance Program to a Self-Funded Plan, the Department Would Face Significant Costs

One suggestion for improving the insurance program's benefits is to convert the existing commercial and self-funded plans to a so-called true group plan, under which participation in life and disability coverage would be mandatory and all veterans would pay the same premiums. However, one disadvantage of this proposed true group plan is that it would return the department to managing a self-funded insurance program and being responsible for all liabilities not covered by veterans' premiums. On the other hand, the cost to veterans of this plan would be low, with all veterans paying one premium of $50 per month to cover both life and disability insurance, with an additional $3.19 per month to cover the department's administrative costs, including hiring insurance industry professionals to manage the program. Thus, veterans of all ages would pay the same premium amount. In addition, for the first year only, each new veteran entering the true group plan would pay a surcharge of $10 per month to establish a reserve fund. The true group plan would offer only regular life insurance and disability insurance. Coverage and benefits for both types of insurance would extend for the life of the loan.

Highlighted Features of True Group Plan

- Mandatory participation in the group plan would bring younger veterans to the plan and improve its financial health.
- The insurance program would be organized within the department but outside the Farm and Home Purchases Division.
- Premiums are fixed at $50 per month for insurance coverage, plus $3.19 per month for administrative costs.
- Each new entrant to the insurance program would pay $10 per month for the first year to establish a reserve fund.
- Coverage and benefits for life and disability insurance would extend for the life of the loan.
- The department would hire insurance industry professionals to operate the program.

Under all of our scenarios, the cost of a return to a self-funded plan is in excess of premiums paid by veterans to provide the benefits is exorbitant. As shown in Table 4, we estimate that the 30-year up-front cost of this plan, in excess of premiums paid by veterans, could range from $144 million to $270 million, with a most likely cost of $165 million. The figures in Table 4 include the costs for only the veterans in the current commercial plan (plans 1 and 2) and do not take into account the $35 million liability for the veterans receiving disability in the current self-funded plan. Table 4 also shows the range of premiums and benefits associated with the costs of the true group plan.

The proponent of this proposal believes that these costs can be substantially mitigated through changes in the administration of the insurance program. Specifically, the proponent believes the department can save money in the following ways:

TABLE 4

Costs to Implement a True Group Plan

	Highest Enrollment	Lowest Enrollment	Most Likely Enrollment
Estimated premium incomes	$ 343,980,000	$ 195,120,000	$ 220,740,000
Estimated claims	1,169,535,000	509,589,000	624,557,000
Estimated expenses	21,578,436	12,349,128	13,937,748
Estimated total expenditures	1,191,113,436	521,938,128	638,494,748
Total Deficit for Period	**$ (847,133,436)**	**$ (326,818,128)**	**$ (417,754,748)**
Total Deficit in Today's Dollars	**$ (269,685,000)**	**$ (143,534,000)**	**$ (165,094,000)**

- Require veterans in the loan program to participate in the insurance program, thus saving underwriting costs and improving the financial health of the true group plan.

- Purchase insurance policies from commercial insurers for selective subgroups within the group plan.

- Rely on disability determinations performed by the U.S. Social Security Administration (social security administration) to reduce the department's cost to process claims.

- Hire insurance industry professionals to manage the program, thus saving on fees paid to insurance administrators and consultants.

- Purchase reinsurance, or insurance from commercial insurers, using interest earnings on premiums collected, to cover the costs of paying disability benefits beyond two years and integrating disability benefits in excess of two years with social security administration and other disability programs in which veterans may have enrolled.

The estimates shown in Table 4 do not include the effect of the savings the proposal's proponent expects because a considerable amount of uncertainty exists. For example, to calculate the savings from purchasing reinsurance and insurance coverage for selective subgroups within the true group, we would have to be able to determine the cost and benefits to the department. The department would have to negotiate the terms of each policy with prospective commercial insurers. Because this has not been done, we are not able to estimate the results of such a hypothetical suggestion. Another uncertainty arises in estimating the effects of integrating the department's disability insurance program with the social security administration or other disability programs. Specifically, the department would need to obtain data on the various programs for which veterans may be eligible and to obtain an understanding of the benefits offered by each program for current and future participants. The administrative costs to the department for establishing a process to coordinate the integration of disability benefits with other programs may outweigh the savings.

Finally, the proponent recommends that the department establish the insurance program separate from its loan program and contract with insurance professionals to administer the insurance program. But the department is concerned that any movement toward returning to a self-funded plan and assuming the insurance risk for unknown liabilities may adversely affect the loan program's bond rating. In the past, when the department did not effectively manage its self-funded insurance program, the resulting estimated liabilities caused concern with nationally recognized credit analysts. We also have serious reservations that the department can effectively manage a new self-funded plan, because as we discussed in Chapter 1, the department still has not set aside sufficient cash and properly evaluated its liabilities for the existing self-funded plan.

To Restore Pre-1996 Coverage to Veterans in the Program Before the Commercial Plan, the Department Would Face High Costs

One option the department can consider entails restoring the insurance program's premiums and benefits to the pre-1996 levels for the veterans who were in the insurance program before June 1, 1996, including any veterans who chose to withdraw from the insurance program during its change to the current commercial plan. In addition, it could continue the premiums and benefits for veterans who obtained a loan on or after February 1, 1998, and are now covered under the current commercial plan 2. For calculating the cost relating to the commercial plan 2, we used the life insurance rates for veterans classified by Pacific Life as a standard risk. Table 5 shows that the up-front costs in excess of income from veterans' premiums range from about $49 million to $67 million, with a most likely cost of about $53 million. On top of these high costs, the department also retains the $35 million liability for veterans receiving disability benefits in the current self-funded plan.

TABLE 5

Costs to Restore Pre-June 1996 Coverage to Plan 1 Enrollees

	Highest Enrollment	Least Enrollment	Most Likely Enrollment
Estimated premium incomes	$ 696,268,500	$ 278,267,500	$ 350,765,500
Estimated claims	721,543,000	311,508,000	382,818,000
Estimated expenses	146,251,000	58,473,000	73,696,000
Estimated total expenditures	867,794,000	369,981,000	456,514,000
Total Deficit for Period	**$ (171,525,500)**	**$ (91,713,500)**	**$ (105,748,500)**
Deficit in Today's Dollars	**$ (67,478,000)**	**$ (48,782,000)**	**$ (52,033,000)**

Another option for improving the benefits under the commercial plan entails maintaining existing premiums and benefits, with one exception—the department could fully restore the benefit of paying the monthly mortgage, principal and interest only, for the life of the loan for permanently disabled veterans. However, we could not calculate the cost to restore these benefits since the department's insurance administrator, Pacific Life, does not capture this data because the current disability benefits last for only 24 months.

To Close the Program to New Participants and Allow the Current Program to Run Out, the Department Would Face Significant Costs

None of the other four states that make home loans to veterans offer a life and disability insurance program.

As another option, the department could consider phasing out all or part of the insurance program. None of the four other states that make home loans to veterans offers a life and disability insurance program. In fact, the only other state that offers any insurance is Oregon, which offers only life insurance to veterans. Veterans in the loan programs in Alaska, Wisconsin, and Texas purchase life or disability insurance coverage on the open market. We estimate the various options for closing part or all of the commercial insurance program could cost the department as much as $28 million. However, closing any or all of the commercial plan does not relieve the department of the $35 million liability for the veterans receiving disability in the current self-funded plan.

Because the department feels especially responsible for coverage to veterans who were in the original self-funded plan and are now in its current commercial plan 1, we calculated the cost of terminating the program except for all veterans who were in the loan program before June 1, 1996, using the pre-June 1996 premiums and benefits. We also included those veterans who entered the program after June 1, 1996, but are currently receiving disability benefits. The 30-year up-front costs of this option, in excess of income from veterans' premiums, are almost $28 million.

We also calculated the financial impact of continuing to offer life insurance but offering disability insurance only to those veterans who are currently receiving benefits in the commercial plan. For calculating the cost relating to the current commercial plan 2, we used the life insurance rates for veterans classified by Pacific Life as a standard risk. Because the current life insurance plan receives more in premiums than it pays out in claims expenses, in all three scenarios for the loan program, this option actually shows a profit. The financial impact of this option ranges from $7 million to $3 million in excess of premiums over claims as shown in Table 6.

TABLE 6

Offering Life Insurance and Discontinuing Disability Insurance Except for Those Veterans Receiving Benefits

	Highest Enrollment	Least Enrollment	Most Likely Enrollment
Estimated premium incomes	$269,552,000	$139,982,000	$161,686,000
Estimated claims	190,038,000	100,259,000	115,275,000
Estimated expenses	55,348,000	27,772,000	32,381,000
Estimated total expenditures	245,386,000	128,031,000	147,656,000
Total Surplus	**$ 24,166,000**	**$ 11,951,000**	**$ 14,030,000**
Surplus in Today's Dollars	**$ 7,149,000**	**$ 3,036,000**	**$ 3,690,000**

Finally, we estimated the financial impact of terminating both the life and disability plans. The department will bear no cost for settling existing claims under the commercial plan; these costs are the responsibility of the current commercial insurer, Pacific Life. However, the department is responsible for any liabilities associated with its current self-funded plan, which were about $35 million as of June 30, 2000.

THE DEPARTMENT HAS LIMITED CHOICES FOR FUNDING THE INSURANCE PROGRAM

The department believes it can subsidize the purchase of additional benefits to veterans using the loan program's unrestricted funds. However, doing this will mean fewer home loans for veterans. A more feasible source of money is small increases in veterans' life and disability insurance premiums, a solution the department hesitates to use because it anticipates negative reactions from veterans. Another source is the possibility of using as much as $1.3 million yearly savings in operational costs for the loan program that the department will realize when it makes operational changes we recommended in our May 2000 report.

The department estimates that starting on July 1, 2001, it can transfer about $1.5 million each year in unrestricted funds from the loan program to the insurance program for up to 10 years without adversely affecting its ability to meet the loan program's bond payments. However, using the loan program's unrestricted funds to fund improvements in the insurance program will decrease the number of veterans who can receive home loans from the department. In fiscal year 1999-2000, the average amount of new loans from unrestricted funds was about $193,000. Consequently, using $1.5 million to subsidize the insurance program would result in almost eight fewer loans each year to qualified veterans. Moreover, using unrestricted funds to subsidize the insurance program is a temporary solution, because the department's consultant projects that by 2015 the department will have to use these funds to retire its bonds. And spending unrestricted funds for the insurance program will deplete the unrestricted funds sooner.

Modest Increases in Insurance Premiums Can Increase Funding for the Insurance Program

In the past, the department has been reluctant to increase veterans' premium rates although it was warned repeatedly by its consultants that the premiums were too low to ensure the long-term financial solvency of the insurance program. The department was hesitant to increase premiums because it had been criticized in 1983 for maintaining an excessive reserve fund and it was sensitive to the possible adverse reaction from the veterans in the program.

Given some of the hard choices and trade-offs the department is considering, veterans might themselves choose small premium increases over having part or all of the insurance program discontinued.

However, a modest increase in premiums to each veteran can produce enough additional funding to increase benefits. For example, a modest 10 percent increase in premium rates for the average veteran in the current commercial plan 1 raises the monthly premium by $4.32, but yields almost $900,000 annually for the program; a 20 percent increase in premiums for the average veteran in the program raises the monthly premium by $8.65, but yields almost $1.8 million annually for the program. Given some of the hard choices and trade-offs the department is considering, veterans might themselves choose small premium increases over having part or all of the insurance program discontinued.

Of course, the department must first complete its current efforts to solicit proposals from insurance companies before it can consider any increases in premiums. The department expects to complete its bid solicitations from commercial insurers by the end of 2001.

Savings From Implementing a New Administrative Cost Allocation System for the Loan Program Can Assist the Insurance Program

The department will achieve savings in its operational costs for the loan program when it implements certain recommendations from the report we issued in May 2000. The potential savings to the loan program could be as much as $1.3 million annually and could be used to fund increases in the insurance program's benefits to veterans.

In our previous report, entitled *California Department of Veterans Affairs: Changing Demographics and Limited Funding Threaten the Long-Term Viability of the Cal-Vet Program While High Program*

Costs Drain Current Funding, we identified that the department has been inappropriately charging the loan program for the costs of administering the other veterans' programs. Specifically, we reported that because it does not track the activity of its administrative staff, the department incorrectly charges the loan program for the cost of 30 of 52 positions in its information services division and 7 of 15 positions in its legal division. In addition, we reported that other administrative positions also incorrectly charged 100 percent of their time to the loan program. At the time of our audit, the department was beginning a project to address this problem by establishing an equitable cost allocation system. In November 2000 the department told us that by June 30, 2001, its cost allocation system would be implemented and used to gather each employee's direct time spent working on various agency activities. The department will also use the gathered data to make annual cost adjustments necessary to ensure that direct and indirect administrative costs are properly charged to those programs served by administrative staff.

RECOMMENDATIONS

When choosing its option for the future of the insurance program, the department should establish a long-term strategy for the program that does not adversely affect the financial health or marketability of the home loan program.

Further, any long-term strategy that it develops should include consideration of the following:

- The aging population of veterans in the loan program.
- The uncertainty of future funding for loans to younger veterans.
- The future costs of the insurance program beyond the five years any group insurance policy will cover.
- The discontinuance of the insurance program for veterans who entered the program after 1996 and who are not currently disabled. For example, the department could close the program and secure acceptable coverage, with consideration to affordable costs, for those veterans who were in the program prior to the changes in June 1996 and for those who are currently disabled. This process would include identifying

the future liabilities and setting aside adequate cash to fund future claims, or seeking proposals from commercial insurers to provide a group plan to ensure that the coverage is provided at the lowest cost.

The department should continue its efforts to loosen the federal income tax restrictions on the proceeds of QVMBs to make younger veterans eligible. Such additional funding for younger veterans will serve to lower the average age of veterans in the loan and insurance programs and lower the individual costs of providing life and disability coverage.

To allow public comment and to give interested parties an opportunity to present ideas for improving the insurance program, the department, together with the board, should conduct a series of public meetings regarding the future of the insurance program. Then, the department and the board should consider the public comments when identifying viable options for the program in order to best serve the veterans.

When identifying potential sources of funds for improved insurance benefits to veterans, the department should consider modest and appropriate premium rate increases. It should also continue to explore its options for transferring unrestricted funds to the insurance program.

The department should finish implementing its new cost allocation system to ensure it charges only appropriate administrative costs to the loan program, identify the savings to the loan program that result from the new system, and consider using those savings to improve the insurance program. ■

CHAPTER 3

The Department Needs to More Effectively Administer the Life and Disability Insurance Program

CHAPTER SUMMARY

Flaws in the way the California Department of Veterans Affairs (department) administers the Life and Disability Insurance Program (insurance program) weaken its ability to safeguard the department's and the veterans' assets. Specifically, the department needs to improve its contracting practices to comply with state guidelines for managing contracts. For example, the department's contract with its risk management consultant (consultant) does not adequately detail the extent of service the consultant must provide or adequately specify the form in which the consultant's service must be presented, making the contract difficult to monitor. Also, the department does not have formal policies and procedures for contract managers to follow, creating a risk that the department is paying for services that it did not receive. Further, the department's lack of awareness about its operations and its failure to act promptly on recommendations in our May 2000 report create a weakness in the department's internal controls. This weakness prevented adequate separation of duties for staff who handle cash receipts and disbursements for the insurance program. State law requires state agencies, including the department, to maintain an effective system of internal accounting and administrative controls; the department needs to follow such a system to protect veterans' premiums.

THE DEPARTMENT LACKS MEASURABLE CRITERIA FOR EVALUATING ITS CONSULTANT'S CONTRACT PERFORMANCE

The department's contract with its consultant lacks enough detail to allow it to effectively monitor the consultant's performance. The department relies on its consultant for expert advice on managing the insurance program and expects to pay that consultant up to $353,000 over a period of slightly more than four years. However, the department's contract with its consultant lacks details about the extent of services he must provide and specifics about the form he must use to present his results. Further, the department does not have formal policies and procedures in place for its contract managers to follow. Consequently, it has limited assurance that it complies with state guidelines for monitoring consultant contracts.

The department's consultant provides it with expertise in managing the insurance program, including its agreements with Pacific Life and Annuity Company (Pacific Life). The agreements require Pacific Life to provide group life and disability insurance and to manage the claims and the reserves for the department's self-funded plan. However, the department does not have policies and procedures in place to direct its managers on how to monitor contract performance. According to the department's contract officer, the department has recently taken steps to improve its contract management. Waiting for staff to be hired and trained, the contract officer has just started developing and implementing contract policies and procedures.

Most Tasks Required by the Department's Contract Do Not Specify the Form or Content of the Services

- Monitor and analyze individual plans and overall program experience.
- Prepare quarterly management reports for the department on financial experience, enrollment, premiums, and operations, along with an analysis and interpretation of the data.
- Develop an annual report, as part of the department's annual planning process to be delivered before the annual plan management meeting to be held in April or May of each year.
- Meet with Pacific Life on technical issues as required.
- Make recommendations for plan benefit or operational improvements.
- Develop meeting agendas along with any presentation materials (charts, graphs, etc.) that would be helpful to the department in managing the problem.
- Attend meetings (estimated four times per year) in the role of meeting facilitator with a department staff person as chair.
- Annually review the need for adjustments in premiums and experience rating formula to keep the program sound for the future.

Under the department's contract, the consultant agrees to provide a review of administrative and claims services provided by Pacific Life for the department's self-funded plan; the consultant also provides ongoing program management for the commercial plan to anticipate and solve problems as early as possible. The State Contracting Manual recommends that consulting contracts should specifically identify, in realistic terms, what the consultant is to accomplish, including any desired approach to the problem, specific questions to be answered, the manner in which the work is to be done, a description of the items to be delivered, the format of completed reports, and a timetable for the delivery of services. However, the department's consulting contract, without descriptions of the content and format for the consultant's reviews, reports, and meetings, lacks sufficient detail to measure the consultant's performance. For example, the contract states that the consultant will "monitor and analyze individual plan and overall program experience," but it does not clearly state the questions the

While informal communication is not uncommon in managing consultant contracts, the absence of formal written reports can mean that valuable information for managing the insurance program is overlooked.

department wants answered or how and when the consultant should provide his results. Also, the department requires the consultant to prepare an annual report to assist in its planning, but it does not specify what the annual report should include. Further, the consultant told us that he generally communicates the results of his work either in his annual or quarterly reports or orally at meetings with the department. While informal communication is not uncommon in managing consultant contracts, the absence of formal periodic written reports can mean that valuable information for managing the insurance program is overlooked by the department. This omission is particularly important because the department admits that its past understanding of the insurance business was unclear.

Without clearly defining in the contract what it requires of the consultant, the department limits its ability to monitor the consultant's progress and ensure that his work meets necessary objectives and time frames for effectively managing the insurance program. The contract manager told us that he has knowledge of what the consultant is doing during any given month and uses this knowledge when reviewing the consultant's monthly invoices. However, the contract manager could not demonstrate how the descriptions of services on the monthly invoices meet the contract terms. Equally important, the department must ensure that it complies with state guidelines for monitoring its contracts, which include verifying that the consultant has fulfilled all contract requirements before approving payments.

THE DEPARTMENT LACKS ADEQUATE CONTROLS OVER ITS CASH TRANSACTIONS

Another administrative weakness in the department is its flawed internal controls over cash transactions that weaken its ability to safeguard the assets of its Farm and Home Purchase Program (loan program). The State Administrative Manual states that a person who prepares invoices should not also receive or deposit remittances. Moreover, it states that a person who receives remittances should not also authorize disbursements. This lack of separation of duties creates an opportunity for theft of the premiums paid by veterans or of refunds from impound accounts. However, the department allows one staff member in its insurance unit to perform all the following incompatible tasks:

- Calculate and request the amount of the life insurance benefit necessary to pay off a loan upon the death of a loan program participant.

- Receive the loan payoff check sent by Pacific Life, the insurance carrier.

- Prepare and authorize the disbursement of any amounts left in an impound account after the loan has been paid.

The department's headquarters operations manager was unaware that the loan payoff checks from Pacific Life were not being sent to the accounting unit. After we brought these weaknesses to the department's attention, it began implementing procedures that conform to state policy.

In our May 2000 report, we identified another instance of inadequate separation of duties involving one staff member who receives and deposits monthly loan payments from veterans and who also enters the amounts into the accounting records. Specifically, when the cashiering unit receives a payment with multiple checks but only one coupon, a payment with two coupons but only one check, or a supplemental payment, the cashier separates that payment from the others and gives it to an accounting technician who manually posts the receipt of the check in the accounting system. Because of vacancies in the accounting unit, this accounting technician is performing two incompatible duties—posting checks to the accounting records and preparing bank deposits. The department has sufficient positions to maintain adequate separation of duties, but because the supervisor position for the cashiering unit is vacant, the accounting technician also prepares the checks for deposit. The State Administrative Manual identifies receiving, depositing, and posting remittances to the accounting records as incompatible duties. As of February 5, 2001, the department has yet to correct this internal control weakness. According to the accounting administrator for the cashiering unit, the department is currently reviewing the entire process to correct any inadequate separation of duties and to fill its vacancies.

RECOMMENDATIONS

To improve its contracting procedures, the department should ensure that its contracts reflect the level of service it requires from the contractors by following the guidelines set forth in the State Contracting Manual and implement procedures for monitoring the contractor's performance.

To protect its assets, the department should ensure that it establishes and maintains an adequate system of internal controls as set forth in the State Administrative Manual and should work diligently toward filling vacancies in the accounting unit.

We conducted this review under the authority vested in the California State Auditor by Section 8543, et seq., of the California Government Code and according to generally accepted government auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,

Elaine M. Howle

ELAINE M. HOWLE
State Auditor

Date: March 28, 2001

Staff: Joanne Quarles, CPA, Audit Principal
Norm Calloway, CPA
Phillip Burkholder, CPA
Jessica Tucker

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APPENDIX

Concerns About the Department's Use of Bond Proceeds for Its Loan Program Have No Merit

The Joint Legislative Audit Committee (audit committee) requested the Bureau of State Audits to review a report released in February 2001 by a certified public accountant (CPA) on the California Department of Veterans Affairs' (department) use of bond proceeds from 1980 to 1996. The report was released jointly by the CPA and a critic of the department's management of its Farm and Home Purchase Program (loan program) acting as a consultant. The audit committee was interested in knowing whether the CPA's methodology was appropriate and whether his conclusions were reasonable and sound. Although in the report the CPA and his consultant admit they were unable to substantiate the accuracy of some of the department's financial and program data, they render an opinion that the department has misappropriated, misused, or diverted as much as $4.6 billion. Our review of the sources and uses of funds for the department's loan program between 1980 and 1996 did not yield similar results.

An Example of How Loans Made to Veterans Are Included In the Net Loans Receivable Balance

Net loans receivable beginning balance, July 1, 1980 (Table 7)	**$2,232,690**
1981 loans to veterans (Table 8)	+423,773
1981 payments on loan principal (Table 8)	–159,007
Net loans receivable ending balance, June 30, 1981 (Table 7)	**$2,497,456***

* Differences arising in the net loans receivable shown at Table 7 may be attributable to the netting of unpaid accrual interest and reserves for uncollectible loans.

The CPA and consultant raise four major areas of concern about certain loan program data they analyzed. The first concern, the cornerstone of the report, suggests there is a discrepancy of about $4.6 billion between the proceeds of bonds the department issued and the amount of those proceeds the department used for loans to veterans. The CPA arrives at this amount by identifying proceeds from bond issuances of $5.6 billion and subtracting a maximum total increase in net loans receivable occurring between 1980 and 1986 of $1 billion. In arriving at the $1 billion, the CPA uses the net loans receivable balances stated on the department's audited financial statements, which includes any new loans made to veterans plus unpaid accrued interest and is reduced by payments for loan principal balances and an estimate of uncollectible loans. Specifically, the

CPA took the largest net loans receivable balance during the 17-year period from 1980 to 1996, which was $3.2 billion in 1986, and subtracted the 1980 net loans receivable balance of $2.2 billion shown on Table 7 (column III) on page 50. We disagree with the CPA's methodology. Our analysis at Table 8 on page 51 shows the department's sources and uses of its cash for the loan program, including bond proceeds, using information from the department's audited financial statements for fiscal years 1979-80 through 1995-96. Using Table 8, we are able to demonstrate that the net loans receivable balances shown on Table 7 (column III) include new loans made to veterans. In the text box on the previous page we show an example of how we verified annual net loans receivable balances. Further, Table 8 shows that at least $4.4 billion was used to make loans to veterans. It is highly unlikely that the department would have been able to hide more than $4 billion from the four different independent auditors it used between 1980 and 1996.

Another concern the CPA raised is that the interest rate charged to California veterans for their loans appears to be excessive. This conclusion is flawed because it is based on the CPA's and consultant's erroneous assumption that the department did not use bond proceeds of up to $4.6 billion to make loans. Specifically, they raise the question of why the department would issue bonds in an amount so much greater than the amount of funds used to make loans to California veterans. As previously stated, the department's audited financial statements indicate that at least $4.4 billion of the bond proceeds were used to make loans. Moreover, federal law allows the department, in some instances, to use part of the bond proceeds to pay for bond issuance costs and a reasonable amount for required reserves.

The report also raises the concern that administrative costs incorrectly charged by the department to the loan program have the effect of causing the interest rate paid by veterans to be excessive. In our May 2000 report, entitled *California Department of Veterans Affairs: Changing Demographics and Limited Funding Threaten the Long-Term Viability of the Cal-Vet Program While High Program Costs Drain Current Funding,* we found that the department was incorrectly charging some administrative positions to the loan program and that it could not be certain that indirect administrative costs were equitably allocated among its programs. The department admits to overcharging administrative costs to the loan program. However, it is inappropriate to assume that the department will use savings generated from our recommendation to lower interest rates. In fact, in Chapter 2 of this report, we suggest the department could use its savings to support the Life and Disability Insurance Program. The department has discretion on how it will use loan program funds as long as the use is consistent with the laws governing the loan program.

Finally, the CPA's report raises concerns about discrepancies noted in the average annual rate of prepayments reported by the department in its official statements. The department calculates this rate by computing the average net loans receivable balance for a given year and dividing the result by the amount received during that year for payments of all or part of the loan principal (prepayments). The CPA and the consultant question how early prepayments of loans reported in the official statements could result in such a low number of existing loans in 1996. However, the methodology supporting this conclusion is flawed. The CPA and the consultant maintain that because they did not have access to the department's records, they attempted to use the annual average prepayment percentages reported by the department in its official statements to calculate the number of loans funded in a given year. However, this is not an appropriate methodology because neither the amount of the net loans receivable balance nor the prepayments by themselves provide sufficient information on the number of existing loans. For example, although the average loan balance for roughly 17,200 veterans in plan 1 of the department's current commercial plan is about $50,000, the maximum loan amount for the loan program can be as high as $250,000 for any individual veteran. Moreover, we question the CPA's and consultant's rationale for challenging the number of loans presented by the department, because loans to veterans constitute the department's largest asset on its balance sheet. Generally, we would expect the department's independent auditors to spend considerable time each year identifying the completeness of the loans receivable balance and selecting a sample of individual loans to verify their existence and ensure the accuracy of the loan balance.

Note: This table represents an excerpt from the CPA's report on the department's use of bond proceeds from 1980 to 1996 and has not been altered by the Bureau of State Audits.

TABLE 7

Comparison of Cal-Vet Program Data: Stated Proceeds From Bonds Issued, Stated Amount of Bond Funds Used to Make Loans to Veterans, Stated Receivables Under Contract of Sales, Stated Amounts of Contracts Prepaid, Stated Amounts of "Other Principal Losses," and Stated Annual Prepayment Percentage Rates.

($ Numbers in Thousands)

Year	(I) Stated proceeds from bonds issued	(II) Stated bond funds allegedly used to make loans to veterans	(III) Stated receivables under contract of sales	(IV Stated contract prepayments during years 1980-1996	(V) Stated other principle gains/losses during years 1980-1996	(VI) Annual average prepayment rate
1980	$ 675,000	$ 722,833	$2,232,690*	$ 100,540	$ 69,079	5.40%
1981	450,000	423,773	2,497,453*	82,393	70,472	3.20
1982	300,000	281,867	2,657,193*	44,608	74,891	1.45
1983	200,000	254,029	2,731,574*	92,146	87,536	3.05
1984	550,000	408,546	2,907,972*	132,911	94,930	4.74
1985	572,000	446,943	3,139,726*	123,669	88,308	5.60
1986	578,000	405,177	3,268,535*	179,809	94,970	8.20
1987	300,000	184,659	3,099,368	261,675	99,569	6.40
1988	340,000	335,118	3,112,889	198,396	114,178	6.60
1989	450,096	335,872	3,124,710	207,471	105,896	7.44
1990	770,643	223,563	3,024,692	232,085	96,639	5.72
1991	92,600	227,450	2,671,981	171,895	92,722	8.87
1992	0	Unknown	2,771,184	246,150	92,975	10.32
1993	0	Unknown	2,493,894	273,817	105,629	13.65
1994	0	Unknown	2,168,170	359,749	98,773	5.62
1995	385,530	173,582	2,341,752	111,984	74,706	6.00
1996	0	0	2,216,193	141,767	92,521	
	$5,663,869	$4,423,412		$ 3,085,933	$1,622,034	
	$1,240,447**			$4,707,967***		****

* Represents the $1,035,845,000 or "**maximum total increase**" in receivables under contract of sales occuring between 1980 and 1996.

** $1,240,547,000 difference between "bonds issued" and "bonds used to make loans to veterans," 1980 through 1996.

*** The DVA's "stated prepayment amounts" for 1979 to 1996 (see column III) are added to their "stated principle gains/losses" (see column IV) have been totaled together amounting to $4,707,967,000. **This was done because there were no principal gains only principal losses for each and every fiscal year 1979-1996.**

**** The vast majority of the DVA's stated prepayment percentage rates do not coincide with the DVA's stated prepayments amounts in Columns IV and V above.

The numbers in this exhibit have been taken from the DVA's Annual Audit Reports 1980-1996; and from the Cal-Vet Program Data in the December 10, 1997 "Official Statement", page D-3.

TABLE 8

Statement of Cash Flows Developed Using Audited Financial Statements for the Veterans Farm and Home Building Fund of 1943

	Source of Cash (in thousands)						Use of Cash (in thousands)				
Year	Beginning cash and investments balance	Excess (deficiency) of revenues over (under) expenditures*	Payments on loan principal‡	Bond proceeds	Cash provided (used) by other accounts§	Advance from general fund	Bond redemption and retirement	Loans to veterans‡	Other uses of funds**	Payment of general fund advance	Ending cash and investments balance
1980	$ 185,273	$ 10,166	$ 175,790	$ 675,000	$ 9,765	$21,845	$ 106,950	$ 722,833	$ 19,496	$21,845	$ 206,715
1981	206,715	24,345	159,007	450,000	30,627		123,000	423,773	32,063	0	291,858
1982[††]	276,569	24,920	122,115	300,000	3,902		150,750	281,867	407	0	294,482
1983	294,482	33,037	179,648	200,000	(4,411)		183,600	254,029	2,348	0	262,779
1984	262,779	30,881	232,148	550,000	101,412		191,300	408,546	68,443	0	508,931
1985	508,931	33,948	215,188	572,000	25,754		189,750	446,943	32,564	0	686,564
1986[††]	728,027	23,412	276,367	578,000	8,052		188,425	405,177	29,416	0	990,840
1987	990,840	(8,000)	362,826	300,000	14,647		188,810	184,659	37,276	0	1,249,568
1988	1,249,568	(28,760)	312,597	340,000	19,475		185,210	335,118	973	0	1,371,579
1989[††]	1,371,048	(15,432)	309,706	450,096	15,030		198,778	335,872	75,687	0	1,520,111
1990	1,520,111	14,956	323,578	770,643	31,337		311,080	223,563	27,250	0	2,098,732
1991	2,098,732	13,341	280,364	92,600	41,304		342,700	227,450	2,444	0	1,953,747
1992[†]	11,756	13,445	201,387	0	205,710		408,745	0	6,430	0	17,123
1993	17,123	(45,531)	277,290	0	67,502		305,774	0	1,801	0	8,809
1994	8,809	(21,528)	325,724	0	153,271		466,195	0	81	0	0
1995	0	(28,740)	0	385,530	173,067		351,440	173,582	243	0	4,592
1996	4,592	(6,709)	125,559	0	140,239		249,455	0	112	0	14,114
Total		**$ 67,751**	**$3,879,294**	**$5,663,869**	**$1,036,683**	**$21,845**	**$4,141,962**	**$4,423,412**	**$ 337,034**	**$21,845**	

* This column represents the difference between revenue and costs to the department for administering the program such as payroll, losses on sale of repossessed property, etc.

† The independent auditor changed the presentation of its statement of cash flows. This amount represents cash in State Treasury only.

‡ In 1992 the independent auditor changed the presentation of the cash flow statement to only show net change in the loans receivable. Therefore, only one value appears in either the payments on loan principal or loans to veterans columns above.

§ The other accounts include the debenture revenue fund, fixed assets, and other receivables.

** Other uses of funds include adjustments for the debenture revenue fund, fixed assets, etc.

†† The difference between the prior ending balance and this beginning balance represents reclassifications or prior period adjustments made by the independent auditors.

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Agency's comments provided as text only.

DEPARTMENT OF VETERANS AFFAIRS
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March 19, 2001

Elaine Howle, State Auditor
Bureau of State Audits
555 Capitol Mall, Suite 300
Sacramento, California 95814

Dear Ms. Howle:

Attached is the Department of Veterans Affairs' response to your draft report entitled "THE CALIFORNIA DEPARTMENT OF VETERANS AFFAIRS: *Its Life and Disability Insurance Program, Financially Weakened by Past Neglect, Offers Reduced Insurance Benefits to Veterans and Faces an Uncertain Future* (No. 2000-132)."

The Department appreciates your review of its Life and Disability Programs and the opportunity to respond to the draft report. The options and analysis presented in the report will be helpful in determining the future direction of the Life and Disability Programs. The Department agrees with the report's recommendations, and as pointed out in the draft report, steps are already being taken to comply. These steps, as well as some additional clarification of the findings, are addressed in the attached response.

If you require additional information, please do not hesitate to contact me, or George Flores, Chief of the Farm and Home Purchases Division, at (916) 503-8318.

Sincerely,

(Signed by: Bruce Thiesen)

BRUCE THIESEN
Interim Secretary

Attachment

RESPONSE TO THE BUREAU OF STATE AUDIT'S REPORT NO. 2000-132 "CALIFORNIA DEPARTMENT OF VETERANS AFFAIRS: ***Its Life and Disability Insurance Program, Financially Weakened by Past Neglect, Offers Reduced Insurance Benefits to Veterans and Faces an Uncertain Future*.**"

OVERVIEW OF THE REPORT

The California Department of Veterans Affairs (Department) has reviewed the findings, conclusions and recommendations presented in the above-named report. As discussed in this response, the Department will consider all recommendations and take appropriate action.

Overall, the Department is pleased with the Bureau of State Audit's (BSA) in-depth review of its Life and Disability Programs, and agrees with the recommendations. As stated in the audit report, this is a complicated issue difficult to resolve "because future participation in the loan program is unpredictable for reasons that are out of the Department's control, such as federal eligibility restrictions and uncertainties over funding." This issue is further complicated by political sensitivity and the Department's desire to continue to serve California's veterans.

As the BSA points out, usage of program funds was consistent with allowable applications. The Department's goal was always to protect the veteran, and in the early 1980's when the Department was criticized for maintaining excess cash in the reserves, the excess cash was returned to the veterans through payment reductions (reduction in interest rate, and moratorium on premiums). These decisions, upon hindsight, may have contributed to later instability in the Life and Disability Program; however, the Department has always tried to do the appropriate thing for veterans. Over the years, an inequity developed with the aging of the veterans and a decreasing portfolio. The Department removed itself from the self-insurance business in order to continue to provide the best life and disability program for the money with the least risk to the Cal-Vet Program as a whole.

The Department appreciates the options presented in the audit report, and believes that the report supports the Department's position that the return to self-insurance is not a viable option. Once the bid process has been completed, additional information will be available to assess options.

The Department is aware of and understands the scope and methodology the audit team used to prepare the draft report.

<u>CHAPTER 1</u>: *The Department's Decisions Created Financial Woes for the Life and Disability Insurance Program and Reduced Insurance Benefits to Most California Veterans*

The Department agrees with the facts as presented by the audit team in the summary and regarding changes in the program, as well as the descriptions of the plan groups. However, the following clarifications provide a complete understanding of the issues.

The draft report discussed the number of participants currently remaining in the self-insured group. As stated in the report, the group originally consisted of 1,700 contracts in 1996, and has decreased to 840 in March 2001. The report indicates this decrease was from veterans or surviving spouses paying off their loans. This is true in many of the cases; however, the Department has and will continue to aggressively monitor the cases and take action to reduce loans in this group. Actions taken to reduce loss exposure from this group include:

- Offering the deeds to permanently disabled participants;
- Frequent monitoring of disability status and requiring independent medical examinations in questionable cases; and,
- Investigating the acceptability of eliminating premium or interest charges, which would mean more of the benefit is applied to principle and the loan term is reduced.

The Department agrees that Plan 1 life insurance coverage rates doubled for veterans over age 60 who came under contract prior to June 1, 1996. It should be noted that the pre-June 1, 1996 rates of $.43 per $1,000 of coverage per month for individuals over age 45 were artificially low and could not be sustained. The current rate of $.86 is not actuarially sufficient unless subsidized by the younger veterans in the insured program. This current rate is still lower than commercial rates for similar coverage. The premium rates of Plan 1 and Plan 2 differ because of the average age of the pooled insureds, and a mandatory benefit of 5, 3 or 1 year of principle and interest payments (depending on health status), limits the claim liability of the insurer.

RECOMMENDATION:

The Department should ensure that it is able to meet future liabilities for the current self-funding plan by revising its method for annually determining its liabilities and developing a long-term strategy to set aside sufficient cash.

DEPARTMENT'S RESPONSE:

Chapter 1 states that the Department continues to underfund its current self-funded plan by not making annual determinations of its liabilities and not setting aside enough cash to pay for future liabilities. The report shows $35 million estimated as needed in reserve, but only $22 million set aside in cash to pay these liabilities.

The Department believes the self-funded plan is *not fully funded*, rather than underfunded. Through prudent cash flow management, the funds are being made available when needed. The

Department has liabilities set up to cover all the costs of the self-insured. Current cash set aside is more than adequate for our needs for the immediate future. A methodology is being developed to calculate the amount needed to fund the program annually, and the Department has demonstrated that it has income to cover its annual exposure.

CHAPTER 2*:* *The Department Seeks to Increase Program Benefits, but Long-Term Costs and Funding are Difficult to Forecast*

The Department agrees with the facts presented by the audit team in the summary regarding its desire to improve its Life and Disability Program.

RECOMMENDATION:

When choosing its option for the future of the life and disability insurance program, the Department should establish a long-term strategy for the program that does not adversely affect the loan program. Further, any long-term strategy that it develops should include consideration of the following:

- The unpredictability of the ages of veterans in the loan program;
- The uncertainty of future funding for loans to younger veterans;
- The future costs of the insurance program beyond the five years any group insurance policy will cover; and,
- The discontinuance of the insurance program for veterans who entered the program after 1996 and who are not currently disabled.

DEPARTMENT'S RESPONSE:

The Department agrees that its primary responsibility is to ensure the health of the program overall. Every effort will be made to consider only options that have no adverse affect on the Department's bond rating or assist one group of contract holders at the expense of another group. Any long-term strategy will include consideration of the unpredictable variables of the aging population of veterans in the loan program, the uncertainty of future funding for loans to younger veterans, the future costs of the insurance program beyond the five years any group insurance policy will cover, and the discontinuance of the insurance program for veterans who entered the program after 1996 and who are not currently disabled. The Department will use all available resources, which would include the sources recommended in the audit report.

The Department's Farm and Home Purchases Division was established to make low-cost home loans to honor and assist California's veterans. As the audit report indicates, other states with veterans mortgage loans do not offer insurance, with the exception of Oregon which offers life insurance. The Department intends to continue to focus on the Cal-Vet loan program. One of our primary goals is to provide the best mortgage loans to the veterans we serve. Insurance programs are considered an additional benefit, if resources allow.

In regard to continuing efforts to loosen the federal tax code restrictions on the proceeds of Qualified Veterans Mortgage Bonds, the Department has joined with four other states having veterans mortgage programs to continue efforts to loosen the federal tax code restrictions. The Department believes the current political climate is more favorable to successful passage of legislation (HR959 and S97) than in previous years.

Regarding public meetings, Cal-Vet Board meetings are open and public. An agenda is available and interested parties are able to respond. The Life and Disability Program issue has been previously discussed at Board meetings. When market information has been received and the Department has a better idea of its options, the Department will actively solicit public comment and consider any viable suggestions.

The financial outlook of the Department is strong. According to Moody's Investors Service (1999):

> *"The credit outlook is stable. Recently obtained mortgage insurance coverage on a portion of the contracts results in a stronger asset portfolio generating revenue for the 1943 Fund which secures the bonds. Changes to the Department's Life and Disability insurance programs has reduced financial exposure to program losses. These features will allow the program to remain financially viable throughout most housing markets or economic downturns. Potential risks are likely to result from the Department's management changes to the program; however, such further actions are not expected over the foreseeable future."*

Further, according to Standard & Poors (2000):

> *"Management's restructuring of the 1943 fund in 1997 was a major step toward helping to maintain the viability of the program over the longer term. The Department effectively:*
>
> - *Outsourced the life, disability, fire, and hazard insurance risks, which were a part of older contracts of purchase;*
> - *Enacted legislation that eliminated the uniform interest rate requirement of contracts;*
> - *Lowered interest rates on 95% of existing contracts of purchase to a competitive interest rate;*
> - *Expanded loan origination potential through mortgage brokers certified by management;*
> - *Increased the pool of eligible veterans to include Gulf War and peace time veterans;*
> - *Obtained primary mortgage insurance with Radian Guaranty (double-'A') for the majority of contracts with high loan-to-value (LTV) ratios; and*
> - *Began originating high LTV contracts with guarantees from the federal Department of Veterans Affairs."*

CHAPTER 3: *The Department Needs to More Effectively Administer the Life and Disability Insurance Program*

The Department agrees with the facts presented by the audit team regarding contract performance measurement and cash controls.

RECOMMENDATION:

To improve its contracting procedures, the Department should ensure its contracts reflect the level of service it requires from the contractors by following the guidelines set forth in the State Contracting Manual and implement procedures for monitoring the contractor's performance.

To protect its assets, the Department should ensure that it establishes and maintains an adequate system of internal controls as set forth in the State Administrative Manual and should work diligently toward filling vacancies in the Accounting Unit.

DEPARTMENT'S RESPONSE:

The Department has taken steps to improve its contracting procedures, and will follow the guidelines set forth in the State Contracting Manual. The Department has developed forms and formats for all contract managers to use in order to standardize and document every requirement and track performance. Training will be given to all contract managers.

In regard to adequately safeguarding the cash and loans receivable assets of the loan program, every action is being taken to safeguard Department assets in compliance with the State Administrative Manual. The Accounting Unit is working diligently toward reviewing their entire process and getting staff in place.

cc: Members of the Legislature
Office of the Lieutenant Governor
Milton Marks Commission on California State
Government Organization and Economy
Department of Finance
Attorney General
State Controller
State Treasurer
Legislative Analyst
Senate Office of Research
California Research Bureau
Capitol Press