

# DEPARTMENT OF VETERANS AFFAIRS

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

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### ***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.***
- It is currently seeking to increase the insurance program's benefits, but the long-term costs and funding for increased benefits are uncertain.***

***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.***

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In conjunction with its California Veterans Farm and Home Purchase program (loan program), which provides low-cost home loans to veterans living in California, the California Department of Veterans Affairs (department) offers a life and disability insurance program (insurance program) to qualifying veterans. The insurance program is intended to provide adequate protection to veterans so that injury or illness will not stop them from making loan payments and so their surviving spouses can pay off all or some of the mortgage. At the request of the Joint Legislative Audit Committee (audit committee), we conducted 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 veterans, and future options for the program. The audit committee also requested that we review a study released in February 2001 by a certified public accountant on the department's use of mortgage bond proceeds from 1980 to 1996. Based on our review, we found the following:

**Finding #1: In June 1996 the department made sweeping changes to its insurance program, aiming to reduce the program's exposure to substantial estimated liabilities and restore financial stability. As of June 30, 2000, the department had not adequately identified and funded its remaining liabilities.**

The department reduced its future liabilities by transferring the majority of its insurance risk to a commercial insurer. However, the department continues to administer a relatively small self-funded plan for those veterans who were receiving disability benefits prior to the June 1996 change. As of June 30, 2000, the department's estimates of liabilities for the self-funded plan totaled

\$35 million, however, it has set aside only \$22 million in cash to pay for these 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. 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 without an actuarial study because the group of veterans in the plan is small and most are permanently disabled.

We recommended that the department ensure 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.

***Department Action: Partial corrective action taken.***

The department reports that its future liabilities for its self-funded plan are diminishing and it is taking action to ensure it has sufficient funds to meet those future liabilities. The number of borrowers under the self-funded plan is declining as a result of normal loan payoffs. In addition, the department is actively seeking to pay off the loans of permanently-disabled contract purchasers who will accept payoff of their loan balances in lieu of ongoing monthly benefits, thereby, reducing the department's future liabilities.

After it completes all possible loan payoffs, the department reports it will review the economic feasibility of administering in-house all or some of the remaining permanently disabled contract purchasers in the self-funded plan. Further, the department is developing a methodology to calculate the amount of cash needed to fund the program annually.

**Finding #2: The department is exploring ways to improve its insurance program; however, unpredictable future costs and the changing demographics of California's veteran population may prove obstacles for the department when selecting options.**

The department plans to seek competitive bids from commercial insurers to obtain a wide range of options and associated costs. However, this would provide only a short-term solution because

any proposals the department receives will most likely be based on short-term agreements and will bring higher insurance costs to the program.

In addition, funding options for the insurance program depend on younger veterans qualifying for loans. However, an aging population of veterans in the loan program and a dwindling supply of money for home loans to younger veterans will drive up the costs of providing life and disability insurance to veterans in the loan program.

Finally, in choosing among alternative plans, the department faces a wide range of costs. These alternatives range from returning to a self-funded plan to terminating the insurance program. We estimate 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 before June 1996, now covered under the current self-funded plan.

We recommended that when choosing its option for the future of the insurance program, the department establish a long-term strategy for the program that does not adversely affect the financial health or marketability of the home loan program. Any long-term strategy that it develops should include consideration of the following:

- The aging population of the 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.

In addition, the department should allow public comment and give interested parties an opportunity to present ideas for improving the insurance program and consider the public comments when identifying viable options for the program in order to best serve veterans.

***Department Action: Partial corrective action taken.***

In order to help ensure future funding availability, the department will continue to work with the other four states with veterans' mortgage programs to loosen federal restrictions on the proceeds of bonds used to finance veterans' home purchases. Current federal restrictions limit the amount of funds the department can loan to younger veterans, thereby, driving up the average age of, and the cost to insure, the current pool of veterans in the insurance program.

In addition, the department is working to solicit bids from insurers on a variety of options for the current life and disability benefits. By examining all the costs associated with insuring and administering the life and disability program, the department reports it will be able to make an informed decision regarding the long-term viability of the loan programs and its ancillary benefit program.

**Finding #3: The department has limited choices for funding the insurance program.**

The department estimates it can transfer approximately \$1.5 million each year in unrestricted funds from the loan program to the insurance program for up to 10 years. However, using the loan program's unrestricted funds for the insurance program will decrease the number of veterans who can receive home loans by about eight loans using current average loan amounts.

On the other hand, modest increases in insurance premiums can provide additional funding for the insurance program. A 10 percent increase in premiums to veterans raises the average monthly premium by \$4.23 but generates 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 generates almost \$1.8 million annually for the program.

Additionally, savings the loan program will achieve when the department implements its new administrative cost allocation system in June 2001, could be used to fund increases in the insurance program's benefits. (Its current system has been inappropriately charging the loan program for the costs of administering the department's other programs.) These savings could be as much as \$1.3 million annually.

We recommended that when identifying potential sources of funds for improved insurance benefits to veterans, the department should consider modest and appropriate premium rate increases and continue to explore its options for transferring unrestricted funds to the insurance program. In addition, 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, and consider using those savings to improve the insurance program.



***Department Action: Partial corrective action taken.***

The department did not respond to our recommendation that it look for additional sources to fund the insurance program.

However, in response to our May 25, 2000, report, *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*, the department reports it has developed and tested a process to properly charge direct and indirect costs to its programs, but has not stated whether it intends to use the cost savings to improve the life and disability benefits to veterans.

**Finding #4: The department lacks measurable criteria for evaluating its consultant's contract performance.**

The department relies on its consultant for expert advice on managing the insurance program, but the consultant's contract lacks enough detail about the extent of services he must provide and specifics about the form he must use to present his results to allow the department to effectively monitor the contractor's performance. 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 the necessary objectives and time frames for effectively managing the insurance program. Further, the department does not have firm policies and procedures in place for its contract managers to follow. Without firm policies and procedures, the department has limited assurance that it complies with state guidelines for monitoring consultant contracts.

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

***Department Action: Partial corrective action taken.***

The department reports it is working with its insurance consultant to ensure quarterly and annual reports are completed in a timely manner. In addition, the department's Contract Management Section has completed training contract managers. Training is intended to provide contract managers with a greater ability to develop and write clear, concise, detailed descriptions of the work that will be performed by the contractors, and provide knowledge of techniques to monitor contractual compliance and work performance.

**Finding #5: The department lacks adequate controls over cash transactions.**

The State Administrative Manual identifies certain duties that should not be performed by the same person because doing so creates an opportunity for theft. Nonetheless, the department allows one person in its insurance unit to perform some of these 'incompatible' tasks. In addition, because of staff vacancies, another person in the accounting unit sometimes performs incompatible duties.

We recommended that the department should protect its assets by ensuring that it establishes and maintains an adequate system of internal controls as set forth in the State Administrative Manual.

***Department Action: Corrective action taken.***

The department reports that it has reviewed its internal controls and corrected the deficiencies in the separation of duties in the cashiering function. In addition, the department created a detailed matrix of accounting and cashiering duties for routine monitoring of internal control requirements in the event of staff absences, vacancies, or reassignment workload.