STATE OF WEST VIRGINIA

PRELIMINARY PERFORMANCE REVIEW
OF THE

BOARD OF RISK AND INSURANCE MANAGEMENT

OFFICE OF
LEGISLATIVE
AUDITOR
Performance Evaluation
and Research Division

BRIM Is Making Progress In Reducing Its Unfunded Liability

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STATE OF WEST VIRGINIA

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EXECUTIVE SUMMARY

ISSUE AREA 1: <u>BRIM Is Making Progress In Reducing Its Unfunded Liability</u>

Since 1993, the Board of Risk and Insurance Management (BRIM) has operated with an unfunded liability of between $40 million and $70 million. By definition, an unfunded liability represents liabilities which exceed the agency's assets. In short, if these liabilities became due at once, BRIM would be unable to pay them completely, resulting in insolvency. Table 1 presents a brief description of the unfunded liability based on BRIM's audited balance sheets for fiscal years 1993 through 1996.[1] As Table 1 illustrates, the unfunded liability has declined by over $50 million over the past four years. This represents a 73.8% decrease.

Table 1
BRIM's Unfunded Liability
(In Millions)

	1993	1994	1995	1996	1997
Total Assets	$52.6	$65.6	$74.2	$89.2	$101.7
Total Liabilities	$121.3	$132.8	$134.0	$133.3	$119.8
Unfunded Liability	**-68.7**	**-67.2**	**-59.8**	**-44.1**	**-18.0**

Source: Ernst & Young's independent audits of BRIM's financial statements.

In fiscal year 1994, BRIM initiated a plan to reduce and eventually eliminate the unfunded liability which it is on course to accomplish according to plan. The plan involved substantial increases in premium charges, increases in State appropriations, and cost cutting measures.

Although the unfunded liability is on course to be eliminated, there are areas in which BRIM can improve. Premium charges should reflect not only loss history but exposure to potential loss. Currently, BRIM's premium charges are based primarily on loss history. Risk management, which is mandated by statute, needs to improve to reduce the exposure to future losses. BRIM also needs to re-examine its policies on assessing surcharges and incentives. Its surcharges can lead to inadequacies in cost recovery, and incentives are not broad enough to acknowledge those entities with good loss history.

[1] *Data for 1997 are unaudited. BRIM provided this information with the expectation that Ernst and Young's audit will closely reflect the provided information (see Appendix A). Ernst and Young's audit is expected to be released shortly after the printing of this report.*

Review Objective, Scope and Methodology

This preliminary review on the performance of the Board of Risk and Insurance Management (BRIM) is required and authorized by the West Virginia Sunset Law, Chapter 4, Article 10, Section 11 of the West Virginia Code, as amended. BRIM provides property and liability insurance for all units of State government and to any political subdivision, charitable or public service organization in the State. Furthermore, BRIM provides mine subsidence insurance to homeowners and businesses of the State covering damage caused by the collapse of underground coal mines.

The objective of this review was to determine BRIM's effectiveness and progress towards eliminating the agency's current unfunded liability. Also, the review examined whether BRIM has implemented measures to prevent a re-occurrence of an unfunded liability.

The scope of this review covered the period of FY 1992 through FY 1997. Primary focus was given to the areas of operation that contributed to the occurrence of the unfunded liability. These areas included the premium determination process, and loss control and risk management procedures.

The methodology included personal interviews with members of BRIM's staff and the Chairperson of the Board. Other interviews were conducted with Ernst & Young personnel and officials of Advanced Risk Management Techniques, Inc. (ARMTech), BRIM's actuary. A review was made of BRIM's financial documents, annual reports, Board minutes, actuarial studies, independent audits, and budget documents. Reliance was placed on Ernst and Young's opinion of the fair representation of BRIM's financial condition based on BRIM's financial balance sheets. Also, particular attention was paid to recommendations made by Ernst and Young with the intent of assessing the agency's compliance with such findings. Every aspect of this review complied with **Generally Accepted Government Auditing Standards.**

Background

The West Virginia Board of Risk and Insurance Management (BRIM) provides property and liability insurance for all units of State government since 1957. Since 1980, BRIM has been authorized to provide insurance to County Boards of Education. In 1982, BRIM's program was expanded to offer mine subsidence insurance to homeowners and businesses for collapses and damage caused by underground coal mines. In 1986, the legislature passed Senate Bill 3, and the Governor issued Executive Order number 12-86, which authorized BRIM to offer liability and property insurance to any political subdivision, charitable or public service organizations. These entities were included under BRIM's responsibility because various private insurance companies had notified city and county governmental entities that they would no longer write liability insurance for these governments after June 30, 1986.

BRIM insures 143 State agencies, close to 1,500 Senate Bill 3 (SB3) entities, and approximately 15,000 homeowners and businesses are provided mine subsidence insurance. Funding for BRIM comes through State general revenue and special revenues. The following table illustrates total funding for fiscal year 1997. The general revenue appropriation pays the premiums for State agencies that receive general revenue funds, depending on what portion of the agency's total budget is funded by general revenues. This is provided to BRIM in a lump sum by the Legislature. For agencies that are funded through general and special revenues, BRIM bills the agency directly for the remaining portion of the premium which is paid from their special revenue funds. A surplus appropriation of $1 million was also provided by the Legislature for County Boards of Education. BRIM's total administrative expenses for FY 1997 were $3.1 million.

State Appropriation & Estimated Receipts
Fiscal Year 1997

Entities	General Revenue	Special Revenue	Total Funding
State Spending Units	$15,304,116	$12,945,884	$28,250,000
Public Entities	$1,000,000	$34,000,000	$35,000,000
Mine Subsidence		$2,300,000	$2,300,000
Flood Fund		$40,000	$40,000
Total Funding	$16,304,116	$49,285,884	**$65,590,000**
Administrative Expenses			$3,111,311

Sources: Expenditure Schedule Account Summary, Administrative Expenses provide by BRIM

ISSUE AREA 1: BRIM Is Making Progress In Reducing Its Unfunded Liability

Since 1993, the Board of Risk and Insurance Management (BRIM) has operated with an unfunded liability of between $40 million and $70 million. By definition, an unfunded liability represents liabilities which exceed the agency's assets. In short, if these liabilities became due at once, BRIM would be unable to pay them completely, resulting in insolvency. In its 1993 audit, Ernst and Young stated that ***"If BRIM were a private insurance carrier, this deficit [unfunded liability] could preclude BRIM from doing business in the State of West Virginia (the State) under minimum statutory surplus requirements."***

In BRIM's case, 95% of its liabilities represent estimates of insurance claims payments and related claims adjustment expenses that BRIM will be liable to pay when these claims are filed in future years. Other liabilities are relatively small such as premium taxes and commissions. Most insurance claims usually are not filed or paid in the same year in which the insurance was provided. Actually, for the types of insurance coverage offered by BRIM, most claims and payments will be filed and paid from one to ten years after the policy year. Although BRIM's total liabilities will not become payable in any one year time period, if the unfunded liability grows, BRIM's annual payments will also grow which would threaten BRIM's solvency.

Table 1 presents a brief description of the unfunded liability based on BRIM's audited balance sheets for fiscal years 1993 through 1996.[2] The unfunded liability is simply the difference between total assets and total liabilities. As Table 1 illustrates, the unfunded liability has declined by over $50 million over the past four years. This represents a 73.8% decrease. The reasons for the decline are discussed below.

Table 1
BRIM's Unfunded Liability
(In Millions)

	1993	1994	1995	1996	1997
Total Assets	$52.6	$65.6	$74.2	$89.2	$101.7
Total Liabilities	$121.3	$132.8	$134.0	$133.3	$119.8
Unfunded Liability	**-68.7**	**-67.2**	**-59.8**	**-44.1**	**-18.0**

Source: Ernst & Young's independent audits of BRIM's financial statements.

[2] *BRIM's financial statements were audited by Ernst & Young LLP. According to Ernst & Young, the financial statements fairly represented BRIM's financial position for each fiscal year through 1996. Data for 1997 are unaudited. BRIM provided this information with the expectation that Ernst and Young's audit will closely reflect the provided information (see Appendix A). Ernst and Young's audit is expected to be released shortly after the printing of this report.*

How did the Unfunded Liability Occur?

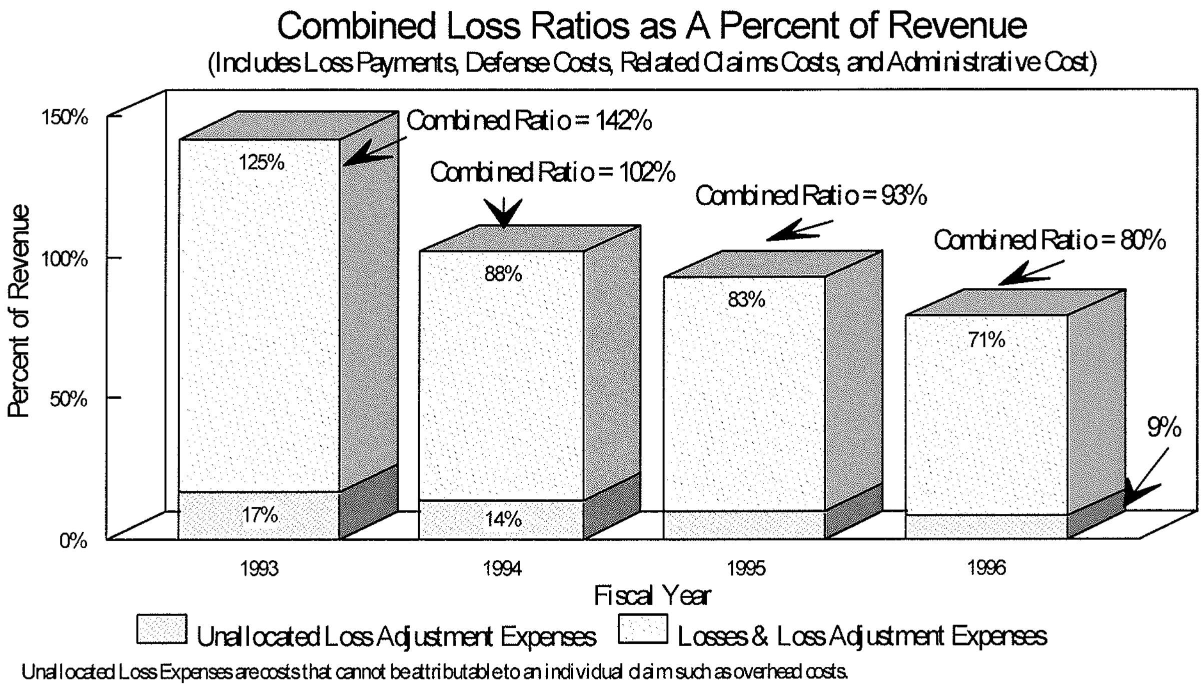
Four causes of the unfunded liability were identified in the 1993 independent audit conducted by Ernst and Young. These causes include:

1) a **premium structure** that did not adequately reflect the total costs of providing insurance coverage.
2) the **lack of a financial accounting system** designed to produce financial information in conformity with generally accepted accounting principles (GAAP).
3) the **lack of forecasting data** to determine if the premium structure and investment income would be sufficient to cover incurred losses and loss adjustment expenses.
4) **minimal risk management** measures that would reduce exposure to losses.

Fiscal year 1993 was the first year that BRIM's financial statements received an independent audit. In a written response, BRIM told the Legislative Auditor that prior to 1993, "*BRIM was unable to receive an audit of its financial statements or any other related documents because of the lack of records to produce the necessary items for auditible financial statements.*" Consequently, 1993 was the first year that the unfunded liability was calculated.

As an example of the insufficiency of premiums to cover total costs, in 1993 BRIM's total operating expenses, including claims and claims adjustment costs, exceeded total premiums received, resulting in a net operating loss of over $12 million. Furthermore, BRIM's loss ratios for 1993 and 1994 exceeded 100%. Loss ratios represent the loss payments and expenses as a percentage of revenues. Figure 1 illustrates that for 1993, loss payments and related expenses were 142% of total revenue. Simply stated, premiums were insufficient to cover loss payments. This required BRIM to pay losses through current funds that were being invested. The loss ratios have come down to where revenues are sufficient to cover loss claims and related expenses. BRIM has indicated that loss ratios must remain under 90% in order to reduce the unfunded liability.

Figure 1



BRIM's Action to Reduce the Unfunded Liability

In fiscal year 1994, BRIM initiated a plan to reduce and eventually eliminate the unfunded liability over ten years for the State's portion of the unfunded liability, and 15 years for local governments and non-profit organizations (SB3 entities).[3] Both plans called for substantial premium increases, an increase in State appropriations, and cost reductions. Table 2 shows that from 1993 to 1997, total assets increased by 93% while liabilities declined by 1.2%. The growth in assets primarily reflects increases in premium charges and State appropriations.

Table 2
Percentage Change in Total Assets, Premiums, Liabilities, and Unfunded Liability

	1993	1997	Percentage Change
Total Assets	$52.6 Mil	$101.7 Mil	93.3%
Premiums	$35.9 Mil	$56.6 Mil	57.7%
Total Liabilities	$121.3 Mil	$119.8 Mil	-1.2%
Estimated Unpaid Claims	$114.6 Mil	$117.3 Mil	2.4%

[3] SB3 entities include nearly 1,500 cities, counties and non-profit organizations throughout the State. BRIM was authorized to provide insurance to these entities through passage of Senate Bill 3 of the 1986 Legislature. BRIM also insures the 55 County Boards of Education which it has been authorized to do since 1980.

Unfunded Liability	-68.7 Mil	-18.0 Mil	-73.8%

The decline in the unfunded liability also benefitted from revised estimates of unpaid claims and claims expenses. Estimated unpaid claims are recomputed periodically to reflect recent settlements, changes in claims frequency, and changes in economic and social factors. The re-estimates of unpaid claims have stabilized over the last four years. In fact, the estimate for 1997 unpaid claims declined by 7.6% over the 1996 estimate. Overall, the large decline in the unfunded liability corresponds with the large growth in assets and the relatively small decrease in liabilities.

The Legislature provided additional funding to help reduce the unfunded liability. Table 3 shows the General Revenue Fund appropriations for BRIM. The lump sum appropriation is for the purpose of paying the insurance premiums, losses and loss expenses for the current year for all State agencies that are funded through the General Revenue fund. State agencies that are funded from both general revenue and special revenue pay a portion of their premium from their special revenue account. The special revenue portion is billed directly by BRIM.

Table 3
General Revenue Fund Appropriations to BRIM

Fiscal Year	Lump Sum Appropriation	Appropriation toward the Unfunded Liability	County Boards of Education	Total General Fund Appropriation
1993	$3,754,116			$3,754,116
1994	$7,054,116			$7,054,116
1995	$10,454,116	$3,600,000		$14,054,116
1996	$10,454,116	$4,850,000	$2,000,000	$17,304,116
1997	$10,454,116	$4,850,000	$1,000,000	$16,304,116

Source: West Virginia Budget Digest for selected years.

Since 1993, when the magnitude of the unfunded liability became apparent, the Legislature has responded with relatively large increases in appropriations. In 1993, the appropriation for premiums was $3.7 million. The appropriation rose to $10.4 million by 1995. In addition to the lump sum appropriation, the Legislature provided BRIM with an annual dedicated appropriation of $3.6 million beginning in fiscal year 1995 to offset the State's portion of the unfunded liability. In 1996, the dedicated appropriation was increased to $4.8 million dollars in order to maintain the original goal of eliminating the unfunded liability in 10 years. The additional appropriations were also for the purpose of offsetting the significant increases in premiums that BRIM needed to charge State agencies.

BRIM's plan to eliminate the unfunded liability of local governments and non-profit organizations consists of adjusting the pool premiums by 2 million dollars annually for 15 years. Each pool represents a type of insurance coverage such as liability, property, and automobile insurance. These dollars are divided proportionally among all of these entities. The premium increases required to implement the plan are as high as 30% for some of these entities. In 1996, the Legislature provided a $2 million appropriation for County Boards of Education, and $1 million in 1997. The Budget Digest stated that the appropriation for the Boards of Education would serve two purposes, "*one million dollars shall be expended to reduce the unfunded liability in the insurance fund and one million dollars shall be allocated to the county boards of education to defray the increased cost of premiums.*"

Over the last four years, the unfunded liability has declined by over $50 million, which averages about $12.5 million a year. If this rate of reduction continues, BRIM will eliminate the unfunded liability in less than ten years. BRIM has indicated that it "*is ahead of the planned estimates for reducing the unfunded liability in both programs.*"

BRIM has also made efforts in reducing certain costs as a part of its reduction plan. BRIM reduced costs of claims administration by changing its insurance carrier from Continental Casualty to American International Group (AIG) in FY 1996. The change resulted in significant savings to the program through reductions in the fixed fee, claims administration costs, and allocated expenses. Savings for the first year (FY 1996) alone exceeded $5 million (See Table 4). BRIM indicated that claims handling is fixed at $1,750,000 with AIG regardless of the number of claims processed. Under the previous contract, Continental Casualty received payments of 7% of the loss payments up to the first $250,000. Allocated expenses are primarily defense costs such as attorney fees. According to BRIM, AIG's method of defending cases is faster which results in quicker payments made and lower defense costs. AIG's allocated expenses were 21% of the total loss payments and expenses, compared to 30% for Continental Casualty.

Table 4
Cost Savings Estimates for FY 1996
Continental Casualty vs. American International

ITEM	Continental Casualty	American International	SAVINGS
Fixed Fee	1,771,000	850,000	921,000
Claims Handling	2,444,000	1,750,000	694,000
Allocated Expense**	12,000,000	8,400,000	3,600,000
Percent of Total Incurred	30%	21%	________
Total	16,215,000	11,000,000	**5,215,000**

**	These numbers are estimates. They are projected based on current data and information concerning claims handling and expense control.

Finally, as BRIM moved to a healthier financial position, investment income improved, lowering the unfunded liability. The increases in State appropriations and premium charges resulted in BRIM having a greater amount of funds to invest, which resulted in substantial growth in investment earnings, as reported in Table 5. BRIM's investment income increased by 198% from FY 1993 to FY 1997, which was applied to the unfunded liability.

Table 5

Investment Earnings

Year	Investment Earnings	Percent Increase Over Previous Year
1993	$1,781,000	n/a
1994	$2,591,000	45.5%
1995	$3,710,000	43.2%
1996	$4,017,000	8.3%
1997	$5,302,000	32.0%

BRIM Established an Improved Accounting System

A major deficiency identified by Ernst and Young in its 1993 audit was the lack of an internal control system that could produce financial statements in accordance with Generally Accepted Accounting Principles (GAAP). In 1992, BRIM began the process of receiving GAAP based financial statement audits. Since then, Ernst and Young has been able to provide an opinion that BRIM's financial position is fairly represented by its financial statements. Although Ernst and Young still identified areas of material weaknesses in BRIM's internal control structure, it was noted in 1995 and 1996 that significant progress had been made in correcting matters.

BRIM Now Uses Forecasting Information

In its 1993 audit, Ernst and Young indicated that a hindrance to BRIM's management was the lack of important information. The following statement was made in the audit:

> *Presently, BRIM management is hindered in the decision making process by the lack of key information. For example, no forecasting information is available to determine how long the present premium structure and return on investments will be sufficient to meet loss and loss adjustment expense obligations as they become due.*

Starting in fiscal year 1993, BRIM employed an actuary to provide projections of losses and loss adjustment expenses BRIM will incur in the future. This helps BRIM establish premium rates that are sufficient to cover estimated losses and related expenses.

The Unfunded Liability Could Be Further Reduced Through Better Risk Management

Although significant progress has been made in reducing the unfunded liability, **BRIM needs to improve its loss control and risk management functions.** Ernst and Young indicated in its 1993 audit and in the audits for 1995 and 1996, "*BRIM has employed minimal risk management activities.*" Risk management (or loss control) is mandated by BRIM's governing statute (§29-12-5(a)) which states that:

> *It is empowered and directed to make a complete survey of all presently owned and subsequently acquired state property subject to insurance coverage by any form of insurance, which survey shall include and reflect inspections, appraisals, exposures, fire hazards, construction, and any other objectives or factors affecting or which might affect the insurance protection and coverage required. It shall keep itself currently informed on new and continuing state activities and responsibilities within the insurance coverage herein contemplated.*

Ernst and Young recommended that BRIM implement a comprehensive risk management program. Such a program should include:

1) Inspections of property;
2) Review for potential hazards;
3) Loss control recommendations for inspected property; and
4) Incentives for implementing loss prevention measures.

BRIM has implemented a loss control and risk management program through a contract with **Schirmer Engineering Corporation.**[4] Schirmer is contracted to provide inspection services and

[4]Schirmer Engineering Corporation is located in Deerfield, Illinois. The value of the contract for FY 1998 is $278,200.

make recommendations for all buildings insured by BRIM with a value of more than $1 million. These inspections are for State property, County Boards of Education, and public entities. BRIM has also required Schirmer to emphasize liability risk exposures in its inspections because liability coverage represents BRIM's largest exposure of claims payments.

A list of inspection sites contained nearly 2,000 property locations throughout the State. These properties are to be surveyed on a semi-annual basis or an annual basis as assigned. The contract also specifies that Schirmer provide six to eight regional seminars and safety bulletins as the need is identified by BRIM and Schirmer. BRIM indicated that in 1996 eight safety and risk management seminars were held in the State. (For topics, location, and number attending, see Appendix B.)

Schirmer writes a report for each property location that gives a basic description of the property, the condition of the property, and recommendations. BRIM forwards the Schirmer reports to the respective property managers with a cover letter which contains the following information:

1) A statement indicating that "*Any recommendation involving emergency lights, emergency generators or fire alarms must be addressed immediately upon receipt of this report.*"
2) A request by BRIM that "*within sixty (60) days you furnish a 'Plan of Action' for compliance with each recommendation enumerated.*"
3) A compilation of outstanding recommendations from the previous report, completed recommendations, new recommendations and total outstanding recommendations.

BRIM indicated that if an insured does not provide an "action plan" within 60 days, "*a second and third request may be necessary.*" There are insureds, both State agencies and SB3's, who have not submitted action plans. However, BRIM cannot provide a total because it does not monitor the number of insureds that have not submitted action plans. The Legislative Auditor's Office was given five examples of Schirmer reports. The number of outstanding recommendations ranged from 3 to 55, with some of the outstanding recommendations being several years old. Some outstanding recommendations included: 1) corrective actions to prevent floors of the building from sinking, 2) the need for sprinkler systems, 3) repairing inoperative smoke detectors, and 4) repairing deteriorated sidewalks. BRIM stated that "*there are several reasons that an insured customer may not be able to readily comply with the risk management recommendations. Recommendations that may involve large capital outlay often are not in budgetary plans for compliance....BRIM does not have the policy cancellation threat with State Agencies that is commonly used in the commercial market.*"

As of September 1997, the total recommendation status is as follows:

Previous recommendations	17,866
Completed recommendations	3,659
Total old outstanding	14,207

New recommendations	4,009
TOTAL outstanding	18,216

There are over 18,000 outstanding recommendations. Completed recommendations were 20% of previous recommendations. Some outstanding recommendations involve fire hazards, electrical defects, inadequate sprinkler systems, and unsafe conditions. BRIM should monitor the number of entities without actions plans and determine the seriousness of outstanding recommendations. Although BRIM is limited in its enforcement of Schirmer recommendations, it is possible to incorporate the outstanding recommendations data, the level of severity, and whether an action plan has been submitted as a basis for determining an insured's premium rate. Currently, this is not done by BRIM. This would act as an incentive for insureds to comply with a larger number of recommendations.

Premium Rates Should Incorporate Loss Exposure Data

The basis for determining premiums, except property insurance, is primarily based on the insured's loss history for the last five to seven years. Having premiums based primarily on past experience does not take into account current changes that increase the exposure to losses. BRIM is required by §29-12-5(a) to "*keep itself currently informed on new and continuing state activities and responsibilities within the insurance coverage.*" In its 1996 report, Ernst and Young indicated the importance of using loss exposure data in determining premiums in the following statement:

> *Claims loss exposure data in not only important for loss reserving or estimation purposes, but for successfully underwriting insurance, particularly for determining appropriate premium rates to be charged to insureds. As in the prior year, we strongly recommend upgrading existing underwriting computer programs necessary to capture and report relevant risk data about each insured in order to properly perform loss experience rating.*

The Schirmer reports can be used to facilitate this responsibility if more of the information can be used in the rate determination process. The same is true of a liability questionnaire that is submitted each year by insureds. Some of this information provides data that reflect current loss exposure, such as an increase in the number of automobiles used by insureds. If an insured's fleet of automobiles increases significantly, its exposure increases. However, BRIM does not incorporate this current data into its premium calculation. BRIM is in the process of basing its premium charges on a combination of loss history and loss exposure data. According to BRIM, "*The program will utilize an exposure vs. loss experience mix of between 80/20 and 70/30.*" The completion date for this program is the fiscal year 1999 rating period.

Property insurance is based on property value. However, State property value is provided by the insured. BRIM does not appraise State property value or verify insured information.

Therefore, BRIM is completely reliant on the accuracy of the insured's information. If actual State property values are significantly higher than what insureds indicate, then the premium will be lower than it should be. According to §29-12-5(a), BRIM's survey of State property shall include appraisals, and any other factors that could affect insurance coverage.

BRIM Needs to Improve Its Application of Incentives and Surcharges

Providing incentives or applying surcharges can encourage insureds to reduce their exposure to losses. Ernst and Young has stated in its last three audits that BRIM should re-examine its method of assessing surcharges. Currently, any insured with a loss ratio above 80% will be billed a 10% surcharge. However, this treats insureds with loss ratios of 100% or more equally. Ernst and Young stated that "*an entity with a loss ratio of 81% would be charged the same 10% surcharge as one with a loss ratio of 150%, leading to inadequacies in cost recovery.*"

BRIM also needs to examine the incentives it provides. BRIM provides a 5% reduction in premiums for insureds with loss ratios below 60%. Again, insureds with significantly better loss ratios that 60% are treated the same as those with higher loss ratios. Furthermore, insureds with loss ratios between 60% and 80% do not receive either an incentive or a surcharge.

Recommendation 1

The Legislative Auditor recommends that BRIM continue the progress in removing material weaknesses in its internal control structure, as identified in the Ernst and Young audits.

Recommendation 2

BRIM should consider basing its premium charges on a combination of loss history and loss exposure data.

Recommendation 3

BRIM should incorporate appraisals of State property in its survey and inspection of State property.

Recommendation 4

BRIM should consider applying a wider range of incentives and surcharges to account for significant differences in loss ratios.

Recommendation 5

BRIM should monitor the number of entities without actions plans in response to Schirmer reports, and determine the seriousness of outstanding recommendations. Consideration should be given to incorporating within the premium rate such information as action plans not submitted, outstanding recommendations, and the level of seriousness of outstanding recommendations

APPENDIX A
Unaudited Figures for 1997

APPENDIX B

Liability Seminars and Safety Bulletins

APPENDIX C
Agency's Response