# STATE OF WEST VIRGINIA

## FULL PERFORMANCE EVALUATION
## OF THE

# DIVISION OF WORKERS' COMPENSATION

Compliance Review of
Independent Auditor's Findings:
Self-Insurance
Underwriting/Risk Management

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# WEST VIRGINIA LEGISLATURE
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**Director**

July 10, 1996

The Honorable A. Keith Wagner
State Senate
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The Honorable Joe Martin
House of Delegates
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Gentlemen:

Pursuant to the West Virginia Sunset Law, we are transmitting the Full Performance Evaluation of the Division of Workers' Compensation, which will be reported to the Joint Committee on Government Operations on Sunday, July 14, 1996. The issues covered herein are "Compliance Review of Independent Auditor's Findings: Self-Insurance Underwriting/Risk Management."

Sincerely,

Antonio E. Jones

AEJ/wsc

Enclosure

# TABLE OF CONTENTS

# TABLE OF TABLES

# EXECUTIVE SUMMARY

In 1991, Ernst and Young (E & Y) was employed by the Bureau of Employment Programs to audit the Workers' Compensation Division's financial statements for fiscal year 1991. In lieu of issuing financial statements for the Division, ***E & Y issued a final draft management letter on March 16, 1992 that represents the most comprehensive and up-to-date independent audit of the Workers' Compensation Division. The Performance Evaluation and Research Division is conducting a compliance review to measure the responsiveness of management to the E & Y recommendations, as well as the Division's progress toward reestablishing the security and solvency of the fund.*** Generally Accepted Government Auditing Standards (GAGAS) requires following-up the work of other auditors and places emphasis on the importance of management controls (the final draft management letter raised many management controls issues). For these reasons, as well as a desire to avoid duplication of efforts, the compliance review format was adopted.

## PART 1 - GENERAL

### Self-Insurance

**Issue Area 1:** Approval for self-insurance was being granted on a case-by-case basis at the sole discretion of the Commissioner.

*Level of Compliance:* **In compliance.** All applications for self-insurance must be approved by the Compensation Programs Performance Council.

**Issue Area 2:** The Division should develop and implement standard procedures for reviewing the information supplied by employers.

*Level of Compliance:* **Partial compliance.** The Division has developed a comprehensive self-insurance application process in collaboration with Ernst and Young. Full implementation of the new applications process has been achieved. However, the re-application process has not been implemented due to vacancies in key positions in the Self-Insurance Unit.

**Issue Area 3:** The application/re-application reviews should be adequately documented and conclusions should be reached as to whether employers should be allowed to maintain self-insured status.

*Level of Compliance:* **In compliance.** The Self-insurance Unit presents appropriately detailed reports to the Compensation Programs Performance Council (CPPC) which include the recommendations of management.

**Issue Area 4:** The Division should change its surety policy to avoid putting the fund in a liability position.

*Level of Compliance:* **Partial compliance.** The Division has developed a policy which requires all self-insured employers to provide surety equal to the larger of one-million dollars or the actuarially-determined liability of the firm. Other than new self-insurers, the policy has only been enforced on six employers because of vacancies in key positions in the Self-Insurance Unit.

**Issue Area 5:** The Division should require self-insured employers to submit audited financial statements and proof of required amount of surety bond within 90 days of their fiscal year end.

*Level of Compliance:* **Partial compliance.** Because of staffing difficulties, the Division is currently not requesting self-insured employers to submit re-application materials. Proof of surety issues are being adequately addressed. The Division's new processes, policies and procedures manuals adequately address this issue.

**Issue Area 6:** The Division should develop a plan for the timely transition from self-insured to subscriber status prior to any bankruptcy petition to facilitate adequate premiums commensurate with insured risk.

*Level of Compliance:* **In compliance.** The Division has developed a process for the revocation of self-insured status and has revoked the self-insured status of one employer. At the time the employer was transitioned to subscriber status, the Division calculated its experience modified subscriber premium rate by figuring what its rate would have been had the employer been a regular subscriber during the period of self-insurance.

## Underwriting/Risk Management Initiatives

**Issue Area 7:** The Division should obtain the necessary computer systems and employ experience rating formulas to increase premiums commensurate with incurred losses.

*Level of Compliance:* **Partial compliance.** New computer systems have been installed that will enable the Division to make premiums commensurate with incurred losses. Ratemaking methodologies are being explored and the Division has completed a considerable amount of planning to this end. An employee of the Self-Insurance Unit is being trained to serve as a ratemaking specialist.

**Issue Area 8:** The Division should establish a comprehensive risk management program to work with employers to reduce exposure to injuries.

*Level of Compliance:* **Planned compliance.** The Compensation Programs Performance Council has created a Safety and Loss Control Advisory Committee. Two administrative rules (exempt from the legislative review process) have been proposed which provide both positive and negative incentives to require or encourage employers to take certain measures to develop/maintain safe workplaces. Efforts are being made to hire a Safety Director.

| COMPLIANCE SCORECARD | | |
|---|---|---|
| **Level of Compliance** | **Issues** | **Percent of Total** |
| In Compliance | 3 | 37.5% |
| Partial Compliance | 4 | 50.0% |
| Planned Compliance | 1 | 12..5% |
| In Dispute | 0 | 0.0% |
| Non-Compliance | 0 | 0.0% |
| **Total** | 8 | 100.0% |

# OBJECTIVE, SCOPE AND METHODOLOGY

This full performance evaluation of the West Virginia Workers' Compensation Division was conducted in accordance with the West Virginia Sunset Law, Chapter 4, Article 10 of the *West Virginia Code*. A full performance evaluation is a means to determine for an agency whether or not the agency is operating in an efficient and effective manner and to determine whether or not there is a demonstrable need for the continuation of the agency. The evaluation will help the Joint Committee on Government Operations determine the following:

- if the agency was created to resolve a problem or provide a service;
- if the problem has been solved or the service has been provided;
- the extent to which past agency activities and accomplishments, current projects and operations and planned activities and goals are or have been effective;
- if the agency is operating efficiently and effectively in performing its tasks;
- the extent to which there would be significant and discernable adverse effects on the public health, safety or welfare if the agency were abolished;
- if the conditions that led to the creation of the agency have changed;
- the extent to which the agency operates in the public interest;
- whether or not the operation of the agency is impeded or enhanced by existing statutes, rules, procedures, practices or any other circumstances bearing upon the agency's capacity or authority to operate in the public interest, including budgetary, resource and personnel matters;
- the extent to which administrative and/or statutory changes are necessary to improve agency operations or to enhance the public interest;
- whether or not the benefits derived from the activities of the agency outweigh the costs;
- whether or not the activities of the agency duplicate or overlap with those of other agencies, and if so, how the activities could be consolidated;
- whether or not the agency causes an unnecessary burden on any citizen by its decisions and activities;
- what the impact will be in terms of federal intervention or loss of federal funds if the agency is abolished;

The evaluation of the Division covers the period of January 1, 1992 to the present. However, events prior to this period may be included when necessary. The evaluation included a planning process and the development of audit steps necessary to collect competent, sufficient and relevant evidence to answer the audit objectives. Physical, documentary, testimonial and analytical evidence used in the evaluation was collected through interviews, review of records, and site visitations.[1] The evaluation was conducted in accordance with Generally Accepted Government Auditing Standards (GAGAS) issued by the Comptroller General of the United States.

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[1] *Documentary evidence is created information such as letters, contracts and records. Physical evidence is the direct observation of the activities of people, property or events. Testimonial evidence consists of statements received in response to inquiries or from interviews, and analytical evidence includes the separation of information into components such as computations, comparisons and reasoning.*

## Mission of the Workers' Compensation Division

***...to accurately, fairly and promptly administer quality workers' compensation services through the collection of premiums from employers and the payment of benefits to injured workers and to dependents of fatally injured workers, with the intent of hastening the workers return to work.***

The Workers' Compensation Division (WCD), codified in Chapter 23 of the *West Virginia Code,* was created in 1913 for the purpose of offering workers' compensation insurance. Initially an optional plan, the program became compulsory in 1974. The purpose of the program is "to provide workers with a simple method of securing immediate relief from the physical and economic effects of job related injury and disease." Further, the state is the sole provider of workers' compensation insurance. However, those employers that are eligible may opt to self-insure their workers' compensation risk. ***Although the Division is a public entity it operates like a private insurance company, collecting premiums, investing the funds, and paying benefits to injured workers making compensable claims.*** The Division administers several funds including the Workers' Compensation Fund, the Coal Workers' Pneumoconiosis Fund, Employers' Excess Liability Fund, the Disabled Workers' Relief Fund and a Surplus Fund which is made up of a Catastrophe Reserve, a Second Injury Reserve, and a Supersedeas Reserve. See APPENDIX 1 for fund administered by the Division. APPENDIX 2 contains an organizational chart of the Division.

The financial condition of the Division has eroded over many years. For FY 1989 the Division was believed to have a $404 million to $504 million deficit.[2] By FY 1995 the deficit was believed to be $1,910 million. In 1990, the Division transferred $210 million declared to be an actuarially determined surplus from the Coal Workers' Pneumoconiosis Fund to the Workers' Compensation Fund. While the assets transferred cannot be used to satisfy the debts of the Workers' Compensation Fund until all other assets of the Fund have been expended, the interest earnings may be used for this purpose.

In 1991, Ernst and Young (E & Y) was engaged in a $45,000 contract by the Bureau of Employment Programs to audit the Workers' Compensation Division's financial statements for fiscal year 1991. In lieu of issuing financial statements for the Division, ***E & Y issued a draft management letter on March 16, 1992 that found the Workers' Compensation Division to have "an overall lack of internal controls resulting in what we [Ernst and Young] consider to be a pervasive material weakness situation..."*** E & Y defined a material weakness as

> a reportable condition in which the design or operation of one or more of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited

[2] *Financial audits indicate the reliability of financial information pre-dating FY 1995 is highly suspect. In addition, a change in the methodology of calculating the estimated liability for unpaid claims beginning FY 1993 was made as required by GAAP. This new methodology increased the deficit, as reported, by over $565 million.*

> may occur and may not be detected within a timely period by employees in the normal course of performing their assigned functions.

The final draft management letter detailed the material weaknesses of the Division, which rendered the Division impossible to audit. In subsequent financial audits for FY 1993 and FY 1994, Ernst and Young continued to find the Division's records to be

> generally inadequate to produce reliable financial information with respect to premiums receivable from subscribers and self-insurers; premium advance deposits; and the estimated liability for unpaid claims and claim adjustment expenses, including contingent liabilities for self-insured employers who have defaulted or who may reasonably be expected to default. Additionally, weaknesses in the internal control structure are of an extent that cannot be overcome by auditing procedures.

Generally, the purpose of a financial audit is to provide the users of the resulting financial statements assurance that the financial statements do accurately represent the financial status of the auditee (an "unqualified opinion"). Because of the pervasive material weakness situation, E & Y was unable to express an opinion on the Division's financial statements. The 1993 and 1994 reports of E & Y also stated "the Division's recurring losses and deficit raise substantial doubt about its ability to continue as a going concern in its present form," meaning the Workers' Compensation Division would not be able to meet its obligations to claimants in the foreseeable future if problems were not corrected.

During the 1995 Legislative Session, the West Virginia Legislature passed S.B. 250 which made many reforms to the workers' compensation system. As a result of the legislation, the efforts of the management and employees of the Bureau and Division, and several consulting firms involved in the Division's Total Quality Initiative (TQI), the Workers' Compensation Division received its first unqualified audit opinion from Ernst and Young for fiscal year 1995. More importantly, the 1995 financial audit also marked the end of the "going concern" paragraph.

***Because the 1992 Ernst and Young final draft management letter represents the most comprehensive and up-to-date independent audit of the Workers' Compensation Division, the Performance Evaluation and Research Division is conducting a compliance review to measure the responsiveness of management to the E & Y recommendations.*** The approach will enable us to evaluate the Division's progress toward reestablishing the security of the fund and resolving the unfunded liability. Other justifications for the selection of a compliance audit format include a desire not to duplicate the work Ernst and Young had already conducted, the 1992 final draft management letter's primary focus on management controls and the GAGAS standards requiring the following up of the work of other auditors. Excerpts of the GAGAS standards relating to the importance of management controls and the importance of checking compliance with previous audits have been included in TABLE 1.

## TABLE 1
## Generally Accepted Government Auditing Standards Relating to Management Controls and Compliance Reviews

### *Importance of Management Controls*

6.39 Auditors should obtain an understanding of management controls that are relevant to the audit. When management controls are significant to audit objectives, auditors should obtain sufficient evidence to support their judgments about those controls.

6.40 Management is responsible for establishing effective management controls. The lack of administrative continuity in government units because of continuing changes in elected legislative bodies and in administrative organizations increases the need for effective management controls.

6.41 Management controls, in the broadest sense, include the plan of organization, methods, and procedures adopted by management to ensure that its goals are met. Management controls include the processes for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

### *Standards on follow up and work of others*

6.12 Auditors should follow up on significant findings and recommendations from previous audits that could affect the audit objectives. They should do this to determine whether timely and appropriate corrective actions have been taken by auditee officials. The audit report should disclose the status of uncorrected significant findings and recommendation from prior audits that affect the audit objectives.

6.13 Much of the benefit from audit work is not in the findings reported or the recommendations made, but in their effective resolution. Auditee management is responsible for resolving audit findings and recommendations, and having a process to track their status can help it fulfill this responsibility. If management does not have such a process, auditors may wish to establish their own. Continued attention to significant findings and recommendations can help auditors assure that the benefits of their work are realized.

6.14 Auditors should determine if other auditors have previously done, or are doing, audits of the program or the entity that operates it. Whether other auditors have done performance audits or financial audits, they may be useful sources of information for planning and performing the audit. If other auditors have identified areas that warrant further study, their work may influence the auditors' section of objectives. The availability of other auditors' work may also influence the selection of methodology, as the auditors may be able to rely on that work to limit the extent of their own testing.

To assess and report on the degree of compliance by the Workers' Compensation Division with the findings and recommendations considered in the 1992 Ernst and Young final draft management letter, compliance measures have been adopted. These compliance measures are defined in TABLE 2.

| TABLE 2<br>**Levels of Compliance** |
|---|
| In Compliance - The Division has corrected the problems identified in the final draft management letter. |
| Partial Compliance - The Division has partially corrected the problems identified in the final draft management letter. |
| Planned Compliance - The Division has not corrected the problem but has provided sufficient documentary evidence to find that the agency will do so in the future. |
| In Dispute - The Division does not agree with either the problem identified or the proposed solution. |
| Non-Compliance - The Division has not corrected the problem identified in the final draft management letter. |

## PART 1 - GENERAL

### Self-Insurance

*West Virginia Code* §23-2-9 provides that employers meeting certain statutory criteria may be permitted to self-insure their workers' compensation risk, including their risk of catastrophic injuries. In 1995, this authority was narrowed by S.B. 250 which eliminated self-insurance of *second injury* coverage for new self-insurers. According to Milliman and Robertson, Inc. in its *Rate Level Projections: Fiscal Year Ending 1996*, self-insured second injury coverage "generated a substantial portion of the Division's overall unfunded liability," approximately $400 million or 22% of the overall unfunded liability of $1.84 billion as of June 30, 1994. Statutory prerequisites to granting self-insured status require each such employer to:

- demonstrate sufficient financial capability and responsibility,
- provide a health and safety program in its workplaces,
- submit security or bond sufficient to balance the employer's financial condition against its existing and expected liability, and
- satisfy any liability that is in excess of premiums paid to the Division.

Currently, there are about 300 self-insured accounts, about 150 of which are active. The statute requires the Division to review each self-insured employer annually to ensure that each self-insured employer is providing adequate levels of surety and continuing to meet its financial obligations and all other statutory requirements. Created in 1994, the Self-insurance Unit is a relatively new entity of the Division that was established to provide for the processing of new applications and review of existing self-insured employers.

Ernst and Young's Subscriber/Self-insurance Equity issue focused on the *prevention* of losses incurred as a result of unfit employers being permitted to self-insure. In the past, regular subscribers have shared such losses. While the 1992 final draft management letter did not address the problem of how to assign the losses that do occur, it provided guidance for the prevention of their occurrence.

**ISSUE AREA 1:** **APPROVAL FOR SELF-INSURANCE WAS BEING GRANTED ON A CASE-BY-CASE BASIS AT THE SOLE DISCRETION OF THE COMMISSIONER**

*Level of WCD Compliance:* IN COMPLIANCE

All applications for self-insurance must be approved by the Compensation Programs Performance Council.

## *Analysis*

Legislative Rule §85-9-4 contemplates that self-insurance application approval/denial decisions are to be made at the discretion of the Commissioner. However, the Compensation Programs Performance Council, of which the Commissioner is the statutory chair, adopted a resolution transferring this authority from the Commissioner to the Performance Council. The authority to do so is provided in *West Virginia Code* §21A-3-7, powers and duties of the Compensation Programs Performance Council, and provides that

> [t]he council should have the following powers and duties:
> (a) Assist the governor and the commissioner in the development of overall administrative policy for the unemployment compensation and workers' compensation systems of the state.
> (b) Recommend legislation and establish regulations designed to ensure the effective administration and financial viability of the unemployment compensation system and the workers' compensation system of West Virginia...
> (l) Consider such other matters regarding the unemployment compensation system or the workers' compensation system as the commissioner or any other appointed member of the performance council may desire...

Furthermore, a proposed rewrite of §85-9 substitutes references to the *Commissioner* with *Division*. The self-insurance policies and procedures dictate that the decision of whether to approve or deny applications for self-insurance rests with the Compensation Programs Performance Council. Reports from the Division's Self-insurance Unit to the Performance Council as well as minutes from Performance Council meetings demonstrate a systematic, case-by-case method for making these determinations.

## *Conclusions and Recommendations*

By allowing the Performance Council to make approval/denial decisions as a body through a systematic and well documented process, the WCD has introduced controls that significantly reduce the hypothetical risks associated with biased decision making. ***The revision of §85-9 will be necessary to eliminate ambiguities in the administrative law.***

## ISSUE AREA 2: THE DIVISION SHOULD DEVELOP AND IMPLEMENT STANDARD PROCEDURES FOR REVIEWING THE INFORMATION SUPPLIED BY EMPLOYERS

*Level of WCD Compliance:* PARTIAL COMPLIANCE

The Division has developed a comprehensive self-insurance application process in collaboration with Ernst and Young. Each new application is reviewed on an individual basis and includes the steps outlined in TABLE 3.

| TABLE 3<br>Self-Insurance Application Process |
|---|
| **Request for Application** - Appropriate application materials are sent along with an "informational supplement" explaining the process and specific filing requirements. |
| **Receipt and Review of Application** - Application is checked for completeness and request for additional information is sent if necessary. Employer is notified of receipt and file is established. |
| **In Good Standing Audit** - An audit is conducted to determine if the employer's WC account is current. |
| **Pre-audit** - Employer's account is audited to determine if claims payments have exceeded premium taxes collected from the employer. The employer must repay any excess liability, or enter a repayment agreement with the Commissioner (not to exceed 3 years). |
| **Buy-out Audit** - Division's actuary projects the future cost of awards and medical benefits granted after the effective date of SI status for all injuries that occurred while the employer was a regular subscriber. The employer must either repay the present value of the liability, enter a payback agreement for this amount (not to exceed 3 years), or agree to assume the liability. If the employer chooses repayment agreement or assumption of liabilities options, the employer must post additional security. |
| **Financial Review** - Financial statement analysis (including footnotes), Z-score analysis, and other financial ratio analyses are completed, and the authenticity of the information is evaluated. A comprehensive review of other financial information, such as federal income tax return, SEC Form 10-K, SEC Form 10-Q, SEC Form 8-K, organization chart, corporate structure, ownership history, company description and presence/lack of excess insurance coverage. A review of the third party administrator and the employer's standing with other governmental agencies are also completed. |
| **Conclusion** - A conclusion is then made concerning approval or denial of the application. The appropriate level of surety is then determined. |
| **Reporting** - The self-insurance section then compiles information and prepares a standard report including its recommendation. |
| **Supervisory Review** - The Director of the self-insurance section completes an extensive final review of the entire file before submission to the Performance Council (all stages of the process also require adequate review of work). |
| **Performance Council Approval** - The Compensation Programs Performance Council approves or disapproves the applicant by vote. |

Comparable policy and procedures have been developed for the re-application or review process. Re-application involves many of the same steps as the new application process with the addition of pay order compliance audits and surety reviews.

## *Analysis*

While comprehensive procedures have been developed for the application and re-application processes, staffing problems have precluded full implementation. As of April 30, 1996, only 1 of the 4 Account Manager positions (those responsible for the analysis of new applications and re-applications) was filled, and the one existing account manager spent only 20% of her time on self-insurance work due to her planning and training for a position in a new underwriting/ratemaking section. ***During this period, the self-insurance section was effectively staffed at only 5% the planned level with respect to Account Managers.*** The Division initiated the hiring process in October of 1995. In May of 1996, two Account Managers were hired, one position remained vacant, and the other Account Manager had yet to transfer to the planned underwriting/ratemaking section.

As of May 1, 1996, the new procedures had only been applied to the processing of initial applications for self-insurance. At that time, nine self-insurance applications had been processed since the conversion to the new process. ***While a small backlog has mounted, due to the staffing problem, the Division has achieved full compliance with Ernst and Young's issue with new applications.*** However, in the history of the Division, a systematic and comprehensive review of self-insured employers has never occurred.

Each self-insured employer is required to maintain a level of surety equal to the greater of one-million dollars or the actuary's estimate of the Division's exposure to liability for the employer's outstanding and future claims. A surety review completed in 1995, using 1994 information, found the Division's surety shortage to be nearly $650 million (see TABLE 4). Firms denoted as representing "severe financial risk" constituted a shortage of $148.8 million. Five of the employers classified as "severe financial risks" represented surety shortages of $20.5 million, $18.9 million, $20.1 million, $54.2 million and $25.8 million respectively. Several of the employers classified as "severe financial risks" were in bankruptcy at the time Ernst and Young completed the surety project. Bankrupt employers represented $20.8 million of these surety shortages. Firms classified as being "high financial risks" represented a shortage of $42.2 million collectively. Employers classified as having "moderate financial risk" comprised $368.8 million collectively, with one firm and its affiliates representing a $174.6 million potential liability to the division. The remaining shortage is divided between companies representing "low financial risk" and those whose risks were unclassified at $41.1 million and $47.4 million, respectively. ***Following the surety study, the Self-insurance Unit pursued collateral adjustments with only six employers because of the staffing shortage.***

| TABLE 4<br>Surety Shortages by Classification of Financial Risk<br>(1994) | | |
|---|---|---|
| **FINANCIAL RISK** | **SHORTAGE BY CLASSIFICATION** | **PERCENTAGE OF TOTAL SHORTAGE** |
| Extreme | $148.8 million | 23% |
| High | 42.2 million | 7% |
| Moderate | 368.8 million | 57% |
| Low | 41.1 million | 6% |
| Unclassified | 47.4 million | 7% |
| **TOTAL SHORTAGE** | **$649.9 million** | **100%** |
| Source: Ernst and Young surety study dated May 1, 1995. | | |

***Because of the lack of standardization of the self-insurance application process in prior years; mergers, acquisitions and divestitures; the lack of re-application reviews; and the volatility of most businesses, many self-insured employers may not meet the financial or other requirements provided in statute. This increases the likelihood of the Division incurring some of the losses these surety shortages represent.***

## Conclusions and Recommendations

In light of the potential liabilities that could be realized by the Division, ***management should continue to work to bring the Self-insurance Unit up to an optimal staffing level.*** The re-application/surety review process should be given top priority by the Division as it is imperative to solvency of the fund and is required by statute. It should be abundantly clear that if each self-insured employer is properly collateralized, even firms representing extreme risks for bankruptcy hold no real risk to the Division. ***The Division should establish timeline goals of 50%, 60%, 70%, 80%, 90%, and 100% collateralization by future dates, allowing for maturation of workout plans but still driving aggressive resolution of the surety shortage.***

**ISSUE AREA 3:** **THE APPLICATION/RE-APPLICATION REVIEWS SHOULD BE ADEQUATELY DOCUMENTED AND CONCLUSIONS SHOULD BE REACHED AS TO WHETHER EMPLOYERS SHOULD BE ALLOWED TO MAINTAIN SELF-INSURED STATUS**

*Level of Compliance:* IN COMPLIANCE

The Self-insurance Unit presents appropriately detailed reports to the Compensation Programs Performance Council (CPPC) which include the recommendations of management.

*Analysis*

The reports to the CPPC summarizing eight applications processed under the new system were analyzed as to their content.[3] The reports are in a standardized format, which includes a description of the company, the results of the in-good-standing audit, the results of the pre-audit, the buy-out process, the financial analysis, recommended surety amount, a section for other information/concerns, the company's standing with other state agencies, and a conclusion containing the recommendation to the Performance Council. The *Information Summary* is consistent with the format set forth in the application policies and procedures manual developed in collaboration with Ernst and Young.

*Conclusions and Recommendations*

***The reporting standard specified in the re-application policies and procedures manual should be employed when the Self-insurance Unit implements its re-application process.***

*[3] In total, 9 employers have been evaluated under the new application process as of May 1, 1996. Of these nine, eight were recommended for approval and were approved, and one withdrew from the process after being advised that it would be given an unfavorable recommendation.*

## ISSUE AREA 4: <u>THE DIVISION SHOULD CHANGE ITS SURETY POLICY TO AVOID PUTTING THE FUND IN A LIABILITY POSITION</u>

***Level of Compliance:*** PARTIAL COMPLIANCE

The Division has developed a policy which requires all self-insured employers to provide surety equal to the larger of $1,000,000 or the actuarially-determined liability of the firm. The actuarially-determined liability of a firm is comprised of the accrued and contingent liability for the past, current and future operations. The new formula was introduced by rule §85-9-9 in 1993. However, as of May 1, 1996, the policy has only been enforced on six existing employers and the eight new self-insurers, thus the Division is only in partial compliance with the issue.[4]

### *Analysis*

The Division and Ernst and Young completed a self-insurance surety project in April 1995. The project culminated in a comprehensive surety review process, a surety database and an up-to-date surety status report detailing each self-insured employer's financial condition and surety position. Due to the staffing shortage, the unit did not aggressively pursue these surety amounts. The Self-insurance Unit has requested additional surety of six employers in total. Five of these six shortages were addressed as other self-insurance issues arose, such as mergers of self-insured employers, parental guarantees, and acceptable surety language, etc. The other was pursued because of the relative size and risk associated with the shortage.[5] As of May 31, 1996, the Division has received or accepted work-out-plans for $46.7 million in surety shortages. The eight new self-insured employers were also required to provide appropriate surety.

### *Conclusions and Recommendations*

Enforcement of the revised surety requirements should be a high priority of the Self-insurance Unit, now that the Unit is moving toward its optimal staffing level.

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[4] *This is not to suggest that all other self-insurers are under-collateralized. Several employers are properly collateralized. A few employers have provided surety in excess of the Division's requirements. E & Y noted in the 1992 final draft management letter, "that there [was] no specific methodology to follow in determining the required amount of security."*

[5] *Such cases must be considered on individual bases. Impact on citizen-employees, the cost of unemployment compensation and other benefits that must be provided, lost tax revenue, etc. often make it difficult to force employers to correct collateral shortages immediately.*

## ISSUE AREA 5: THE DIVISION SHOULD REQUIRE SELF-INSURED EMPLOYERS TO SUBMIT AUDITED FINANCIAL STATEMENTS AND PROOF OF REQUIRED AMOUNT OF SURETY BOND WITHIN 90 DAYS OF THEIR FISCAL YEAR END

*Level of Compliance:* PARTIAL COMPLIANCE

Due to the staffing problems discussed in earlier sections of this report, the Division has not required employers to submit audited financial statements and other information on an annual basis. The policies and procedures manual does however, adequately address the Division's needs for information by specifying that audited financial statements and other materials be requested on an annual basis. With respect to the collection of annual proof of surety, the Division has changed language on these instruments to include "evergreen clauses" (versus specific coverage dates), which cause such instruments to be effective perpetually, until 60 days after receipt of cancellation notice from the guarantor.[6] New surety instruments must be provided to the Division when surety adjustments are required. The Division does require annual proof of surety from the 15 employers maintaining surety instruments having the antiquated, finite period language.

### Analysis

The Division's processes, policies and procedures document adequately addresses materials that should be requested in the re-application process on an annual basis. The document does not require that these items be provided by 90 days before the employers' fiscal year end or specify a due date, other than requiring that these documents be provided to the Division within 30 days of the letter of request's date. The policy does however satisfy the primary intent of the E & Y recommendation at the planning level, by addressing the need for annual collection of this information.

In 1995, while Ernst and Young was assisting with the development of re-application procedures, the exercise of collecting 1994 financial statements and other information was executed as set forth in the process manual. The information was compiled in three-ring binders to facilitate the re-application process. Due to the lack of staff, this information was not collected the following year.

Prior to September 1, 1994, the Division accepted bond language restricted to coverage of specific periods of time. This language led to a situation where multiple bonds could cover multiple periods of time for a single employer. This language also allowed lapses in coverage periods to occur. It was under this environment that the E & Y recommendation to require annual proof of surety was made. Since September 1, 1994, the Division has required that all *new* surety instruments contain "evergreen" language. This language obligates an instrument to cover all time periods relating to an employer's self-insured status. The adoption of a bond

[6] *In the event of a cancellation by the guarantor, the Division has 60 days to draw on the full penal value of the letter of credit, if the self-insured employer fails to provide replacement surety.*

language template has eliminated the need for the Division to require self-insured employers to provide proof of surety other than at times new surety instruments are submitted.

There are however surety instruments held by 15 employers which contain the antiquated, finite period language, which require annual proof of their existence. The Division requires these employers to provide proof of renewal before the instrument expires.

*Conclusions and Recommendations*

***The Division should fully implement the policies and procedures it has developed for the re-application process as soon as possible. Re-applications and related information should be requested even if the unit lacks the resources to complete the evaluations.*** The threat of enforcement is better than no enforcement. With the recent filling of two of the three vacant Account Manager positions, the Self-insurance Unit should be better equipped to meet its statutory requirements.

**ISSUE AREA 6:** **<u>THE DIVISION SHOULD DEVELOP A PLAN FOR THE TIMELY TRANSITION FROM SELF-INSURED TO SUBSCRIBER STATUS PRIOR TO ANY BANKRUPTCY PETITION TO FACILITATE ADEQUATE PREMIUMS COMMENSURATE WITH INSURED RISK</u>**

***<u>Level of Compliance:</u>*** IN COMPLIANCE

The Division has developed a process for the revocation of self-insured status. The Division has revoked the self-insured status of one employer. At the time the employer was transitioned to subscriber status, the Division calculated its experience modified subscriber premium rate by figuring what its rate would have been had the employer been a regular subscriber during the period of self-insurance.

*<u>Analysis</u>*

The Division's revocation process consists of the following steps:

- Self-insurance Unit compiles and reviews all relevant data, meets with the subject employer, determines exposure/risk, and makes recommendation to executive management.
- Executive management reviews recommendation and relevant data and makes final recommendation to Performance Council.
- Performance Council reviews recommendation to revoke employer's self-insured status and approves or rejects it.
- Employer is notified of revocation.
- Workout plan is negotiated for claims and surety.

Because the re-application process has not been implemented, the Division has revoked the self-insured status of only one employer to date. In that case, the company returned to the regular fund at the base rate applicable to its class which was modified by a factor that was calculated by examining the premiums the company would have paid had they been a regular subscriber during a three year "look back" period and the expected loss rates, limited charges and composite loss limit computed as if the fund paid the claims on behalf of the company during the same three year period. The resulting rate was the same as it would have been had the company been a regular subscriber.

The Division has also subscribed to a Dunn and Bradstreet service which will provide monthly reports on companies having self-insured status. The service should help the staff to identify those companies representing substantial risks to the Division. This should enable the Division to transition struggling firms to subscriber status before the health of the business is too precarious to absorb the high costs associated with continuing to meet liabilities incurred while self-insured and paying full subscriber premiums for the immediate quarter.

## *Conclusions and Recommendations*

Transitioning self-insured employers to regular subscriber status prior to failure is a difficult but important task. The Division appears to have the policy in place to fulfill this responsibility. Once the Division embarks on its re-application process, transition to subscriber status may be necessary in some cases in order for the Division to protect the solvency of the fund.

## Underwriting/Risk Management Initiatives

*Underwriting* is the process of selecting and classifying exposures to risk. The term *underwriting* is also commonly applied to the closely related, overlapping science, *ratemaking*. Such is the case with the E & Y final draft management letter. Ernst and Young recommended that the Division work to make rates commensurate with losses. This results in a more equitable distribution of costs, but more importantly, it creates an incentive structure under which employers that succeed in preventing losses pay lower rates and employers not effectively managing risks pay higher rates.

*Risk management* or *loss control* in the context of workers' compensation insurance involves the prevention of deaths or injuries by identifying hazards in the workplace and providing remedies for them. Examples of hazards are unstable storage shelves, heavy lifting without support belts, slippery floors, high levels of respirable dust and personnel lacking safety training. Ernst and Young recommended the development of a comprehensive risk management program, including inspections of employer sites. Underwriting, ratemaking and risk management are core functions of any insurance entity.

## ISSUE AREA 7: THE DIVISION SHOULD OBTAIN THE NECESSARY COMPUTER SYSTEMS AND EMPLOY EXPERIENCE RATING FORMULAS TO INCREASE PREMIUMS COMMENSURATE WITH INCURRED LOSSES

***Level of Compliance:*** PARTIAL COMPLIANCE

New computer systems have been installed that will enable the Division to make premiums commensurate with incurred losses. Ratemaking methodologies are being explored and the Division has completed a considerable amount of planning to this end. An employee of the Self-Insurance Unit is being trained to serve as a ratemaking specialist.

### *Analysis*

The most critical component in the development of a ratemaking system is quality information with which to calculate experience modification factors. The Workers' Compensation Insurance System, also known as WCIS, was installed in stages during October 1995 and April 1996. WCIS is a database tool that can sort claim information by employer, class code, accident year, and other critical information. In March 1996, the Micro Insurance Reserve Analysis system or MIRA, an automated case reserving system capable of generating reserves for each individual claim, was established. In its simplest form, WCIS stores claims information for which MIRA establishes *reserves*. The *reserves* are liabilities for the past, present and future cost of each claim. Reserving allows for the calculation of actual and expected losses, which provide the fundamental elements for calculating *experience modification factors*. An experience modification factor is equal to actual losses *divided by* expected losses *times* a weight factor to give consideration to the employer's size or variance of its actual losses.[7] Thus, WCIS and MIRA have provided the foundation on which to build an experience-based ratemaking system.

S.B. 250 passed by the 1995 Legislature granted the Division authority under §23-2-4 to develop by rule:

> a system for determining the classification and distribution into classes of employers subject to [Chapter 23], a system for determining rates of premium taxes applicable to criteria for subscription thereto, and criteria for an annual employer's statement providing both benefits liability information and rate determination information.

Under this authority, a rewrite of Exempt Legislative Rule §85-9 is being drafted to address underwriting issues and is expected to be released for public comment in November. The proposed rule provides for implementation of a more diverse product line, experience-based rates, receivables management, employer payroll/classification audits, employer classification and other critical underwriting matters. The Division had originally planned to finalize this underwriting rule in two phases. However, the first phase of this rule was released and

[7] *This is a highly simplified illustration of how modification factors are calculated by the Workers' Compensation Division's methodology.*

subsequently withdrawn following the public comment period. Because of the complexity of these issues and public comments indicating a need for more information, the decision has been made to abandon the phase-in approach and release a comprehensive version in November.

The underwriting, ratemaking and risk management vision is the centerpiece for the Division's TQI project that is ongoing. Two phases of deliverables have been provided by the Ernst and Young consultants to date. The underwriting vision contemplates a variety of product lines within the workers' compensation system. Some of the products being considered are outlined in TABLE 5.

The Division is currently in the process of planning for a payroll audit blitz that will help to ensure that employers are assigned to the appropriate classes. A recent Workers' Compensation Division audit project indicates that approximately one-third of the State's employers are currently assigned to the wrong class. This severely undermines the integrity of the underwriting process, because one misplaced employer causes two insurance classes to be in error, the class in which the employer is erroneously included and the one from which the employer is erroneously excluded.

The Division has been training an employee of the Self-Insurance Unit to specialize in ratemaking. This employee is currently working with management and the consultants in the development of a specific ratemaking process.

| TABLE 5<br>Insurance Products Under Consideration | |
|---|---|
| **Plan Type** | **Description** |
| *Assigned Risk Plan* | Employers with substandard performance levels are assigned to this plan and additional premium taxes are imposed on them. Purposes for the assigned risk plan include encouraging employers to improve their performance and allowing high risk employers to share their losses with other high risk employers. |
| *Deductible Rating Plan* | A plan that allows employers to pay a portion of the lost wages for injured employees up to a specified limit, in exchange for receiving a discount on their premium. |
| *Group Rating Plan* | A plan that modifies a group of employers' base rates based on the claims experience of the group. Employers retain separate risk identity, but are pooled and grouped for rating purposes only, specifically with respect to experience modification. |
| *Guaranteed Cost Plan* | Similar to conventional subscriber plan. The employer receives coverage for a fixed premium, determined by class of employment and experience modification. |
| *Retrospective Rating Plan* | A loss-sensitive rating option which allows an employer to pay premiums based on losses. At the end of the retro-rated policy year, the employer faces either a refund or additional premium based on losses. The amount an employer can gain depends on the employer's capacity to pay. |
| *Self-insurance Plan* | Plan allows employers meeting certain qualifications to insure their own compensation and catastrophic risk. |
| Source: Workers' Compensation Division. | |

## *Conclusions and Recommendations*

Although much work remains to be completed to bring the underwriting/ratemaking/risk management vision to fruition, ***the Division's aggressive approach in re-inventing its underwriting/ratemaking/risk management structure is commendable.*** While the goal of experienced-rated premiums is yet to be obtained, the breadth of the Division's plan to address the concerns raised by E & Y in 1992 vastly exceeds the recommendations of the final draft management letter.

**ISSUE AREA 8:** **THE DIVISION SHOULD ESTABLISH A COMPREHENSIVE RISK MANAGEMENT PROGRAM TO WORK WITH EMPLOYERS TO REDUCE EXPOSURE TO INJURIES**

***Level of Compliance:*** PLANNED COMPLIANCE

The Compensation Programs Performance Council has created a Safety and Loss Control Advisory Committee. Two exempt legislative rules have been proposed which provide both positive and negative incentives to require or encourage employers to take certain measures to develop/maintain safe workplaces. Management and the Safety and Loss Control Advisory Committee are working to hire a Safety Director.

***Analysis***

In December 1994, the Finance Committee of the Compensation Programs Performance Council formed a Safety and Loss Control Advisory Committee to promote workplace health and safety programs while encouraging compliance with occupational safety and health laws, regulations and standards. The eight member committee represents both labor and business concerns.

Two exempt legislative rule proposals, §85-23 and 24, have completed the rulemaking process and need only to be filed in their final forms with the Secretary of State in order to become effective within 30 days. West Virginia Code §21A-3-7(c) provides the Compensation Programs Performance Council authority to promulgate such rules and exempts it from legislative review. The statutory authority with respect to the objectives of the proposed rules §85-23 and 24 is provided by §23-2A-2 and 3 as per H.B. 2802, enrolled Regular Session 1993.

Proposed rule §85-23, entitled *Loss Prevention*, provides for the implementation of mandatory safety programs for certain employers who fall within certain risk categories as determined by their experience modification factor and annual premium size. This rule creates three tiers of employers who fall within the mandatory program range. The requirements for each tier are progressive. The first two tiers are determined by an examination of the experience modification factor and annual premium size. Tier One requirements consist of a basic safety education component for the employer. Tier Two requirements consist of the basic safety education component, a safety plan, the establishment of a joint labor management safety committee, quarterly reports and discretionary safety inspections. Tier Three employers are determined as a result of their non-participation at Tier One and Tier Two levels or non-compliance with Tier Two requirements. In addition to the requirements of Tier Two, Tier Three employers may be subject to premium surcharges.

Proposed rule §85-24, *Qualified Loss Management Programs*, provides for a prospective credit to the premium tax rate of a subscribing employer who participates in a qualified loss management program with a private loss management vendor. The prospective credit is provided for a period of up to three years. The proposed rule specifies the qualifications of loss management service providers. The rule provides that the amount of credit against premium rates shall vary from firm to firm based upon the loss reduction success experienced by all of the subscribing employers of the sponsoring loss management firm.

Efforts are being made to hire a Safety Director. However, differences between the Workers' Compensation Division and the Division of Personnel need to be resolved with respect to the appropriate civil service classification of the Safety Director position before it can be filled.

## *Conclusions and Recommendations*

Because the Loss Prevention and Qualified Loss Management Programs are driven by experience modification factors, these risk management strategies are heavily dependent upon the implementation of the planned ratemaking strategy. The implementation of the planned ratemaking and underwriting overhaul should lead to a successful risk management program.

While the Division appears to be giving appropriate emphasis to the prevention of deaths and injuries, its mission statement does not address the importance of this proactive approach. ***The Performance Council should amend the mission statement to incorporate language reflecting its commitment to the prevention of deaths and injuries.***

# APPENDIX 1
## Funds Administered by the Division

*Workers' Compensation Fund:*

Consists of premiums, deposits, the Coal Workers' Pneumoconiosis Fund Transfer Reserve and earnings thereto, and any other moneys or funds which may be given, appropriated or otherwise designated or accruing thereto. Disbursements include medical, temporary and permanent partial, permanent total, fatal, and miscellaneous disability benefit payments (i.e. attorney, funeral, etc.), as well as salaries and other expenses related to the fund's administration.

*Surplus Fund:*

Funding from a percentage of premiums paid into the Workers' Compensation Fund and certain interest earnings attributable to the Surplus Fund. The Surplus Fund consists of three reserves, Catastrophic, Second-Injury, and the Supersedeas Reserve. The Supersedeas Reserve was established to cover losses resulting from overpayments and benefits paid for injuries later ruled to be non-compensable, which, as required by statute §23-4-1c(i), can only be recovered from claimants by withholding future permanent partial disability benefits.

*Coal Workers' Pneumoconiosis Fund:*

A fund created to insure the liability of employers subject to the provisions of Title IV of the Federal Coal Mine Health and Safety Act of 1969. Consists of premiums and other funds paid thereto by employers.

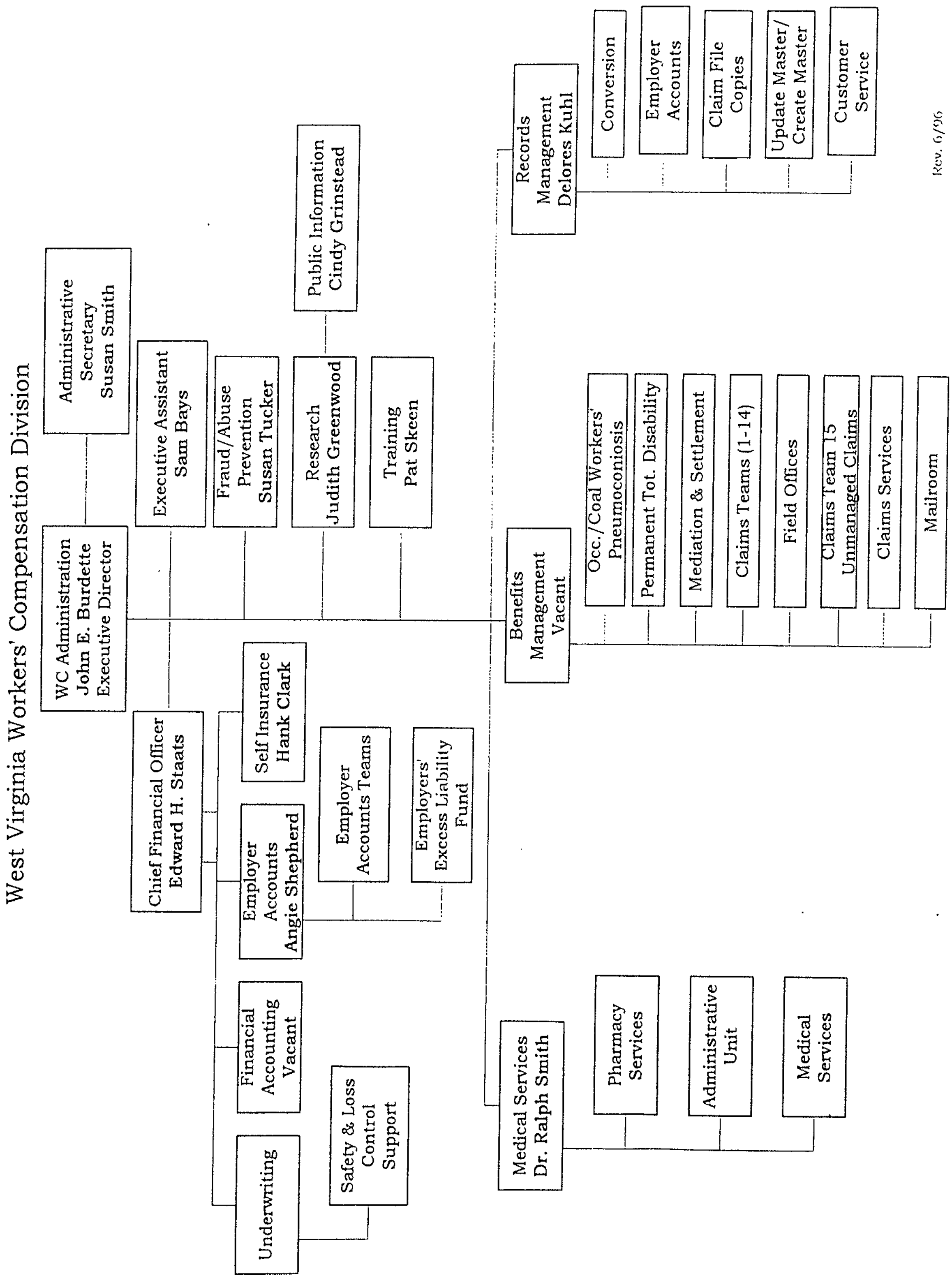
*Disabled Workers' Relief Fund:*

Funding by transfer of certain interest earnings of the Workers' Compensation Fund and an assessment from self-insured employers. The fund provides relief to persons who are receiving benefits pursuant to a permanent total disability or death benefit awards in amounts less than 33-1/3% of the average weekly wage for the State per month.

*Employers Excess Liability Fund:*

A voluntary insurance product established to provide coverage for employers who may be subjected to liability for excess damages over the amounts received or receivable under the statute. Funding by employers who elect to subscribe.

# APPENDIX 2
## Workers' Compensation Division Organizational Chart



# APPENDIX 3
## Agency's Response

**Bureau of Employment Programs**
112 California Avenue
Charleston, West Virginia 25305-0112

Gaston Caperton, Governor
Andrew N. Richardson, Commissioner of Employment Programs

July 9, 1996

Mr. Antonio Jones, Ph.D., Director
Performance Evaluation and Research Division
West Virginia Legislature
Building 5, Room 75 1A
1900 Kanawha Boulevard East
Charleston, West Virginia 25305-0592

Dear Dr. Jones:

Thank you for sharing with us a copy of the Performance Evaluation of Workers' Compensation, which you plan to report to the Joint Committee on Government Operations at the July interims.

We have reviewed the draft report, and are in agreement with the substance of the conclusions and findings contained in that report. There are some minor factual points that need clarification such as on Page 12 in the 2nd paragraph in the section entitled "Analysis", there have actually been 13 applications processed since the conversion to the new process. This same item appears on Page 17 in the 1st paragraph.

We believe it is important to point out that the revised Self-Insurance process has resulted in an improvement in the division's balance sheet in the amount of $9,954,000. In addition, the surety held has increased by $32,000,000. It is also important to note that we have concentrated our efforts in the surety area on those accounts that have been identified as being in the "extreme financial risk" classification.

We have enjoyed the working relationship and the objective review of this program area, and look forward to continuing this relationship through the remainder of the audit.

Sincerely,

Andrew N. Richardson
Andrew N. Richardson
Commissioner

Job Service • Job Training Programs • Labor and Economic Research • Unemployment Compensation • Workers' Compensation