August 10, 1993
ILR 93-M

Representative Byron L Harward
Representative John L Valentine
House of Representatives
State Capitol Bldg
Salt Lake City UT 84114

Subject: Employers' Reinsurance Fund

Dear Representatives Harward and Valentine:

As a result of your request, we have conducted an informational survey of the Employers' Reinsurance Fund (the Fund). Your first request was that we determine how the Fund currently sets its premiums and how the Fund should set its premiums in the future. We have found that the Fund currently operates, by statute, on a cash basis. Whether the Fund should continue to operate in this manner or move to an actuarially-sound method is debatable and based, in large part, on what type of risk the legislature is willing to take. Your second request was that we determine why the fund's debt has grown so significantly over the past few years. We did find that the actuarial deficit as well as the number of participants on the permanent total disability rolls have increased. While various explanations are possible, we were unable to determine the specific cause for the increases. If the Fund continues to be administered by a state agency, we feel this issue should be looked at in more detail. However, we also found that retention of Fund administration by the state may be in question.

The original objective of an employer's reinsurance fund was to encourage employers to hire disabled people. The basic rationale behind this encouragement is that a preexisting physical impairment could make a job injury more severe then if the preexisting impairment had not been present. As an example, if a worker with preexisting blindness in one eye sustains a work injury causing blindness in the other eye, that worker is now totally blind rather than partially blind and considered permanently and totally disabled.

Before the establishment of reinsurance funds, an injury on the job occurring to a previously disabled employee meant one of two things: either workers were penalized by

having their workers' compensation benefits limited to the impairment directly attributable to the second injury, or the employer was penalized by having to pay the entire resulting impairment. It was thought this latter possibility provided a strong economic disincentive for employers to hire or retain disabled employees. A reinsurance fund tries to encourage employers to hire disabled people by exempting an employer from liability for an employee's preexisting impairments. The reinsurance fund, rather than the employer, covers the preexisting liability. In Utah, the Reinsurance Fund is totally funded by employers. No state money is involved.

Since 1988, Utah's Employers' Reinsurance Fund has provided benefits to only those persons declared permanently and totally disabled. The Fund no longer pays benefits to those persons declared permanently and partially disabled or to those declared temporarily disabled nor does it pay death benefits to surviving dependents or continuing medical costs to those that are being provided permanent and total disability benefits. This statutory change was made in an attempt to control Fund costs. To be declared permanently and totally disabled does not necessarily mean the person is unable to perform any type of work. However, it does mean that the person is unable to return to the labor market. Once a person is declared permanently and totally disabled, Fund benefits are paid for the person's lifetime. Because of the 1988 change in statute, we have chosen 1988 as our base comparison year throughout this report.

In order to pay benefits, the Fund receives revenue from two sources. First, self-insured entities, such as Kennecott and West Valley City, are assessed an amount each year based on the premium which would have been paid had they been insured by the Workers' Compensation Fund. Second, the Workers' Compensation Fund as well as every insurance carrier writing workers' compensation insurance are assessed a premium of between one and eight percent of the total workers' compensation premium they receive from employers. Because employers provide all the revenue for the Fund, and because statutory provision makes the employers exclusively liable for work place injuries, employers consider the Fund theirs. While there are no concerns regarding the funding sources themselves, there is a concern regarding the premium assessments. Specifically, concern centers around whether the premiums assessed are based on the Fund's cash position or on its actuarial deficit. In other words, does the Fund operate on a cash basis or an actuarially-sound basis and, further, on which method should the Fund operate?

The Choice Between A Cash or Actuarial Basis Is Debatable

Currently, the Fund statutorily operates on a cash basis; however, a good argument can be made to support the position that the Fund should operate on an actuarially-sound basis. The choice made is dependent on what kind of risk the Legislature is willing to take. We should note that we are not aware of any other funds operated by the State on a cash basis where large actuarial deficits exist.

The Fund Operates On A Cash Basis

The Employers' Reinsurance Fund is funded using a pay-as-you-go or cash basis philosophy. Examples of other funds operating on a cash basis include the federal Social Security program and the Medicaid program. That the Employers' Reinsurance fund will operate on a cash basis is stated in **Utah Code** section 59-9-101(2)(b)(i):

> The Industrial Commission shall determine the amount of the premium tax to be assessed each year. The determination shall be based on the recommendations of a qualified actuary. The actuary shall recommend a premium tax rate sufficient to provide payments of benefits and expenses from these funds on a positive cash flow basis from year to year, and sufficient to provide cash reserves at the beginning of each fiscal year of approximately $5,000,000 in the Employers' Reinsurance Fund and $2,000,000 in the Uninsured Employers' Fund.

In other words, the Industrial Commission has been instructed to generate revenues using a premium tax which will cover the current year's expenses and maintain a cash reserve large enough to cover the current year's unexpected expenses. The Industrial Commission does not collect or maintain enough cash reserves to cover future obligations.

As an example of how a cash system operates, assume person A is permanently and totally disabled and is starting to collect benefits from the Fund. For the current year, assume the Fund will pay benefits to person A totaling $8,000. In addition, assume the actuary has estimated the Fund's total lifetime benefit payments to person A (i.e., the Fund's future obligation to person A) to be $240,000. Further assume that the actuary has estimated the present value of the $240,000 future debt to be $140,000. Because the Fund operates on a cash basis, the revenue generated through the yearly premium taxes will only be enough to cover the current expenditure of $8,000. The revenue collected will not be enough to place into the Fund's reserve account the $140,000 present value of the future obligation. Thus, the $140,000 obligation is unfunded debt.

Utah's Chief Financial Officer Is Concerned With This Funding Mechanism

That the Fund's cash-based system is accruing a substantial amount of unfunded debt concerns Utah's chief financial officer. In 1988, the Fund had unfunded debt totalling approximately $71 million. In 1992, the unfunded debt had risen to a present value of $223 million, a 214 percent increase. By the year 2000, the Fund's actuary projects that the unfunded debt will rise to a present value of $324 million. It should be remembered that this obligation is future debt, and as such, is payable over a long period of time (50 years). Nonetheless, Utah's chief financial officer feels strongly that this fund should be managed in an actuarially-sound fashion as is required of private insurance companies. By moving to an actuarially-sound system, costs would be assigned to businesses operating in the years the obligations are created. In addition, the full accounting disclosure of an actuarially-sound system would help in managing program costs better. Specifically, this accrual type of accounting provides incentives which encourage proactive claims management rather than reactive claims management. However, moving to an actuarially-sound system would mean that the Fund would be required to maintain cash reserves sufficient to cover accrued future debt. In making the decision as to which system is best, legislators need to consider the benefits and risks of each system.

There are Advantages to the Cash System

The Fund's cash system provides businesses covered by the fund with a financial advantage. Specifically, businesses do not have to tie up their capital in a reserve account to cover future

liabilities. They only have to supply funds to cover the liability due and payable in the current year. By not tying up funds to cover future debt, businesses have more funds available in the present to apply to other areas.

In addition to providing businesses with a financial advantage, the cash system is also a very common system in use among other states' reinsurance funds. In fact, Administration magazine reports that most of the reinsurance funds account for their funds on a cash-only basis. In addition, of the four Western states we contacted (Arizona, California, Washington, and Colorado), three account for their reinsurance fund using the cash system. Only one state, Arizona, indicated that it accounted for its reinsurance fund in an actuarially-sound manner. Based on these data, it appears that the cash system is an accepted practice when managing state reinsurance funds.

There Are Disadvantages of A Cash System

A primary disadvantage of a cash system is that it is financially risky relative to an actuarially-sound system. In the event that the Fund were to fail, either through a total economic collapse or through the failure of one or more large self-insured employers, there is no reserve fund to cover the future liability currently estimated at $223 million. While the

risk of a fund failure is very unlikely, the $223 million in unfunded debt is worth examining. If the Fund were to fail in some capacity, the state, as the administrator of the Fund, may find itself involved in a dispute over who is liable to cover the unfunded debt.

In addition to the financial risk of the cash system, there is also the issue of equity. Specifically, businesses which were not a member of the Fund when liabilities were incurred, will assume responsibility for paying for those incurred liabilities upon joining the Fund. In other words, the Fund passes off current obligations to future generations. This creates what is known as intergenerational inequities. As a result, any new business joining the Fund today would be required to pay a portion of the $223 million unfunded debt which the business had no part in generating. In fact, a Utah Foundation report concludes that:

> "Businesses will be reluctant to move into Utah or expand operations in the state if they know that they eventually will be held liable for this sizable and rapidly-growing obligation."

Given these disadvantages, Utah's chief financial officer is opposed to the use of the cash system within the Employers' Reinsurance Fund. He notes that other state managed funds similar to the Employers' Reinsurance Fund are actuarially sound. Specifically, the Risk Management Fund, the Workers' Compensation Fund, and the Retirement Fund all have full funding or ratable funding over time of unfunded liability. Since Utah is a conservatively managed state, required by the **Utah Code** to be managed according to Generally Accepted Accounting Principles (GAAP), it is the opinion of Utah's chief accounting officer that the Fund should become actuarially sound.

In addition, Utah's chief financial officer fears that the unfunded debt of the Fund which is reported in the state's financial statements may, in a negative economy, have some negative affect on the state's bond rating. While a change in bond rating is not imminent, it is a possibility worth consideration. According to Standard and Poor's, one important consideration in their credit analysis is risk management, i.e., how the entity manages and plans for knowable risks and provides some cushion for the unknown. For the state to allow a $223 million liability to remain unfunded could possibly affect the state's bond rating.

One possible solution to the bond issue, but probably not the liability issue, might be to account for the Employers' Reinsurance Fund as an enterprise fund. The state of South Carolina recently received approval from the Governmental Accounting Standards Board to do this. What this means is that future fund liability does not have to be reported in the state's financials. Thus, the state's bond rating would not be affected. Utah's chief financial officer is aware of this ruling but maintains that Utah is too financially conservative to take this approach. Rather, the most financially sound approach is for the Fund to become actuarially sound.

There Is An Advantage to an Actuarially-Sound System

The principle advantage of an actuarially-sound system is that, over time, unfunded liabilities disappear. Cash reserves are invested and the earnings, together with current premiums, are used to keep the system fully funded. So, if Utah's Employers' Reinsurance Fund were actuarially funded, the fund would have enough cash in reserve to fund the $223 million of currently unfunded debt. If the Fund were to close today, no additional premiums would need to be collected. The fund would simply begin to pay its future obligations from the reserves collected.

Because no unfunded liability is allowed to accrue, an actuarially-sound system is the most financially conservative system to follow. In addition, it is equitable because the businesses incurring the injury related liabilities pay up front for the cost of the claims. Further, it is possible that an actuarially-managed system will save businesses money in the long run since businesses will pay the present value of a future obligation rather than the entire future obligation. The drawback is that businesses would have to pay the entire present value amount up front rather than paying the future obligation over a 30 to 40 year time-period.

Because an actuarially-sound system is the most conservative financially, private insurance companies are required by the Department of Insurance to be managed in this fashion. Thus, if the Employers' Reinsurance Fund were operated in the private sector, it would not be allowed to operate using a cash system. The cash system is too risky financially when such large future debts are possible.

There Is A Disadvantage of an Actuarially-Sound System

In our opinion, the primary disadvantage of moving to an actuarially-sound system is one of implementation. As stated earlier, businesses view the Fund as theirs and thus want it run as a benefit to themselves. The cash system provides businesses a benefit by not tying up current funds for future obligations. Moving to an actuarially-sound system will remove this benefit. In addition, businesses will see their premiums increase without any increase in the benefits offered by the Fund. Rather, those increased premiums will go toward accruing adequate cash reserves to cover future obligations. Even if the Fund is brought into an actuarially-sound position over a period of 30 or more years, premiums will still increase with no increase in benefits.

In conclusion, it is debatable which method is correct. Governmental agencies primarily use the cash basis while private insurance agencies in Utah are required to use an actuarially- sound system. In making their decision, legislators will have to determine which risk they are more willing to bear: the financial risk of the cash system or the political risk of implementing an actuarially-sound system.

In addition to the question concerning proper accounting methods for the Fund, the question was also raised as to why Fund expenses have increased so significantly.

Expenses and Fund Participants Have Increased

Both current expenses and actuarial expenses have increased. In addition, the number of permanently and totally disabled people supported by the Fund has also increased. Since expenses should be related to the number of fund participants, we tried to determine why fund participation has increased, but were unable to accomplish this in the time available. However, we were able to identify some possible explanations for participant increases and some possible actions the legislature may want to consider to control fund increases.

In 1988, Utah's fund had current expenses of $8.8 million associated with permanently and totally disabled rolls, while in 1992 current expenses had increased to $12 million, a 36 percent increase. Actuarial expenses, on the other hand, have risen from $71 million in 1988 to $223

million in 1992, a percentage increase of 214 percent.

The number of participants on the permanent and total disability rolls has also increased. In 1988, the number of people classified as permanently and totally disabled on the Fund was 381. As of March 1993, this number had risen to 886, an increase of 132 percent. In addition to the gross percent increase in participants, even more significant is the rate at which people are entering the permanent and total rolls. In the six years between January 1982 and January 1988, the rate of people entering the fund as permanently and totally disabled was approximately 31 a year. After the statute change in 1988, the rate changed to 95 people per year entering the rolls as permanently and totally disabled.

Since other states have different statutes which can affect expenses and numbers of participants, we were unable to make meaningful state comparisons in the time available. However, it seems to us that actuarial expenses and the participant rate for permanent and totally disabled are increasing significantly. While we could not determine specific causes, some explanations were offered to us for why participation rates are increasing.

Possible Explanations for Increased Number of Participants

While there are a number of possible explanations for the increasing numbers on the permanent and total disability rolls, three have been represented to us as being the most likely. The first addresses the broad interpretation of current statute; the second addresses the statute of limitations for permanent and total disability; and the third addresses general public awareness of the Fund.

One explanation argues that the permanent and total disability rolls are increasing because current law defining preexisting conditions and disabilities is being interpreted too broadly. In fact, this is a primary concern of Thomas Carlson and Steven Hadley, two of the Commissioners of the Industrial Commission. Conditions that years ago would not be considered a serious impairment, for example, the need for eyeglasses, are now being classified as a preexisting condition. The more preexisting conditions there are, the more likely a person will be classified as permanently and totally disabled.

A second explanation involves the statute of limitations for permanent total disability cases. Specifically, the Supreme Court has ruled that there is no statute of limitations for permanent total disability cases. Thus, a person who suffered injury 50 years ago could qualify for Reinsurance Fund coverage today. In this case, the Fund would have to pay the person for its share of medical expenses and monthly benefits for the 50- year time period and then continue paying them benefits until their death. According to a paralegal working with the Fund, many people who have been retired and out of work for a long time try to get on the Fund. She believes the Fund is viewed as another retirement program.

A final explanation given to us is that lawyers have become more knowledgeable about the Employers' Reinsurance Fund and how they can use it. Further, because lawyers are able to advertise their services, people have become more knowledgeable regarding personal injury claims and how to file them. Given this increased knowledge on both sides, it seems reasonable that claims involving the Reinsurance Fund would increase.

Possible Action for the Legislature to Consider

Probably all three of these factors influence the numbers of people entering the permanent and total rolls. If legislators are concerned with the increase in numbers, they can consider changing the statute affecting entry onto the Fund. This can be done by modifying the type of preexisting condition subject to recovery and/or by modifying the requirement concerning employer knowledge of the preexisting condition.

There are some who feel that the law should be rewritten to specifically state what is considered a permanent and total disability rather than allowing judicial review to interpret the law. In fact, this was one of the recommendations made in our 1984 sunset audit of the Industrial Commission (Report # 84-12). Thus, the legislature could limit participation in the Fund by statutorily restricting the types of injuries that are covered by the Fund and to define the injuries so that they are not subject to interpretation by the judicial system.

Another possible modification to the statute concerns employer knowledge of the preexisting disability. Since the primary purpose of a reinsurance fund is to encourage the hiring of disabled persons, it stands to reason that an employer must have knowledge of the permanent and disabling nature of the preexisting disability of its employee at the time of hiring or retention. If the employer had no knowledge of the disability then it does not seem possible for discrimination based on the preexisting disability to have occurred. Consequently, it does not seem logical that the Fund would be liable when the employer had no previous knowledge of the preexisting condition. The Council of State Governments has recognized this concern and recommended the following:

> In order to qualify for reimbursement from the special fund, the employer must establish by written record that the employer had knowledge of the permanent impairment at the time the employee was hired, or at the time the employee was retained in employment after the employer acquired such knowledge.

Other states have included the above language or a similar variation as a statutory provision and Utah could consider doing the same in an effort to restrict entry into the Fund.

As previously stated, it is not clear what is specifically causing increases in Utah's fund. Some explanations have been offered but they are probably not the only explanations possible. However, we think both the issue involving more specific definitions of qualifying preexisting conditions and the issue involving employer knowledge of the preexisting condition are worth pursuing if the Employers Reinsurance Fund is retained. It is possible, however, that the Fund will not be retained at the state level.

Retention of the Employers' Reinsurance Fund In Question

Our 1984 audit of the Industrial Commission concluded that the Employers' Reinsurance Fund is no longer meeting its primary purpose of encouraging employment of the handicapped. Commissioners Carlson and Hadley of the Industrial Commission concur with this finding and feels the Fund may have outlived its usefulness. As a result, Commissioners Carlson and Hadley

believe the Fund should no longer be administered by the state. If the Fund is transferred to the private sector, businesses will probably be unhappy since their costs will increase for a period of time with no increase in benefits. This is because businesses will still have to pay premiums to the Fund to cover those future obligations which have not been funded as well as pay premiums to a new insurance company to cover any new people classified as permanently and totally disabled. It is our understanding that a task force will be convened to consider whether the Fund should continue to be maintained at the state level.

The Fund May Not Be Meeting Primary Purpose

In our 1984 sunset audit of the Industrial Commission (Report Number 84-12), we indicated that the Employers' Reinsurance Fund was not meeting its primary purpose of encouraging the employment of the handicapped. As stated earlier, the fund was established to cover an employer's additional liability for an injury which a person with a preexisting condition might suffer. For example, a worker already missing an eye who loses the other becomes totally disabled. The employer must then compensate for total disability at a much higher rate than for that of a single eye. Some feel that employers will not hire the handicapped if they have to risk liability for additional compensation. Therefore, the Employers' Reinsurance Fund allows the employer to pay only the compensation attributable to the industrial injury. The Fund pays the rest.

The 1984 report concluded that the Fund had little impact on handicapped employment because most Utah employers were unaware of the fund and also because employers faced more disincentives than just those posed by preexisting handicaps. Commissioners Carlson and Hadley of the Industrial Commission concur with this finding and add that the original purpose of the Fund to encourage hiring the handicapped has now been, in large part, supplanted by the Americans with Disabilities Act(ADA). The ADA states that employers cannot discriminate against individuals with disabilities. As a result, Commissioners Carlson and Hadley believe employers will be required by the ADA to reasonably accommodate impaired and injured workers and, in this regard, the purpose of the Employers' Reinsurance Fund has been supplanted. As a result, Commissioners Carlson and Hadley believe the Employers' Reinsurance Fund should no longer be administered by the state. If the fund is transferred to the private sector, businesses will probably look closer at their safety programs. However, businesses will probably also complain about continuing fund costs.

Businesses Will Experience Temporary Premium Increases

According to the Insurance Commissioner of the State of Utah, if the obligation of the Employers' Reinsurance Fund is transferred to the private sector, businesses will experience increased costs over the next seven to eight years. Part of the reason for this is that even if the Fund were eliminated, the people who are currently receiving benefits are entitled to them until their death. Since the Fund does not have cash reserves to cover its future debt, businesses will still need to maintain their current premium payments to the Fund to cover their future obligations. In addition, businesses will have to pay additional premiums to either Workers' Compensation or another insurance carrier to cover themselves against new claims for permanent and total disability. The net result is a temporary increase in overall premium payments for businesses.

Task Force To Consider Options

It is our understanding that a task force is to be convened to consider the question of what action to take regarding the Employers' Reinsurance Fund. From discussions with various people, we think it is possible that the option of eliminating the Fund at the state level may be

taken. If this occurs, coverage for needy people will not necessarily end. Rather, it is possible that the Fund could be brought to a point where a private company would want to assume management control. Another option is that businesses would assume responsibility for their own reinsurance coverage through a private company. Either way coverage for needy people could continue.

If the task force recommends that the Fund be maintained by the state, then other issues must be decided. First, the legislature will have to decide if they want the Fund to continue operating on a cash basis or if they would feel more comfortable if the fund became actuarially sound. If an actuarially-sound system is chosen, then the task force needs to determine who will manage the cash reserves and how those reserves will be managed. This is extremely important in a system where cash reserves can easily exceed $100 million. Second, the task force or the Industrial Commission should determine why Utah's rate of participation for permanent total disability is increasing so significantly and make recommendations as to what should be done.

We hope this letter provides you with some information that will be helpful to you. Responses from the Industrial Commission of Utah and the Division of Finance are attached. If there are any questions or you need additional information, please let us know.

Sincerely,

Wayne L Welsh
Auditor General

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