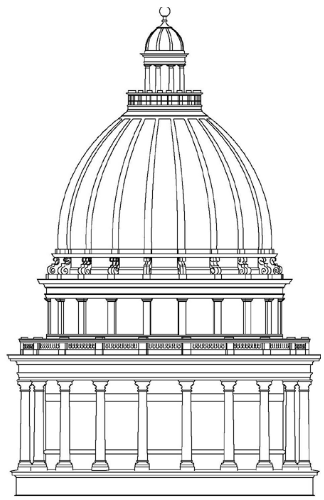
REPORT TO THE

UTAH LEGISLATURE

Number ILR 2016-E



A Limited Review of the Division of Risk Management

August 2016

Office of the
LEGISLATIVE AUDITOR GENERAL
State of Utah

STATE OF UTAH

Office of the Legislative Auditor General

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JOHN M. SCHAFF, CIA
AUDITOR GENERAL

August 2016

TO: THE UTAH STATE LEGISLATURE

Transmitted herewith is our report, **A Limited Review of the Division of Risk Management** (Report #ILR 2016-E). The objectives and scope of the audit are explained in the Introduction.

We will be happy to meet with appropriate legislative committees, individual legislators, and other state officials to discuss any item contained in the report in order to facilitate the implementation of the recommendations.

Sincerely,

John M. Schaff

John M. Schaff, CIA
Auditor General

JMS/lm

REPORT TO THE
UTAH LEGISLATURE

Report No. ILR 2016-E

A Limited Review of the Division of Risk Management

August 2016

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Office of
LEGISLATIVE AUDITOR GENERAL
State of Utah

Report Number ILR 2016-E
August 2016

A Limited Review of the Division of Risk Management

The Legislative Audit Subcommittee requested our office to conduct a risk assessment of the Division of Risk Management (DRM). Although we do not recommend additional audit work, we do offer four recommendations in response to the activities we reviewed in DRM's Loss Control Program area. We also reviewed DRM's claims process and found that it appears to be effective in managing claims. Finally, an overall shortfall between $1.1 and $1.5 million in the Risk Management portion of Internal Service Fund (ISF) funding for fiscal year 2017 may require a supplemental appropriation.

Our limited review does not recommend additional audit work but offers recommendations that we believe can improve the division's operations.

The DRM is housed in the Department of Administrative Services (DAS). According to the 2015 DAS annual report, the mission of the DRM is to protect state assets, promote safety, and control against property, liability, and auto losses. DRM insures property and provides liability coverage for state agencies, higher education, school districts, and charter schools and their employees. DRM insures over 200 public organizations, including all state agencies, institutions of higher education, and voluntarily, all school districts and 61 charter schools. ***Utah Code*** 63A-4-201 establishes the intent of the Risk Fund, which is to cover property, liability, fidelity, and other risks.

The Division of Risk Management insures property and provides liability coverage for all state agencies, higher education, school districts, and most charter schools.

Additional Policies Could Improve Two Loss Control Programs

DRM's Loss Control provides preventative maintenance programs to help insureds reduce the likelihood of an accident or claim.

We reviewed two of DRM's Loss Control inspection programs and found that both the formal inspection and self-inspection survey could benefit from additional policies to ensure they are implemented as needed for all insured properties.

Loss Control services are risk management techniques with an aim to reduce the possibility or severity of a loss. These preventative programs are intended to reduce the likelihood of an accident resulting in a claim to the Risk Fund.

Policies Needed for Formal Inspections

We believe that DRM could benefit by having a policy establishing a formal inspection schedule to ensure that all properties are inspected as needed. Additional policies could also provide structure to ensure that inspections and other loss prevention activities (such as consultations and trainings) are consistently recorded in DRM's case management system for useful measurement and analytical purposes.

Formal inspections are those that are initiated by DRM where the division's inspectors visit a facility site to examine insured property. During our review, we attended three inspections and found them to be conducted with consistency by three different inspectors. At that time, one of the inspectors was using a different inspection tool but has since moved to the same program as the other two inspectors. Now all the inspectors use the same inspection tool.

We found that, over the last three years, some insureds have received many formal inspections by DRM inspectors while others have received none.

However, DRM's inspection records for the last three years show that some properties have been inspected many times while others have not been inspected at all. The records do not list the information by location, only by insured account. Some insureds have more property (more locations) to inspect than others; therefore, some insureds may receive more inspections than others. From the data, we are unable to determine if one insured receiving over 150 inspections in three years is justified compared to another insured receiving no inspections over the same period of time.

Our review found that the average number of inspections an insured received over the three-year period was 14. Thirty-eight agencies received more inspections than average, 109 received fewer, and 73 received no formal inspections. Because of the potential risks associated with certain agencies receiving no formal inspections, we recommend that formal policies be established creating an inspection schedule to ensure that all insureds are receiving inspections as needed on a consistent basis.

DRM should establish formal policies which include an inspection schedule to ensure all insureds receive inspections as needed.

DRM's loss prevention team performs many functions, including inspection and follow-up inspections, consultations, and trainings. These services provide value to both the insureds and the Risk Fund because they are intended to prevent loss and reduce hazards. We examined the number of these activities conducted for a three-year period.

Because DRM does not apply a weighting to loss control activities, we were unable to measure the value of a consultation versus an inspection or training given to an insured. Therefore, we were unable to determine if an insured receiving several consultations but no inspections was an adequate exchange. DRM could benefit from reviewing loss prevention activities to determine how a combination of activities equates to providing all insureds with necessary preventative guidance.

Finally, we found that activities logged into DRM's system may not be recorded consistently or accurately among inspectors. One inspector may group an inspection of a site with multiple locations (buildings) under one case number while another may divide the inspection into more than one case number. Also, inspectors may not be logging all of their activities, which compromises DRM's ability to get useful metrics from their loss prevention program. We believe that DRM could benefit from establishing formal documentation policies to ensure that all loss control activities are recorded consistently to create more reliable metrics.

Establishing formal documentation policies will help DRM to ensure that loss control inspection metrics are reliable.

Policies Needed for Self-Inspections Surveys

Administrative Rule R37-1-8 requires each of DRM's insureds to complete a self-inspection survey (SIS) by June 1 each year, unless the risk manager has granted a special exemption.[1] We found that the

[1] DRM does not require the insured to conduct a SIS on every piece of property. The SIS is required of buildings $50,000 and over in value or where numerous people are present or have access.

special exemptions have not been documented in policy, nor has DRM kept formal records of why insureds have been granted exemptions for not completing the SIS.

The Self-Inspection Survey (SIS) helps insureds to eliminate hazards and reduce risk on their own.

The entire survey, which is online, consists of almost 2,000 questions, divided into 13 sets on different topics. However, the survey is tailored to each insured's needs and none are required to complete the entire survey.

For example, state agencies are only required to complete the occupational, environmental, and security areas, which consist of 46 questions. The DRM website explains that, "The survey is a tool for recognizing and eliminating hazards that can significantly affect the public, our co-workers, the property we are charged to preserve, and the Risk Fund. The timely submission of the online survey will qualify entities to a premium credit."

When an insured completes a SIS, the entity receives a 10 percent reduction in the DRM insurance premium. If the insured does not complete the SIS, it is charged a full premium for the following policy year. Therefore, when an insured does not complete a SIS, there are two results. First, unless the property to be self-inspected receives a formal inspection during the year by DRM, possible hazards may not be abated. Second, the insured must now pay the full premium the following fiscal year and does not benefit from the 10 percent reduction.

Completing the SIS will earn the insured a 10 percent reduction on its insurance premium, yet some are not completing it.

DRM reports that in fiscal year 2015, 32 insureds did not complete a SIS but some of them received the premium discount under management discretion as though they had. Reasons for not completing the SIS include:

- The insured did not have an assigned facility or risk coordinator for the entire year
- Since DRM's case management system does not communicate with the SIS program, some pieces of property were actually maintained by the Division of Facilities Construction and Management instead of the insureds
- According to DRM, some insureds may have not completed the SIS because they did not believe it was cost-effective

(reasoning that conducting the SIS costs more in labor than they would receive in a discount)

- They simply chose not to complete the SIS.

However, neither the exemptions nor the process to receive an exemption has been established in policy.

We believe that, unless a documented, approved exemption has been granted, each insured should annually complete the SIS, both to mitigate potential hazards and to ensure their publically funded budgets are being managed prudently and benefitting from the 10 percent premium reduction. We recommend that DRM establish a policy that outlines when a SIS exemption is allowed. We also recommend that DRM document insureds' approved exemptions from completing the annual SIS to ensure there is a valid, approved reason for lack of completion.

Policies should provide a process for approving and documenting exemptions to completing the SIS.

DRM's Claims Program Appears Effective

We reviewed 11 claims and found them to be well managed for the risk areas we examined. The cases were well documented, including pictures, police reports, hospital bills, subrogation reviews, insurance documentation, and other necessary documentation. The adjusters' notes were adequate for detailing the events and how the claim was managed, including vehicle valuations and auction records for totaled vehicles. Therefore, our review of DRM's claims processing does not support further auditing.

Utah Code 63A-4-102 authorizes DRM to adjust, settle, and pay claims. According to its 2015 annual report, DRM opened 2,565 and closed 2,700 auto, liability, and property claims during the year. DRM also managed 812 Worker's Compensation Fund claims in 2015 but those were not included in this limited review.

Measuring the amount of time from opening to closing a claim may not be a reliable indicator of claim processing efficiency. Many factors affect this measurement, including the statute of limitations and the age of the parties involved at the time of the incident. For example, when the claimant is a minor child, the claim may remain open until one year after the child's 18th birthday. However, we found that, over the last five fiscal years, 93 percent of DRM's claims have closed within one year, 70 percent of them closing within the first three months. We believe this appears to indicate efficiencies on DRM's part.

Our review of claims in the risk areas we examined support a private consultant's review of DRM claims, finding them to be well managed and effective.

We also reviewed a consultant's audit of DRM's liability and property claims for 2015. In the audit report, the consultant states that DRM's overall performance level of 98 percent exceeds the industry standard of 95 percent for superior performance, with no individual score below 97 percent. In the audit, the consultant reviewed DRM's performance in multiple claims areas, including case reserves, payment reconciliation, allocated expenses, file documentation, subrogation, accuracy and timeliness, and many more.

Shortfall in ISF Funding for Fiscal Year 2017 May Require a Supplemental Appropriation

DRM and the Legislative Fiscal Analyst report that, during the 2016 General Legislative Session, some Internal Service Fund (ISF) impacts (positive or negative changes in ISF costs) were not funded for fiscal year 2017. Although some impacts were not funded, the State Agency Fees and Internal Service Fund Rate Authorization and Appropriations bill (House Bill or H.B. 8) authorized DRM to charge its insureds a premium rate that includes all impacts.

If Internal Service Fund impacts (positive or negative) are not funded, agencies receive the same amount of ISF funding as the previous year, regardless of changes in their ISF obligations.

In general, when ISF impacts are not funded, the next year's appropriated amounts for ISF expenditures will be the same as the current year's. Therefore, regardless of the premium due to DRM, insureds will receive the same amount of ISF funding as in the prior year. The net result is twofold: when the premium goes up for some in fiscal year 2017, the insured's budget will be short on ISF funds by the amount of the increase. And for others, the premium will go down and the insured will have funds remaining in its budget.

Although there is an overall shortfall, some insureds will have excess ISF funds in their budgets because of lower DRM premium bills.

Because of time constraints, we were unable to verify the exact amount of the ISF shortfall of insurance premiums, but estimate that it will exceed $2 million. However, if the Legislature does provide a supplemental appropriation to cover the shortfall, and also readjusts the budgets of those insureds with excess funds in their budgets (because of a premium reduction), we estimate the amount that will be needed to cover the overall (net) shortfall will be between $1.1 and $1.5 million.

About 23 percent of DRM's insureds' premiums went down for fiscal year 2017. Therefore, these insureds will have excess funds in their budgets. The excess funds cover a wide range, including one insured that will have over $88,000 excess in its budget and another that will have about $18 excess in its budget. The majority of insureds' budgets will be short because their insurance premiums will increase in fiscal year 2017. These include an insured with a shortfall of over $188,000 a contrasted with another insured that will essentially break even.

Utah Code 63A-4-101 requires the risk manager to "manage the [Risk] fund in accordance with economically and actuarially sound principles to produce adequate reserves… ." In determining the annual insurance premiums, ***Utah Code*** 63A-4-202 authorizes DRM to charge each insured its proportionate share of the cost incurred, based upon actuarially sound rating techniques and including all costs of operating the fund.

***Utah Code* requires the Risk Fund to be actuarially sound with adequate reserves.**

For liability insurance, DRM's actuary (Deloitte Consulting LLP) annually assesses DRM's losses and claims to determine DRM's liability for premiums and the reserves needed to remain actuarially sound. For property premiums, DRM utilizes a property valuation book that is updated annually by Marshall & Swift (a national provider of building cost data) to value insureds' properties and set premium rates.

DRM is fully funded from dedicated credits through the ISF. Therefore, this shortfall will be directly felt by the insureds because their budgets will be affected by the impacts not funded in H.B. 8. According to the Division of Finance, the shortfall cannot be paid from the Risk Fund. Because some of the fund's customers (which are DRM's insureds) have programs that are partially federally funded, those customers pass some of their costs on to the federal government.

The ISF shortfall cannot be paid by the Risk Fund or it will risk the federal funding received by some of DRM's insureds.

Because the Risk Fund's customers include those that receive federal funding, federal law requires the same funding calculation be used for each customer. If the Risk Fund were to be used to correct the shortfall for only those customers that did not receive adequate ISF funding to cover their DRM premium costs, the allocation of those funds would, in essence, be recalculating the formula for allocating the funds to customers. This means that, if those customers with a budget deficit are made whole using the Risk Fund, they will be treated differently from those that did not receive assistance from the Risk Fund.

There are two options to remedy the shortfall: 1) insureds pay from their existing budgets, or a 2) Legislative supplemental appropriation.

Therefore, using the Risk Fund to pay the shortfall would then be an inequitable allocation of the funds between the insureds. Those that were not appropriated enough ISF funds to cover their insurance premiums would benefit over those that did not have a shortfall. According to the Division of Finance, the practice of treating the customers unequally is prohibited by federal law.

Two options available to remedy this shortfall include the following:

- The insureds with a shortfall could pay the premiums in full, requiring them to make up the difference between what was appropriated for the ISF and other revenues from their budgets; however, this may put a strain on those insureds' budgets for which they have not prepared

- The Legislature could authorize a supplemental appropriation to cover:

  A) Either the overall shortfall of between $1.1 and $1.5 million, and at the same time, readjust the budgets of those insureds that will have excess funds in their budgets because of a lower insurance premium than last year, or

  B) Cover the total shortfall of over $2 million without readjusting the budgets of those insureds that will have excess funds due to their insurance premium being lower than last year's premium.

Looking forward, the premium rates calculated for fiscal year 2018 will include the impacts not funded in fiscal year 2017, assuming that property and liability valuations remain constant or increase. If, overall, the premiums increase, the shortfall could be even larger next year. If the Legislature chooses not to fund the ISF impacts (as related to DRM insurance premiums) in full for fiscal year 2018, insurance premiums could face a shortfall next year as well. We cannot estimate the impact because insureds' premiums change from year to year.

For the Risk Fund to be actuarially sound as required by law, the insurance premiums must be paid in full as determined by DRM's actuary and property valuation calculations. According to DRM, in order to continue providing services to insureds and meet broker and insurance obligations, full funding will need to be determined by July 1, 2016, regardless of whether the premiums are paid fully by the insureds or through a legislative supplemental appropriation.

Recommendations

1. We recommend that DRM establish formal policies creating an inspection schedule to ensure that all insureds are receiving inspections as needed on a consistent basis.

2. We recommend that DRM review all loss prevention activities to determine what combination of activities equates to providing all insureds with necessary preventative guidance.

3. We recommend that DRM establish formal documentation practices to ensure that all loss control activities are recorded consistently to create more reliable metrics.

4. We recommend that DRM establish policy that outlines when a self-inspection survey exemption is allowed and document when insureds have received this approval.

5. We recommend that the Legislature consider the two options for satisfying the insureds' fiscal year 2017 DRM insurance premiums obligations and decide if Legislative action is needed. Two options available to remedy this shortfall include the following:

   - The insureds with a shortfall could pay the premiums in full, requiring them to make up the difference between what was appropriated for the ISF and other revenues from their budgets; however, this may put a strain on insureds' budgets for which they have not prepared

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Agency Response

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May 26, 2016

John M. Schaff, CIA
Auditor General
W315 Utah State Capitol Complex
Salt Lake City, UT 84114-5315

RE: Report Number ILR 2016-E
Audit of the Division of Risk Management

Dear Auditor General Schaff:

Thank you for the opportunity to respond to the Legislative Audit of the Division of Risk Management. Below you will find our responses to the recommendations.

1. **We recommend that DRM establish formal policies creating an inspection schedule to ensure that all insureds are receiving inspections as needed on a consistent basis.**

   DRM agrees in part but lacks FTEs to increase the frequency of inspections. If the Legislature would like more frequent inspections on a regular basis, DRM would need additional FTEs. However, the current inspection schedule takes into account that some locations require more frequent inspections than others based on their risks rather than a set schedule where, with our current number of FTEs, we may not be able to visit a location for 3+ years. State Risk welcomes further guidance from the Legislature as to how frequently it would like inspections scheduled on a regular basis.

   DRM has three FTE's performing inspections of approximately 6,143 unique "buildings," covering nearly 138,000,000 square feet, valued at over $26,000,000,000. The State Risk Fund insures four unique groups (higher education, state agencies, school districts, and charter schools), each of which presents different inspection needs and complexities. In some cases there may be multiple buildings at one location, i.e. a high school may have one or more classroom buildings; a separate building for the auto shop

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and/or wood shop; a separate location for music arts; a shed used for storage; and another building used for various types of art instruction. (See Table 1.)

DRM's three FTEs have other duties in addition to inspections that are equally important in helping our insureds avoid liability. Among these three FTEs, the historical ratio of inspections to other expected and necessary duties (consultations, training, client meetings, and administrative assignments) is 75/25. Applying this ratio to our 3,148 individually-inspectable locations means our three FTEs can only realistically inspect up to 712 buildings a year (or 237 per FTE), meaning that each building would only receive an inspection once every 4.4 years.

With each FTE performing an average of 237 inspections per year, this is a significant number given that there are only 250 possible working days available per year. In comparison to other site-inspection-oriented organizations, it appears that DRM has performed remarkably well. The Utah Division of Occupational Safety and Health (UOSH) and the United States Occupational Safety & Health Administration (OSHA) generally expect their compliance officers and safety consultants to manage a caseload of approximately 40 cases/inspections annually.[1] While this comparison illustrates the quality and efficiency of the work DRM's life-safety consultants perform each year, we recognize there is always room for improvement.

One effort DRM has recently undertaken is to expand an existing contract with the Utah School Boards Association (USBA). USBA will begin performing regular inspections for the elementary schools for all 41 districts. DRM will still perform inspections in the middle schools and high schools because they present a greater likelihood of substantial claims due to their higher student, faculty, and staff counts and their more inherently dangerous activities.[2]

Table 2 illustrates the number of FTEs Risk would need to have in order to meet a specified annual review schedule. This is based on an annual number of inspections placed at 225 for the average employee working at .75 FTE.

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[1] To be clear, this is a primary function for these entities whose inspections are performed for the purpose of compliance and potential citation. Their inspection reports are often used in administrative and legal enforcement proceedings. DRM's inspections and reports are intended to be used as instructional tools for our insureds, and our internal expectation is that we perform a minimum of 100 inspections per year. At the UOSH/OSHA rate, DRM would not be able complete its facility inspection cycle for over 25 years.

[2] See the Utah State Office of Education site on the CTE Skilled and Technical Sciences site for the types of programs offered: http://schools.utah.gov/cte/sts.

2

DRM's current plan is to schedule inspections for all schools (K-12, and higher education) on a two-year rotation and for low-risk state agency buildings on a three-year rotation. If the Legislature desires a more frequent rotation scheduled, DRM will need to request additional FTEs.

Table 1

Insured Group	Square Footage	Values	Number of Inspectable Buildings/Locations	USBA Assistance	Net
School Districts	87,796,339	$ 15,726,615,963	1138	596	542
Higher Education	32,018,411	$ 7,049,507,366	841	0	841
Charter Schools	2,263,512	$ 431,045,696	79	0	79
State Agencies	15,699,833	$ 3,419,936,924	1686	0	1686
Total	137,778,095	$ 26,627,105,949	3744	596	3148

Table 2

Cycle	Annual Inspections	Employees at .75 FTE	Employees at 1.0 FTE
1 year	3148	14	10.5
2 year	1574	7	5
3 year	1049	5	3.5
4 year	787	3.5	3

2. **We recommend that DRM review all loss prevention activities to determine what combination of activities equates to providing all insureds with necessary guidance.**

While DRM agrees in theory with this recommendation, the nature of DRM's work makes it very difficult to determine what is effective and necessary guidance. On its recent customer survey, DRM's customers rated DRM a 4.43 out of 5. This seems to suggest DRM's customers believe it is effectively and timely responding to their requests for assistance on all their differing types of issues. Additionally, DRM will research whether any best practices exist to help us determine how many other loss-prevention activities equal an inspection. We are currently unaware of any. However, DRM welcomes any specific guidance on ways to improve its services.

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3. **We recommend that DRM establish formal documentation practices to ensure that all loss control activities are recorded consistently to create more reliable metrics.**

   DRM agrees with this recommendation and has already begun efforts to standardize documentation of loss control activities and include requirements to comply in each employee's performance evaluation. Additionally, DRM will establish a policy as to whether multiple buildings on one property are considered one inspection or multiple inspections so that employees' efforts can be more accurately compared.

4. **We recommend that DRM establish a policy that outlines when a self-inspection survey exemption is allowed and document when insureds have received this approval.**

   DRM agrees with this recommendation. While these expectations have been frequently communicated to our insureds in trainings, periodicals and emails, DRM will establish self-inspection survey expectations, consequences, and appropriate surcharge exemptions in a formal written procedure to ensure consistency can be shown.

5. **We recommend that the Legislature consider the two options for satisfying the insureds' fiscal year 2017 DRM insurance premiums obligations and decide if Legislative action is needed. Two options available to remedy this shortfall include the following:**
   - **The insureds could pay the premiums in full, requiring them to make up the difference between what was appropriated through the ISF and other revenues from their budgets; however, this may put a strain on insureds' budget for which they have not prepared**
   - **The Legislature could authorize a supplemental appropriation to cover:**
     A) Either the shortfall of between $1.1 an $1.5 million, and at the same time, readjust the budgets of those insureds that will have excess funds in their budgets because of a lower insurance premium than last year, or
     B) Cover the total shortfall of over $2 million without adjusting the budgets of those insureds that will have excess funds due to their insurance premium being lower than last year's premium.

   DRM agrees with this recommendation.

Sincerely,

Tani P Downing

Tani Pack Downing
State Risk Manager

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