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REPORT TO THE CONGRESS

Administration Of Federal Employees' Group Life Insurance Program By The U.S. Civil Service Commission

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BY THE COMPTROLLER GENERAL OF THE UNITED STATES

FEB. 3,1970

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

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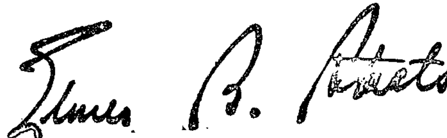
To the President of the Senate and the
Speaker of the House of Representatives

This is our report on the administration of the Federal employees' group life insurance program by the United States Civil Service Commission. Our review was made pursuant to the Budget and Accounting Act, 1921 (31 U.S.C. 53), and the Accounting and Auditing Act of 1950 (31 U.S.C. 67).

Copies of this report are being sent to the Director, Bureau of the Budget, and to the Chairman, United States Civil Service Commission.



Comptroller General
of the United States

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ABBREVIATIONS

BRIOH Bureau of Retirement, Insurance, and Occupational Health, U.S. Civil Service Commission

FEGLI Federal employees' group life insurance

GAO General Accounting Office

COMPTROLLER GENERAL'S REPORT TO THE CONGRESS

ADMINISTRATION OF FEDERAL EMPLOYEES' GROUP LIFE INSURANCE PROGRAM BY THE UNITED STATES CIVIL SERVICE COMMISSION B-125004

D I G E S T

WHY THE REVIEW WAS MADE

About three million Federal employees--active and retired--are insured under the Federal employees' group life insurance program. Most of them participate under a group policy issued to the United States Civil Service Commission by the Metropolitan Life Insurance Company which provides for regular and optional insurance. Some participate under a group policy issued to the Commission by the Shenandoah Life Insurance Company which provides for beneficial association insurance.

Approximately $1.4 billion was paid by the insurance companies to beneficiaries from the inception of the program in 1954 through June 30, 1968.

Approximately $2 billion in premiums was paid to the insurance companies from funds contributed by the Government and its employees to finance the program through June 30, 1968.

Because of the amount of these premiums, the General Accounting Office (GAO) selected certain aspects of the administration of the program for this review. The review did not include evaluations of the actuarial assumptions used by the Commission. GAO will consider these subsequently.

FINDINGS AND CONCLUSIONS

The Civil Service Commission has administered the group life insurance program in a generally satisfactory manner. Certain policy provisions and practices by the insurance companies should be reexamined by the Commission.

The policy with Metropolitan provides for reimbursement of its actual operating expenses for the administrative office of the group life insurance program. It provides also for an annual allowance for "other expenses" of Metropolitan and other insurance companies participating with Metropolitan (reinsurers). From 1954 to June 30, 1968, charges for "other expenses" of about $5.8 million were determined using a fixed percentage of gross premiums. On this basis, the amount charged for "other expenses" would increase, without limitation, in direct proportion to increases in total gross premiums and without regard to the actual expenses incurred.

GAO expressed doubt that the insurance companies would incur a corresponding increase in "other expenses" when gross premiums were increased as a result of Federal employee pay raises, decisions to finance the insurance on a sound actuarial basis, or liberalization of amounts of insurance available to Federal employees. (See p. 20.)

The group policy requires Metropolitan to furnish the Commission an annual accounting of transactions, including the status of the contingency reserve Metropolitan is authorized to hold. The annual accounting does not show the status of certain funds related to the group life insurance program--totaling about $8.5 million--which are held by Metropolitan in addition to the contingency reserve. The policy does not specifically provide for the return to the Commission, in the event of policy discontinuance, of any portion of the funds held outside the contingency reserve to which the program may be rightfully entitled. (See p. 33.)

An employee whose group insurance is terminated, because of separation from his job or certain other conditions, may convert to an individual life insurance policy without proving insurability. The group policy with Metropolitan is charged for the increased mortality risk expected under the individual policies at the rate of $65 for each $1,000 of group insurance converted. The conversion charges are paid into a conversion pool. Although $1.6 million has been distributed to the insurance companies from balances remaining in the pool, the Commission had not made any independent evaluation of the reasonableness of the conversion charge to the program. (See p. 39.)

With respect to the policy with Shenandoah, GAO questioned:

--The equitableness of the method used for charging direct expenses. (See p. 46.)

--The risk charge rate which had remained unchanged since 1956 although Shenandoah's risk was considerably lessened when a contingency reserve fund was established in 1961. (See p. 46.)

--The method used for computing interest earned on the contingency reserve funds held by Shenandoah. (See p. 53.)

Information is included in the report on the following financial management matters:

--Commission reduction, at the Bureau of the Budget's recommendation, of the maximum amount of the interest-bearing contingency reserve held by Metropolitan from $300 million--approximately equal to 1 year's premium when fixed in December 1967--to $200 million beginning July 1, 1968. The $100 million was transferred to the U.S. Treasury for credit to the Employees' Life Insurance Fund in fiscal year 1969, thereby effecting a corresponding reduction in Federal budget expenditures for that year. (See p. 30.)

--Approval by GAO of the group life insurance program's accounting system. (See p. 56.)

--Impact of the expected annual deficits under the beneficial association insurance on the financial status of the regular insurance. (See p. 60.)

--The Commission's audits of operations under the program. (See p. 62.)

RECOMMENDATIONS OR SUGGESTIONS

On the basis of the above findings, GAO made a number of proposals to the Commission aimed at improving administration of program operations. (See pp. 21, 23, 36, 42, 46, 53, and 60.)

AGENCY ACTIONS AND UNRESOLVED ISSUES

The policy with Metropolitan was amended to provide a revised formula for computing the allowance for "other expenses" as well as the risk charge. This resulted in estimated annual savings of about $443,000 in "other expenses" and $744,000 in the risk charge. However, the reduced allowance for "other expenses" is still based on a fixed percentage of gross premiums.

GAO believes that the allowance to Metropolitan for its "other expenses" should be determined on the basis of accounting support and is recommending that the policy be so amended.

Because of the numerous reinsurers and the relatively small portion of the total allowance received annually by each, GAO believes that, with regard to the "other expenses" of the reinsurers, a separate expense allowance expressed as a percentage of gross premiums may be appropriate. GAO is recommending action accordingly. (See pp. 22 to 27.)

The Commission did not believe that the group life insurance program had a vested interest in certain of the funds related to the program which were held by Metropolitan outside the contingency reserve. However, it agreed to review some of the items covered by such funds, where the question of a vested interest by the program was not clear-cut, to determine whether they should be recorded on the records of the Commission.

In GAO's opinion, the Commission's proposed action does not go far enough. GAO believes that there is a need for Metropolitan to report systematically to the Commission concerning all funds related to the

program, including those outside the contingency reserve. In this way, the Commission would be apprised of developments which may warrant attention and be continually aware of items in which the program may have a vested interest.

GAO believes also that the policy should provide that, in the event of the policy's discontinuance, all funds related to the program which are held by Metropolitan outside the contingency reserve and to which the program has a vested interest be returned to the Commission, after all charges accrued under the program have been considered. GAO is recommending appropriate action. (See p. 37.)

The Commission advised GAO that the Commission's staff had reviewed conversion charge studies made by representatives of the conversion pool members and believed that they supported the $65 rate; the Commission believed that further studies on its part would involve extensive evaluations which could only produce borderline cost adjustments, if any. In view of the size of reported distributions to insuring members from the conversion pool, GAO is recommending that the Commission satisfy itself in the near future, through independent evaluation, that the conversion rate constitutes a reasonable charge for the excess mortality risk being borne by the insurers. (See p. 42.)

Concerning the Shenandoah operations:

--The Commission and Shenandoah agreed to combine the provision for the risk charge with the provision for allocation of expenses into a single retention rate which would reduce by about 30 percent Shenandoah's retentions for the expenses of maintenance and operation and the risk charge. GAO has estimated that application of the single retention rate may result in annual savings of about $57,000. Since the expense and risk-charge factors will no longer be separately determinable in Shenandoah's annual accounting to the Commission, GAO is recommending that the Commission periodically satisfy itself as to the reasonableness of the single retention rate. (See pp. 47 to 49.)

--Shenandoah revised its method for computing interest earned on the contingency reserve funds and made adjustments retroactively to 1961 when the contingency reserve was initially authorized by the Commission. The retroactive adjustments resulted in additional interest earnings of $243,840 to the group life insurance program for policy years 1961 through 1967. GAO has estimated that the revised method for computing interest will result in prospective additional earnings of about $39,000 annually. (See p. 54.)

MATTERS FOR CONSIDERATION BY THE CONGRESS

Because of the continuing expressions of congressional concern over the administration of Federal employee benefit programs, GAO is bringing its findings and observations to the attention of the Congress.

Information is included in this report on the relative amount of taxes on insurance premiums paid by the insurance carriers to the various States and other taxing jurisdictions and charged against the group policies under the program. Such taxes totaled about $35 million through June 30, 1968. (See pp. 16 to 18 and p. 49.) This information is presented for possible use by the legislative committees of the Congress in their deliberations on proposed legislation such as House bill 769, ninety-first Congress, which would exempt the insurance premiums under the program from taxation by States and political subdivisions.

CHAPTER 1

INTRODUCTORY COMMENTS

As part of its audit of the activities and financial transactions of the United States Civil Service Commission, the General Accounting Office (GAO) has reviewed selected aspects of the Commission's administration of the Federal employees' group life insurance (FEGLI) program, including its responsibilities related to its group insurance policies with the Metropolitan Life Insurance Company of New York, N.Y., and the Shenandoah Life Insurance Company of Roanoke, Virginia. The scope of our review is described on page 64 of this report.

The FEGLI program was established pursuant to the provisions of the Federal Employees' Group Life Insurance Act of 1954, approved August 17, 1954 (Public Law 83-598) (68 Stat. 736).[1]

The FEGLI program provides group life insurance for active and retired Federal employees. As of June 30, 1968, about 3.1 million active and retired employees were insured under the program through the following three types of insurance:

--Regular insurance (effective August 1954).

--Optional insurance (effective February 1968).[2]

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[1] Pertinent sections, except section 10 relating to beneficial associations (5 U.S.C. 2099, 1964 edition), of the Federal Employees' Group Life Insurance Act of 1954, as amended, were revised and codified as chapter 87 of title 5, United States Code, by enactment of Public Law 89-554, approved September 6, 1966 (80 Stat. 378).

[2] An employee eligible for the regular insurance, who died (or retired and died) between December 16, 1967--the date of enactment of Public Law 90-206 which authorized the optional insurance--and February 14, 1968--the effective date--was automatically covered under the optional insurance.

--Beneficial association insurance (effective January 1956).

A description of the major provisions of the law and regulations, and related explanations, pertaining to the above types of insurance coverage appears as appendix I of this report.

Regular and optional insurance is provided by Metropolitan; insurance for members of certain former employees' beneficial associations is provided by Shenandoah. The insurance is provided under the terms of group policies issued to the Commission by the insurance companies.

The Federal Government and the employees share the cost of the regular insurance; the cost of the optional insurance is borne entirely by the employees. See page 60 with regard to the cost to be assumed by the Employees' Life Insurance Fund under the beneficial association insurance operations. All the insurance is term insurance and carries no loan or cash surrender value.

The Commission administers the FEGLI program through its Bureau of Retirement, Insurance, and Occupational Health (BRIOH). (See p. 55.)

FINANCIAL AND STATISTICAL DATA

Gross premiums paid to the insurance carriers from the inception of the FEGLI program in August 1954 through June 30, 1968, aggregated about $2 billion. During this same period more than 260,000 claims totaling about $1.4 billion were paid to beneficiaries. The excess of contributions by employees and Federal agencies over claims paid and other costs, such as taxes and administrative expenses, and interest earnings on such excess, are being held for future requirements of the FEGLI program. At June 30, 1968, assets available for future requirements of the FEGLI program totaled about $693 million, including reserve funds of about $203 million held by the insurance carriers. (See p. 67.)

Regular insurance

For fiscal year 1968, premium contributions for regular insurance totaled about $247 million--$165 million withheld from employees' salaries and $82 million contributed by their employing agencies. For the same year, Metropolitan paid 28,098 regular insurance claims amounting to about $170 million, of which 26,930 claims amounting to about $160 million were for life insurance and 1,168 claims amounting to about $10 million were for accidental death and dismemberment insurance.

For the group policy year commencing July 1, 1968, about 3.1 million active and retired employees were covered by an estimated $35 billion of regular insurance in force compared with about 2 million employees covered by about $7 billion of regular insurance in force at the inception of the FEGLI program.

Optional insurance

Premium contributions withheld from employees' salaries for their optional insurance coverage totaled about $18.5 million for the portion of fiscal year 1968 during which such insurance was in effect. For the same period, Metropolitan paid 2,710 claims amounting to about $27 million, of which 2,510 claims amounting to about $25 million were for life insurance and 200 claims amounting to about $2 million were for accidental death and dismemberment insurance.

As of July 1, 1968, about 350,000 employees were covered by about $3.5 billion of optional insurance in force.

Beneficial association insurance

During fiscal year 1968, the members of the beneficial associations paid insurance premiums of about $2.8 million directly to the Commission. Shenandoah paid 3,123 beneficial association insurance claims amounting to about $4 million for the policy year ended December 31, 1967.

At June 30, 1968, about 96,000 members were covered by beneficial association insurance, compared with about

136,000 members covered at the time the beneficial association insurance was assumed under the FEGLI program. Group life insurance coverage in force totaled about $154 million and accidental death and dismemberment insurance coverage totaled about $8 million at June 30, 1968.

GROUP INSURANCE POLICY WITH METROPOLITAN LIFE INSURANCE COMPANY

The Federal Employees' Group Life Insurance Act of 1954 authorized the Commission to purchase group insurance policies from a life insurance company or companies that meet certain specified requirements. Pursuant to this authorization the Commission and Metropolitan agreed to a group policy effective August 29, 1954, under which Metropolitan became the prime insurer of the regular insurance. The Commission's group policy with Metropolitan was subsequently amended, effective December 16, 1967, to provide for the optional insurance. The group policy does not provide for a termination date, but it may be canceled by either Metropolitan or the Commission under the conditions specified in the policy.

The principal arrangements under the policy with Metropolitan, as revised effective December 16, 1967, in addition to the provision for regular and optional insurance for Federal employees, are:

1. Reinsurance by Metropolitan with other eligible insurance companies electing to participate in the FEGLI program, as required by law.

2. The establishment of an administrative office--designated the Office of Federal Employees' Group Life Inurance--at the home office of Metropolitan in New York City, responsible for the adjudication and payment of insurance claims.

3. An annual charge of the actual expenses of operating and maintaining the FEGLI office not in excess of 0.6 percent of gross premiums.

4. An annual allowance for "other expenses" in an amount equal to 0.3 percent of the first $190 million

of gross premiums, plus 0.06 percent of the amount in excess of the $190 million of gross premiums.

5. An annual risk charge in an amount equal to 0.4 percent of the first $190 million of gross premiums, plus 0.2 percent of the amount in excess of the $190 million in gross premiums.

6. An annual charge equal to the actual amount of taxes incurred attributable to premiums, insurance in force, or reserves under the insurance policy.

7. Charges at the rate of $65 for each $1,000 of group life insurance converted to an individual life insurance policy by a separated employee without evidence of insurability.

8. The establishment of an interest-bearing contingency reserve fund to be held by Metropolitan for use in the event of adverse fluctuations in claims.

9. Reversion to the employees' life insurance fund of amount of insurance for which valid claim has not been made within 4 years of the death of an insured.

10. The furnishing by Metropolitan to the Commission of an annual accounting of the transactions under the policy, including the status of the contingency reserve, not later than 90 days after the close of the policy year--June 30.

In accordance with the provisions of the group insurance policy, the Commission and Metropolitan have agreed to use a tentative method for determining the amount of insurance premiums payable to Metropolitan. The agreement provides for the Commission to transfer to Metropolitan at semimonthly intervals 99 percent of the sum of (1) the amounts withheld from the pay of employees for group insurance and (2) the amounts contributed by the employing agencies. The Commission retains the remaining 1 percent of the funds from which it pays its administrative expenses which are subject to the annual limitations of the appropriation acts. The excess of insurance premiums over claims and other costs is held by Metropolitan in the contingency

reserve, up to a maximum amount specified by the Commission for that reserve. (See p. 30.)

GROUP INSURANCE POLICY WITH
SHENANDOAH LIFE INSURANCE COMPANY

Pursuant to the authorization contained in section 10 of the Federal Employees' Group Life Insurance Act of 1954, as amended, the Commission and Shenandoah agreed to a group insurance policy, effective January 1, 1956, to provide for the beneficial association insurance coverage. The group policy has no termination date, but it may be canceled by either party under conditions specified in the policy. Shenandoah had previously provided the insurance for 16 of the 27 beneficial associations involved in the Government's assumption of the insurance agreements. The number of insured members in the 16 associations constituted about 85 percent of all the insured members of the 27 associations.

The principal arrangements under the group policy with Shenandoah, as revised effective January 1, 1968, in addition to the provision for group insurance for the members of the beneficial associations, are:

1. An annual allowance to Shenandoah of 2.25 percent of premiums, in lieu of former charges for expenses of maintenance and operation and risk charge.

2. The payment to Shenandoah of the actual amount of taxes incurred attributable to the premiums under the group policy.

3. The establishment of an interest-bearing contingency reserve to be held by Shenandoah in an amount determined by the Commission.

4. The establishment of an interest-bearing premium waiver reserve containing the face amount of the insurance applicable to members who become totally and permanently disabled.

5. The furnishing to the Commission of an annual accounting of Shenandoah's operations under the FEGLI

program not later than 135 days after the close of the policy year--December 31.

Shenandoah bills the Commission quarterly for the gross premiums of the life insurance for all insured individuals and the accidental death and dismemberment insurance for those individuals who have such coverage. The quarterly premium rate billed by Shenandoah in 1968 was $10.25 per $1,000 of group life insurance coverage and $0.15 per $1,000 of accidental death and dismemberment insurance coverage.

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The principal officials of the Commission responsible for the administration of the activities discussed in this report are listed in appendix III.

CHAPTER 2

PROGRAM ADMINISTRATION

In our opinion, the Commission has discharged, in a generally satisfactory manner, its responsibilities for administering the FEGLI program. We believe, however, that the Commission's administration of the FEGLI program could be improved through the strengthening of the management controls over certain aspects of the program. Our findings and recommendations pertaining to these matters, discussed in the following chapters of this report, relate primarily to:

--Requiring accounting support for certain costs charged to the FEGLI program by Metropolitan and presently paid for on the basis of a fixed percentage of gross premiums. (See p. 23.)

--Requiring systematic reporting by Metropolitan to the Commission on funds relating to the FEGLI program which are not included in the accounting for the contingency reserve, and providing for the disposition of any such funds in which the program may have a vested interest, in the event of discontinuance of the group policy. (See p. 33.)

--The desirability of an independent evaluation by the Commission of the reasonableness of the charge provided for under the group policy with Metropolitan when an insured employee converts to an individual life insurance policy. (See p. 39 .)

--The need for the Commission to satisfy itself periodically as to the reasonableness of the amounts being charged under the group policy with Shenandoah for expenses of maintenance and operation and for risk charge. (See p. 46.)

--Appraising the impact of expected annual deficits under the beneficial association insurance on the financial status of the regular insurance. (See p. 60.)

Our findings, observations, and general information on certain financial management aspects of the FEGLI program are presented in the following chapters of this report. They relate to:

--A reduction in the amount of the contingency reserve held by Metropolitan. (See p. 30.)

--Approval by GAO of the accounting system for the FEGLI program. (See p. 56 .)

--Enactment of legislation in December 1967 to provide for financing regular and optional insurance at level cost. (See p. 58 .)

--The Commission's audits of operations under the FEGLI program. (See p. 62 .)

By letter dated June 17, 1969, the Chairman of the Commission provided us with his views on matters contained in a draft of this report. His letter is included as appendix II, and the comments therein have been incorporated in the body of the report where appropriate.

CHAPTER 3

OPERATIONS UNDER

GROUP INSURANCE POLICY WITH METROPOLITAN

Certain salient data tabulated below--on an accrual basis--pertain to the operations under the Commission's group insurance policy with Metropolitan covering the regular and optional insurance of the FEGLI program for the 14th policy year ended June 30, 1968, and for the period from date of issue of the policy in August 1954 through June 30, 1968. Our findings and observations relative to certain aspects of these operations are presented in the ensuing sections of this report.

	For the 14th policy year ended June 30, 1968		For the period from date of issue of group policy in August 1954 through June 30, 1968	
Premiums received by Metropolitan		$261,676,774		$1,975,876,150
Mortality and other claims paid by Metropolitan		$216,440,565		$1,451,071,054
Expense and risk charges received by Metropolitan:				
Taxes to Federal, State, and local governments	$5,344,353		$35,693,689	
Expense of maintenance and operation of Office of FEGLI	518,403		4,805,853	
Allowance for "other expense" and risk charge--distributed as follows:				
Reinsurers' allowances	1,247,454[a]		12,850,513[a]	
Retained by Metropolitan	268,906		2,840,952	
Total expense and risk charges		$ 7,379,116		$ 56,191,007
Premiums in excess of claims paid and expense and risk charges		$ 37,857,093		$ 468,614,089
Interest credited on FEGLI funds held by Metropolitan		$ 9,006,432		$ 68,175,862
Excess premiums and interest returned to Civil Service Commission		$ -		$ 339,926,427[b]

[a]Computed on the basis of percentage of premiums as specified in Reinsurance Agreement.

[b]Over and above amount of excess premiums and interest authorized to be retained by Metropolitan for contingency reserve.

EXPENSE AND RISK CHARGES

The group insurance policy with Metropolitan provides for charging against the policy certain specified expenses and a risk charge. From the inception of the FEGLI program on August 29, 1954, through the 14th policy year ended June 30, 1968, the total of such charges aggregated $56,191,007 as classified in the following table.

	Amount	Percent of total expense and risk charges
Taxes	$35,693,689	63.52
Expense of maintenance and operation of the Office of FEGLI	4,805,853	8.55
Other expenses	5,789,414	10.31
Risk charge	9,902,051	17.62
Total	$56,191,007	100.00

Of the above amounts for "other expenses" and "risk charge" amounting to $15,691,465, the reinsurers received $12,850,513 and Metropolitan retained $2,840,952. (See p. 15.)

Taxes

The group insurance policy with Metropolitan provides for charging against the policy the amount of taxes attributable to insurance premiums, amounts of insurance in force, or reserves under the policy.

Taxes on life, accidental death, and dismemberment insurance premiums are paid by Metropolitan to the 50 States, the District of Columbia, Puerto Rico, and certain Canadian provinces on the basis of the geographical distribution of the annual compensation of the Federal employees within the taxing jurisdictions. Fees, licenses, and assessments of certain State insurance departments and local jurisdictions are also paid by Metropolitan and charged to the FEGLI program.

From August 29, 1954, through December 31, 1957, Federal income taxes of $147,239 were paid on premiums applicable to accidental death and dismemberment insurance. This tax was eliminated as a result of a change in the Internal Revenue Code of 1958.

In congressional hearings leading to the enactment of the Federal Employees' Group Life Insurance Act of 1954, the Under Secretary of the Treasury stated that the payment of taxes on premiums could be avoided by including an appropriate provision in the then-proposed insurance legislation but that he believed the Government and the Federal employees should pay their fair share of State insurance taxes in the same manner as paid by employees and employers in private industry.[1] The law as enacted, did not provide for elimination under the Federal employees' group life insurance program of taxes and other charges levied by States and local jurisdictions against insurance companies.

From the inception of the FEGLI program in August 1954 through June 30, 1968, State taxes on insurance premiums, fees, and licenses of local jurisdictions and Federal taxes on insurance premiums, charged against the group policy with Metropolitan, aggregated $35,693,689 as shown in the following tabulation.

State taxes on insurance premiums	$34,755,431
State and local jurisdiction fees, licenses, and assessments	791,019
Federal taxes on insurance premiums (eliminated after 1957)	147,239
Total taxes	$35,693,689

The following tabulation, prepared from data obtained from the records of Metropolitan for fiscal year 1968, serves to illustrate the relative amounts of taxes on insurance premiums paid to the various States and other taxing jurisdictions under the FEGLI program.

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[1]Page 20 of a transcript of Hearings before the Committee on Post Office and Civil Service, U.S. Senate, 83d Cong. 2d sess., on S. 3507, June 10, 1954.

Taxing jurisdiction	Amount	Percent of total	Taxing jurisdiction	Amount	Percent of total
Alabama	$167,533	3.17	Nebraska	27,070	.51
Alaska	53,472	1.01	Nevada	13,794	.26
Arizona	44,165	.84	New Hampshire	17,076	.32
Arkansas	33,892	.64	New Jersey	124,324	2.36
California	590,780	11.19	New Mexico	54,042	1.02
Colorado	77,047	1.46	New York	387,773	7.35
Connecticut	28,144	.53	North Carolina	69,567	1.32
Delaware	7,606	.14	North Dakota	14,252	.27
Florida	115,114	2.18	Ohio	236,055	4.47
Georgia	106,189	2.01	Oklahoma	176,895	3.35
Hawaii	72,273	1.37	Oregon	47,023	.89
Idaho	22,086	.42	Pennsylvania	250,425	4.74
Illinois	190,129	3.60	Rhode Island	24,244	.46
Indiana	65,588	1.24	South Carolina	47,041	.89
Iowa	34,664	.66	South Dakota	18,998	.36
Kansas	39,924	.76	Tennessee	75,157	1.42
Kentucky	53,752	1.02	Texas	302,946	5.74
Louisiana	40,038	.76	Utah	70,049	1.33
Maine	19,924	.38	Vermont	5,222	.10
Maryland	341,771	6.47	Virginia	376,538	7.13
Massachusetts	122,123	2.31	Washington	94,184	1.78
Michigan	88,000	1.67	West Virginia	27,827	.53
Minnesota	48,006	.91	Wisconsin	38,018	.72
Mississippi	47,773	.91	Wyoming	13,643	.26
Missouri	99,506	1.89	District of Columbia	214,878	4.07
Montana	22,466	.43	Puerto Rico	18,878	.36
			Canadian provinces	863	.02
			Total, fiscal year 1968	$5,278,747	100.00

House bill 769, ninety-first Congress, first session, introduced in the House of Representatives on January 3, 1969, would provide for exempting the insurance premiums under the FEGLI program and the Federal Employees' Health Benefits program from taxation by States and political subdivisions.

The foregoing information as to State taxes on insurance premiums charged against the group insurance policy with Metropolitan, along with information as to such taxes charged against the group policy with Shenandoah (see p. 49), is presented for possible use by the legislative committees of the Congress in their deliberations on House bill 769 or any similar legislation that may be proposed.

Expense of maintenance and operation of the Office of FEGLI

The charges of $4,805,853 shown on page 16 for Metropolitan's maintenance and operation of the Office of FEGLI constituted 0.24 percent of the total gross premiums of about $2 billion paid by the Commission to Metropolitan for the 14 policy years ended June 30, 1968. As previously stated in this report, the ceiling for such charges as set forth in the policy is 0.6 percent of gross premiums.

The charges made by Metropolitan for the maintenance and operation of the Office of FEGLI include (1) expenses incurred directly by the Office FEGLI in connection with, among other things, performing the functions of approving and paying mortality and dismemberment claims under the FEGLI program and corresponding with Government agencies, employees, beneficiaries, and others on claims, conversions, and related matters, (2) expenses incurred by other organizational units of Metropolitan considered attributable to the operations of the Office of FEGLI, such as the expenses of accounting and auditing, certain actuarial services, supervision, printing and duplicating, certain clerical services, and personnel support services, and (3) fees paid for independent legal and other services related to the settlement of claims.

Other expenses

The group insurance policy with Metropolitan provides for charging against the policy an amount representing an annual allowance for "other expenses" in addition to the charges for the actual expenses of operation and maintenance of Metropolitan's Office of FEGLI and the actual taxes incurred. The charges for "other expenses" since the inception of the FEGLI program were based on fixed percentages of the total gross premiums specified in the policy.

The Director, BRIOH, informed us that the allowance for "other expenses" was intended to cover expenses incurred by reinsuring companies for correspondence, maintaining records for preparation of annual statements, and Federal income taxes resulting from their participation in the FEGLI program and additional expenses of Metropolitan

which could not practically be charged as direct expenses to the FEGLI program, such as costs of services of its controller, actuary, and other executives participating in the administration of FEGLI and of services of legal staff and data processing and computer operations supporting the above. Except for the first policy year ended November 20, 1955, Metropolitan distributed two thirds of the amount charged for "other expenses" to itself and the various reinsurers--numbering 332 in policy year ended June 30, 1968--in proportion to each insurer's share of the insurance in force under the group policy. The remaining one third was retained by Metropolitan. For the first policy year, Metropolitan received an added allowance, which, according to an official of Metropolitan, was intended to cover start-up costs.

The distribution of the total amount of $5,789,414 charged for "other expenses" in the 14 policy years beginning in August 1954 and continuing through June 30, 1968, follows.

Reinsurers' share of "other expenses"		$3,591,347
Metropolitan's share of "other expenses":		
Pro rata share determined on basis of amount of insurance in force	$ 245,723	
Remainder retained by Metropolitan	1,952,344	2,198,067
Total charges for "other expenses" through June 30, 1968		$5,789,414

Possible adverse effect of allowance for "other expenses" based on fixed percentage of premiums

During our review, we raised certain questions with the Commission regarding the reasonableness of the allowance for "other expenses" on the basis of a fixed percentage of

gross premiums. We pointed out that on this basis the amount charged for "other expenses" would increase without limitation, in direct proportion to increases in total gross premiums, and without regard to the actual expenses incurred. We expressed doubt that the insurers would incur a corresponding increase in "other expenses" in situations where gross premiums were increased as a result of Federal employees' pay raises or because of a decision, such as was later made, to finance the regular insurance of the FEGLI program on a sound actuarial basis or to liberalize the amounts of insurance available to Federal employees.

We pointed out to the Commission that, if the maximum life insurance coverage available to Federal employees were to be increased to one and one third of their annual basic salaries plus an additional $2,000, as proposed in legislation pending at that time, the corresponding increase in the charge to the FEGLI program for "other expenses" would total about $288,000 annually--$96,000 for Metropolitan and $192,000 for distribution among all the insurers.

Since neither the number of covered employees nor the number of claims filed would have been affected by the proposed liberalization of insurance coverage, we questioned the merit of any increase in the charge for "other expenses" on the basis of such liberalization. We suggested that the Commission consider the need for a limitation on the total charges for "other expenses" if they were to be based on a fixed percentage of gross premiums, in order to preclude unrestricted future increases unrelated to actual costs involved.

In response to our inquiry, the Director, BRIOH, advised us by letter dated November 30, 1966, that, although the increases in the dollar amounts of "other expenses" which had occurred as of that time were considered reasonable, the policy provisions affecting "other expenses" would be reexamined, along with other policy provisions similarly affected, if legislation were subsequently enacted substantially changing the amount of insurance in force or the premium rate.

Amendment of group insurance policy to reduce allowance for "other expenses"

The Postal Revenue and Federal Salary Act of 1967 (Public Law 90-206) (81 Stat. 613), which was enacted in December 1967, provided for, among other things in title IV, (1) a minimum of $10,000 in regular insurance, plus an increase of $2,000 to a maximum of $32,000[1] in regular insurance, (2) optional insurance in the larger of $10,000 or an amount which, when added to the regular insurance, equals an employee's annual pay, and (3) financing the regular and optional insurance on the basis of level cost.[2]

Following the enactment of Public Law 90-206, the Commission's group insurance policy with Metropolitan was amended in April 1968, to provide that, effective July 1, 1967, the annual charge for "other expenses" would be reduced from 0.3 percent of annual gross premiums to 0.3 percent of the first $190 million of gross premiums (the amount of premiums for fiscal year 1967) plus 0.06 percent of gross premiums in excess of $190 million. On the basis of annual premiums of about $375 million for the policy year ended June 30, 1969, the reduction in the percentage rate used to arrive at the amount of the allowance for "other expenses" resulted in savings of about $443,000 for that year. The amount of the annual savings in subsequent years will be dependent on the amount of the gross premiums for those years.

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[1] Public Law 90-206 also provided that, to the extent that the annual rate of basic pay for positions at level II of the Executive Schedule under 5 U.S.C. 5313 was increased, then the maximum amount of regular insurance was to be automatically increased correspondingly. Accordingly, coincident with the increase in the annual rate of such basic pay from $30,000 to $42,500, the maximum amount of regular insurance was increased to $45,000 effective on the first day of the first period beginning after February 14, 1969. (See 115 Cong. Rec. H 403-405; H. Doc. 91-51.)

[2] Level cost equals the constant premium for each $1,000 of insurance which, when supplemented by interest earnings on a fund created by the excess of premiums over insurance benefits and administrative and other costs, will pay for the benefits in perpetuity.

Although the amendment to the group insurance policy will result in reducing the allowance for "other expenses," it should be noted that the allowance will continue to increase, without limitation, as gross premiums increase, although at a much lower rate than prior to the policy amendment. The establishment of an allowance for "other expenses" on the basis of a fixed percentage of gross premiums, without relation to the actual costs incurred for the activities intended to be financed, may be unfair to the Government or to Metropolitan.

Officials of Metropolitan informed us that the costs to be financed by the "other expenses" allowance were not readily identifiable and that a fixed rate for "other expenses" was specified in the policy to eliminate detailed recordkeeping. Metropolitan took the position that attempts to furnish accounting support for "other expenses" would lead to endless misunderstandings and differences of opinion as to methods of allocating overhead expenses, which would materially increase expense charges as well as auditing expenses. We noted, however, that Metropolitan was maintaining detailed expense records consistent with the policy provision for the reimbursement of the actual costs incurred for its Office of FEGLI.

Because of the lack of specific accounting support, we were unable to determine whether the amounts paid to Metropolitan and the reinsuring carriers for "other expenses"--$5.8 million from inception of program through June 30, 1968--were fair and reasonable.

In order to protect the interests of both the Government and the insurance carriers by reasonably ensuring that expenses of the FEGLI program are reimbursed on a fair and equitable basis, we proposed to the Commission in a draft of this report that all amounts charged by Metropolitan as reimbursement for expenses should be limited to necessary expenses incurred under the FEGLI program, determined on a reasonable and equitable basis with appropriate accounting support. We stated, however, that, if the Commission determined that it would not be feasible to require accounting support for expenses incurred by the more than 330 reinsurers under the FEGLI program and believed that, as far as the reinsurers were concerned, an expense allowance based

on a fixed percentage of gross premiums would achieve equitable results, the group policy should at least provide for such reinsurers' expense allowance subject to a limitation on the total amount of premiums to be considered in computing this allowance.

Agency comments and our evaluation

The Chairman of the Commission, by letter to us dated June 17, 1969 (app. II), stated that on several occasions the Commission had previously studied the possibility of changing the allowance for "other expenses" from a flat percentage of premiums to an amount determined on a cost-finding basis. The Chairman stated also that the Commission had concluded that such a change was impracticable because the cost of developing and keeping records necessary to identify the numerous administrative expenses of the many reinsuring companies--by class of policy, operating functions, and overhead--would, in its opinion, be out of proportion to the expenses in question. The Chairman stated further that Metropolitan was able to maintain detailed records for expenses of the Office of FEGLI because the physical and functional separation of this office from other activities of Metropolitan simplified the identification of those expenses but that neither Metropolitan nor any of the reinsuring companies had a system that provided for allocating miscellaneous "other expenses" to individual policies.

We noted, however, that Metropolitan was actually providing accounting support for certain direct and indirect costs charged to the FEGLI program which were incurred outside the Office of FEGLI established to administer the FEGLI program. We noted further that the Commission's contracts with the carriers for the Government-wide employees' service (Blue Cross-Blue Shield) and indemnity (Aetna Life Insurance Company) health benefit plans provided that administrative expenses under the contracts be the necessary incurred expenses determined on an equitable and reasonable basis with proper justification and accounting support. Therefore, we believe that a change in the basis for the allowance for "other expenses" to Metropolitan from a fixed percentage of premiums to a cost-finding basis may be practicable.

The Chairman of the Commission was of the opinion that such a limitation as we proposed for making the reinsurers' expense allowance subject to a limitation on the total amount of premiums to be considered in computing the allowance, would not recognize the rapidly rising salary and other costs. He pointed out that the adjustment, effective July 1, 1967, in the allowance for "other expenses," which reduced the percentage of premiums allowed for such expenses from 0.3 percent to 0.06 percent of premiums exceeding $190 million annually (see p. 22), resulted in a rate, on premiums in excess of $190 million, which is now only one fifth of the rate on premiums below that level. No further action by the Commission was indicated.

We believe that--in view of the numerous reinsurers that share in the "other expenses" allowance under the Commission's group policy with Metropolitan, the relatively small portion of the total allowance received annually by each of the reinsurers, and the Commission's opinion that the costs to such reinsurers of keeping records identifying their actual expenses incurred under the FEGLI program would be out of proportion to the costs involved--a separate reinsurers' expense allowance, expressed as a percentage of gross premiums, may be appropriate. We noted that the Commission's policies with Aetna under the Federal employees' health benefits program also provided for a reinsurers' expense allowance based on a fixed percentage of premiums.

Recommendation to the Chairman
U.S. Civil Service Commission

We recommend that the Commission initiate action to amend the group insurance policy with Metropolitan (1) to provide that all amounts to be charged by Metropolitan as reimbursement for its expenses be limited to necessary expenses incurred under the FEGLI program, determined on an equitable and reasonable basis with proper justification and accounting support and (2) to provide a separate reinsurers' expense allowance expressed as a percentage of gross premiums, which the Commission believes should result in a fair and reasonable allowance for such expenses.

Risk charge

The group insurance policy with Metropolitan provides for charging against the policy an amount representing an annual risk charge. The annual risk charges since the inception of the FEGLI program have been based on fixed percentages of the total gross premiums specified in the policy. Metropolitan distributed the amounts received for risk charge among the various reinsurers and itself in proportion to each insurer's share of the insurance in force under the group policy.

The distribution of $9,902,051 charged for risk from the inception of the FEGLI program in August 1954 through June 30, 1968, is shown by policy years in the following tabulation.

Policy year ended	Total risk charge	Metropolitan's share of risk charge	Reinsurers' share of risk charge
Nov. 1955	$ 676,200	$ 55,973	$ 620,227
" 1956	591,900	50,351	541,549
" 1957	625,500	50,212	575,288
" 1958	672,600	53,740	618,860
" 1959	582,500	44,510	537,990
" 1960	628,000	44,229	583,771
June 1961	402,321	26,438	375,883
" 1962	692,196	45,486	646,710
" 1963	738,786	43,776	695,010
" 1964	775,910	44,462	731,448
" 1965	806,080	44,409	761,671
" 1966	857,916	46,555	811,361
" 1967	948,788	48,287	900,501
" 1968	903,354	44,458	858,896
Total charges for risk through June 30, 1968	$9,902,051	$642,886	$9,259,165

Amendment of group insurance policy to reduce risk charge

The Director, BRIOH, in a letter dated November 30, 1966, responding to our inquiry regarding certain questionable aspects of the allowance for "other expenses," informed us that the group policy provisions affecting the risk charge would be reexamined along with the allowance for "other expenses" if legislation should be enacted substantially changing the amount of insurance in force or the premium rate.

The amendment to the group policy approved by the Commission and Metropolitan following enactment of title IV of the Postal Revenue and Federal Salary Act of 1967, in addition to providing for a reduction of the annual charge for "other expenses" (see p. 22), provided that, effective July 1, 1967, the annual risk charge be reduced from 0.5 percent of total gross premiums to 0.4 percent of the first $190 million of gross premiums, plus 0.2 percent of gross premiums in excess of $190 million. On the basis of annual premiums of about $375 million for the policy year ended June 30, 1969, the reduction in the rate used to arrive at the amount of the risk charge resulted in savings of about $744,000 for that year. The amount of annual savings in subsequent years will be dependent upon the amount of the gross premiums for those years.

REINSURANCE

The group insurance policy with Metropolitan provides, in accordance with the Federal Employees' Group Life Insurance Act of 1954, that Metropolitan reinsure portions of the total insurance under its policy. The insurance law requires, subject to certain limitations, that the amount of reinsurance of each participating insurer be based on the total amount of each insurer's group life insurance in force in the United States at the end of the most recent calendar year. The Commission is authorized to determine the amount of each reinsurer's portion of the reinsurance in advance of the policy year.

The number of life insurance companies participating as reinsurers under the Metropolitan group policy increased substantially from 161 companies at the inception of the program in August 1954 to 332 companies for the 14th policy year ended June 30, 1968. Included among the 332 companies were eight Canadian companies, all of which were licensed to do business in the United States.

The distribution of Federal employees' group insurance to Metropolitan, as the prime insurer, and the reinsuring life insurance companies for each policy year since inception of the program, is summarized below.

Policy year ended	Estimated total regular life insurance in force (billions)	Number of reinsurers	Metropolitan's percentage of insurance in force	Reinsurers' percentage of insurance in force
Nov. 1955	$ 7.0	161	(8.27753[a] (8.50675[b]	(91.72247[a] (91.49325[b]
" 1956	9.0	159	8.50675	91.49325
" 1957	10.5	161	8.02745	91.97255
" 1958	11.0	165	7.98994	92.01006
" 1959	12.0	169	7.64115	92.35885
" 1960	12.5	179	7.04276	92.95724
June 1961	14.0	206	6.57127	93.42873
" 1962	14.0	205	6.57127	93.42873
" 1963	15.0	225	5.92534	94.07466
" 1964	16.6	237	5.73035	94.26965
" 1965	18.1	253	5.50930	94.49070
" 1966	18.5	269	5.42652	94.57348
" 1967	21.0	313	5.08927	94.91073
" 1968	31.5	332	4.92148	95.07852

[a]In effect through April 9, 1955.

[b]In effect from April 10, 1955, through the end of the policy year.

Each reinsurer receives from Metropolitan, according to its share of the total amount of group life insurance in force, a proportionate share of the amounts charged by Metropolitan, under the group policy, for other expenses and for risk charge.

The 25 largest reinsurers under the Metropolitan group policy are shown below together with data on their proportionate shares of the regular and optional insurance carried for the policy year ended June 30, 1968. The tabulation also shows the percentage of insurance carried by the remaining 307 reinsurers and Metropolitan, as well as the total amounts of reinsurers' allowances for "other expenses" and risk charge received under the group policy for the year ended June 30, 1968.

Insurance Company	Percentage of insurance in force under the group policy	Reinsurers' allowances
Prudential Insurance Company of America	3.72184	
Equitable Life Assurance Society of the United States	3.22728	
Aetna Life Insurance Company	3.15604	
Travelers Insurance Company	3.00796	
John Hancock Mutual Life Insurance Company	1.97340	
Connecticut General Life Insurance Company	1.52865	
Occidental Life Insurance Company of California	1.12511	
Continental Assurance Company	.98070	
New York Life Insurance Company	.93093	
Provident Life and Accident Insurance Company	.81166	
Minnesota Mutual Life Insurance Company	.80428	
Lincoln National Life Insurance Company	.76414	
General American Life Insurance Company	.71507	
Bankers Life Company	.69706	
Massachusetts Mutual Life Insurance Company	.67124	
League Life Insurance Company	.65555	
California-Western States Life Insurance Company	.63778	
Pacific Mutual Life Insurance Company	.63603	
Mutual Benefit Life Insurance Company	.63365	
United Benefit Life Insurance Company	.63135	
Allstate Life Insurance Company	.63024	
State Mutual Life Assurance Company of America	.60994	
Northwestern National Life Insurance Company	.60351	
Union Labor Life Insurance Company	.59373	
Pilot Life Insurance Company	.58589	
Percentage of insurance in force carried by the 25 largest reinsurers and total amount of their reinsurers' allowances	30.33303	$ 397,977
Percentage of insurance in force carried by 307 other reinsurers and total amount of their reinsurers' allowances	64.74549	849,477
Percentage of insurance in force ceded by Metropolitan to all reinsurers and the total amount of the reinsurers' allowances	95.07852	$1,247,454
Percentage of insurance in force held by Metropolitan	4.92148	
Total	100.00	

CONTINGENCY RESERVE HELD BY METROPOLITAN

In accordance with the Federal employees' group life insurance law, the group insurance policy provides for the retention of an interest-bearing contingency reserve by Metropolitan up to an amount determined by the Commission to be satisfactory to meet adverse fluctuations in future charges under the policy. The contingency reserve consists of the excess of the cumulative premiums plus interest earnings over the cumulative mortality and other claim charges and the expense and risk charges, reduced by the cumulative excess premiums and interest returned to the Commission. Metropolitan is required to furnish the Commission an annual accounting of the transactions under the group policy, including the status of the contingency reserve, not later than 90 days after the end of each policy year. A summary, prepared by us, of Metropolitan's statements of annual accounting for the 14 policy years ended June 30, 1968, is shown as schedule 3 of this report.

Funds in excess of the maximum contingency reserve authorized by the Commission are paid by Metropolitan to the Commission for deposit to the credit of the Employees' Life Insurance Fund in the U.S. Treasury. In December 1956 the Commission authorized Metropolitan to retain a maximum contingency reserve of $100 million. The Commission increased the maximum amount of the contingency reserve to $150 million in December 1964 and to $300 million in December 1967. Each of these amounts was fixed as being approximately equal to 1 year's premiums at that time.

However, in December 1968 the Commission reduced the maximum amount of the contingency reserve beginning with fiscal year 1969 to $200 million. This action was taken at the recommendation of the Bureau of the Budget to effect what the Bureau considered an equitable balance between the fiscal requirements of the Federal Government and the operating and investment requirements of Metropolitan. Premiums for policy year 1969 totaled about $375 million, which would make the new level of the contingency reserve equal to somewhat less than three fifths of a year's premiums.

As a result of this change, $100 million which otherwise would have been part of the contingency reserve held by

Metropolitan was transferred to the U.S. Treasury in fiscal year 1969 for credit to the Employees' Life Insurance Fund, thereby effecting a corresponding reduction in Federal budget expenditures for that fiscal year.

For the 14 policy years ended June 30, 1968, funds paid by Metropolitan to the Commission in excess of the authorized amount of the contingency reserve aggregated about $334 million. In addition, $5.9 million of interest was applied by Metropolitan toward premiums due from the Commission prior to July 1, 1964.

In the event of termination of the group policy, Metropolitan is required to pay to the Commission any balance remaining in the contingency reserve, after all allowable charges have been made, subject to the right of Metropolitan to return the reserve funds in equal monthly installments over a period of not more than 2 years.

Interest earned on FEGLI funds held by Metropolitan

The Commission's group insurance policy with Metropolitan provides that the contingency reserve bear interest at a rate (contractual interest rate) to be determined in advance of each policy year by Metropolitan. The contractual interest rate for each policy year ended on June 30 has been the average of the annual interest rate declared by Metropolitan's Board of Directors for similar reserves held under other group life insurance policies for each of the 2 calendar years within which the policy year falls. The annual contractual interest rate has ranged from 2.5 percent for the first policy year to 4.4 percent for the 14th policy year ended June 30, 1968.

Metropolitan's Board of Directors authorizes annually, on a calendar year basis, an amount of additional interest to be credited to the group policy in addition to the interest credited to the contingency reserve at the contractual interest rate. The additional interest represents a pro rata share of Metropolitan's investment earnings generated through the use of FEGLI funds in excess of (1) the amount of contractual interest earned and (2) amounts retained by Metropolitan for certain operating requirements.

Prior to July 1, 1964, Metropolitan called the additional interest a dividend and applied such dividends toward the premiums due from the Commission. Beginning with the 11th policy year ended June 30, 1965, the additional interest earnings have been shown as part of the FEGLI program funds held by Metropolitan in its annual accounting statement under the group insurance policy.

Interest earnings credited to the group policy for the 14th policy year ended June 30, 1968, and for the 14 policy years from August 29, 1954, through June 30, 1968, as classified by Metropolitan, are shown in the following table.

	For the 14th policy year ended June 30, 1968	For the 14 policy years from August 29, 1954, through June 30, 1968
Interest earned at contractual rate	$7,432,856	$57,491,995
Additional interest earned (commencing with 11th policy year)	1,573,576	4,739,377
Dividends (additional interest) earned prior to July 1, 1964	-	5,944,490
Total interest earned	$9,006,432	$68,175,862

FUNDS RELATING TO THE FEGLI PROGRAM HELD BY METROPOLITAN OUTSIDE THE CONTINGENCY RESERVE

As previously stated (see p. 30), Metropolitan is required under the group insurance policy to furnish the Commission an annual accounting of the transactions under the group policy, including the status of the contingency reserve. However, this annual accounting does not show the status of certain funds relating to the FEGLI program which are held by Metropolitan and which are not part of the contingency reserve. In addition, we noted that the group policy did not specifically provide for the return to the Commission, in the event of discontinuance of the group policy, of any portion of such funds to which the FEGLI program may be rightfully entitled.

At June 30, 1966, Metropolitan held $186.1 million of funds related to the FEGLI program. However, the annual accounting to the Commission for the period ended at the above date, prepared in accordance with the provisions of the group policy, showed the status of only $177.6 million of FEGLI funds and did not cover $8.5 million retained by Metropolitan and included in its "investment contribution balance" for the FEGLI department. The investment contribution balance is the excess of cash income from premiums received from the Commission, investments, and other sources over cash disbursements for claims, administrative expenses, taxes, and other expenditures. Monthly investment contribution balances are used by Metropolitan as a basis for determining the group policy's pro rata share of Metropolitan's investment income.

The difference of $8.5 million between the amount shown on Metropolitan's statement of annual accounting and contingency reserve and the investment contribution balance for the FEGLI department at June 30, 1966, represented funds in the investment contribution balance retained by Metropolitan to cover FEGLI's pro rata share of (1) certain estimated liabilities, (2) investment fluctuation reserves, (3) deferred income, and (4) certain assets of Metropolitan, less accrued income on investments. This $8.5 million

also included unallocated surplus funds. A summary of these retained funds follows.

Estimated liabilities:		
Unpaid installments on optional settlements of insurance claims	$5,720,000	
Accrued expense and risk charges	1,277,413	
Suspended insurance claims pending submission by beneficiaries of necessary documents	683,787	
Unallocated expenses	115,433	
Anticipated expenses of investigations and settlements of claims	77,934	
Real estate taxes and related investment expenses	23,975	
Federal income taxes on investment income	22,484	$7,921,026
Investment fluctuation reserves	1,400,000	
Deferred income	243,630	
Miscellaneous assets	138,720	1,782,350
		9,703,376
Less accrued income on investments		1,726,749
		7,976,627
Surplus		522,490
Total		$8,499,117

Our explanatory comments follow concerning the larger items shown in the above summary.

The liabilities of (1) $5,720,000 for unpaid installments on optional settlements of insurance claims and (2) $683,787 for insurance claims suspended pending submission of necessary documents were included as paid claims in Metropolitan's annual accounting to the Commission.

The liability of $1,277,413 for accrued expense and risk charges, included in Metropolitan's annual accounting

to the Commission as "other expenses and risk charges" incurred, included $1,135,906 payable to insurance companies participating in the FEGLI program as reinsurers for their proportionate share of other expenses and risk charges and $141,507 payable to Metropolitan.

The liability of $115,433 for unallocated expenses consisted of FEGLI's pro rata share of expenses incurred by Metropolitan but not distributed to the applicable expense accounts as of the close of the annual accounting period under the policy.

According to Metropolitan, (1) the purpose of the investment fluctuation reserves, of which the FEGLI share was estimated by Metropolitan to be $1,400,000 at June 30, 1966, is to enable Metropolitan to meet its obligations to policyholders even though it may incur losses on its investment portfolio, (2) the amounts of these reserves are determined by Metropolitan's Board of Directors for the company as a whole, subject to requirements established by the National Association of Insurance Commissioners, and (3) the amounts allocated as the FEGLI share thereof are determined in the same way as those for the other departments of the company.

The deferred income of $243,630 consisted primarily of FEGLI's pro rata share of the excess of unamortized discounts over unamortized premiums on mortgage loans.

The miscellaneous assets of $138,720 consisted of the pro rata share of FEGLI's interest in sundry investments and receivables and furniture and equipment.

FEGLI's share of accrued income on investments totaling $1,726,749 consisted of accrued interest receivable on mortgages and bonds amounting to $1,529,164; accrued rents, dividends, and other investment income amounting to $17,286; and the excess of the admitted[1] value of stocks

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[1]Admitted value relates to the value of the assets of an insurer permitted by a State to be taken into account in determining the insurer's financial condition. Generally, the admitted value of stocks is fair market value. The admitted value of bonds may be either amortized value or fair market value.

and bonds over their recorded book value, amounting to $180,299.

The surplus of $522,490 was the residual amount after all allocations of the FEGLI funds of $186.1 million retained by Metropolitan as of June 30, 1966, had been made. As stated on page 31 of this report, Metropolitan authorizes annually on a calendar year basis, an amount of additional interest to be credited to the group policy. The amount of additional interest authorized as of December 31 of a calendar year serves to reduce the residual surplus of the investment contribution balance.

In a draft of this report, we proposed that the Commission arrange with Metropolitan for annual reports on the status of all funds relating to the FEGLI program which Metropolitan is holding, whether they represent premiums remitted to the company by the Commission or allocated income on company investments which have been generated by premium income.

We believe that the Commission should receive reports on all funds relating to the FEGLI program because such reports would assist in keeping the Commission apprised, on a current basis, of developments under the FEGLI program which may warrant its attention and consideration in administering program activities. For example, a steady escalation in the amounts of suspended insurance claims, not presently apparent from Metropolitan's annual accounting statements, may indicate a need for revising claims settlement procedures in order to improve the quality of service to beneficiaries.

We proposed further that the Commission initiate action to amend the group insurance policy with Metropolitan to provide for the return to the Commission, upon discontinuance of the policy, not only of the balance remaining in the contingency reserve, but also of any additional funds remaining in the investment contribution balance of the FEGLI department, to which the FEGLI program may be rightfully entitled, after considering all charges accrued under the program. We stated that by such action the Government's interest in such remaining funds would be clearly defined in the event of termination of the group policy.

Agency comments and our evaluation

The Chairman of the Commission, by letter to us dated June 17, 1969 (app. II), stated that the Commission did not consider that the FEGLI program had a vested interest in the funds relating to the FEGLI program held by Metropolitan outside the contingency reserve, such as the funds covering the estimated liability of $5,720,000 for unpaid installments on optional settlements of insurance claims. (See p. 34.) The Chairman stated also that such optional settlements were made by the insurer with the beneficiaries and were not obligations of the FEGLI program.

The Chairman stated further, however, that there were some other smaller items, described previously in this section (see pp. 34 to 36), where the question of a vested interest by the FEGLI program might not be so clear-cut. He advised us that the Commission would review these items individually to further consider the question of whether they should be recorded on the financial records of the Commission.

In our opinion, the action proposed by the Commission does not go far enough to fully protect the interests of the Government under the FEGLI program. In order to be continually aware of the type of items included in Metropolitan's investment contribution balance for the FEGLI program, in which the FEGLI program may have a vested interest, there still remains, in our opinion, a need for Metropolitan to report systematically to the Commission on all funds relating to the FEGLI program which Metropolitan is holding outside the contingency reserve. Such reporting will also enable the Commission to more effectively administer the program activities, as discussed on page 36.

To facilitate an orderly liquidation of program activities in the event of discontinuance of the policy, we believe that the group insurance policy should be amended to provide that, in such event, all funds relating to the FEGLI program which are held by Metropolitan outside the contingency reserve and to which the FEGLI program has a vested interest be returned to the Commission, after consideration of all charges accrued under the FEGLI program.

Recommendations to the Chairman, U.S. Civil Service Commission

Accordingly, we recommend that the Commission (1) arrange with Metropolitan for the submission of an annual report on funds relating to the FEGLI program held by Metropolitan outside the contingency reserve, (2) identify the types of items covered by such funds in which the FEGLI program has a vested interest, and (3) enter into negotiations with Metropolitan for amending the group insurance policy to provide that, in the event of discontinuance of the group policy, all funds relating to the FEGLI program held by Metropolitan outside the contingency reserve and to which the FEGLI program has a vested interest be returned to the Commission, after consideration of all charges accrued under the FEGLI program.

CONVERSIONS TO INDIVIDUAL LIFE INSURANCE POLICIES

In accordance with the Federal employees' group life insurance law and the provisions of the Commission's group insurance policy with Metropolitan, an employee may convert his insurance, at his option, to an individual life insurance policy, without a medical examination or other evidence of insurability, when he is separated from Government civilian service or enters into active military service, or upon the expiration of 12 months in a continuous nonpay status.

The former employee's written application for the individual policy and the payment of the first premium must be made within 31 days after employment ceases (or within such longer period as the insurer may allow). Premiums for the individual life insurance policy are based on the former employee's attained age and class of risk. The insurance policy may be obtained from Metropolitan or from any insurance company which has been accepted by the Commission as being eligible to issue individual policies in the jurisdiction in which the former employee resides.

The group policy provides that the increased mortality risk which may be expected under the individual life insurance policies issued to separated employees without medical examination, be charged against the group policy at the rate of $65 for each $1,000 of group life insurance converted. In the event that a converted policy is terminated, no portion of the $65 charge is refunded to the Commission.

The number of conversions, the total amount of group life insurance converted to individual policies, and the amount of conversion charges assessed against the group policy, for the calendar years 1954 through 1967, on the basis of the records maintained by Metropolitan, are set forth in the following tabulation.

Calendar year	Conversions to individual policies: Number	Conversions to individual policies: Amount of insurance	Conversion charges assessed to FEGLI program
1954	328	$ 1,178,007	$ 76,570
1955	2,689	9,141,644	594,207
1956	3,708	13,090,777	850,900
1957	3,131	11,015,227	715,990
1958	2,939	10,095,187	656,187
1959	2,233	8,784,577	570,998
1960	2,333	9,608,692	624,565
1961	1,516	7,429,547	482,921
1962	2,031	9,551,169	620,826
1963	1,559	7,440,805	483,652
1964	1,566	7,896,049	513,243
1965	1,340	7,430,170	482,961
1966	1,343	7,714,441	501,439
1967	1,470	8,607,184	559,467
Total	28,186	$118,983,476	$7,733,926

The conversion charges of $65 for each $1,000 of converted insurance assessed against the group policy for the expected excess mortality costs are paid into a conversion pool which was established in 1955 with Metropolitan as agent for those insuring companies which issued individual life insurance policies to former employees.[1] A separate pool account is maintained for each calendar year of issue. Each insurer which issues an individual policy also contributes to the conversion pool on the basis of a prescribed schedule of charges consisting of a one-time initial charge and annual charges normally for each of the succeeding 10 years.

The stated purpose of the conversion pool is to provide for an equitable distribution among the insurers, totaling 95 members at June 30, 1968, of the risk of excess mortality

[1]Prior to the establishment of the conversion pool, group life insurance of about $1,133,000 was converted to individual life insurance policies which were underwritten primarily by Metropolitan without participation by other insurance companies. The conversion charges relating to these policies totaled $73,669.

losses as a result of the conversion from group life insurance to individual policies. The risk of loss under a converted policy is assumed by the conversion pool normally for a period of 10 years from the date of issuance of the policy. At the end of the 10-year period, the risk of loss is assumed by the issuing insurance company. In the event of the death of an insured individual within the 10-year period, the conversion pool pays to the member insurer the net amount of the risk--the face value of the policy less the accumulated cash surrender value--and the member insurer settles directly with the beneficiary.

Upon the expiration of 10 years, any funds remaining in the conversion pool account for a particular year of issue, after the satisfaction of all obligations, are divided among the member insurers in proportion to each member's share of the conversion pool for the particular year of issue. Similarly, member insurers would be charged a pro rata share of any deficit resulting from operations of the conversion pool for a particular year of issue. The FEGLI program does not participate in the distribution of conversion pool funds or in any deficits which the conversion pool may incur.

The results of operations of the conversion pool, prepared from data furnished by Metropolitan, for the first 13 calendar years beginning in 1955 and continuing through 1967 are summarized below.

Income to conversion pool:		
From the FEGLI program ($65 for each $1,000 of converted group insurance)		$ 7,660,257
From insuring members of conversion pool:		
Conversion pool account for 1955 calendar year	$ 847,915	
Conversion pool account for 1956 calendar year	867,722	
Conversion pool account for 1957 calendar year	884,791	
Conversion pool accounts for 1958 through 1967 calendar years	4,192,812	6,793,240
Interest earned on conversion pool funds		1,928,392
Total conversion pool funds available		16,381,889
Disbursements from conversion pool:		
Individual policy insurance claims paid		9,719,919
Administrative expenses		423,261
Distribution of conversion pool funds to insuring members upon expiration of 10 years' experience:		
Conversion pool account for 1955 calendar year (distributed in 1966)	469,998	
Conversion pool account for 1956 calendar year (distributed in 1967)	314,998	784,996
Total conversion pool funds disbursed		10,928,176
Undisbursed pool fund balance at December 31, 1967		$ 5,453,713

An official of Metropolitan informed us that the rate of $65 for $1,000 of converted insurance, established in 1954, was based upon comparable rates charged at that time to other large group policyholders. The most recent study developed by a technical subcommittee representing conversion pool members indicated that this $65 charge was not excessive.

An official of the Commission informed us that the Commission's staff had reviewed the reports on studies submitted by the technical subcommittee. He stated his belief that the subcommittee had supported the $65 rate, but informed us that the staff had not made any independent evaluations of the reasonableness of the conversion charge.

Conversion charges totaling $7,733,926 were assessed against the group policy for the period 1954 through December 31, 1967. In addition, as shown in the preceding tabulation on the results of operation of the conversion pool, funds totaling $784,996 remained in the 1955 and 1956 pool accounts--$469,998 in the 1955 account and $314,998 in the 1956 account--after providing for outstanding obligations, and were distributed, as tentative settlements of the accounts, to the insuring members in 1966 and 1967, respectively. In May and June 1968, the insuring members received additional distributions of conversion pool funds totaling $805,679--$30,679 in final settlement of the 1955 account and $775,000 in tentative settlement of the 1957 account.

Because of the sizable distributions made on pool accounts for years completed, we expressed the view in a draft of this report that the Commission's actuarial staff should satisfy itself from time to time that the $65 conversion charge was based on reasonable actuarial assumptions and conclusions and that such rate did not result in surplus amounts subsequently divided among member insurers.

In his letter to us dated June 17, 1969 (app. II), the Chairman of the Civil Service Commission stated that there was no way to ensure that there would be no residual surplus amounts to be divided among companies sharing in converted insurance--likewise there was no way to ensure that there would be no losses to be divided. In was also his opinion that further studies by the Commission--in addition to the

reviews made by the Commission staff of the studies conducted by the technical subcommittee for the conversion pool--would involve extensive evaluations which could only produce borderline cost adjustments, if any.

Although we are not in a position to dispute the Commission's conclusions, it seems that the conversion pool operations would warrant close scrutiny if sizable distributions to insuring members continue to be made year after year.

Recommendation to the Chairman, U.S. Civil Service Commission

In view of the size of the distributions made to insuring members from the conversion pool to date, we recommend that the Commission satisfy itself in the near future, through independent evaluation, that the conversion rate under the group insurance policy constitutes a reasonable charge for the excess mortality risk being borne by the insurers.

CHAPTER 4

OPERATIONS UNDER

GROUP INSURANCE POLICY WITH SHENANDOAH

Tabulated below are certain salient data--prepared on an accrual basis--pertaining to the operations under the Commission's group insurance policy with Shenandoah, covering the beneficial association insurance of the FEGLI program for the 12th policy year ended December 31, 1967, and for the 12-year period from date of issue of the policy, effective January 1, 1956, through December 31, 1967. Our findings and observations relative to certain aspects of these operations are presented in the ensuing sections of this report.

	For the 12th policy year ended December 31, 1967	For the 12 policy years from January 1, 1956, through December 31, 1967
Premiums received by Shenandoah	$6,155,653	$57,724,230
Mortality and other claims paid by Shenandoah	4,364,359	40,465,871
Expense and risk charges received by Shenandoah	249,495	2,400,892
Premiums in excess of claims paid and expense and risk charges	1,541,799	14,857,467
Interest credited on FEGLI funds held by Shenandoah	366,883	1,632,842
Excess premiums and interest returned to Civil Service Commission	1,908,682	10,490,309[a]

[a]Over and above amount of excess premiums and interest authorized to be retained by Shenandoah for contingency reserve.

EXPENSE AND RISK CHARGES

The group insurance policy with Shenandoah provided, through December 31, 1967, for Shenandoah to charge against the policy certain specified expenses and a risk charge.

From the first policy year beginning January 1, 1956, through the 12th policy year ended December 31, 1967, the total charges for expenses and risk charge aggregated $2,400,892, as classified below.

	Amount	Percent of total expense and risk charges
Expenses of maintenance and operation	$1,071,567	44.63
Risk charge	865,863	36.07
Taxes	463,462	19.30
Total	$2,400,892	100.00

The charges of $1,071,567 shown above for maintenance and operation under the group policy constituted 1.86 percent of the total gross premiums of about $57.7 million paid by the Commission to Shenandoah for the 12 policy years ended December 31, 1967.

The group policy with Shenandoah provided for Shenandoah to charge against the policy, among other things, the actual expenses (direct and indirect) of maintenance and operation of the beneficial association insurance, but not more than 2 percent of gross insurance premiums. During the first 5 policy years, from 1956 to 1960, Shenandoah charged directly or indirectly against the policy a portion of the salaries and other expenses incurred by its various operating units. By a policy amendment, effective January 1, 1961, however, provision was made to charge indirect expenses at the fixed rate of 66-2/3 percent of direct expenses, with the understanding that the classification of expenses was to be the same as that used prior to the effective date of the amendment.

The risk charge, which aggregated $865,863 for the 12 policy years ended December 31, 1967, was set at an amount equal to 1.5 percent of gross premiums effective January 1, 1956.

Questions raised on amounts charged for expenses of maintenance and operation and risk charge

Expenses of maintenance and operation--Shenandoah charged certain direct expenses under the group policy on the basis of the ratio of the number of group insurance certificates under the policy to the total number of all Shenandoah group certificates in force. Our review indicated that less time was expended on a per certificate basis in the maintenance and operation of the group policy for the beneficial association insurance than was expended on other Shenandoah group policies. Therefore, in a report to the Commission on February 19, 1968, we questioned the equitableness of Shenandoah's method for charging the direct expenses referred to above.

In the same report we expressed the view that the method provided under the group policy of reimbursing Shenandoah for indirect expenses by an amount equal to 66-2/3 percent of direct expenses was generally undesirable. We pointed out that the payment for indirect or overhead costs by means of a fixed percentage of direct costs could be unfair to the Government or the insurer because, most likely, it would not result in the reimbursement of actual costs.

Risk charge

An amendment to the group insurance policy, effective January 1, 1961, authorized Shenandoah to retain a contingency reserve to provide for possible adverse fluctuations in future charges under the policy. (See p. 50.) The contingency reserve, presently established at $6 million, approximately equivalent to the total of 1 year's premiums, may be used by Shenandoah for the payment of claims and other charges in excess of the insurance premiums received.

We noted, however, that the risk charge rate specified in the group policy had remained unchanged since 1956 although the risk to Shenandoah under the group policy was considerably lessened when the contingency reserve fund was established. Therefore, in our report of February 19, 1968, we recommended that the Commission look into the possibility of obtaining an appropriate reduction in the risk charge in view of the availability of the contingency reserve which was not in existence at the time the risk charge was established.

Agency action

In response to the questions raised and recommendations made in our report to the Commission, the Commission's Executive Director advised us by letter dated October 25, 1968, that the Commission had entered into an agreement, effective January 1, 1968, with Shenandoah to combine the provision for risk charge (1.5 percent of gross premiums) with the provision for allocation of both direct and indirect expenses (amounted to about 1.7 percent of gross premiums for calendar year 1967) into one rate of 2.25 percent of premiums. He commented that the rate of 2.25 percent would (1) reduce by about 30 percent Shenandoah's retentions for the expenses of maintenance and operation and the risk charge and (2) eliminate the problems inherent in allocating indirect expenses on the basis of a fixed percentage of direct costs.

The Commission's Executive Director stated also that the Commission's position had been conservative regarding retentions allowed Shenandoah in relation to what Shenandoah would have been making on the same insurance policies if the Government had not established the FEGLI program. He said that, in negotiating the group insurance policy with Shenandoah in 1955, the Commission had reduced the amount of premiums Shenandoah retained for administrative expense and risk charge by more than 20 percent compared with premiums Shenandoah retained for such purposes under the individual beneficial association insurance policies which the Commission's group insurance policy superseded.

On the basis of the results of Shenandoah's financial operations under the group policy for calendar year 1967,

it appears that adoption of the new single retention rate of 2.25 percent of premiums will result in significant prospective annual savings. Application of the single retention rate to calendar year 1967 operations would have resulted in reducing the program costs relative to Shenandoah's expenses of maintenance and operation and the risk charge for that year by about $57,000, or approximately 30 percent.

Depending upon the amount of annual insurance premiums and Shenandoah's incurred direct expenses of maintenance and operation under the group policy, the actual reduction in retentions by Shenandoah for calendar year 1968 and subsequent years resulting from the adoption of the single retention rate of 2.25 percent of insurance premiums may be more or less than the annual savings of approximately 30 percent indicated by the financial operations for calendar year 1967.

Although the agreement entered into between the Commission and Shenandoah to establish a single retention rate apparently will result in a significant reduction of prospective retentions by Shenandoah covering the expenses--direct and indirect--of maintenance and operation and the risk charge, the expense and risk-charge factors will no longer be separately determinable in Shenandoah's annual accounting to the Commission.

We believe that the amounts charged by Shenandoah as reimbursement for its expenses under the beneficial association operations should be limited to necessary expenses determined on a reasonable and equitable basis with proper justification and accounting support. However, in view of the limited availability of the beneficial association insurance (see p. 78), the diminishing number of insureds (see p. 8), and the recent agreement entered into between the Commission and Shenandoah apparently resulting in a substantial reduction in retentions by Shenandoah, we believe that the use of the single retention rate may be acceptable. We believe, however, that the Commission should periodically satisfy itself as to the reasonableness of the amounts being charged through a single retention rate for expenses of maintenance and operation and the risk charge.

Recommendation to the Chairman,
U.S. Civil Service Commission

We recommend that the Commission periodically satisfy itself as to the reasonableness of the amounts being charged under the group insurance policy through the single retention rate.

Taxes

The group insurance policy with Shenandoah provides for charging against the policy the amount of taxes directly attributable to insurance premiums under the policy.

Taxes on insurance premiums are paid by Shenandoah to 13 States and the District of Columbia in which Shenandoah is licensed to do business. The amount of tax payable to an individual State is determined generally by applying the tax rate of the State to the total amount of premiums applicable to the insured individuals who reside in the State.

Insurance premium taxes of $409,911 were paid by Shenandoah to the 13 States and the District of Columbia for the 11 policy years from January 1, 1956, through December 31, 1966, as shown in the following tabulation.

State	Amount	Percent of total
Alabama	$ 8,811	2.15
Delaware	1,399	.34
District of Columbia	123,927	30.23
Florida	16,770	4.09
Georgia	10,875	2.65
Kentucky	5,090	1.24
Maryland	62,701	15.30
North Carolina	9,026	2.20
Ohio	22,626	5.52
Pennsylvania	72,956	17.80
South Carolina	8,340	2.04
Tennessee	6,411	1.56
Virginia	56,156	13.70
West Virginia	4,823	1.18
Total	$409,911	100.00

States taxes accrued for the policy year ended December 31, 1967, totaled $53,551.

CONTINGENCY RESERVE HELD BY SHENANDOAH

By an amendment to the group insurance policy, effective January 1, 1961, Shenandoah was authorized to retain an interest-bearing contingency reserve in an amount to be determined by the Commission to be satisfactory to meet adverse fluctuations in future charges under the policy. A maximum contingency reserve of $6 million, approximately equivalent to the total of 1 year's premiums, was authorized by the Commission in December 1964.

The contingency reserve held by Shenandoah is composed of the excess of premiums received from the Commission over mortality and other claim charges and expense and risk charges, plus interest earnings credited to the reserve. Funds in excess of the authorized contingency reserve of $6 million are paid by Shenandoah to the Commission for deposit to the credit of the Employees' Life Insurance Fund in the U.S. Treasury. Prior to January 1, 1961, the effective date of the policy amendment authorizing the contingency reserve, Shenandoah was required to return to the Commission the excess of premiums over mortality and other claim charges and expense and risk charges for each policy year. For the 12 policy years ended December 31, 1967, funds paid to the Commission in accordance with the above arrangements totaled about $10.3 million.

Shenandoah is required to furnish the Commission an annual accounting of the transactions under the group policy, including the status of the contingency reserve, not later than 135 days after the end of each policy year. A summary prepared by us, of Shenandoah's statements of annual accounting for the 12 policy years ended December 31, 1967, is shown as schedule 4 of this report.

The group policy requires that, in the event of discontinuance, Shenandoah shall pay to the Commission any balance remaining in the contingency reserve after all allowable charges have been made. Shenandoah has the right, however, to make such payment in equal monthly installments, with interest, over a period of not more than 2 years.

Interest earned on FEGLI funds held by Shenandoah

The amendment to the group insurance policy, effective January 1, 1961, authorizing the contingency reserve provides for Shenandoah to pay interest on the mean average amount of the contingency reserve at a rate to be determined by Shenandoah and approved by the Commission. The premium waiver reserve (see p. 11), which amounted to $321,086 at December 31, 1967, bears the same rate of interest as that of the contingency reserve. The policy amendment also provides that the amounts of excess contingency reserve funds and interest due to the Commission at the end of the policy year shall bear interest until the date of payment.

The Commission and Shenandoah agreed in 1961 that the rate of interest on the contingency reserve for each policy year would consist of a guaranteed rate which would be the same as the contractual rate received from Metropolitan under the group policy for the regular insurance, plus an additional rate equal to the lesser of (1) the rate of the additional interest received from Metropolitan for the policy year (see p. 31) or (2) the rate of investment income earned by Shenandoah on its mean assets during the policy (calendar) year, as reported in Shenandoah's annual statement to State insurance departments, less the guaranteed rate.

From January 1, 1956, the effective date of the group policy, through the 12th policy year ended December 31, 1967, interest earnings on the contingency reserve and premium waiver reserve held by Shenandoah totaled $1,632,842, including $366,883 for the 12th policy year ended December 31, 1967. A summary of the interest earnings, as classified by Shenandoah, is presented in the following tabulation.

	For 12th policy year ended December 31, 1967	From January 1, 1956, through 12th policy year ended December 31, 1967
Interest earned on contingency reserve (commencing January 1, 1961):		
At guaranteed rate	$297,920	$1,329,629
At additional rate	30,469	123,553
On excess contingency reserve funds, determined at end of policy year, to date of payment	22,818	42,456
Interest earned on premium waiver reserve	15,676	137,204
Total	$366,883	$1,632,842

Removal of limitation on rate of interest payable on reserve funds

The 1961 agreement between the Commission and Shenandoah had the practical effect of limiting the total interest rate payable by Shenandoah on both the contingency reserve and the premium waiver reserve to the lesser of the total rate paid by Metropolitan on the contingency reserve of the regular insurance or the rate earned by Shenandoah on its mean (average) assets as reported in its annual statement to State insurance departments.

The rate of investment income earned by Shenandoah on its mean assets during calendar year 1961 exceeded the rate of interest paid by Metropolitan on the contingency reserve of the regular insurance for that year. However, in accordance with the provisions of the agreement with the Commission, Shenandoah paid the Government interest at the lower rate paid by Metropolitan. For the policy years 1962 through 1966, the rate of investment income earned by Shenandoah was less than the rate of interest paid by Metropolitan, and Shenandoah paid interest based on its own earning rate.

We considered this arrangement to be inequitable because it did not always result in the payment of interest based on Shenandoah's own earning rate. We discussed with officials of the Commission and Shenandoah the possibility of having Shenandoah pay interest on the contingency reserve fund at a rate equal to the rate of investment income which it earned on its mean assets.

The Commission and Shenandoah subsequently agreed that, for policy years beginning with 1968, the rate of interest paid by Shenandoah on the contingency reserve (and the premium waiver reserve) would be equal to the rate of investment income earned by Shenandoah on its mean assets as reported in its annual accounting statement to State insurance departments, without regard to the rate of interest paid by Metropolitan.

Additional interest income obtained through revision of method of computation

Certain insurance premium funds paid by the Commission to Shenandoah were not considered for the appropriate period of time in the computation of interest earned on the contingency reserve funds held by Shenandoah. As a result such funds, in effect, were held by Shenandoah on an interest-free basis.

The Commission's group insurance policy with Shenandoah, as amended effective January 1, 1961, specifies that interest shall be computed as of the end of each policy year (December 31) on the mean amount of the contingency reserve during the year at the interest rate applicable for that policy year.

Shenandoah determined the mean amount of the contingency reserve to be one half the sum of the reserve balances at the beginning and at the end of the policy year. The amount used as the reserve balance at the beginning of the year was the lesser of (1) the actual amount of the contingency reserve, including interest earnings thereon, at the close of the preceding year or (2) the authorized maximum amount of $6 million. The reserve balance used at the end of the policy year consisted of the reserve balance at the beginning of the year, plus the excess of insurance premiums paid to Shenandoah over claim charges and expense and risk charges made for the year.

Since insurance premiums were due and payable at the beginning of each quarter of the year, the amount of the quarterly premium due and payable on January 1 was not included in the contingency reserve fund balance at the beginning of the year. Therefore, premium funds equivalent to one quarterly insurance premium, which averaged about $1.5 million in 1967, in effect, did not earn interest for a period of about 6 months during each policy year.

The above situation was brought to the attention of the Commission's Executive Director in our report to the Commission dated February 19, 1968, wherein we recommended that Shenandoah be requested to revise its method for

computing interest earned on the contingency reserve fund to give appropriate effect to the full time during which insurance premiums under the Commission's group policy were available to Shenandoah. We also recommended that Shenandoah be requested to recompute the interest earnings for the applicable prior years in accordance with such revised method and make appropriate refunds to the Commission.

The Commission's Executive Director advised us by letter dated October 25, 1968, that Shenandoah had agreed to revise the basis for computing interest on the contingency reserve to include the quarterly premium payment in the balance of the reserve at the beginning of the year, effective January 1, 1968, and that appropriate adjustments would be made retroactive to 1961, when the contingency reserve fund was initially authorized by the Commission.

Shenandoah's retroactive adjustments were voluntarily agreed to although its method of computing interest was not in violation of the provisions of the group policy. These retroactive adjustments based on the revised method for computing interest on the contingency reserve resulted in additional interest earnings of $243,840 for policy years 1961 through 1967. From Shenandoah's operations under the group policy for the 1967 policy year, we have estimated that the revised method for computing interest will also result in prospective additional interest earnings of about $39,000 annually.

CHAPTER 5

FINANCIAL MANAGEMENT ASPECTS

OF FEGLI PROGRAM

The Commission's Bureau of Retirement, Insurance, and Occupational Health at its headquarters office in Washington, D.C., is responsible for administering the FEGLI program in accordance with the Federal employees' group life insurance law. The Bureau is responsible for, among other things, (1) contracting with private insurance carriers to provide the benefits authorized and, when necessary, negotiating amendments to the contracts, (2) preparing regulations and procedures for employees, retirees, and employing agencies, (3) answering inquiries and advising employees and retirees of their rights, privileges, and benefits, (4) receiving and accounting for employees', retirees', and agencies' contributions, (5) determining obligations and authorizing payments to the insurance carriers, (6) developing and maintaining financial and statistical data for management use and for annual reporting to the Congress, and (7) auditing and reporting on the operations of the insurance carriers.

The Bureau's Claims Division reviews insurance claims paid by Metropolitan, and its Office of Systems and Audits performs audits and makes reports on Metropolitan's and Shenandoah's financial transactions under the insurance policies.

The contributions collected from insured employees and the employing agencies are deposited by the Commission in the Employees' Life Insurance Fund in the U.S. Treasury. The fund is available, without fiscal year limitation, for the payment of premiums under the group insurance policies and for the payment of administrative expenses and other charges of the insurance carriers and of the Commission in the administration of the FEGLI program. Funds not immediately needed in the operations of the FEGLI program are invested by the Secretary of the Treasury in interest-bearing securities of the United States. At June 30, 1968, the Secretary of the Treasury had invested about

$484 million in interest-bearing securities of the United States. The average interest yield on U.S. Treasury securities held by the Employees' Life Insurance Fund during fiscal year 1968 was about 4.35 percent.

The financial statements for the FEGLI program for fiscal year 1968, consisting of a statement of financial condition at June 30, 1968, and a statement of income and expense for the year then ended, are shown as schedules 1 and 2 of this report. The statements were prepared by the Commission, and minor modifications were made by us for the sake of clarity. (See pp. 67 to 68.)

Our comments on certain significant financial management aspects of the FEGLI program are presented below. These matters relate to (1) approval of the accounting system for the FEGLI program, (2) enactment of legislation to provide for financing regular and optional insurance at level cost, (3) the loss resulting from the assumption of beneficial association life insurance agreements, and (4) the Commission's audits of operations under the FEGLI program.

APPROVAL OF ACCOUNTING SYSTEM FOR FEGLI PROGRAM

In furtherance of our interest in the financial management practices of Federal agencies, we made a number of suggestions to the Commission aimed at improving its accounting and reporting for the operations under the FEGLI program.

In line with such suggestions, the Commission, during our review, made certain revisions in its accounting and reporting procedures in order to provide full disclosure of the financial results of the FEGLI program activities. The more significant revised procedures provided for recording in the program financial records and including in the financial statements:

--The actuarial estimates of net future program costs[1] and the resultant effect on the net investment in each type of insurance under the program. The actuarial estimates of the net future program costs at June 30, 1968, totaled about $739 million--$690 million on the regular insurance, $-14 million on the optional insurance (see note b, p. 67), and $63 million on the beneficial association insurance (including the estimated loss as of that date of $46 million resulting from the assumption of the life insurance agreements of beneficial associations). (See p. 67.)

--The program assets held by the insurance carriers as contingency reserves. At June 30, 1968, these funds totaled about $203 million, of which $197 million was held by Metropolitan and $6 million was held by Shenandoah. (See p. 67.)

In addition, the interest received on the contingency reserve funds held by the insurance carriers is now considered interest income instead of return on insurance premiums as was previously the Commission's practice. In our opinion, this is the preferable accounting treatment. Such interest income amounted to $9.4 million for the fiscal year ended June 30, 1968. (See p. 68.)

After reviewing and testing the Commission's accounting system for the FEGLI program in operation, we approved the system on November 25, 1968, as being adequate and in conformity with the principles, standards, and related requirements of the Comptroller General.

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[1]The actuarial estimate of net future FEGLI program costs represents the present value of the excess of anticipated insurance claims and related costs applicable to current active and retired employees over anticipated premium income from the employees and their employing agencies.

LEGISLATION ENACTED TO PROVIDE FOR FINANCING REGULAR AND OPTIONAL INSURANCE AT LEVEL COST

In a prior report to the Congress on our review of certain aspects of the operations of the FEGLI program (B-125004, May 16, 1962), we recommended, among other things, that the Congress consider adopting the level cost[1] principle as the basis for establishing premium rates for the regular insurance and authorize the Commission, on the basis of a cost-sharing ratio specified by the Congress, to revise preimum rates as the need arose in the future.

Whenever the level cost rate exceeds the premium rate, a deficiency or unfunded liability arises which continues to increase from year to year. An actuarial valuation made by the Commission as of June 30, 1965, indicated that the biweekly level cost of the regular insurance was 45.5 cents for each $1,000 of insurance, or 8 cents more than the then-current total biweekly premium of 37.5 cents. The Commission estimated that the deficiency at June 30, 1965, totaled about $912 million. The estimated deficiency had increased to about $1.1 billion at June 30, 1967.

The Commission primarily attributed the deficiency in level cost to certain amendments to the group life insurance law, which liberalized eligibility for continued insurance coverage without corresponding increases in premium rates.

The level cost principle for financing the regular and optional insurance was adopted by the Congress through enactment of Title IV, Public Law 90-206, approved December 16, 1967 (81 Stat. 646), which requires, in part, that the contribution rate for regular insurance cover the level cost of the insurance, as determined by the Commission, and be shared two thirds by the employees and one third by the Government. On the basis of this law, the Commission determined the biweekly level cost of the regular insurance to be 41.5 cents for each $1,000 of insurance. It established the current biweekly contribution rate for each $1,000 of insurance at 27.5 cents for employees and at one half of this

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[1]See note 2 on p. 22 for definition of level cost.

amount for the Government. With regard to the optional insurance, the same law authorized the Commission to deduct the full cost from employees' salaries and retirees' annuities without any contribution by the Government. (See p. 77.)

The enactment of the above legislation and its implementation by the Commission has accomplished the objectives of our earlier recommendation to the Congress.

However, there still remains the problem of financing the loss to the FEGLI program, resulting from the assumption by the Employees' Life Insurance Fund, of employees' beneficial associations' life insurance agreements, pursuant to section 10 of the Federal Employees' Group Life Insurance Act of 1954, as amended. (See p. 78.) This matter is discussed further in the following section.

LOSS RESULTING FROM ASSUMPTION
OF BENEFICIAL ASSOCIATION
LIFE INSURANCE AGREEMENTS

When the assumption by the Employees' Life Insurance Fund of the life insurance agreements of certain employees' beneficial associations was authorized in 1954, the insurance obligation of these associations exceeded the sum of their assets and anticipated future premiums by approximately $33 million on the basis of actuarial computations. The comparable deficiency of the program as of June 30, 1968, was estimated by the Commission to be $46 million.

In the report of the Senate Committee on Post Office and Civil Service (S. Rept. 686, 84th Cong., 1st sess., dated June 28, 1955), on an amendment to the Federal Employees' Group Life Insurance Act of 1954, it was indicated that no additional appropriations to cover the loss under the beneficial association insurance operations were then required and it was anticipated that the added cost of this insurance could be financed from the Employees' Life Insurance Fund as then constituted.

As of June 30, 1968, the net assets of the Employees' Life Insurance Fund attributable to the beneficial association insurance totaled about $16.9 million, including $6 million held as a contingency reserve by Shenandoah. However, each year since the fiscal year ended June 30, 1968, the annual income from beneficial association insurance operations has been insufficient to cover the expenditures involved in providing the insurance. For example, operations under the beneficial association insurance resulted in a loss of about $1.3 million during fiscal year 1968. See schedule 2.) Consequently, assets pertaining to the beneficial association insurance operations are being gradually diminished and eventually will be exhausted if the operating losses continue to be incurred.

The Commission has advised us that the assets of the beneficial association insurance probably will not be sufficient to cover actual disbursements beginning in fiscal year 1974. The Commission has also advised us that at the present time it has no plans for requesting appropriations to

finance the accumulating deficit under the beneficial association insurance operations.

On the basis of projections of pertinent income and expense factors furnished us by Shenandoah covering an estimated 35-year remaining life and of other related information supplied by the Commission, the cash deficit in the beneficial association insurance operations will aggregate about $91 million over such estimated remaining life.

We were informed by an official of the Commission that the estimated cumulative deficiency for the beneficial association insurance had not been included in any estimates of level cost for the regular insurance and that, if such deficiency were to be borne by the regular insurance, the impact would not be significant. The official indicated that he did not believe that the optional insurance would be expected to bear any part of the deficit.

Conclusion

Although, according to Shenandoah's estimates, the beneficial association insurance operations are expected to terminate in approximately 35 years, these operations will apparently begin to generate cash deficits in fiscal year 1974. Such deficits will reduce the funds which would otherwise be available in the Employees' Life Insurance Fund and also will result in a loss of interest earnings on such funds.

If, because of the impact of these annual deficits, the contributions for regular insurance should no longer cover the level cost of the insurance as required by law, the Commission would be required to arrange for additional financing--either through appropriations or increased contributions--in order to maintain the level cost principle.

Recommendation to the Chairman, U.S. Civil Service Commission

Therefore, in order for the Commission to be in a position to appraise the impact of these deficits on the integrity of the level cost principle for the regular insurance, we recommend that the Commission include the deficiency of

the beneficial association insurance in its periodic actuarial valuations for the regular insurance.

The Chairman of the Commission advised us by letter dated June 17, 1969 (app. II), that the Commission saw no particular problem in considering the beneficial association insurance deficiency in its periodic actuarial valuations for the regular insurance.

COMMISSION'S AUDITS OF OPERATIONS UNDER FEGLI PROGRAM

We found that the Commission's audit efforts under the FEGLI program consisted of (1) periodic external audits performed by the Office of Systems and Audits of BRIOH, directed mainly toward verifying the accuracy and fairness of the accounting statements submitted by the insurance carriers to the Commission, (2) review made by the Claims Division of BRIOH of the insurance claims paid by Metropolitan, and (3) internal audits of the Commission's annual financial statements of the FEGLI program.

The external audits have included review of pertinent administrative procedures and internal controls of the insurance carriers and examination into expense charges, mortality and other claim charges, and interest credited by the insurance carriers under the provisions of the group policies. However, there were no independent reviews or evaluations made by the Commission's internal auditors of the activities relating to the Commission's negotiation of the insurance policies, or amendments thereto, or to BRIOH's general administration of the program activities.

In our prior report to the Congress on the review of the Commission's internal auditing activities (B-160759, March 20, 1967), we expressed the view that the scope of the Commission's internal audit program should give recognition to the need for review of the external audit work, as well as the contract negotiation and administration activities of the Commission, from an internal audit standpoint, in the same manner as for other Commission activities, to ascertain on behalf of top management, whether they are being carried out properly and effectively.

The benefits to be derived from such independent internal reviews are apparent from the findings of our audit wherein we questioned:

--The reasonableness of negotiated provisions of the group policies pertaining to such matters as the allowance for "other expenses" and the risk charge. Downward adjustments were subsequently made in these program costs. (See pp. 20, 26 and 46.)

--The method of computation of interest earned on the contingency reserve funds held by one of the carriers. The method was subsequently revised resulting in additional interest income to the FEGLI program. (See p. 53.)

In addition, we pointed out a need for:

--Revised reporting to the Commission under one of the group insurance policies to cover funds relating to the FEGLI program and for amending the policy to specify the disposition of certain FEGLI funds held outside the contingency reserve in the event of termination of the group policy. (See p. 36.)

--Determining the reasonableness of the fixed charge set forth in the group policy covering conversions by separated employees to individual policies. (See p. 42.)

--Including the deficiency of the beneficial association insurance in the Commission's periodic actuarial valuations for the regular insurance. (See p. 61.)

Subsequent to the completion of our review, the Director of the Commission's internal audit organization informed us that a review of the external audit and management aspects of the FEGLI program was to be included as part of an internal audit of the activities of BRIOH which was started in June 1969.

CHAPTER 6

SCOPE OF REVIEW

Our review was directed toward an evaluation of the effectiveness of the Commission's management controls over the FEGLI program, including its responsibilities related to its group insurance policies with the Metropolitan Life Insurance Company--the insurer of the regular and optional insurance--and the Shenandoah Life Insurance Company--the insurer of the beneficial association insurance. The review did not include evaluations of the actuarial assumptions used by the Commission.

We reviewed the basic legislation authorizing the FEGLI program and the policies and procedures established by the Commission for the administration of the program. We also reviewed pertinent records, reports, and documents, and interviewed officials of the Commission, Metropolitan, and Shenandoah concerning various aspects of FEGLI program operations. We examined into, among other things, (1) the reasonableness of the negotiated provisions of the Commission's group insurance policies with Metropolitan and Shenandoah, (2) the equitableness of the allocations of costs charged by the insurers against the Commission's group insurance policies, and (3) the propriety of the methods used by the insurers in computing interest earned on FEGLI funds held by them. We also examined the Commission's audit reports and related working papers pertaining to the FEGLI program.

Our review was performed at the headquarters office of the Commission in Washington, D.C., at the offices of Metropolitan in New York, N.Y., and at the offices of Shenandoah in Roanoke, Virginia.

SCHEDULES

U.S. CIVIL SERVICE COMMISSION

FEDERAL EMPLOYEES' GROUP LIFE INSURANCE PROGRAM

STATEMENT OF FINANCIAL CONDITION

JUNE 30, 1968

	Regular insurance	Optional insurance	Beneficial association insurance	Total insurance program
ASSETS				
CASH	$ 9,842,550	$ 1,701,643	$ 116,800	$ 11,660,993
U.S. GOVERNMENT SECURITIES:				
Par value	484,456,500	-	10,691,500	495,148,000
Unamortized discount	-10,696,409	-	-266,833	-10,963,242
CONTINGENCY RESERVES HELD BY INSURANCE CARRIERS	196,863,524	-	6,000,000	202,863,524
WITHHOLDINGS AND CONTRIBUTIONS RECEIVABLE	19,503,933	3,412,295	-	22,916,228
ACCOUNTS RECEIVABLE:				
Interinsurance segment	14,323,915	-	-	14,323,915
Other	42,898	-	680,005	722,903
ACCRUED INTEREST RECEIVABLE	4,717,791	-	258,428	4,976,219
Total assets	$ 719,054,702	$ 5,113,938	$ 17,479,900	$ 741,648,540
LIABILITIES				
ACCOUNTS PAYABLE:				
Insurance carriers	$ 29,000,000	$ 5,000,000	$ -	$ 34,000,000
Interinsurance segment	-	14,323,915	-	14,323,915
Other	20,998	-	23,003	44,001
PREMIUMS COLLECTED IN ADVANCE	-	-	576,113	576,113
ACCRUED ANNUAL LEAVE	10,809	-	9,918	20,727
Total current liabilities	29,031,807	19,323,915	609,034	48,964,756
ACTUARIAL ESTIMATES OF NET FUTURE PROGRAM COSTS	690,022,895	-14,209,977	62,905,866	738,718,784
Total liabilities	719,054,702	5,113,938	63,514,900	787,683,540
SURPLUS (DEFICIT-)				
BALANCE, JULY 1, 1967	-1,100,000,000	-	-44,400,000	-1,144,400,000
NET OPERATING INCOME (LOSS-), FISCAL YEAR 1968 (schedule 2)	84,047,434	-14,209,977[b]	-1,331,537	68,505,920
ADJUSTMENT TO ACTUARIAL ESTIMATES	1,015,952,566	14,209,977	-303,463	1,029,859,080
DEFICIT JUNE 30, 1968 (note a)	-	-	-46,035,000	-46,035,000
Total liabilities and surplus	$ 719,054,702	$ 5,113,938	$ 17,479,900	$ 741,648,540

[a]The deficit of $46,035,000 at June 30, 1968, consists of the excess of the actuarial estimates of net future program costs of $738,718,784 over the net assets of the insurance program of $692,683,784 (assets of $741,648,540 less liabilities of $48,964,756). With respect to the regular insurance segment, the deficit of $1.1 billion at July 1, 1967, was eliminated during fiscal year 1968 as a result of an increased employee-agency contribution rate instituted in February 1968 pursuant to Public Law 90-206 which requires, in part, that the contributions cover the level cost of the regular insurance. (See p. 58.)

[b]The net loss of $14, 209,977 on the optional insurance operations for 1968 was due to the nonrecurring free insurance for all Federal employees eligible for regular insurance for a 2-month period. Current rates should recoup this loss in future years, so that there is no actual deficit.

GAO note: This statement, prepared by the Civil Service Commission with minor modifications made by GAO for sake of clarity, has not been audited by GAO.

SCHEDULE 2

U.S. CIVIL SERVICE COMMISSION

FEDERAL EMPLOYEES' GROUP LIFE INSURANCE PROGRAM

STATEMENT OF INCOME AND EXPENSE

FOR THE FISCAL YEAR ENDED JUNE 30, 1968

	Regular insurance	Optional insurance	Beneficial association insurance	Total insurance program
INCOME:				
Withholdings from salaries and annuities	$164,501,982	$18,471,626	$ -	$182,973,608
Agency contributions	82,239,336	-	-	82,239,336
Premiums collected	-	-	2,749,536	2,749,536
Interest earned on U.S. Government securities	19,680,613	-	418,083	20,098,696
Operations under group insurance policies:				
Excess of premiums over claims and other costs	51,904,738	-14,047,645	1,557,238	39,414,331
Interest on reserve funds	9,282,702	-276,270	349,701	9,356,133
Other income	29,600	-	3,351	32,951
Total income	327,638,971	4,147,711	5,077,909	336,864,591
EXPENSE:				
Premiums paid to insurance carriers	243,451,434	18,225,339	6,246,559	267,923,332
Administrative expense	138,853	132,349	162,887	434,089
Other expense	1,250	-	-	1,250
Total expense	243,591,537	18,357,688	6,409,446	268,358,671
NET OPERATING INCOME OR LOSS(-)	$ 84,047,434	-$14,209,977	-$1,331,537	$ 68,505,920

GAO note: This statement, prepared by the Civil Service Commission, with minor modifications made by GAO for the sake of clarity, has not been audited by GAO.

SUMMARY PREPARED BY GAO OF STATEMENTS FURNISHED BY

METROPOLITAN LIFE INSURANCE COMPANY TO THE

U.S. CIVIL SERVICE COMMISSION

ON ANNUAL ACCOUNTING AND CONTINGENCY RESERVE

UNDER GROUP INSURANCE POLICY

CUMULATIVE FROM AUGUST 29, 1954, TO THE END OF

THE 14TH POLICY YEAR, JUNE 30, 1968

	Regular insurance	Optional insurance	Total
PREMIUMS ACCRUED	$1,957,650,810	$18,225,340	$1,975,876,150
INTEREST ADDED TO OR DEDUCTED FROM(-) CONTINGENCY RESERVE (note 3)	62,507,642	-276,270	62,231,372
Total	2,020,158,452	17,949,070	2,038,107,522
MORTALITY AND OTHER CLAIM CHARGES INCURRED:			
Insurance claims	1,411,093,264	31,841,800	1,442,935,064
Excess mortality charges on conversions to individual policies	8,125,340	10,650	8,135,990
Total	1,419,218,604	31,852,450	1,451,071,054
EXPENSE AND RISK CHARGES INCURRED:			
Taxes	35,402,650	291,039	35,693,689
Expense of maintenance and operation of Office of FEGLI	4,781,969	23,884	4,805,853
Other expense and risk charges	15,585,853	105,612	15,691,465
Total	55,770,472	420,535	56,191,007
Total charges against group policy	1,474,989,076	32,272,985	1,507,262,061
EXCESS OR DEFICIENCY(-) OF TOTAL INCOME OVER TOTAL CHARGES	545,169,376	-14,323,915	530,845,461
FUNDS RETURNED TO THE COMMISSION (note 3)	333,981,937	-	333,981,937
CONTINGENCY RESERVE OR DEFICIT(-), JUNE 30, 1968	$ 211,187,439	-$14,323,915	$ 196,863,524

GAO notes:

1. The basic financial statements used in preparing this summary have not been audited by GAO.

2. The data shown in the regular and optional insurance segments of this summary statement are classified, as between (1) life insurance and (2) accidental death and dismemberment insurance, in schedule 3a.

3. Does not include additional interest of $5,944,490 paid by Metropolitan prior to July 1, 1964.

CLASSIFICATION OF THE DATA ON REGULAR AND OPTIONAL INSURANCE

AS BETWEEN LIFE INSURANCE AND ACCIDENTAL DEATH AND DISMEMBERMENT INSURANCE

CUMULATIVE FROM AUGUST 29, 1954, TO THE END OF

THE 14TH POLICY YEAR, JUNE 30, 1968

	Regular insurance		
	Life insurance	Accidental death and dismemberment insurance	Total regular insurance
PREMIUMS ACCRUED	$1,835,552,007	$122,098,803	$1,957,650,81[illegible]
INTEREST ADDED TO OR DEDUCTED FROM(-) CONTINGENCY RESERVE	59,305,833	3,201,809	62,507,64[illegible]
Total	1,894,857,840	125,300,612	2,020,158,45[illegible]
MORTALITY AND OTHER CLAIM CHARGES INCURRED:			
Insurance claims	1,331,173,436	79,919,828	1,411,093,26[illegible]
Excess mortality charges on conversions to individual policies	8,125,340	-	8,125,34[illegible]
Total	1,339,298,776	79,919,828	1,419,218,60[illegible]
EXPENSE AND RISK CHARGES INCURRED:			
Taxes	33,268,784	2,133,866	35,402,65[illegible]
Expense of maintenance and operation of Office of FEGLI	4,381,606	400,363	4,781,96
Other expense and risk charges	14,613,762	972,091	15,585,85
Total	52,264,152	3,506,320	55,770,47
Total charges against group policy	1,391,562,928	83,426,148	1,474,989,07
EXCESS OR DEFICIENCY(-) OF TOTAL INCOME OVER TOTAL CHARGES	503,294,912	41,874,464	545,169,37
FUNDS RETURNED TO THE COMMISSION	301,497,378	32,484,559	333,981,9[illegible]
CONTINGENCY RESERVE OR DEFICIT(-), JUNE 30, 1968	$ 201,797,534	$ 9,389,905	$ 211,187,4[illegible]

SCHEDULE 3a

Optional insurance		
Life surance	Accidental death and dismemberment insurance	Total optional insurance
7,088,624	$1,136,716	$18,225,340
-255,026	-21,244	-276,270
5,833,598	1,115,472	17,949,070
9,252,800	2,589,000	31,841,800
10,650	-	10,650
9,263,450	2,589,000	31,852,450
272,574	18,465	291,039
22,057	1,827	23,884
99,025	6,587	105,612
393,656	26,879	420,535
9,657,106	2,615,879	32,272,985
2,823,508	-1,500,407	-14,323,915
-	-	-
2,823,508	-$1,500,407	-$14,323,915

SCHEDULE 4

SUMMARY PREPARED BY GAO OF STATEMENTS FURNISHED BY

SHENANDOAH LIFE INSURANCE COMPANY TO THE

U.S. CIVIL SERVICE COMMISSION

ON ANNUAL ACCOUNTING UNDER GROUP POLICY

FOR THE BENEFICIAL ASSOCIATION INSURANCE

CUMULATIVE FROM JANUARY 1, 1956, TO THE END OF

THE 12TH POLICY YEAR, DECEMBER 31, 1967

AGGREGATE PREMIUMS		$57,724,230
AGGREGATE MORTALITY AND OTHER CLAIM CHARGES	$40,465,871	
AGGREGATE EXPENSE AND RISK CHARGES:		
Expenses of maintenance and operation	1,071,567	
Risk charge	865,863	
State premium taxes	463,462	
Total	2,400,892	
Total charges against group policy		42,866,763
EXCESS OF TOTAL PREMIUMS OVER TOTAL CHARGES		14,857,467
INTEREST ON CONTINGENCY RESERVE (note 2)		1,453,182
EXCESS OF TOTAL PREMIUMS AND INTEREST OVER TOTAL CHARGES		16,310,649
FUNDS RETURNED TO THE COMMISSION PRIOR TO DECEMBER 31, 1967 (note 2)		8,440,461
CONTINGENCY RESERVE, DECEMBER 31, 1967 (note 3)		$ 7,870,188

GAO notes:

1. The basic financial statements used in preparing this summary have not been audited by GAO.

2. The statements of annual accounting for the 12 policy years ended December 31, 1967, do not include additional interest income of $179,660 paid directly to the Commission.

3. The amount of $1,870,188 in excess of the authorized maximum of $6 million, together with interest thereon from January 1, 1968, was paid to the Commission in April 1968.

APPENDIXES

DESCRIPTION OF INSURANCE COVERAGE

PROVIDED UNDER THE FEGLI PROGRAM

The three types of insurance coverage--regular, optional, and beneficial association insurance--provided under the FEGLI program are described below.

REGULAR INSURANCE

Civilian officers and employees in the Federal service, with certain exceptions such as temporary or intermittent employees, are eligible for regular group life and an equal amount of accidental death insurance, and certain dismemberment insurance. The regular insurance coverage is equal to the larger of $10,000 or the current rate of an employee's annual compensation, rounded to the next higher $1,000, plus $2,000 additional insurance but not exceeding a total of $45,000. However, to the extent that the annual rate of basic pay for positions at level II of the executive schedule under the provisions of section 5313 of Title 5, United States Code, is increased, then the maximum amount of insurance is to be automatically increased correspondingly. Partial or full benefits, as prescribed by the insurance law (5 U.S.C. 8704(b)), are paid for loss of limb or eyesight.

The amount of insurance in effect is payable upon proof of death, with double indemnity if death is accidental. All insurance claims may be settled by lump-sum payments. Death claims may be settled also, upon written election of the beneficiary, by payment of monthly or annual installments over a specified number of periods, or by other optional methods of settlement.

In accordance with the provisions in the insurance law, death claims are paid in the following order of precedence.

1. Designated beneficiary or beneficiaries.

2. Widow or widower, if there is no designated beneficiary.

3. Child or children in equal shares, if there are neither of the above.

4. Parents in equal shares or the entire amount to the surviving parent, if there are none of the above.

5. Executor or administrator of the estate, if there are none of the above.

6. Next of kin as determined under the laws of the State where the insured was domiciled, if there are none of the above.

The insurance law (5 U.S.C. 8707 and 8708) requires (1) withholding of amounts from insured employees' salaries at the rate of 66-2/3 percent of the level cost[1] of each $1,000 of regular insurance, as determined by the Commission, and (2) contributions by employing agencies of amounts equal to half of the amounts withheld from the pay of employees. Pursuant to this requirement, the Commission has established a withholding rate of 27.5 cents a biweekly period for each $1,000 of regular insurance coverage.

The regular insurance of an employee terminates, subject to a 31-day extension of coverage, upon his separation from the Federal service, 12 months after discontinuance of his pay, or upon his entry on active military duty. During the 31-day grace period, the employee may convert all or any part of his regular group life insurance--without the accidental death and dismemberment provisions--to an individual policy, without a medical examination.

Regular life insurance is available without cost to retirees who retire for disability or on an immediate annuity after at least 12 years of creditable service and to employees who are receiving compensation for job-related disablements, who are unable to return to duty, and whose regular insurance would otherwise terminate because of separation from the service or completion of 12 months of nonpay status. The amount of insurance in effect at the date

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[1]See note 2 on p. 22 for definition of level cost.

of retirement is reduced 2 percent each month beginning the second calendar month after such date or after age 65, whichever is later, until the insurance is reduced to 25 percent of the amount held at retirement. The accidental death and dismemberment provisions are not continued in force after the date of retirement, or while an employee is covered by the regular life insurance, without cost to him, because he is receiving compensation for job-related disablements.

OPTIONAL INSURANCE

Optional insurance for Federal employees was authorized by title IV of the "Postal Revenue and Federal Salary Act of 1967" approved December 16, 1967 (5 U.S.C. 8714a). A Federal employee may purchase at his own expense optional group life insurance and an equal amount of accidental death insurance, and certain dismemberment insurance, in the larger of $10,000, or an amount of insurance which, when added to the regular insurance, equals the employee's total compensation.

The Commission is authorized by the above law to determine the cost of the optional insurance on the basis of such age groups as it considers appropriate and to deduct the full cost from employees' salaries and retirees' annuities. Under this authorization, the Commission has established biweekly withholding rates for $10,000 optional insurance at $3 through age 34; $6 for ages 35 through 54; and $20 for ages 55 and over.

In the same manner as for regular insurance, the optional insurance of an employee ceases subject to a 31-day extension of coverage, upon separation from the Federal service, 12 months after discontinuance of pay, or upon entry on active military duty. During the 31-day grace period, the same conversion privilege to an individual policy is available, without a medical examination or other evidence of insurability.

The optional life insurance--without the accidental death and dismemberment provisions--may be continued after an employee retires for age and service or for disability, or if he is receiving compensation for job-related

disablements and is unable to return to duty, provided the insurance was in force for the full period of service during which the optional insurance was available or for the 12 years immediately preceding the employee's retirement or beginning date of entitlement to compensation.

When an employee retires for age and service or for disability, or while he is receiving compensation for job-related disablements, the full cost of the optional insurance is withheld from his salary or annuity until he reaches age 65. The optional insurance is provided without further cost to retirees after age 65 but is subject to the same 2 percent-a-month reduction as the regular insurance until the amount of life insurance is reduced to 25 percent of the amount of insurance held at the date of separation.

BENEFICIAL ASSOCIATION INSURANCE

Section 10 of the Federal Employees' Group Life Insurance Act of 1954, approved August 17, 1954, as amended by the Act of August 11, 1955 (Public Law 84-356, 69 Stat. 676), authorized the Commission to arrange with certain nonprofit Federal or District of Columbia employees' beneficial associations for the assumption by the Employees' Life Insurance Fund of all life insurance agreements, existing both on August 11, 1955, and on the date of the arrangement, which were provided by the associations for their members.

The authorization was provided because of the anticipated adverse effect on the members of the beneficial associations due to the lower premium rates to be charged for regular insurance under the FEGLI program compared with the premium rates charged by the beneficial associations for group insurance. It was believed that, as a result of the higher premium rates, the recruitment of new members for the beneficial associations would probably decline, the average age of members would increase, and the increasingly higher premium rates would become prohibitive to the remaining members. In line with this authority, the Commission arranged with 27 beneficial associations for the assumption of their life insurance agreements.

A beneficial association accepting the arrangement for the assumption of its life insurance agreements by the Government was required by law to transfer to the Commission the lesser of (1) an amount equal to the actuarial value of the insurance obligations or (2) the total assets of its life insurance fund. At the date of the assumption of the life insurance agreements, the beneficial associations had about $200 million of life insurance in force covering about 136,000 members. The loss to the FEGLI program resulting from the assumption of the life insurance agreements was estimated by the Commission to be about $46 million as of June 30, 1968. (See p. 60.)

The insurance coverage provided to members of the beneficial associations under the FEGLI program was the same as the coverage provided by the associations in their life insurance agreements with the members. The payments of death benefits, however, are made to the survivors in the order of precedence specified in the Commission's group policy with the insurer. The members, if otherwise qualified, are also eligible for regular and optional insurance under the FEGLI program.

The insurance coverage of the members of the beneficial associations terminates, subject to a 31-day grace period, upon discontinuance by the insured, or upon default in the payment of insurance premiums to the Commission. During the 31-day grace period, the beneficial association group life insurance may be converted to an individual life insurance policy without evidence of insurability.

The premiums paid by the members to the Commission for the continuation of the members' insurance coverage are at the same rates previously charged them by the beneficial associations.

UNITED STATES CIVIL SERVICE COMMISSION
WASHINGTON, D.C. 20415

IN REPLY PLEASE REFER TO

YOUR REFERENCE

JUN 17 1969

Mr. Philip Charam
Associate Director, Civil Division
U.S. General Accounting Office
Washington, D. C. 20548

Dear Mr. Charam:

This is in response to your letter dated March 28, 1969, enclosing a draft copy of your proposed report to the Congress on this Commission's administration of the Federal Employees' Group Life Insurance Program. As suggested in your letter we obtained comments from the two insurance companies involved, and copies of their comments are attached.[1]

In line with your suggestion our staff will arrange to discuss items of an editorial nature with your staff. There are some figures that apparently need to be changed. However, our staff has not traced the G.A.O. audit efforts to verify the accuracy of all the figures used in the report.

<u>GROUP INSURANCE POLICY WITH
METROPOLITAN LIFE INSURANCE COMPANY</u>

[See GAO note 2 below.]

GAO notes:

1. The comments by the two insurance companies on a draft of this report have been considered in the preparation of our final report but copies of the replies have not been included.

2. Comments pertaining to draft report material not contained in final report have been deleted.

THE MERIT SYSTEM—A GOOD INVESTMENT IN GOOD GOVERNMENT

Limitation on "other expenses"

You recommend that the Commission amend the Metropolitan policy to provide that all expense incurred under the Federal employee life insurance program be determined on an equitable and reasonable basis with appropriate accounting support. Also, that if the Commission determines that reinsurers' expense allowances (other expenses) now based on a fixed percentage of gross premiums, would achieve equitable results, such allowances be subjected to a total dollar limitation.

On several occasions since the beginning of the program we have studied the possibility of changing the "other expense" limitation in the contract from a flat percentage of premiums to a cost-finding basis. We concluded that such a change was impracticable. The "other expense" involves numerous miscellaneous administrative costs incurred by 350 reinsuring companies, and the cost of developing and keeping records necessary to identify the expenses by class of policy, operating function, overhead, etc., would be out of proportion to the costs in question. Your draft cites the fact that Metropolitan does maintain detailed records for expenses of the Office established to administer the Federal program. That Office comprises a major, separate operating function of the Company, with full time staff. The physical and functional separation from other activities simplifies identification of those costs. But none of the 350 reinsuring Companies, including Metropolitan have a system that allocates the miscellaneous "other costs" to individual policies.

The effect of the second part of your recommendation would be to establish a dollar limit on the expenses, rather than the present limitation based on percent of premiums. Such a dollar limit would not recognize the rapidly rising salary and other costs. The last contract adjustment (1968) reduced the percentage of premiums allowed for these expenses from .3% to .06% for premiums exceeding $190 million annually. Thus, the rate applying above $190 million of premiums is now only one fifth the rate on premiums below that level.

In response to your September 30, 1966, inquiry the Bureau of Retirement and Insurance stated that they would re-examine the "other expense" and risk-charge allowances if the pending life insurance legislation substantially changed either the amount of insurance in force, or the premium rate. After the pending legislation was enacted, as noted in your draft report, the policy was amended to reduce these expense limitations. We feel that this action has adequately resolved the matter.

Funds held by Metropolitan
Outside the Contingency Reserve

You recommend that the Commission arrange for Metropolitan to submit an annual report on Federal employee program funds held outside the contingency reserve; and that we negotiate an amendment to provide that if the contract is terminated all such funds would be returned to the Commission after considering accrued policy charges.

We do not consider that the funds discussed in your report draft represent vested assets of the Federal Employees' Life Insurance Fund. Take for example the largest item, relating to unpaid installments on optional settlements of insurance claims ($5,720,000). When a beneficiary is due life insurance proceeds he occasionally uses the proceeds to buy an installment contract (annuity) from the Company. Though the cash transactions are handled through bookkeeping transfers, the contract is nevertheless between the beneficiary and the Company. The individual could have readily taken the proceeds to another insurance company for a similar contract. Such installment contracts are not obligations of the Federal program but are obligations of the Company. It follows that funds reserved for the payments would be assets of the Company. Since the Commission does not have a vested interest in the assets or liabilities, we do not see any logical reason for having them reported and recorded on the Commission's financial records. Investment income earned on the installment contract funds is used to cover interest on unpaid installments, and the costs of administration. Any excess is available for interest dividend payments to the beneficiaries.

There are some other smaller items you have mentioned where the question of a vested interest may not be so clear cut as in the above example. We will review these items individually to further consider the question of whether they should be recorded on the financial records of the Commission.

Rate for excess mortality
on converted policies

You recommend that the Commission through periodic examinations satisfy itself that the excess mortality conversion rate under the Metropolitan policy constitutes a reasonable charge and does not result in surplus amounts being subsequently divided among member insurers.

There is no way to assure that there will be no residual surplus amounts to be divided among companies sharing in converted insurance--likewise there is no way to assure that there will be no losses to be divided. The very nature of life insurance precludes such assurances; however, the reinsurance agreement does provide that the division of any surplus amounts (or losses) at the end of a pool term constitutes final settlement and is in full discharge of any liability to the members for future excess mortality under the converted policies.

The rate of $65 per $1,000 of insurance converted has periodically been supported by formal studies of the Technical Subcommittee (professional actuaries) appointed by the conversion pool managers, representing the insurance companies. Commission staff has reviewed these studies and believes that they have supported the $65 rate (some have indicated that costs exceeded the $65). Further studies by the Commission would involve extensive actuarial evaluations which could only produce borderline costs adjustments, if any.

<u>OPERATIONS UNDER GROUP INSURANCE POLICY
WITH SHENANDOAH LIFE INSURANCE COMPANY</u>

[See GAO note on p. 84.]

<u>Inclusion of beneficial association deficiency
in periodic actuarial evaluations</u>

You recommend that the Commission include the deficiency of the beneficial association insurance in itsperiodic actuarial valuations for the regular insurance, in order to appraise the impact on the regular insurance.

We see no particular problem in considering the beneficial association deficiency in the actuarial valuation. The two deficiency amounts have been published in the annual financial reports. As noted in the draft report, the impact on any deficit in the regular program will not be significant.

Commission's audit of operations

[See GAO note below.]

Questions raised as a result of audits by the Bureau of Retirement and Insurance over the years have involved many major segments of policy administration. Some of these have resulted in major savings in costs. Others have resulted in substantial increases in earnings.

As suggested in the draft G.A.O. report, the Commission's Office of Management Analysis and Audit will review the external audit and contract management aspects of the Federal Employees" Life Insurance Program as a part of its next internal audit of BRIOH activities. The audit will begin in June 1969. The scope and depth of the audit will be determined by availability of audit personnel and assessment of potential priority areas. Results of the internal audit will be made available to the General Accounting Office.

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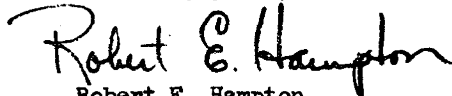
We appreciate the opportunity to review and comment on the draft report.

Sincerely yours,



Robert E. Hampton
Chairman

GAO note: The deleted comments relate to matters presented in the draft report which have been revised in the final report.

PRINCIPAL OFFICIALS

OF THE

U.S. CIVIL SERVICE COMMISSION

RESPONSIBLE FOR THE ADMINISTRATION

OF THE

FEDERAL EMPLOYEES' GROUP LIFE INSURANCE PROGRAM

	Tenure of office	
	From	To
COMMISSIONERS:		
Robert E. Hampton, Chairman	Jan. 1969	Present
John W. Macy, Jr., Chairman	Mar. 1961	Jan. 1969
L. J. Andolsek	Apr. 1963	Present
Robert E. Hampton	July 1961	Jan. 1969
James E. Johnson	Jan. 1969	Present
EXECUTIVE DIRECTOR:		
Nicholas J. Oganovic	June 1965	Present
DIRECTOR, BUREAU OF RETIREMENT, INSURANCE, AND OCCUPATIONAL HEALTH (formerly Bureau of Retirement and Insurance):		
Andrew E. Ruddock	Sept. 1959	Present