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Report to the Co-Chairmen, Federal
Government Services Task Force
House of Representatives

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LIFE INSURANCE

Assessment of Federal Employees' Group Life Insurance Program

GAO

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Comptroller General
of the United States

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The Honorable Michael D. Barnes, and
The Honorable Vic Fazio
Co-Chairmen, Federal Government
  Services Task Force
House of Representatives

This report responds to your request that we compare the Federal Employees' Group Life Insurance Program to private sector group life insurance plans and identify any changes that may be needed in the program. The report shows that the program is financially sound, that premiums are declining, and that a large majority of employees are enrolled. However, private sector insurance programs typically provide greater coverage amounts at less cost to employees than the federal program.

As arranged with your office, we are sending copies to the Director, Office of Personnel Management, and to the Secretary of the Treasury. Copies will also be made available to other interested parties who request them.

Charles A. Bowsher

Charles A. Bowsher
Comptroller General
of the United States

Executive Summary

Members of the Congress have expressed concern that the premiums charged by the Federal Employees' Group Life Insurance (FEGLI) program exceed those of group life insurance programs in the private sector. Because of this concern, 29 members asked GAO to (1) compare the FEGLI program to other life insurance programs, (2) determine whether premiums could be reduced, (3) identify any needed program reforms, and (4) analyze FEGLI participation.

Background

The Office of Personnel Management (OPM) manages the FEGLI program, sets and collects insurance premiums, and invests FEGLI funds. The program provides basic and optional life insurance coverage for federal employees and retirees. Except for the U.S. Postal Service, which pays the full cost of FEGLI basic insurance for its employees, federal agencies pay one-third of the basic insurance cost, and their employees pay the other two-thirds. The cost of optional insurance is borne fully by the employees electing such coverage. (See pp. 8 to 11.)

Results in Brief

When the Congress enacted the FEGLI program in 1954, the expressed objective was that it be comparable to life insurance programs offered by private sector companies. GAO's analysis showed that FEGLI's benefits and premium-sharing requirements do not currently meet this standard. (See p. 12.)

Although FEGLI premiums for basic insurance have been reduced by 44 percent during the past 10 years, GAO identified ways that employee costs could be further reduced by 7.5 percent. (See p. 18.)

Unlike other government trust funds, the FEGLI fund is not invested in special nonmarketable federal securities. To be consistent with other trust funds having similar investment characteristics, GAO believes that FEGLI should invest in the same securities as other government life insurance programs and major trust funds. (See p 24.)

The most recent data available showed that 90 percent of eligible federal employees participate in the FEGLI program. (See p. 30.)

Principal Findings

Benefit Comparability

At the time that the FEGLI program was established, more than 75 percent of private sector plans required employees to share the cost of basic life insurance benefits, but this requirement has been eliminated in most plans. In 1984 the Bureau of Labor Statistics (BLS) found that 80 percent of the employees it surveyed received free basic life insurance coverage. Hay/Huggins, a benefits consulting firm, reported that 83 percent of the employers that it surveyed in 1984 provided basic life insurance at no cost to their employees. Also, private sector employers typically provide basic life insurance coverage equal to 1.5 to 2 times pay; FEGLI provides similar coverage only to employees age 40 and younger. (See pp. 12 to 14.)

Premium Reductions

Between 1975 and 1985, the employees' share of the biweekly cost of basic FEGLI coverage was reduced from $0.355 to $0.20 per $1,000 of insurance because of (1) changes in the actuarial assumptions used in computing premiums and (2) higher-than-anticipated earnings on FEGLI investments. GAO calculated that the employees' share of FEGLI premiums could be reduced an additional 7.5 percent if (1) the economic assumptions in the FEGLI program were updated to be consistent with those used in determining the cost of the civil service retirement system and (2) the government assumed responsibility for FEGLI's unfunded liability which it created due to past funding insufficiencies. (See pp. 18 to 20.)

Investment Policy

OPM fund managers over time have employed varying strategies for investing FEGLI funds in various government securities. In contrast, other government life insurance programs administered by the Veteran's Administration, the civil service retirement system, and other government trust funds have investment policies authorized either by law or by special arrangement with Treasury that provide for the investment of available funds in special nonmarketable federal securities. GAO found these securities to be particularly appropriate because of the long-term nature of FEGLI investments. Also, GAO compared the rates of return on FEGLI and civil service retirement fund investments and found that the retirement fund earned a higher return during 6 of the past 10 years. The net return on retirement fund investments was 4.95 percent greater over the 10-year period. (See p. 24.)

Treasury officials said that legislative authorization would be needed in order to invest FEGLI funds in the special securities.

Participation

About 2.3 million federal employees, 90 percent of those eligible, participate in the FEGLI program. In addition, 955,000 employees elect coverage for their family members. (See p. 30.)

Matters for Congressional Consideration

GAO believes that comparability with the private sector is a valid measure of the appropriateness of federal pay and benefits. It is also important when adjusting pay and benefits that the effect on total compensation comparability be considered. Since total federal compensation currently lags behind the private sector and FEGLI is inferior to private sector programs, Congress should consider making FEGLI comparable to the benefits available to private sector employees.

Recommendations

GAO recommends that the Director, OPM,

- determine FEGLI premiums by using economic assumptions consistent with those used by the civil service retirement system,
- eliminate the charge to employees for the unfunded liability, and
- seek legislative authorization to permit investment of FEGLI funds in special nonmarketable federal securities.

Agency Comments

OPM agreed that the FEGLI program is inferior to private sector programs. OPM does not favor providing all federal employees basic life insurance free of charge because group life insurance plays a more important role in providing survivor benefit protection in private sector compensation packages. But OPM said that free insurance is being considered in connection with the new retirement system for employees hired after 1983. GAO believes that Congress should consider free life insurance for all employees in order to bring overall federal compensation more in line with private sector levels, which have been reported to be higher. (See p. 14.)

OPM stated that the retirement system's revised economic assumptions were not available at the time that it made the valuation on which current FEGLI premiums are based; however, it said that the next FEGLI valuation would give due regard to those assumptions. OPM stated that it saw no reason for the government to assume FEGLI's unfunded liability because the liability had been greatly reduced in recent years. Nevertheless, GAO does not believe the government should charge future FEGLI participants for costs associated with a funding deficiency it created. (See p. 21.)

Neither OPM nor Treasury agreed that FEGLI should invest in the same type of securities as the retirement fund. OPM indicated it was not convinced that the return would be superior to the way FEGLI is now invested. Also, OPM said that such a change, if desirable, would not require legislation but could be done administratively. GAO did not base this recommendation solely on the fact that the retirement fund has been earning a higher return recently; a principal benefit of the recommendation was the consistency it would bring to the investment policies of FEGLI, other government life insurance programs, and the civil service retirement fund. GAO also observes that purchasing a single security at the special interest rate is administratively preferable to purchasing proportionate amounts of almost 100 different government securities to achieve the same rate as would be obtained with special nonmarketable securities. (See p. 26.)

Treasury said that the interest and redemption features of the retirement fund investments could be inequitable to both the Treasury and the retirement fund. While these investments could be handled in a manner that would be unfair to either party, GAO agrees with a 1983 OPM study which concluded that the retirement fund's actual investment practices are neutral and favor neither the fund nor the taxpayers. (See p. 27.)

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Abbreviations

AD&D	Accidental death and dismemberment
BLS	Bureau of Labor Statistics
FEGLI	Federal Employees' Group Life Insurance
GAO	General Accounting Office
OPM	Office of Personnel Management

Chapter 1

Introduction

The Federal Employees' Group Life Insurance (FEGLI) Act of 1954 established a program to provide federal employees the opportunity to obtain low cost life insurance coverage. As of December 31, 1983, the program covered approximately 2.3 million employees and about 1.3 million retirees.[1] Participation in the program is voluntary. Employees working under temporary appointments are not eligible to participate in the program. In fiscal year 1984, program participants paid $642 million in life insurance premiums, and employing agencies contributed $288 million.

The government is a self-insurer of the FEGLI program. The Office of Personnel Management (OPM) manages the program, sets and collects the insurance premiums, and invests FEGLI funds. The Metropolitan Life Insurance Company's Office of Federal Employees' Group Life Insurance, under a contract with OPM, settles and pays insurance claims.

Federal Employees' Group Life Insurance Benefits

The FEGLI program provides basic life insurance coverage equal to the employee's annual salary rounded to the next higher $1,000, plus $2,000. The minimum coverage is $10,000, and the maximum amount of annual salary that can be used in determining the coverage amount is $76,000. For accidental death, the benefit amount is doubled. One-half of the basic benefit is payable for accidental dismemberment—the loss of one hand, one foot, or one eye—while the full benefit is paid for the loss of two or more such members.

Congress amended the FEGLI Act on October 10, 1980, to increase the amount of basic life insurance coverage available to employees under age 45. For employees age 35 or younger, the basic coverage amount is multiplied by two. Beginning at age 36, the multiplication factor decreases by one-tenth of one percent each year until it reaches 1.0 at age 45. The extra amounts for employees under age 45 do not apply to accidental death and dismemberment (AD&D) benefits.

The 1980 amendments also changed the life insurance arrangement for federal retirees. Basic insurance for retirees is provided at no cost until age 65, and then the coverage amount is reduced by 2 percent each month until 25 percent of the original coverage remains. If retirees prefer, the 1980 amendments allow them to elect one of two other alternatives for post-age 65 coverage. They can elect (1) coverage that reduces 1 percent each month after age 65 until it reaches 50 percent or

[1] Since the data are not regularly compiled, this is the most recent date for available information.

(2) no reduction after age 65. The retiree who elects either the 50 percent or the no reduction alternative must pay a premium for the additional coverage. The amendments also provide that employees who retire on or after January 1, 1990, will be required to pay the same premium as active employees until age 65.

Employees with basic FEGLI coverage are eligible to elect additional coverage under three optional insurance programs. However, they must pay the entire premium (no government contribution) for optional life insurance until age 65 or retirement, if later. The premium increases as the participant grows older. The three options are:

- Option A: Standard Optional Insurance. This option provides $10,000 coverage and AD&D protection. Beginning at age 65 or retirement, if later, option A coverage is reduced 2 percent each month until $2,500 in coverage remains.
- Option B: Additional Optional Insurance. This option, added by the 1980 amendments, provides coverage in increments of one, two, three, four, or five times basic pay rounded to the next higher $1,000. AD&D protection is not provided, and at age 65 or retirement, if later, coverage is reduced 2 percent each month until coverage reaches zero.
- Option C: Family Optional Insurance. This option, added by the 1980 amendments, provides coverage for the employee's family members in the amounts of $5,000 for the spouse and $2,500 for each eligible child. AD&D protection is not provided, and when the employee reaches age 65 or retirement, if later, coverage is reduced 2 percent per month until coverage reaches zero.

Under the FEGLI program, life insurance (but not AD&D) continues in force for 31 days after termination of employment. Basic life insurance and options A, B, and C may be converted to individual policies with private insurance carriers within the 31 days without medical evidence of insurability. Insurance for family members under option C is also convertible to individual policies upon the death of the employee or retiree.

FEGLI Premiums

Effective August 1, 1985, the biweekly premium is $.30 per $1,000 of basic life insurance coverage. The U.S. Postal Service pays the entire premium for its employees. Nonpostal federal employees, on the other hand, pay two-thirds of the premium for basic life insurance, and their agencies pay one-third.

The cost elements that comprise the basic life insurance premium as of August 1, 1985, are shown in table 1.1.

Table 1.1: Cost Elements That Comprise the Basic Life Insurance Premium

Cost elements	Cost per $1,000 of basic life insurance per year	Percent
Future benefits		
Death benefits for active employees	$2.505	31.76
Death benefits for retirees	4.237	53.71
Extra benefits for employees under age 45	.391	4.96
AD&D	.313	3.97
Administrative costs		
Metropolitan's administrative expenses	.056	.71
OPM's administrative expenses	.009	.11
Other expenses	.021	.27
Amortization payment for unfunded liability	.356	4.51
Total annual cost	**$7.888**	**100.00**

Objectives, Scope, and Methodology

In their request for this study, 29 Members of the Congress expressed concern that FEGLI premiums exceed premiums charged for group life insurance programs in the private sector. Because of this concern, the members asked GAO to (1) compare the FEGLI program to other life insurance programs, (2) determine whether premiums could be reduced, (3) identify any needed program reforms, and (4) analyze FEGLI participation.

We conducted our review at OPM headquarters in Washington, D.C., and at the Metropolitan Life Insurance Company in New York, New York. We interviewed OPM officials responsible for administering the FEGLI program and reviewed the program's legislative history, policies, and procedures. Using data obtained from OPM, we analyzed employee participation in FEGLI for calendar years 1980 and 1983. We used data for 1980, the year before the 1980 FEGLI amendments were implemented, as a base line for our analysis. The 1983 data were the latest available at the time of our study. To satisfy the needs of the requesters, we did not consider it necessary to verify the accuracy of OPM's data.

We reviewed the OPM actuarial valuations used to set FEGLI premium rates and examined FEGLI financial statements prepared by OPM to determine the appropriateness of premiums being charged. We also interviewed Department of the Treasury officials to obtain information on the investment policies of other government trust funds in order to compare them with FEGLI investment policies.

We identified two studies conducted during 1984 that included data on many features of private sector employers' life insurance programs. These were the only comprehensive studies that we found in our literature search. We did not verify the data in these studies. The studies were as follows:

- The Department of Labor's Bureau of Labor Statistics (BLS) June 1985 report, Employee Benefits in Medium and Large Firms, 1984. The report covered 23.5 million professional, administrative, technical, clerical, and production workers in firms employing as few as 50, 100, or 250 full-time employees, depending on the industry surveyed. It included information on life and health insurance, holidays, vacations, personal and sick leave, sickness and accident insurance coverage, long-term disability, and pension plans.
- The Hay/Huggins Company, The 1984 Hay/Huggins Benefits Comparison, (n.p.: Hay Associates 1984). This report contained information on employee benefits provided by 869 companies (size not specified). The Hay/Huggins Company is a management consulting firm specializing in private sector pay and benefits programs.

We obtained data on premium rates from four insurance companies that regularly advertise their plans in publications directed to federal employees. This information was used to develop illustrative comparisons of FEGLI benefit and premium amounts with other life insurance plans that federal employees could purchase as alternatives to FEGLI.

Our work was performed from April 1984 through July 1985. Except as noted above, our work was conducted in accordance with generally accepted audit standards.

Federal Employees' Life Insurance Benefits Lag Behind Private Sector Benefits

When the FEGLI basic life insurance program was established in 1954, it was intended to be comparable to life insurance programs offered by private sector companies. However, the BLS and Hay/Huggins studies indicate that this objective is not currently being achieved. Basic insurance coverage is typically provided at no cost to private sector employees and retirees, whereas nonpostal federal employees pay two-thirds of the cost of FEGLI basic insurance. Also, private sector employers typically provide basic life insurance coverage equal to 1.5 to 2 times pay; FEGLI provides similar coverage only to employees age 40 and younger. Both FEGLI and private sector plans provide for similar reductions in coverage after retirement.

FEGLI Benefits Intended to Be Comparable With Private Sector Benefits

Although the FEGLI Act of 1954 did not provide any mechanism similar to the pay comparability process[2] to maintain comparability, the legislative history indicates that the intent at the time of enactment was to create a life insurance program comparable to life insurance programs offered by private sector companies. At the time that the FEGLI program was enacted, more than 75 percent of private sector employers' life insurance plans were contributory with the employee paying a substantial portion of the premium.

The original FEGLI program offered employees basic life insurance coverage equal to an employee's annual salary, rounded to the next higher $1,000, with a maximum of $20,00C. The 1954 act also provided for continuation of life insurance coverage after retirement. Under most private sector life insurance plans at 1at time, insurance lapsed when an employee retired. The act as amenaed on December 16, 1967, provided for $10,000 minimum basic insurance or insurance equal to the employee's annual salary rounded to the next higher $1,000, plus $2,000. The 1967 amendments also provided that the maximum coverage amount would automatically increase to correspond with increases in level II executive pay. Since the program began, employees have paid two-thirds of the cost of basic insurance and the government one-third. The U.S. Postal Service began paying the entire premium for its employees in Julv 1974.

Recognizing that private sector life insurance programs were being liberalized, the Congress passed legislation in 1966 and again in 1967 to

[2] The Federal Pay Corr.parability Act of 1970 established policies and procedures for determining annual pay adjustments for white-collar employees. The comparability process is supposed to keep federal employees' salaries comparable with pay for similar levels of work in the private sector.

improve FEGLI. Both bills were vetoed. The legislative changes would have increased the basic insurance coverage to 1-1/3 times the employee's annual salary rounded to the next higher $1,000, plus $2,000. Also, the premium sharing ratio would have been changed with federal employees paying 60 percent of the premium for basic life insurance and the government paying 40 percent. The Presidential veto messages cited cost considerations as a major reason for rejecting the changes.

Comparison With Private Sector Benefits and Premiums

Private sector employers' life insurance programs usually provide more insurance coverage at less cost to employees than the federal program. The amount of coverage after retirement is reduced for both private sector and federal employees. A comparison of the FEGLI program with typical private sector basic life insurance programs is shown in table 2.1.

Table 2.1: Comparison of FEGLI and Typical Private Sector Life Insurance Programs

Program features	FEGLI	Typical private sector life insurance programs
Premium payments	Nonpostal employees pay two-thirds of the premium and the employing agencies pay one-third. Employer pays for postal employees.	Employer pays.
Basic insurance coverage:		
Employees	Employee's annual salary rounded to the next higher $1,000, plus $2,000. For employees age 35 or younger, the basic coverage is multiplied by two. Beginning at age 36, the multiplication factor decreases by one-tenth of one percent annually until it reaches 1.0 times the basic coverage at age 45.	1.5 to 2 times pay
Retirees	Reduced by 2 percent each month until 25 percent of coverage remains.	Although coverage is reduced, there is no typical pattern in the amount of reduction. Reduced coverage generally ranged from 10 to 50 percent.

The 1984 BLS employee benefits study found that 96 percent of the full-time private sector employees surveyed were participating in life insurance plans in 1984. Of these, 80 percent had the cost of a basic plan paid wholly by the employer. Similarly, the 1984 Hay/Huggins report showed that 83 percent of the private sector basic group life insurance plans in the companies surveyed were provided at no cost to the employee. If the government paid the full premiums for basic insurance, its costs for employees participating in fiscal year 1985 would have increased an estimated $338 million plus the cost of insurance for employees not then participating.

The BLS study also found that typical basic insurance coverage amounts for nearly two-thirds of the private sector participants surveyed were based on employee pay levels. For 44 percent of these participants, life insurance coverage was equal to at least two times annual pay; for 10 percent, coverage was equal to 1.5 times pay. Forty-one percent of the participants had coverage equal to their annual pay. The Hay/Huggins report indicated that 60 percent of the private sector basic life insurance plans provided coverage amounts equal to at least two times annual pay.

The BLS study indicated that after retirement, basic life insurance continued until death at no cost to the retiree for 64 percent of the private sector participants. However, the amount of coverage after retirement was reduced for over 90 percent of the retirees. The BLS study indicated that where multiple reductions in retiree basic life insurance were found, the final amount was typically 10 to 25 percent of employee coverage. Hay/Huggins found that 64 percent of the private sector firms surveyed continued coverage at retirement and that 89 percent of these firms provided the coverage at no cost to the retiree. However, 97 percent of the firms reduced the amount of coverage after retirement. The Hay/Huggins report indicated that where basic life insurance was reduced to a percentage of the employee amount, the residual amount of coverage was generally 25 to 50 percent.

Conclusions

When the Congress established the FEGLI program over 30 years ago, the program was comparable to group life insurance programs offered by the private sector. However, no provision was made for maintaining that comparability, and federal employees' life insurance benefits now lag behind private sector benefits. The studies that we reviewed showed that for the FEGLI basic life insurance program to be comparable with typical private sector life insurance programs, all federal employees and retirees would have to be provided basic life insurance coverage at no cost, and the amount of coverage for federal employees would have to be 1.5 to 2 times annual salary for all age groups.

Agency Comments and Our Evaluation

OPM said that it did not believe that the FEGLI law should be amended to provide basic insurance benefits in multiples of 1.5 to 2 times salary to all employees free of charge, as is the prevailing private sector practice. OPM bases its position on the belief that group life insurance has historically played a slightly different role in private sector benefit plans than in the federal system. OPM said that in the private sector, group life insurance has served in many instances as the primary means of providing benefits for certain surviving spouses who are not eligible for social security benefits, whereas the primary protection for survivors of federal employees is provided by the civil service retirement system. OPM pointed out that changes to FEGLI to make it compatible with private sector practices are being considered by the Congress in connection with the development of a new retirement program for post-1983 employees, whose survivor benefits will be modeled far more closely after private sector practices.

We are aware of the proposals being considered by the Congress. As we testified on September 9, 1985, before the Senate Governmental Affairs Committee on the design of a retirement program for post-1983 employees, we believe that both retirement and life insurance benefits for federal employees should follow the prevailing private sector practice, and we continue to advocate that the programs be designed accordingly. As OPM's comments indicate, the proposals being discussed do not apply to employees and retirees under the current retirement system.

In our report Comparison of Federal and Private Sector Pay and Benefits (GAO/GGD-85-72, Sept. 4, 1985), we stated that the Congress may wish to make decisions concerning future changes and adjustments to elements of the federai compensation program from the perspective of their effect on overall compensation levels. We also pointed out that the studies we reviewed suggest that federal employees' overall compensation lags behind the private sector. Therefore, we believe it is appropriate for the Congress to consider raising life insurance benefits for all employees to the private sector level because it would bring overall federal compensation more in line with private sector compensation levels.

A 1984 report of the Hay/Huggins consulting firm showed overall federal compensation lagged the private sector by 7.2 percent and life insurance by 0.3 percent. Hay estimated the lag increased to 9 percent because the 1985 federal pay raise was less than the average increase in the private sector.

Matters for Congressional Consideration

We believe that comparability with the private sector is a valid measure of the appropriateness of federal pay and benefits. It is also important when adjusting pay and benefits that the effect on total compensation comparability be considered. Since total federal compensation currently lags benind the private sector and FEGLI is inferior to private sector programs, Congress should consider making FEGLI comparable to the benefits available to private sector employees.

Chapter 3

Opportunities to Further Reduce Employee Premiums

Since 1975, OPM has reduced premiums for basic FEGLI insurance by 44 percent as a result of changes in actuarial assumptions used in determining premiums and higher-than-anticipated yie!ds on FEGLI fund investments. Our calculations showed that employee premiums could be reduced an additional 7.5 percent if (1) OPM calculated FEGLI premiums using economic assumptions that are consistent with those it uses to calculate the civil service retirement system's cost and (2) the government assumed responsibility for the FEGLI program's unfunded liability, as it has for the civil service retirement system.

FEGLI Premiums Are Declining

In August 1985, premiums for basic insurance were reduced by 9 percent because the 1985 update of the FEGLI actuarial valuation showed a decreasing mortality rate and higher-than-anticipated earnings on fund investments. The rate decrease continued a trend begun in 1978.[3] The history of FEGLI premiums since the program was established is shown in table 3.1.

Table 3.1: History of Biweekly Rates for Basic FEGLI Coverage (Per $1,000 of Insurance)

	Total	Contribution	
Year premium established	premium	Government	Employee[a]
1954	$0 3750	$0 1250	$0.2500
1968	0 4125	0.1375	0 2750
1975	0 5325	0 1775	0 3550
1978	0 3825	0 1275	0 2550
1981	0 3600	0 1200	0 2400
1984	0 3300	0 1100	0 2200
1985	0 3000	0 1000	0 2000

[a]The U S Postal Service began paying postal employees premiums in July 1974

Premiums for optional coverage are also declining. In 1984, OPM reduced the rates on Standard Optional Insurance (option A) by 8 to 29 percent depending on the employee's age; Additional Optional Insurance (option B) by 0 to 33 percent depending on age; and Family Optional Insurance (option C) by 0 to 48 percent depending on age.

Further Premium Reductions Possible

Employee premiums could be reduced by an additional 7.5 percent for basic coverage if two FEGLI funding practices were changed. First, OPM could recalculate premiums using economic assumptions consistent with

[3]OPM reduced premiums about 30 percent in 1978 when it adopted our recommendation to use the dynamic valuation approach in setting premiums as reported in our report, Changes to the Federal Employees' Group Life Insurance Program Are Needed (FPCD-77-19, May 6, 1977)

those used in the civil service retirement system. This change would reduce employee and government premium costs by 3 percent. Second, the government could assume responsibility for the unfunded liability, which would reduce employee premiums by 4.5 percent.

Economic Assumptions

In determining premiums, OPM must make assumptions about the future behavior of certain economic factors that influence the cost of insurance benefits. OPM uses a salary growth assumption to reflect periodic increases in pay for federal employees and an interest rate assumption to reflect the average long-term return on the FEGLI fund's investments. Salary growth increases the cost of benefits, while interest income reduces the cost of benefits. The greater the spread between the interest and the salary assumptions, the lower the premiums will be, provided that the interest rate assumption is always the higher figure.

The last time that OPM adjusted the economic assumptions for FEGLI was in September 1982. OPM calculated basic FEGLI premiums using a 7.5 percent annual salary increase assumption and an 8 percent interest rate assumption, or a difference of 0.5 percent. OPM officials told us that they chose these assumptions because the rates produced a spread that is conservative but consistent with (1) the difference between the yield on FEGLI funds and general schedule salary increases over the 25-year period before 1982 and (2) the 0.5 percent spread between the salary and interest rate assumptions used by the civil service retirement system at that time.

The FEGLI program and the civil service retirement system cover essentially the same universe of federal employees; both invest their funds in government securities. In May 1985, OPM recalculated the cost of the civil service retirement system using updated economic assumptions resulting in a spread of 1 percent between the salary and interest rate assumptions. No action was taken at that time to update the economic assumptions in the FEGLI program in order to see whether premiums should be further reduced. OPM officials told us that there was not enough time to do this because the new rates for open season in June 1985 had already been published.

Unfunded Liability

The unfunded liability for the basic FEGLI program has decreased during the past 3 years from about $2.7 billion in September 1982 to about $1.9 billion in April 1985. OPM attributes the decrease primarily to higher-than-anticipated yields on fund investments.

The unfunded liability represents the estimated amount of future benefit payments less the sum of estimated future premiums and interest earnings plus program assets, all expressed in present value. The unfunded liability, which the governmen' created, was caused by the following factors:

- The employees who retired shortly after the program's inception in 1954 contributed little to the fund but received full benefits.
- The effects of general pay raises on benefit amounts were not included in OPM premium determinations until 1977.
- The premiums in effect before March 1975 were insufficient to cover accruing benefit costs.

In the 1977 report on the FEGLI program, we pointed out that OPM was including an amount in the premiums for interest on the unfunded liability ($3.7 billion at that time) and charging two-thirds of that amount to federal employees. Our report concluded that the liability was the government's responsibility and proposed that the Congress consider authorizing the government to pay the full amount for interest on the liability. Congress took no action on our proposal. However, in 1982, OPM revised FEGLI's premium determinations by eliminating the interest payments on the unfunded liability and by substituting an amount to amortize the liability over the next 100 years.

The civil service retirement system also has an unfunded liability, but unlike the FEGLI program, the government has assumed responsibility for it. An unfunded liability was initially created when the retirement system was established and employees were granted credit for past service; it has grown since then because the government has not paid its full share of accruing costs. In 1969, the Congress enacted new financing provisions for the retirement system that provided for the government to make annual payments for interest on the unfunded liability and to amortize that portion of the liability resulting from liberalization of employee benefits. In fiscal year 1984, the retirement fund received from the U.S. Treasury $9.4 billion for interest on the unfunded liability and $4.1 billion in amortization payments.

Conclusions

While OPM has reduced FEGLI's basic insurance costs in the past 10 years by almost one-half, action could be taken to reduce FEGLI premiums further. We believe that the economic assumptions used in premium calculations should be consistent with the assumptions used to determine the cost of the civil service retirement system because both programs cover the same group of employees and invest their funds in government securities. These assumptions were consistent before OPM updated the retirement system's assumptions. Also, we continue to believe that the government should assume the responsibility for FEGLI's unfunded liability. The unfunded liability exists because of past funding insufficiencies and is unrelated to the cost of providing FEGLI benefits to new employees. Furthermore, we believe that the government should assume responsibility for the unfunded liability of the FEGLI program for the same reason that it has assumed responsibility for the civil service retirement system's unfunded liability (i.e., the unfunded liability was created by the government).

Under the current FEGLI financing arrangements, the government is paying one-third of the unfunded liability. Therefore, if the government assumed responsibility for the remaining two-thirds, its cost over the next 97 years would increase by $1.3 billion. However, the additional costs could be offset by any higher-than-expected earnings on fund investments. Extra earnings were the primary reason for the $800 million reduction in the unfunded liability over the past 2-1/2 years.

Agency Comments and Our Evaluation

OPM said that the revised economic assumptions used to determine the cost of the retirement system were not available at the time that it made the valuation on which current FEGLI premiums are based. OPM was concerned that in applying economic assumptions used in valuation of the retirement system to FEGLI, we appeared to be "picking and choosing" among sets of numbers developed for different programs at different times to produce a slightly lower premium. In so doing, OPM concluded that we were suggesting that it should have ignored the actual assumptions used in the retirement system's cost calculations because use of them would have increased FEGLI rates.

We did not intend to suggest that the actual retirement system assumptions be ignored. In fact, we used them to determine the spread between the two key assumptions (interest and salary rates) for recalculating the cost of FEGLI. Our analysis began with the same complete set of FEGLI assumptions that OPM chose in its 1982 valuation. We concurred with OPM's determination that an interest rate of 8 percent was a reasonable assumption on the basis of fund earnings. OPM also determined in 1982 that historically there had been a 0.5 percent spread between interest earnings and salary increases if the most recent years of high interest rates were ignored. Therefore, OPM backed off 0.5 percent from the interest assumption to arrive at its salary increase assumption of 7.5

percent and to be consistent with the 0.5 percent spread between interest and salary rates used at that time for the retirement system. For our calculations, we backed off 1.0 percent from the interest assumption to derive a spread consistent with the revised assumptions for the civil service retirement system determined by the Board of Actuaries and concurred in by OPM in 1985. Therefore, our methodology is consistent with OPM's actuarial valuation of FEGLI. We do not take issue with the 0.5 percent spread used by OPM at the time that the FEGLI valuation was prepared.

Our point is that the valuation of FEGLI should be revised based on the information developed during the retirement system valuation. OPM apparently agrees because it stated that the next valuation of FEGLI would give due regard to the actuarial assumptions used for the retirement system. We see no reason for OPM to delay the FEGLI revaluation now that the actuaries have completed their work on the retirement system.

OPM said that FEGLI's unfunded liability has been greatly reduced in recent years, and interest earnings and a continual decline in the mortality rate may reduce it even further. Therefore, OPM said that it saw no reason to abandon the formula for sharing program costs set forth in the FEGLI law.

We are not advocating abandonment of the government/employee cost sharing formula. As we have stated, FEGLI's unfunded liability exists because in the past the government did not provide for adequate funding of the program; it is unrelated to the current cost of providing benefits. Also, in our opinion, the fact that the unfunded liability is shrinking does not justify charging these past costs to future participants. We continue to believe that the government should assume total responsibility for the funding deficiency that it created.

Recommendations

We recommend that the Director, OPM, take action to reduce FEGLI premiums by

- recalculating program costs using economic assumptions consistent with those used in determining the cost of the civil service retirement system and
- eliminating the charge to employees for the unfunded liability.

Legislation Needed for FEGLI to Invest in Nonmarketable Federal Securities

By law, FEGLI funds must be invested in government securities, but the type of securities to be purchased is not specified. As of September 30, 1985, the FEGLI program's investments totaled about $6.6 billion, and about $1 billion is invested in new securities each year. OPM fund managers over time have employed varying strategies for investing FEGLI funds in government securities. In contrast, other government life insurance programs, the civil service retirement system, and other government trust funds have investment policies authorized by law or by special arrangement with Treasury that provide for the investment of available funds in special normarketable federal securities.[4] Our analysis showed that the civil service retirement fund rate of return over time was better than that earned on FEGLI investments.

FEGLI Investments

Once each quarter, OPM invests equal amounts of available funds in 3-year and 10-year Treasury notes. For example, in February 1985, the fund had $248 million available which was used to purchase $124 million of 3-year notes and $124 million of 10-year notes. These market-based securities were issued at the interest rates for similar notes sold at that time on the open market.

OPM's fund manager told us that each prior fund manager had decided how FEGLI 'unds were to be invested. The fund manager said that the current investment policy was adopted because it provided a balanced portfolio between short and longer term securities and a reasonable rate of return on fund investments. The fund manager said that the previous fund manager had had a different investment strategy that had stressed the purchase of longer term securities (20- and 30-year government bonds).

Since the notes and bonds mirror marketable securities, their fair value will fluctuate with prices for similar securities on the open market. For example, on September 30, 1983, the FEGLI fund investments that cost $5.2 billion had a fair market value of $4.7 billion. However, the fund does not lose money on its investments because the securities are always held to maturity and redeemed at face value.

[4] These securities are special because they are assigned an interest rate prescribed by law not available on any other federal security and are not sold on the open market.

Investment Policies of Other Trust Funds

We found that the investment policies of 17 other government trust funds are authorized by law and provide for investing available funds in special issue federal securities. Three other funds reached agreements in prior years with Treasury to permit investment in these special securities without legislative authorization. Treasury officials told us that they would not make a similar agreement for other government funds and that OPM would need legislative authorization for the FEGLI program to invest in the special securities.

The special federal securities purchased by the other funds are par-valued, which means that they are purchased and redeemed at their face value. By law, the interest rates on these securities are set on the basis of the average market yield on all outstanding marketable Treasury securities maturing or callable in more than 4 years. Half of the trust funds purchase securities maturing within 1 year or less, while the other funds purchase securities maturing in 1 to 15 years. Since the securities are not marketable, their value does not fluctuate.

We noted that the Veterans Administration, which administers all of the other government life insurance programs, including Servicemen's Group Life Insurance Fund and Veterans Special Life Insurance Fund, invests in par-valued special issue securities. Also, the civil service retirement, social security, and railroad retirement trust funds invest in such securities.

Comparison of Rates of Return

We compared the rates of return earned by the FEGLI and by the civil service retirement funds to determine how the different investment policies affected fund earnings. We found that the retirement fund earned a slightly higher rate of return for 6 of the 10 years between 1975 and 1984 and that the net return over the 10-year period was 4.95 percent greater. Also, the average interest rate being received on all retirement fund investments as of December 30, 1984, was 11.72 percent, or 1.5 percentage points greater than the average interest rate on FEGLI fund investments at that time.

A comparison of the rates of return on the two funds' investments is shown in table 4.1.

Table 4.1: Comparison of the Rates of Return for the FEGLI and the Civil Service Retirement Funds

Percent

Fiscal year	FEGLI fund	Civil service retirement fund
1975	5.55	6.45
1976	6.77	6.67
1977	7.38	8.37
1978	7.61	7.22
1979	7.92	7.92
1980	8.56	8.50
1981	8.82	9.20
1982	10.12	10.46
1983	10.10	10.36
1984	10.45	10.48

Conclusions

In contrast to other government trust funds, the FEGLI fund is not invested in special issue federal securities. In our opinion, investment in special nonmarketable federal securities adopted by other government life insurance programs, as well as by the civil service retirement fund, is appropriate for FEGLI fund investments because they have similar investment characteristics. Moreover, our analysis showed that the civil service retirement fund rate of return over time on investments in the special securities was better than the rate earned on FEGLI investments. To the extent that investing in special securities might increase earnings on FEGLI investments, the overall interest cost to the government would increase accordingly, but FEGLI costs would decrease because of higher interest earnings.

Agency Comments and Our Evaluation

Neither OPM nor Treasury was in favor of investing FEGLI funds in the special nonmarketable securities purchased by the retirement fund and many other government life insurance programs.

OPM said that we apparently based our proposal on the fact that the retirement fund has earned a higher rate of return than FEGLI in recent years. As OPM noted, this higher return resulted from the fact that the retirement portfolio is distributed over a shorter time horizon (redemption period) than the FEGLI fund; therefore, more of the money "rolled over" during the period and could be reinvested at the higher rates. OPM indicated that if there were a sustained period of falling rates, FEGLI would be the better performer.

The relatively higher rate of return earned by the retirement fund in our 10-year analysis is not the only reason that we believe that FEGLI should invest in the securities used by the retirement fund. As OPM concluded in a 1983 study of the retirement fund's investment policy, investment in the Treasury's special nonmarketable securities is a neutral investment policy. The study recognized the potential for gains or losses during periods of rising or falling interest rates but concluded that the fund was following a neutral investment policy that favored neither the fund nor the taxpayers and did not attempt "to play the market" to its advantage. OPM observed that because the retirement fund's investments are spread over 15 years, they are less sensitive to short-term fluctuations in interest rates. We concur with the conclusions of the study.

OPM also said that our proposal could be adopted administratively, without the need for legislation. It is possible that FEGLI fund managers could purchase Treasury securities in a mix that would produce a return equivalent to the special nonmarketable securities. However, instead of purchasing a single special security for each investment, they would have to purchase proportionate amounts of almost 100 different securities to achieve the same rate of return. There would be no particular benefit to be derived from such a procedure, and, administratively, it would be more costly. Therefore, we favor purchase of the special securities.

Treasury was concerned that the average interest rate feature of the special nonmarketable securities might result in gains (or losses) to the fund at the expense (or benefit) of Treasury and taxpayers in general during periods of rising or falling interest rates. As previously discussed, OPM's 1983 study recognized the potential for gains or losses but concluded that overall purchase of these securities represented a neutral investment policy. We agree with the OPM conclusion.

Also, Treasury was concerned that premature redemption of these special securities might result at times in a hidden subsidy to the fund while at other times might result in a loss to the fund. As we stated earlier, FEGLI fund investments are only redeemed at maturity.

Finally, Treasury said that most government trust funds invest in the same type of security that FEGLI is purchasing. We did not study the investment policies of all government trust funds; therefore, we cannot comment on the portfolio needs of all such funds. We believe that sound conclusions about the most appropriate investment policy for FEGLI can be made by comparing FEGLI to the civil service retirement fund and numerous other government life insurance programs having similar investment needs.

Recommendation

We recommend that the Director, OPM, seek legislative authorization to permit the investment of FEGLI funds in special nonmarketable federal securities.

Employee Participation in FEGLI and Alternative Life Insurance Plans

In 1983, about 2.3 million federal employees, 90 percent of those eligible, participated in the FEGLI program. In addition, the families of 955,000 federal employees were covered by optional insurance. Since participation in the FEGLI program is optional, federal employees may choose to purchase alternative life insurance coverage directly from insurance companies.

Trends in FEGLI Participation

Since enactment of the 1980 FEGLI amendments, which liberalized benefits for younger employees, the participation of nonpostal employees in the basic life insurance program has increased, as shown in table 5.1. With few exceptions, all postal employees participate in the FEGLI program because the basic life insurance coverage is provided at no cost to them. In 1983, about 662,000 postal employees were covered by FEGLI.

Table 5.1: Changes in Nonpostal Employees' Participation in the Basic Life Insurance Program

Nonpostal employees	1980	1983
Eligible	1,907,000	1,889,000
Covered	1,553,000	1,622,000
Participation rate	81%	86%

The 1980 FEGLI amendments achieved their intended effect of increased participation in the life insurance program, especially among younger employees. Employees in the younger age groups had the largest increases in participation in the basic life insurance program, as shown in table 5.2 and appendix I.

Table 5.2: FEGLI Participation by Age Group

	Percent of eligible nonpostal employees	
Age	1980	1983
Under age 25	68	74
25 to 29 years	65	75
30 to 34 years	69	77
35 to 39 years	77	82
40 to 44 years	86	88
45 to 49 years	91	93
50 to 54 years	94	95
55 to 59 years	94	95
60 to 64 years	95	95
Over 64	94	94

Many federal employees are also taking advantage of the FEGLI optional programs, as shown in table 5.3.

Table 5.3: Participation in FEGLI Optional Programs

	Percent of participation by eligible employees	
Coverage	1980	1983
Standard optional insurance (option A)	30	38
Additional optional insurance (option B)	Not applicable	29
Family optional insurance (option C)	Not applicable	37

Alternative Life Insurance Plans

Federal employees may choose to purchase individual life insurance policies directly from insurance companies, rather than participate in the FEGLI program. A major consideration in comparing the cost of alternative insurance coverage is the fact that the basic FEGLI premium paid during an employee's working years includes the cost of post-retirement coverage. This cost represents 54 percent of the basic insurance premium.

A comparison of the employees' portion of the annual FEGLI basic premium with the cost of four insurance plans that employees can purchase as an alternative to FEGLI is shown in table 5.4. Although federal employees can enroll in FEGLI either when they are hired or during an open enrollment period without proof of insurability, the four alternative plans that we used for illustration require such proof.

Table 5.4: Comparison of Annual FEGLI Premium With the Cost of Alternative Insurance Plans

	Age at purchase	Amount of life insurance coverage	Annual employee premium
FEGLI[a]	25	$50,000	$130
Government Employees Association, Incorporated (Company A)	25	50,000	108[b]
Worldwide Assurance for Employees of Public Agencies, Incorporated (Company B)[f]	25	55,000[c]	58
Metropolitan Life Insurance Company (Company C)	25	50,000	71[d]
Government Employees Mutual Benefit Association (Company D)	25	50,000	87[e]
FEGLI[a]	35	50,000	130
Company A	35	54,000[c]	132[b]
Company B[f]	35	49,000[c]	66
Company C	35	50,000	82[d]
Company D	35	50,000	160[e]
FEGLI	45	50,000	260
Company A	45	40,000[c]	204[b]
Company B[f]	45	50,000	125
Company C	45	50,000	130[d]
Company D	45	50,000	225[e]

[a] The basic life insurance coverage is $25,000 multiplied by 2

[b] Company pays annual refunds after claims and expenses are paid

[c] Minimum amount of coverage closest to $50,000

[d] Rate for males who do not smoke

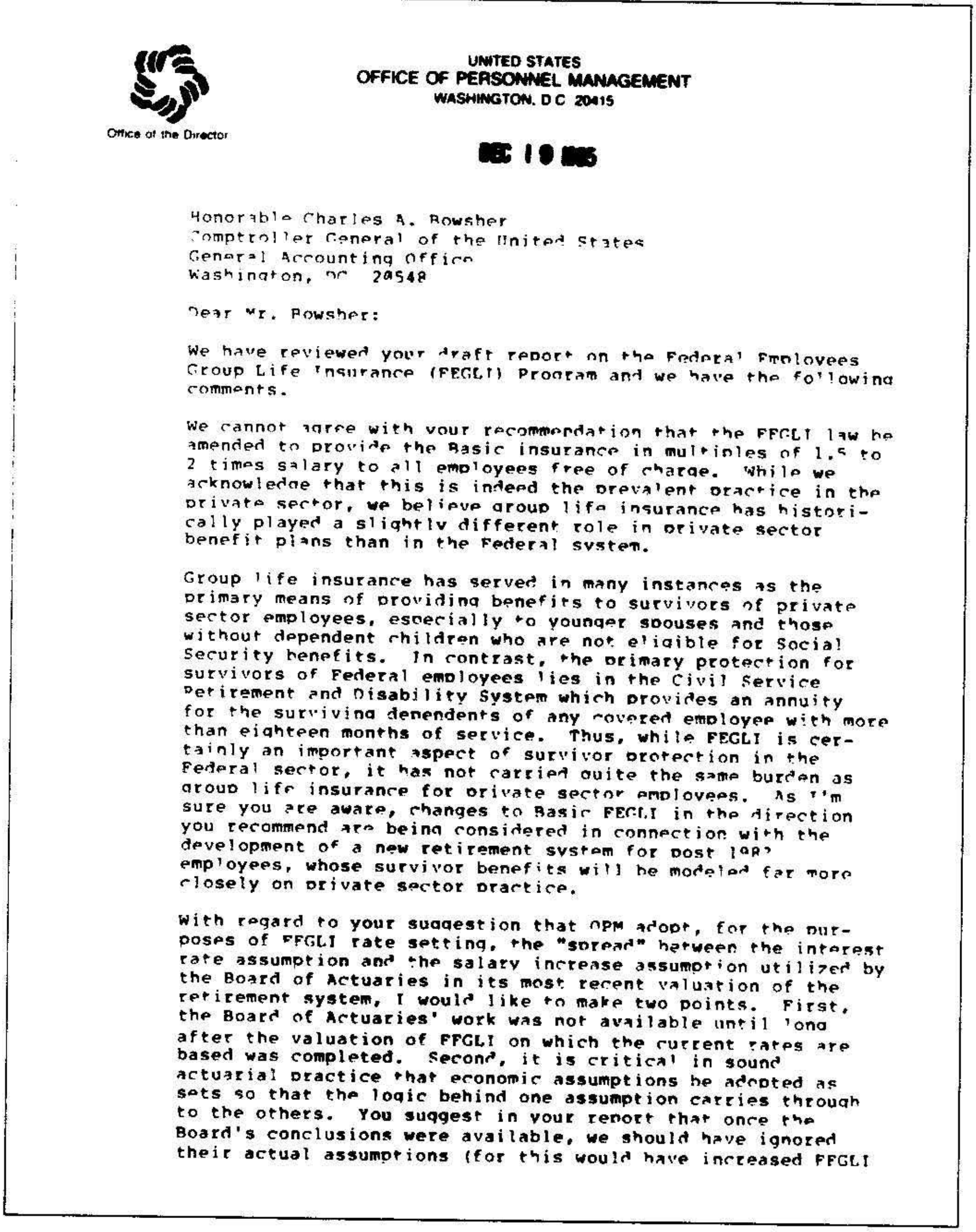
[e] A $5.00 lifetime membership fee is payable with the first premium

[f] Plan also provides accidental death benefits

Data on Nonpostal Employees' Participation in FEGLI: Number of Nonpostal Employees Participating in FEGLI

	1980		1983	
Age group	**Eligible**	**Covered**	**Eligible**	**Covered**
Under 25	111,980	75,774	85,434	63,164
25-29	239,882	156,137	203,324	151,481
30-34	317,081	220,222	293,003	226,387
35-39	246,344	190,654	308,153	253,447
40-44	219,332	188,903	244,180	214,465
45-49	235,606	215,360	232,302	215,337
50-54	234,495	219,911	232,196	220,999
55-59	187,978	177,595	172,469	164,657
60-64	95,860	90,807	98,311	93,520
Over 64	18,697	17,570	19,331	18,243
Total	**1,907,255**	**1,552,933**	**1,888,703**	**1,621,700**

Agency Comments From the Office of Personnel Management



UNITED STATES
OFFICE OF PERSONNEL MANAGEMENT
WASHINGTON, D.C. 20415

Office of the Director

DEC 19 1985

Honorable Charles A. Bowsher
Comptroller General of the United States
General Accounting Office
Washington, DC 20548

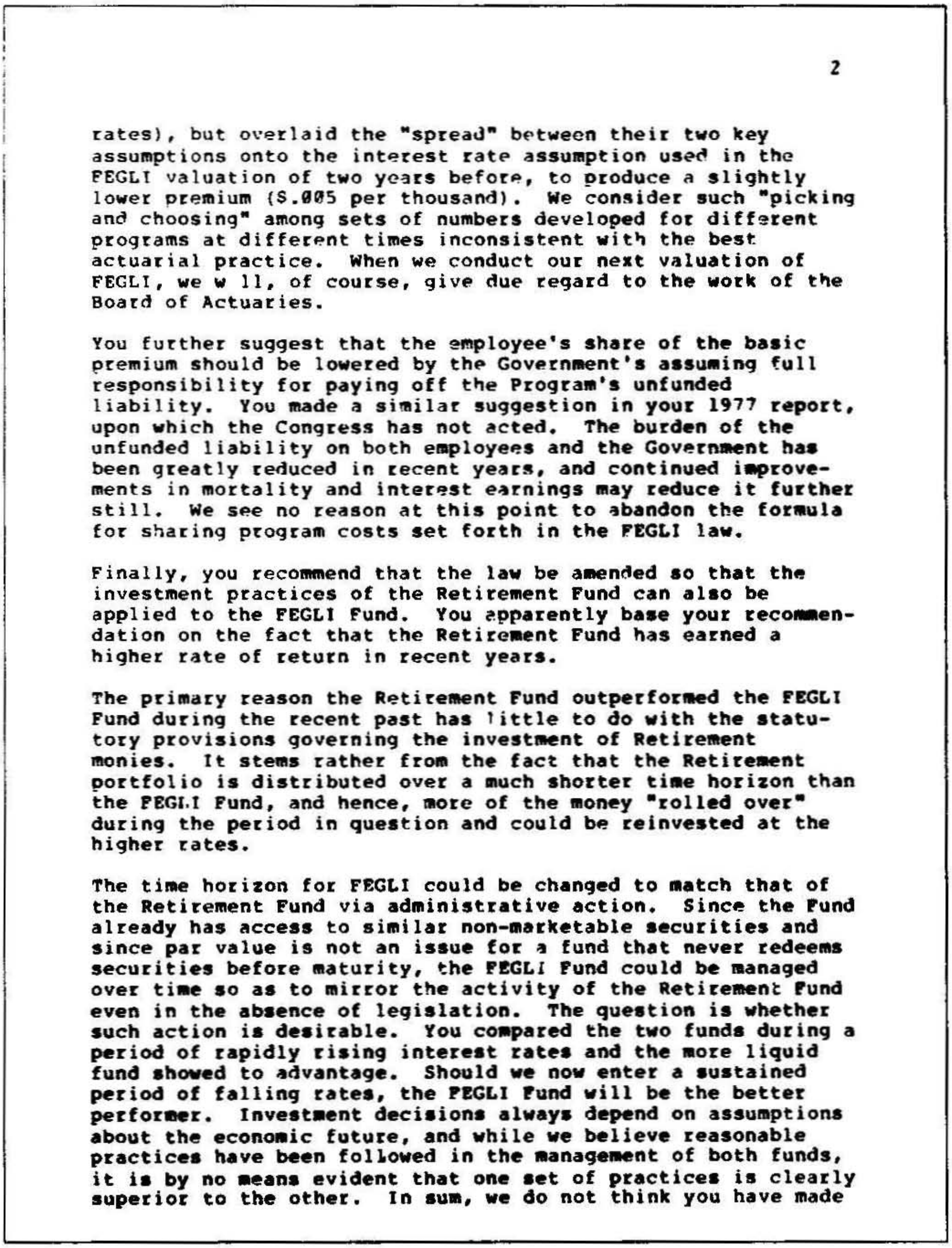
Dear Mr. Bowsher:

We have reviewed your draft report on the Federal Employees Group Life Insurance (FEGLI) Program and we have the following comments.

We cannot agree with your recommendation that the FEGLI law be amended to provide the Basic insurance in multiples of 1.5 to 2 times salary to all employees free of charge. While we acknowledge that this is indeed the prevalent practice in the private sector, we believe group life insurance has historically played a slightly different role in private sector benefit plans than in the Federal system.

Group life insurance has served in many instances as the primary means of providing benefits to survivors of private sector employees, especially to younger spouses and those without dependent children who are not eligible for Social Security benefits. In contrast, the primary protection for survivors of Federal employees lies in the Civil Service Retirement and Disability System which provides an annuity for the surviving dependents of any covered employee with more than eighteen months of service. Thus, while FEGLI is certainly an important aspect of survivor protection in the Federal sector, it has not carried quite the same burden as group life insurance for private sector employees. As I'm sure you are aware, changes to Basic FEGLI in the direction you recommend are being considered in connection with the development of a new retirement system for post 1983 employees, whose survivor benefits will be modeled far more closely on private sector practice.

With regard to your suggestion that OPM adopt, for the purposes of FEGLI rate setting, the "spread" between the interest rate assumption and the salary increase assumption utilized by the Board of Actuaries in its most recent valuation of the retirement system, I would like to make two points. First, the Board of Actuaries' work was not available until long after the valuation of FEGLI on which the current rates are based was completed. Second, it is critical in sound actuarial practice that economic assumptions be adopted as sets so that the logic behind one assumption carries through to the others. You suggest in your report that once the Board's conclusions were available, we should have ignored their actual assumptions (for this would have increased FEGLI



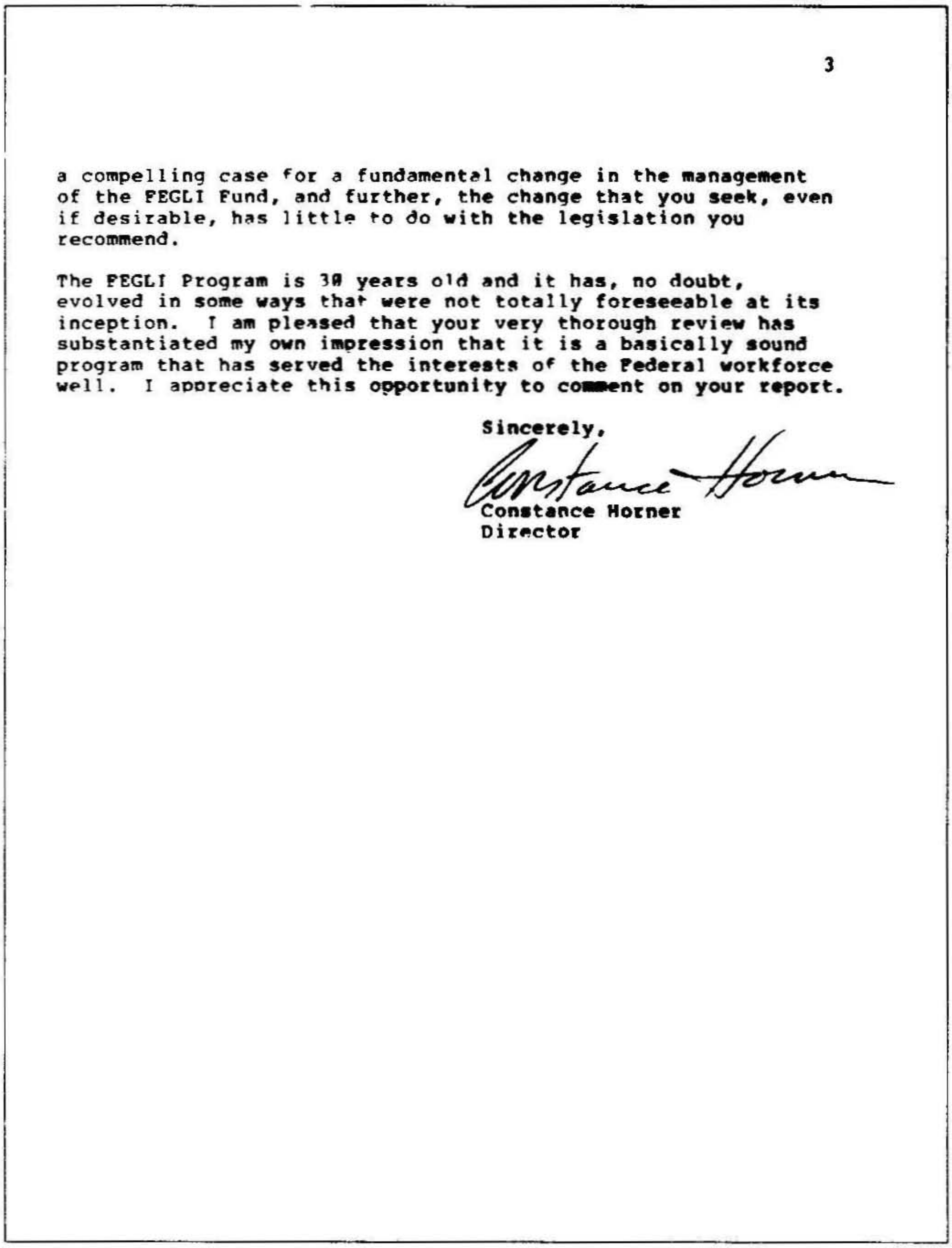
rates), but overlaid the "spread" between their two key assumptions onto the interest rate assumption used in the FEGLI valuation of two years before, to produce a slightly lower premium ($.005 per thousand). We consider such "picking and choosing" among sets of numbers developed for different programs at different times inconsistent with the best actuarial practice. When we conduct our next valuation of FEGLI, we w ll, of course, give due regard to the work of the Board of Actuaries.

You further suggest that the employee's share of the basic premium should be lowered by the Government's assuming full responsibility for paying off the Program's unfunded liability. You made a similar suggestion in your 1977 report, upon which the Congress has not acted. The burden of the unfunded liability on both employees and the Government has been greatly reduced in recent years, and continued improvements in mortality and interest earnings may reduce it further still. We see no reason at this point to abandon the formula for sharing program costs set forth in the FEGLI law.

Finally, you recommend that the law be amended so that the investment practices of the Retirement Fund can also be applied to the FEGLI Fund. You apparently base your recommendation on the fact that the Retirement Fund has earned a higher rate of return in recent years.

The primary reason the Retirement Fund outperformed the FEGLI Fund during the recent past has little to do with the statutory provisions governing the investment of Retirement monies. It stems rather from the fact that the Retirement portfolio is distributed over a much shorter time horizon than the FEGLI Fund, and hence, more of the money "rolled over" during the period in question and could be reinvested at the higher rates.

The time horizon for FEGLI could be changed to match that of the Retirement Fund via administrative action. Since the Fund already has access to similar non-marketable securities and since par value is not an issue for a fund that never redeems securities before maturity, the FEGLI Fund could be managed over time so as to mirror the activity of the Retirement Fund even in the absence of legislation. The question is whether such action is desirable. You compared the two funds during a period of rapidly rising interest rates and the more liquid fund showed to advantage. Should we now enter a sustained period of falling rates, the FEGLI Fund will be the better performer. Investment decisions always depend on assumptions about the economic future, and while we believe reasonable practices have been followed in the management of both funds, it is by no means evident that one set of practices is clearly superior to the other. In sum, we do not think you have made



a compelling case for a fundamental change in the management of the FEGLI Fund, and further, the change that you seek, even if desirable, has little to do with the legislation you recommend.

The FEGLI Program is 30 years old and it has, no doubt, evolved in some ways that were not totally foreseeable at its inception. I am pleased that your very thorough review has substantiated my own impression that it is a basically sound program that has served the interests of the Federal workforce well. I appreciate this opportunity to comment on your report.

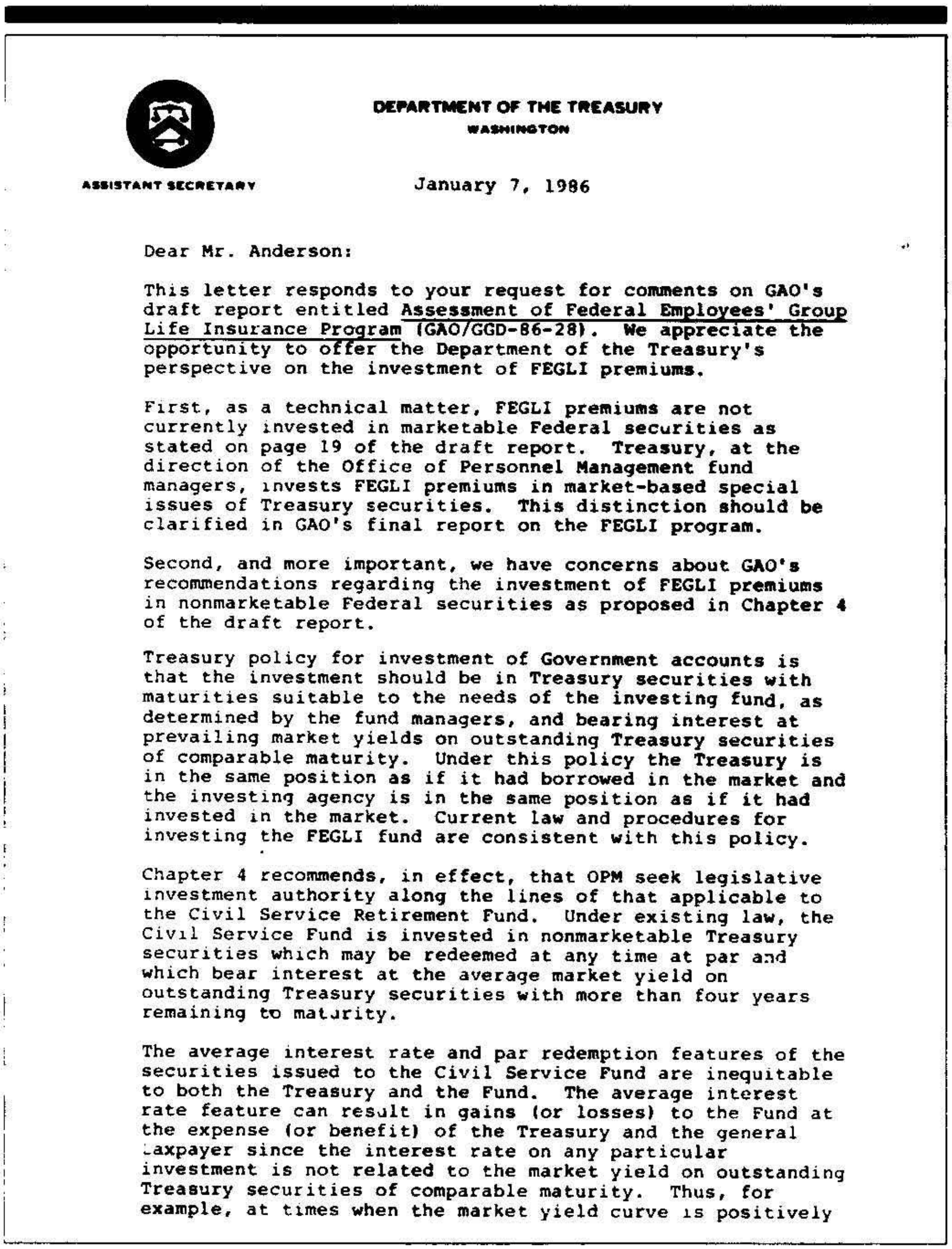
Sincerely,

Constance Horner

Constance Horner
Director

Agency Comments From the Department of Treasury

Note GAO comments supplementing those in the report text appear at the end of this appendix



DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

January 7, 1986

Dear Mr. Anderson:

This letter responds to your request for comments on GAO's draft report entitled Assessment of Federal Employees' Group Life Insurance Program (GAO/GGD-86-28). We appreciate the opportunity to offer the Department of the Treasury's perspective on the investment of FEGLI premiums.

Now on p 24

See comment 1

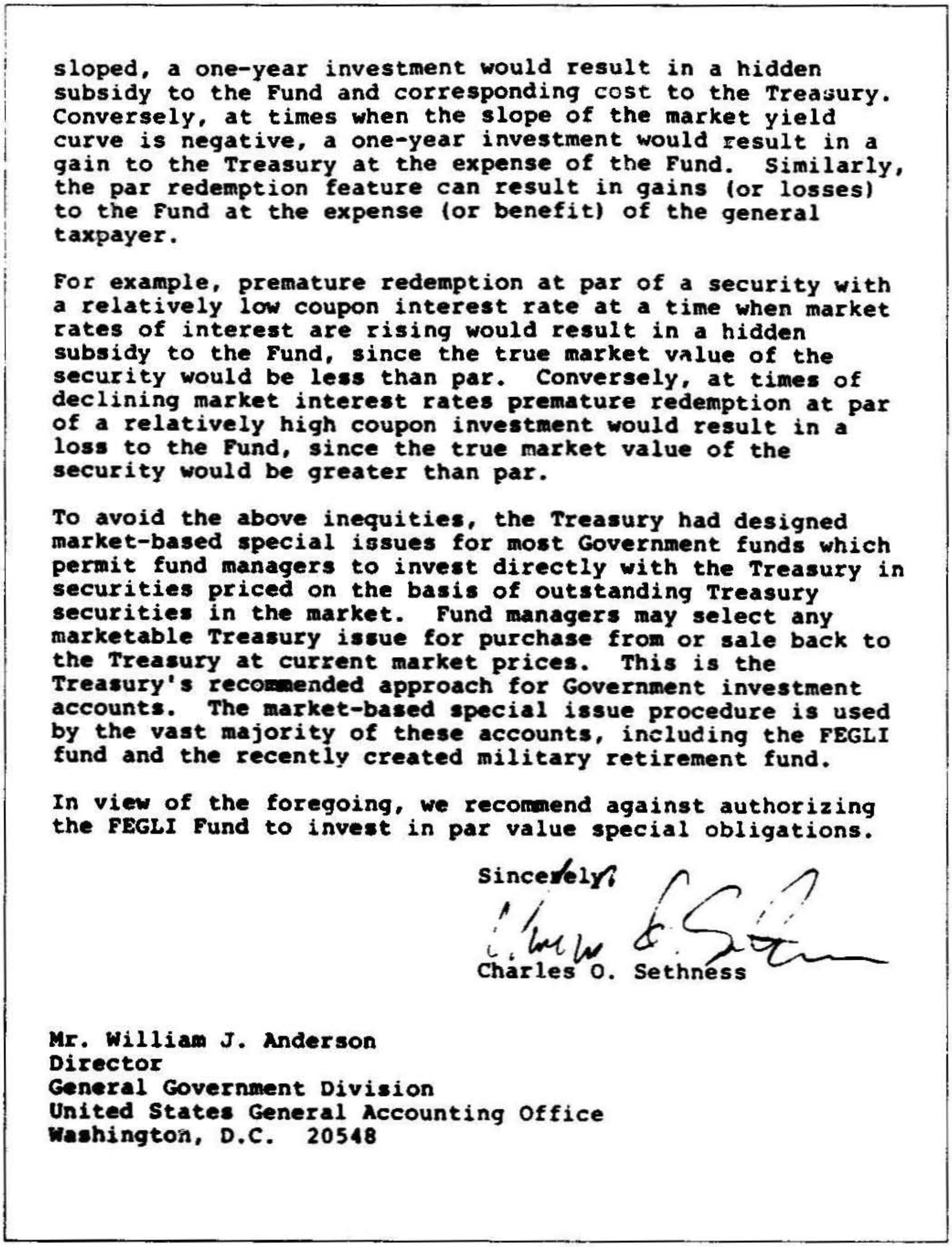
First, as a technical matter, FEGLI premiums are not currently invested in marketable Federal securities as stated on page 19 of the draft report. Treasury, at the direction of the Office of Personnel Management fund managers, invests FEGLI premiums in market-based special issues of Treasury securities. This distinction should be clarified in GAO's final report on the FEGLI program.

Second, and more important, we have concerns about GAO's recommendations regarding the investment of FEGLI premiums in nonmarketable Federal securities as proposed in Chapter 4 of the draft report.

Treasury policy for investment of Government accounts is that the investment should be in Treasury securities with maturities suitable to the needs of the investing fund, as determined by the fund managers, and bearing interest at prevailing market yields on outstanding Treasury securities of comparable maturity. Under this policy the Treasury is in the same position as if it had borrowed in the market and the investing agency is in the same position as if it had invested in the market. Current law and procedures for investing the FEGLI fund are consistent with this policy.

Chapter 4 recommends, in effect, that OPM seek legislative investment authority along the lines of that applicable to the Civil Service Retirement Fund. Under existing law, the Civil Service Fund is invested in nonmarketable Treasury securities which may be redeemed at any time at par and which bear interest at the average market yield on outstanding Treasury securities with more than four years remaining to maturity.

The average interest rate and par redemption features of the securities issued to the Civil Service Fund are inequitable to both the Treasury and the Fund. The average interest rate feature can result in gains (or losses) to the Fund at the expense (or benefit) of the Treasury and the general taxpayer since the interest rate on any particular investment is not related to the market yield on outstanding Treasury securities of comparable maturity. Thus, for example, at times when the market yield curve is positively



sloped, a one-year investment would result in a hidden subsidy to the Fund and corresponding cost to the Treasury. Conversely, at times when the slope of the market yield curve is negative, a one-year investment would result in a gain to the Treasury at the expense of the Fund. Similarly, the par redemption feature can result in gains (or losses) to the Fund at the expense (or benefit) of the general taxpayer.

For example, premature redemption at par of a security with a relatively low coupon interest rate at a time when market rates of interest are rising would result in a hidden subsidy to the Fund, since the true market value of the security would be less than par. Conversely, at times of declining market interest rates premature redemption at par of a relatively high coupon investment would result in a loss to the Fund, since the true market value of the security would be greater than par.

To avoid the above inequities, the Treasury had designed market-based special issues for most Government funds which permit fund managers to invest directly with the Treasury in securities priced on the basis of outstanding Treasury securities in the market. Fund managers may select any marketable Treasury issue for purchase from or sale back to the Treasury at current market prices. This is the Treasury's recommended approach for Government investment accounts. The market-based special issue procedure is used by the vast majority of these accounts, including the FEGLI fund and the recently created military retirement fund.

In view of the foregoing, we recommend against authorizing the FEGLI Fund to invest in par value special obligations.

Sincerely,

Charles O. Sethness

Mr. William J. Anderson
Director
General Government Division
United States General Accounting Office
Washington, D.C. 20548

The following are GAO's comments on the Department of Treasury's letter dated January 7, 1986.

GAO Comments

1. Report has been clarified on page 24 to reflect this distinction.

END

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