United States General Accounting Office

GAO

Report to the Chairman, Committee on Veterans' Affairs, U.S. Senate

July 1992

VA LIFE INSURANCE

Premiums and Program Reserves Need More Timely Adjustments

GAO United States
General Accounting Office
Washington, D.C. 20548

Human Resources Division

B-241607

July 20, 1992

The Honorable Alan Cranston
Chairman, Committee on Veterans' Affairs
United States Senate

Dear Mr. Chairman:

In response to your request, we are reporting on the Servicemen's Group Life Insurance Program, which is administered by the Department of Veterans Affairs. We examined the adequacy of program reserves and the extent of the government's liability for paying claims under the program. This report contains recommendations to the Secretary of Veterans Affairs that should improve program operations.

We are sending copies of this report to interested congressional committees; the Secretary of Veterans Affairs; the Director, Office of Management and Budget; and other interested parties. We will also make copies of this report available to others on request.

If you have any questions concerning this report, please call me on (202) 512-7215. Other major contributors are listed in appendix VI.

Sincerely yours,

Joseph F. Delfico

Joseph F. Delfico
Director, Income Security Issues

Executive Summary

Purpose

The Department of Veterans Affairs (VA) manages eight life insurance programs that provide about $400 billion in insurance coverage for military personnel and veterans. The largest of these programs, Servicemen's Group Life Insurance (SGLI), is administered by The Prudential Insurance Company of America under contract with VA and provides nearly $347 billion in coverage.

The Chairman of the Senate Committee on Veterans' Affairs asked GAO to examine SGLI and determine (1) the size of the reserves held by Prudential and VA in relation to program needs and (2) the extent that Prudential and the government are liable to pay claims arising from this program.

Background

SGLI provides group term life insurance to about 3.8 million active duty and reserve personnel. Operating costs are funded by the policyholder's premiums. Legislation passed in April 1991 increased the maximum SGLI insurance coverage from $50,000 to $100,000 for each individual insured. This coverage was made retroactive to pay claims incurred in the Persian Gulf War.

Under SGLI, premiums are deducted from service members' pay by the military services and forwarded to VA. VA deposits these funds in the SGLI revolving fund in the Treasury of the United States and transfers the amounts needed for processing and paying claims to Prudential on a monthly basis. Monies not needed to pay benefits or for administrative expenses are held in reserves by both VA and Prudential.

VA and Prudential had three SGLI reserves that totaled $432 million as of June 30, 1991. These three reserves are:

- Operating reserves of $165 million. These are maintained by Prudential to pay pending or unreported claims that Prudential would be responsible for processing even if it ceased to be program administrator and would receive no additional premiums from VA.
- Contingency reserves of $76 million. These are held by Prudential to guard against abnormal fluctuations in claims.
- The revolving fund, which held $191 million in excess funds.

Results in Brief

As of June 30, 1991, the operating reserves needed to be increased by about $85 million by 1998 as a result of the doubling of maximum insurance coverage under SGLI. At the same time, the contingency reserves contained about $51 million in excess funds in relation to program needs and the reserves of $191 million in the revolving fund were excess. (See p. 11.)

VA plans to increase Prudential's operating reserves to the required level, in part, by transferring excess funds in the revolving fund to Prudential through 1998. These transfers will increase the federal deficit. The funds are currently in the Treasury and, as they accumulated, reduced the deficit in prior years.

VA also plans to shift some of the excess funds from the contingency reserve to the operating reserves. Using excess funds in the contingency reserve on a one-time basis to offset some of the shortfall, should have no impact on the deficit. GAO and VA disagree, however, on the amount of excess funds that are in the contingency reserve. (See p. 13.)

Throughout the 1980s, VA overcharged military personnel for their insurance. Because premiums were too high, excess reserves continued to grow. VA needs to set true premiums—premiums that accurately reflect both the true costs and resources of the SGLI program as intended by SGLI's authorizing legislation—so that insureds are neither undercharged nor overcharged. (See p. 14.)

Regarding the extent of responsibility for paying SGLI claims, VA, using monies appropriated for the Department of Defense, is responsible for paying claims resulting from hazardous duty situations, such as those involving war. Peacetime claims are generally the responsibility of Prudential. However, VA's contract with Prudential needs to be revised to clarify who is responsible for certain peacetime claims. (See p. 19.)

Principal Findings

VA Needs to Reduce the Contingency Reserve

GAO's analysis shows that only $25 million of the $76 million in the contingency reserve has an actuarial basis. VA, while agreeing that only $25 million can be supported actuarially, has set the contingency reserve at $50 million. VA believes the additional $25 million is needed to protect against catastrophic events and will keep reinsurance costs from rising. GAO believes such criteria are not appropriate. (See p. 12.)

Over the last decade, the contingency reserve has consistently exceeded the level determined necessary by VA. For example, between 1984 and 1990, the maximum level set by VA was $70 million, but the contingency reserve averaged $135 million during that period. VA officials told GAO that they did not reduce the contingency reserve throughout that period because they believed these funds would be needed when the maximum insurance increased. (See p. 12.)

VA Needs to Set True Premiums

Consistent with SGLI's authorizing legislation VA should set premiums that appropriately reflect the experience of the program, and VA has not done so. The last premium change was made in 1984, and since then excess funds in both the contingency reserve and the revolving fund have continued to grow. This growth represents overcharges to past insureds because VA did not properly adjust premiums relative to program needs. (See p. 14.)

Peacetime Liability Needs Clarification

SGLI has been operating under a contract that does not clearly state whether VA or Prudential pays claims in certain peacetime situations that do not involve hazardous duty, such as claims resulting from natural disasters, epidemics, or major accidents. During 1990, VA and Prudential clarified this problem but VA has not amended the contract with Prudential to include the understandings reached. (See p. 20.)

Recommendations to the Secretary of Veterans Affairs

GAO recommends that the Secretary:

- Reduce the contingency reserve held by Prudential to $25 million and use the excess funds, if necessary, in lieu of transfers from the revolving fund to provide a portion of the additional operating reserves. (See p. 16.)
- Compute each year the true premiums to be paid by SGLI participants and adjust premiums as appropriate. The Secretary should consider future excess funds in the contingency reserve as a program resource when making this computation. (See p. 16.)
- Negotiate with Prudential to amend the SGLI contract to explicitly state which party is responsible for paying claims in certain peacetime situations. (See p. 20.)

Agency Comments

The Secretary of Veterans Affairs did not concur with GAO's recommendations. He said that they would undermine the strong financial position of SGLI, jeopardize the reinsurance agreements, and have other negative impacts on program operations. (See app. III.) The Prudential Insurance Company of America agreed with the Secretary's comments. (See app. IV.) GAO disagrees, and continues to believe that the recommended actions are needed to improve SGLI's financial position and program operations, especially with respect to charging insureds the proper premiums. The supporting views of GAO's actuarial consultant are in appendix V. GAO's evaluation of the Secretary's comments are on pages 16 through 18 and page 20.

Contents

Abbreviations

VA	Department of Veterans Affairs
SGLI	Servicemens Group Life Insurance
GAO	General Accounting Office

Introduction

The Department of Veterans Affairs (VA), through its Insurance Center, manages life insurance programs involving about $400 billion in insurance coverage for military service members and veterans. Servicemen's Group Life Insurance (SGLI), the largest VA life insurance program, and a subsidiary program, Veterans Group Life Insurance, had insurance in force of about $347 billion for 3.8 million insureds as of June 30, 1991.

SGLI, established in 1965, offers group term life insurance to active and reserve members of the armed forces.[1] Over the years, SGLI maximum coverage has increased. In April 1991, maximum coverage increased from $50,000 to $100,000 for each individual insured. This higher coverage was requested to be made retroactive to pay claims as a result of the Persian Gulf War. Coverage is automatic unless servicemembers request a lesser amount or no coverage.

VA has contracted with The Prudential Insurance Company of America to administer SGLI. Premiums for SGLI are withheld from servicemembers' pay by their respective military service and forwarded to VA. VA deposits the premiums into the SGLI revolving fund, an account with the Department of the Treasury, and transfers funds to Prudential on a monthly basis. Monies not needed to pay claims or administrative expenses are held in reserves by VA and Prudential. Prudential invests the reserves it holds, and interest on these investments is credited to SGLI. VA-held reserves are kept in the Treasury and invested by Treasury in U.S. government securities. Interest on these funds is also credited to SGLI.

VA and Prudential had three reserves that totaled $432 million as of June 30, 1991.

- Operating reserves of $165 million are maintained by Prudential to pay pending or unreported claims that would be processed if Prudential no longer administered the program and would receive no additional premiums from VA. The level of this reserve is calculated by Prudential using accepted actuarial assumptions. (See app. I for additional details.)
- Contingency reserves of $76 million are held by Prudential to guard the insurer against abnormal fluctuations in claims. VA sets the level of this reserve using factors such as (1) the risk of catastrophic accidents; (2) the lag time in obtaining insurance rate increases, if needed; and (3) the risk of adverse mortality fluctuations.

[1]Veterans Group Life Insurance, a subsidiary program of SGLI, was established in 1974 to assist veterans making the transition from military to civilian life. It offers 5-year nonrenewable term life insurance to recently discharged veterans and provides coverage equivalent to SGLI. This insurance is optional but is available regardless of the veterans' physical condition.

- The SGLI revolving fund, held in the Treasury, contains $191 million in excess funds returned from Prudential's contingency reserve, as required by law, and the interest that has accumulated on these funds.

VA is responsible for (1) setting premium levels (with the mutual agreement of Prudential), (2) ensuring that premiums are collected and deposited into the Treasury, (3) monitoring Prudential's activities, and (4) ensuring that Prudential obtains reinsurance.

Reinsurance is a method used by insurance companies to spread the risk among many companies if claims were to exceed existing reserves. Prudential serves as the primary reinsurer and currently has reinsurance agreements with 161 companies. A company's share of SGLI reinsurance is determined by the company's size. Each participating company receives compensation for reinsurance expenses and their share of insurance risk. Reinsurance costs amount to about $1 million per year for SGLI. Prudential and the other reinsurers are responsible, in general, for claims arising from peacetime deaths. Wartime claims are paid by VA from monies appropriated for the Department of Defense.

Objectives, Scope, and Methodology

The Chairman of the Senate Committee on Veterans' Affairs requested GAO to study the life insurance programs administered by VA. In discussions with the Chairman's office, we agreed to focus our efforts on SGLI, the largest VA life insurance program, and determine the amount of reserve funds held by Prudential and VA in relation to program needs, and the extent to which Prudential and the government are liable to pay claims arising from the program.

To accomplish our objectives, we reviewed legislation, regulations, manuals, policies, and other information on (1) how reserve levels are determined, (2) the uses of reserves, (3) whether VA or Prudential should hold reserves, and (4) the liability for claims.

To more specifically address reserve levels, we

- performed actuarial analyses to determine what operating reserves are necessary, and the appropriate level for contingency reserves;
- discussed the adequacy of reserve levels with VA and Prudential actuaries and with an actuarial consultant outside GAO;
- interviewed officials from several of the nation's largest insurance companies to obtain their views on setting reserve levels;

- reviewed VA's plans for the use of the reserves; and
- reviewed legal opinions obtained from VA and Prudential to determine their understanding of their contractual relationship regarding reserve levels.

To determine who is liable for paying claims, we

- reviewed VA and Prudential agreements concerning liability for paying claims and
- obtained information from the Department of Defense on its responsibility for paying SGLI claims.

We made our review at VA's central office; VA's Insurance Center in Philadelphia, Pennsylvania; and at Prudential's insurance offices in Newark, New Jersey, from April 1990 through December 1991. Our review was conducted in accordance with generally accepted government auditing standards.

VA Should Adjust SGLI Reserve Levels and Set True Premiums

GAO found that as of June 30, 1991, one reserve account needed to be increased to fulfill future program needs and two reserve accounts had excess funds. Specifically:

- The operating reserves held by Prudential needed to be increased by $85 million by 1998 as a result of the increase from $50,000 to $100,000 in maximum insurance coverage.
- The contingency reserves also held by Prudential contained $51 million in excess funds in relation to program needs.
- The SGLI revolving fund held in the Treasury contained $191 million in excess funds.

Much of the excess reserves were accumulated over the past decade due to lower-than-expected death rates and higher-than-expected interest rates on reserve investments. During that period, members of the military services paid more for life insurance than they should have because VA was slow to reduce premiums in relation to program needs. Excess funds in the contingency reserve are required by law to be deposited in the SGLI revolving fund. Once in this Treasury account, any outlays from the excesses in the revolving fund that would reduce the balance of the fund would increase the federal deficit. In order to prevent excesses in the reserve accounts in the future, VA needs to set true premiums and adjust these premiums, as necessary, to reflect the cost of the program.

Changes Needed in SGLI Reserves

The results of our examination of each of the three SGLI reserve accounts follow.

Operating Reserves Need to Be Increased

Operating reserves represent the value of benefits Prudential would have to pay if its involvement with SGLI was terminated. They also represent the types of reserves normally held by insurance companies for post-termination claims. Prudential determines the amount of these reserves using accepted actuarial practices. Both VA and Prudential consider the SGLI operating reserve to be consistent with the type of reserves Prudential would usually have for this type of insurance.

VA data show that by 1998 the operating reserves will have to increase by about $85 million from the June 30, 1991, level of $165 million. VA plans to raise these funds by annual transfers of about $29 million from the SGLI revolving fund through 1998, and by transferring excess funds from the contingency reserve. Premiums may have to be increased if this is not sufficient.

Contingency Reserves Could Be Reduced

About $51 million of the $76 million in the contingency reserves has no actuarial basis for remaining in this account.

By law, VA is required to have a contingency reserve to handle unexpected increases in claims. The law does not specify the amounts to be set aside; rather VA sets the target level for the reserve balance. Excess funds from the contingency reserve must be deposited in the SGLI revolving fund in the Treasury. The contingency reserve has been used four times to cover excess claims. Before to 1980, the reserve was used three times, resulting in total reductions of about $15 million. The last time the reserve was used, in 1986, $14 million was expended for excess claims. At that time Prudential held $152 million in the reserve; VA's target level, however, was only $70 million.

The contingency reserve has consistently exceeded the level determined necessary by VA. Between 1984 and 1990 the maximum level set by VA was $70 million, but the contingency reserve level averaged $135 million. VA officials told us that they did not require Prudential to transfer all the excess funds to the revolving fund because they thought the funds would be needed when the maximum insurance coverage was increased to $100,000.

A January 1990 study by the VA Insurance Center's Chief Actuary concluded that the cost of catastrophic accidents should be considered in setting a limit for the contingency reserve. This study recommended a $50-million maximum level for the contingency reserve.

In a July 18, 1990, letter to GAO, Prudential's Assistant General Counsel and former Actuarial Director stated

> ". . . . The contingency reserve is an additional financial arrangement. Unlike the other reserves, in absence of any specific legislative and contractual requirement, the insurance company would not have any basis for holding the contingency reserve. That is, all of the other reserves are inherent in and arise directly due to the plan of benefits that the code mandates and the corresponding obligations that the insurance company assumes."

We believe that on an actuarial basis, $25 million would be adequate for the contingency reserve. We base this on the less-than-1-percent probability that the $25 million would be needed to pay higher-than-expected claims in one year. This $25 million serves as a deductible against reinsurance claims. Without the deductible, reinsurance claims would be likely every other year. With the deductible, reinsurance claims are not likely within 25 years.

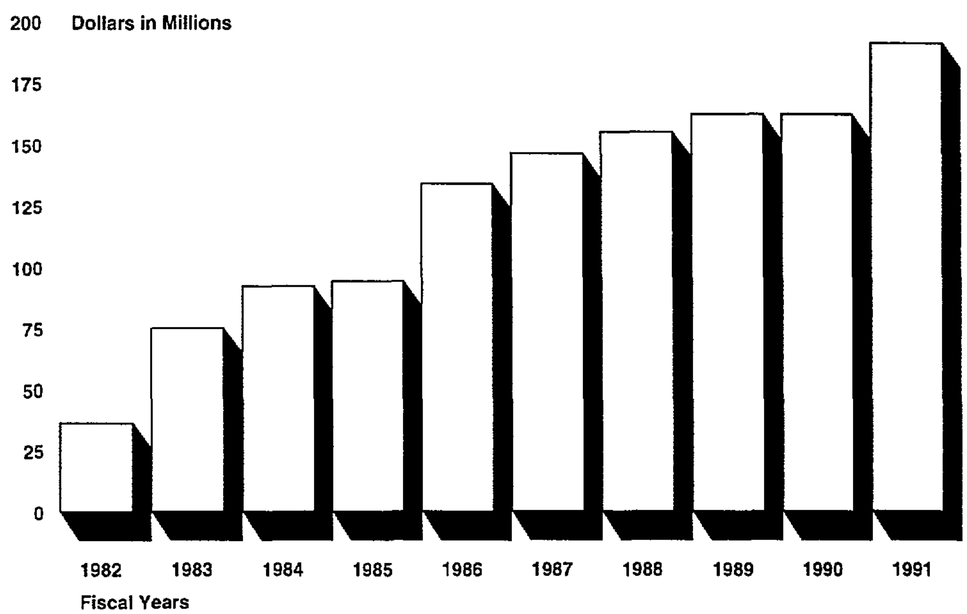
VA officials agree that actuarially $25 million is adequate, but point out that reinsurance would increase if the contingency reserve was reduced to this level, causing insurance premiums paid by service members to increase.

Reductions to the contingency reserve could increase the reinsurance outlay, because the reinsurers would assume more risk by having to pay claims sooner. VA's actuary estimated that reinsurance premiums at the $100,000 maximum insurance level would increase from about $1 million to about $2.2 million per year if the contingency reserve was reduced to $25 million. The exact increase, if any, has been the subject of negotiations between VA and Prudential.

Use of Excess Funds in Revolving Fund Increases the Federal Deficit

As shown in figure 1.1, the excess in the revolving fund grew an average $17.5 million annually between 1982 and 1991, representing overcharges to insureds. Much of this growth was realized from 1982 through 1984 when Prudential returned about $92 million in excess contingency reserve funds to the revolving fund.

Figure 1.1: Growth of Revolving Fund Reserves (1982-91)



VA plans to fund the shortfall in Prudential's operating reserves by transferring $29 million each year from the revolving fund through 1998. The $191 million of excess monies in the revolving fund includes SGLI premiums plus interest income accumulated above levels needed for program expenses and for operating and contingency reserves. The $191 million is already in the Treasury and transfer of these funds to Prudential would constitute an outlay and increase the federal deficit. These funds, as they accumulated, reduced past years' deficits.

Using excess funds in the contingency reserve, on a one-time basis, to offset some of the shortfall in the operating reserve could be a viable short-term remedy. If the excess was moved from the contingency reserve to the operating reserve, it would provide monies for a valid reserve requirement. This transfer would have no impact on the deficit as long as the monies are moved through the revolving fund, as required by law, to Prudential's operating reserves in the same fiscal year.

VA Should Set True SGLI Premiums

Neither VA nor Prudential compute a true premium for the SGLI program. A true premium should adequately cover program expenses, including claims payments, administrative expenses, reserves, and other costs of providing insurance, and take into consideration all current program resources, such as premiums collected, interest income, and excess funds held by Prudential. The growth in excess funds since 1984 indicates that VA does not adjust premiums when receipts greatly exceed costs. When a true premium is not set, overcharges or undercharges to insureds normally result.

During the 1980s, insureds were overcharged for SGLI insurance. This is evidenced by the excess funds in the revolving fund continuing to increase and the funds in the contingency reserve remaining above the level determined necessary by VA. VA attempted to reduce the excesses by lowering the premiums from 11.6 cents per $1,000 in 1982 to the 8 cents per $1,000 that has been in effect since 1984. During this same period, the maximum coverage under SGLI increased from $35,000 to $50,000. No other changes in premiums or coverage had been made until the April 1991 increase in coverage. VA officials told us that higher-than- expected interest rates and lower-than-expected mortality rates have caused continued growth in the reserves despite their belief that the 8 cents per $1,000 premium would reduce the excess funds.

Computing true premiums annually and making timely, appropriate adjustments should put the program on a self-supporting basis. This is consistent with the authorizing legislation including the 1991 amendment, which increased the maximum coverage. This should eliminate the buildup in excess funds or the subsidizing of premiums in the future.

Conclusions

Actions should be taken to reduce the contingency reserve to the level that can be actuarially supported. This reduction should be coupled with transferring the excess funds, as allowed by law, to the operating reserves. This would allow the excess funds to fulfill some of the immediate requirement for more funds in the operating reserves.

VA should also set true premiums and adjust the premiums on a more frequent basis than it did during the 1980s if estimates on mortality and interest do not turn out to be accurate. The Secretary of Veterans Affairs should consider future excess funds in the contingency reserve as a program resource when computing premiums. This would allow VA to use all monies received in computing a true premium and have these monies available for program use on a current basis.

Recommendations to the Secretary of Veterans Affairs

We recommend that the Secretary:

- Reduce the contingency reserve held by Prudential to $25 million and use the excess funds, if necessary, in lieu of transfers from the revolving fund to provide a portion of the additional operating reserves.
- Compute each year the true premiums to be paid by SGLI participants and adjust premiums as appropriate. The Secretary should consider excess funds in the contingency reserve as a program resource when making this computation.

Agency Comments and Our Evaluation

In a letter dated May 22, 1992, the Secretary of Veterans Affairs, in commenting on our draft report, stated that he did not concur with our recommendations and believed that, if implemented, our recommendations would undermine the strong financial position of SGLI. (See app. III.) In a letter dated May 5, 1992, Prudential stated that its comments on our draft report were incorporated with those of the Department of Veterans Affairs and that it agreed with VA's position. (See app. IV.)

We disagree with the Secretary's conclusion. Setting true premiums to cover total SGLI expenses as GAO recommends, would lead to a more sound financial position and stabilize reserves. In contrast, VA's plan to fund the needed increase in Prudential's operating reserve by transferring funds from the revolving fund will create an outlay and add to the federal deficit. Prudential's operating reserve consists of premiums paid by insureds that have not yet been used to pay benefits. Thus, if appropriate premiums were charged, transfers should not be required to supplement Prudential's operating reserves. The effects of VA's planned transfers would be to subsidize premiums and as a consequence, reduce total reserves.

The Secretary also stated that, while he agreed that the level of the contingency reserve could be reduced, our recommendation to reduce the contingency reserve to $25 million would jeopardize the current reinsurance agreements and discourage reinsurers from participating in the program. We disagree. First, the purpose of the contingency reserve is to protect the insurer from abnormal fluctuations in claims, not to protect the insurer from catastrophic events, which is the purpose of reinsurance. Second, as stated above, we believe the risk that excess claims would exceed $25 million is less than 1 percent, and we question whether this would discourage reinsurers from participating. Finally, we note that SGLI reinsurers have never paid a claim.

The Secretary also commented that the number of reinsurers has declined from 310 in 1984 to 161 today, and that their ranks might dwindle further if they were asked to assume more risk. In light of the minimal risk, the fact that the reinsurers have never paid a claim, and that the contingency reserve during this period far exceeded VA's target level, fear of sustaining a loss does not appear to be a factor for decreased participation. Should Prudential not be in a position to maintain a strong base of reinsurers or should the reinsurance outlays increase too much, the Secretary could solicit bids from other insurance companies to operate SGLI. This has not been done since the initial award in 1965.

The Secretary commented that he believes the proper level for the contingency reserve is $50 million not $25 million as we recommended. According to the Secretary, the $50 million calculation is based on the number of deaths that occurred each year between 1984 and 1990, but the Secretary's letter provided no further analysis to support that position. Our proposed reserve level is based on the number of deaths expected each year, since the purpose of the contingency reserve is to protect against adverse fluctuations in expected noncatastrophic deaths. We continue to believe, and our outside actuary agrees, that a contingency reserve in excess of $25 million cannot be supported actuarially. Thus, reserve funds above the $25 million level are only being used to cover part of the cost of any catastrophic occurrences. The Secretary stated that he would seek the views of disinterested outside actuaries to resolve the differences between VA's and GAO's position. We would welcome the opportunity to discuss this issue further with the Secretary and any independent actuaries of his choosing.

The Secretary commented that implementing our recommendation to adjust premiums annually would eliminate the program's ability to offer low-cost insurance at stabilized rates. He further commented that VA sets true premiums and disagreed that insureds were overcharged. The intent of our recommendation to set true premiums was to have VA keep amounts collected from insureds as close as possible to program expenses. We agree that stabilized premium rates are desirable, when warranted by program experience. However, VA has not adjusted premiums since 1984 when it set a premium that it believed was below "break even." Throughout the 1980s, VA saw both the revolving fund and the contingency reserve build substantial excesses, but took no action to slow or stop that growth. Yearly premium reviews should have indicated a possible decrease in premiums rather than letting reserves increase from the premiums paid by the insureds.

In a letter dated May 13, 1992, an actuarial consultant agreed that our positions on the size of the reserve and need for VA to set true premiums are actuarially sound, but believed that annual premium adjustments would be confusing to program participants and generally not necessary. (See app. V.) Instead, he advised that a premium calculation should be performed and premiums adjusted as necessary to keep the contingency reserve at the proper level. He further stated that if favorable experience does not reduce the reserve to the proper level, rates should be adjusted to make the reserve decline to the proper level. Accordingly, considering both the Secretary's view that our recommendation may impede the program's flexibility and the suggestions of our outside actuary, we modified the recommendation in the final report.

Finally, both the Secretary of Veterans Affairs and Prudential provided technical comments on our draft report. We considered these comments and revised the final report as appropriate.

The Government Is More Likely to Pay Claims Than Prudential

The government paid over $500 million for SGLI claims since the program's inception in 1965. In contrast, no claims have ever been paid from resources of Prudential and its reinsurers. VA's actuarial projections show that it is very unlikely that Prudential or its reinsurers will ever have to pay a claim from their own resources. However, VA's contract with Prudential needs to be amended concerning the payment of claims in certain peacetime situations.

Government Responsibility

The law requires the use of appropriated funds to pay SGLI insureds' claims resulting from the extra hazards of military service that exceed the normal annual level of claims for that year. VA calculates the normal annual level as an average of the last 3 years of claims plus 5 percent. For the 1990 policy year, the normal annual level was 3,845 claims. Thus far, the only time that total claims have exceeded normal annual levels was during the Vietnam War when the government paid over $500 million in SGLI claims. VA did not request appropriated funds to pay for claims resulting from the bombing of the marine barracks in Lebanon or for military actions in Grenada, Panama, or the Persian Gulf because actual claims did not exceed normal annual levels.

The Secretary of Veterans Affairs is responsible for determining when an extra-hazardous duty situation exists. When this determination is made and claims exceed the normal annual level, the Secretary is responsible for requesting appropriated funds from the Department of Defense to pay claims.

Prudential and the Reinsurers

SGLI has been operating under a contract that does not clearly state whether VA or Prudential pays claims in certain peacetime situations that do not involve hazardous duty. During 1990, VA and Prudential exchanged a series of letters to clarify who would pay claims in certain situations. The correspondence shows that Prudential agreed it would pay hazardous duty claims, peacetime claims, or both up to the normal annual level using SGLI premiums and interest income. Prudential would then use the contingency reserve to pay peacetime claims that exceed the normal annual level. Prudential and the reinsurers would be responsible for paying any peacetime claims that arise after the contingency reserve has been depleted. Examples of the types of scenarios discussed and the understandings reached are in appendix II. VA and Prudential officials told us that they believe they are not legally bound by this understanding.

Conclusions

VA's contract with Prudential does not clearly address who pays for claims in certain peacetime situations. Contract amendments should cover the agreements reached between VA and Prudential during 1990.

Recommendation to the Secretary of Veterans Affairs

We recommend that the Secretary negotiate with Prudential to amend the contract to explicitly state which party is responsible for paying peacetime claims in scenarios that were the subject of discussions between VA and Prudential during 1990.

Agency Comments and Our Evaluation

The Secretary did not concur with our recommendation to negotiate with Prudential to amend the contract to clarify liability in certain peacetime situations because VA did not believe a contract amendment was necessary. GAO believes that because VA and Prudential found it necessary to "clarify" this issue with what the Secretary referred to as informal letters and neither VA nor Prudential believe it is legally bound by the agreements reached, some uncertainty exists and the contract may not be as clear as the Secretary indicated in his comments. The Secretary also commented that the Veterans Benefits Administration would consider any draft language that GAO might propose to amend the contract. We believe that the negotiations and resulting language would be more appropriately handled by the contract administrator.

SGLI Operating Reserves Held by Prudential

As of June 30, 1991, the end of the full policy year, The Prudential Insurance Company of America held SGLI reserves of approximately $165 million as follows:

- Reserve for pending death claims (claims reported but not yet paid)—$46.9 million.
- Reserve for unreported death claims (claims for deaths unreported but actuarially determined to have occurred)—$46.8 million.
- Reserve for unearned premiums (to hold premiums paid in advance by some members with Veterans Group Life Insurance or Retired Reservist coverage)—$7.3 million.
- Post-separation reserve (to pay premiums for the 120-day free SGLI coverage following release from service)—$3.5 million.
- Term to age 60 reserve (covers claims and expenses in excess of future premiums collected for the existing group of retired reservists insured under 38 U.S.C. section 767(a)(3))—$19.7 million.
- Veterans Group Life Insurance Reserve (held to pay the higher costs of mortality during the latter part of the 5-year term coverage period from the excess premiums paid during the earlier part of the 5-year term when mortality is normally lower)—$40.6 million.

Examples of the Liability for Claims Discussed by VA and Prudential During 1990

Below are examples of the types of scenarios discussed in correspondence between VA and Prudential during 1990 to clarify who would pay claims in certain situations. The $70 million contingency reserve level used below reflects the limit for the fund set by VA in 1984.

1. Natural disaster: An earthquake strikes California, killing 2,000 service members and reservists. Additional claims of $100 million above the normal annual level are incurred, depleting the contingency reserve of $70 million. The reinsurers would be responsible for the remaining $30 million in claims.

2. Epidemic: Disease spreads through service personnel ranks quickly, killing 1,500 service members. Additional claims of $75 million above the normal annual level are incurred, $70 million of which are paid out of the contingency reserve, with the remaining $5 million paid by reinsurers.

3. Accident: An explosion destroys an aircraft carrier, killing 1,700 service members. Additional claims of $85 million above the normal annual level are incurred, depleting the $70 million contingency fund and requiring a $15 million payment by the reinsurers.

4. Military action taken by the United States: The United States sends peacekeeping troops to the Middle East. A terrorist bombing results in 1,500 casualties. The Secretary of Veterans Affairs determines that excess claims occurred as a result of the extra hazard of military service. VA seeks reimbursement from the uniformed services for the additional $75 million in claims above the normal annual level.

5. Limited military action taken by the United States: United States forces invade overseas, resulting in 200 casualties. Although the Secretary determines that excess claims resulted from the extra hazard of military service, the claims for the year do not exceed the normal annual level. Therefore, the $10 million in claims is paid from collected premiums, with no reimbursement from the uniformed services.

6. Accident and military action taken by the United States: The United States sends peacekeeping troops to the Middle East to combat terrorism, resulting in 1,500 casualties. The Secretary determines that the excess claims resulted from the extra hazard of military service. In the same year, an epidemic spreads through service personnel ranks, killing 1,500 service members. VA seeks reimbursement from the uniformed service for $75 million in combat-related claims, and, because the epidemic generates $75

million in claims, depleting the $70 million contingency reserve, $5 million is payable by the reinsurers.

Comments From the Department of Veterans Affairs

DEPARTMENT OF VETERANS AFFAIRS
INSPECTOR GENERAL
WASHINGTON DC 20420

MAY 22 1992

Mr. Joseph F. Delfico
Director, Income Security Issues
Human Resources Division
U.S. General Accounting Office
441 G Street, NW
Washington, DC 20548

Dear Mr. Delfico:

I have read your draft report, **VA LIFE INSURANCE: Premiums and Program Reserves Need More Timely Adjustments**, (GAO/HRD-92-71), and do not concur with its recommendations. I believe that, if implemented, the report's recommendations would:

- Undermine the strong financial position of SGLI;

- Jeopardize the current reinsurance agreements;

- Eliminate the ability of the program to offer low cost coverage at a stabilized rate over an extended period of time, and

- Impede the flexibility that the program has had in implementing Congressionally mandated changes with a minimum impact on the insureds and the uniformed service departments.

It is my goal that Department of Veterans Affairs (VA) programs be administered as economically and efficiently as possible. This should be accomplished in the context of ensuring that veterans' rights and benefits are protected to the utmost.

Regarding your recommendation that the contingency reserve be reduced, I agree that it can be reduced, and we are already reducing it. However, I believe your recommended level of $25 million is too low to meet my responsibility of ensuring that Prudential obtains and maintains reinsurance. A $25 million reserve level would only allow for 250 claims above normal expectations and would discourage reinsurance providers from participating in the program. Additionally, in view of the significant differences in the position of GAO's actuarial consultants versus that of VA's and Prudential's actuarial staff, VBA will seek the views of disinterested outside actuaries from the industry to determine the reasonableness of both sides' positions. This should resolve our differences concerning the contingency reserve level.

Second, you recommend that I compute and adjust "true premiums" annually. We are already doing this. Although premium rates have not changed since 1984, we reviewed the program each year and determined premium changes were not needed. We strongly disagree that we overcharged policyholders in the 1980s. Designed to reduce the contingency fund, the current premium was set below the break-even point. We feel this is appropriate. We will continue to analyze premium rates each year and adjust premiums as might be warranted.

GAO also recommended that VA negotiate with Prudential to amend the contract terms to clarify which party is responsible for paying claims under certain peacetime situations. VA and Prudential have been working closely to clarify this issue, and we do not believe a contract amendment is necessary. Nevertheless, VBA officials are willing to consider any specific contract language amendments that GAO would recommend while assuring consistency with 38 U.S.C. and 38 CFR.

The enclosure details our concerns with the report's recommendations, and provides corrections for several erroneous statements in the report. Thank you for the opportunity to comment on your report.

Sincerely yours,

Edward J. Derwinski

Enclosure
EJD/vz

Enclosure

DEPARTMENT OF VETERANS AFFAIRS
COMMENTS TO GAO DRAFT REPORT, VA LIFE INSURANCE:
Premiums and Program Reserves Need More
Timely Adjustments
(GAO/HRD-92-71)

GAO recommends that I reduce the contingency reserve held by Prudential to $25 million and use the excess funds in lieu of transfers from the revolving fund to provide a portion of the additional operating reserves.

Do not Concur - While we agree that the contingency reserve that Prudential holds should be reduced, our analysis indicates the proper level would be $50 million. This would permit us to continue the premium rate at 8 cents per month per $1000--below the break even level. It will also serve to gradually liquidate the revolving fund for the benefit of SGLI insureds.

See pp. 3 and 13.

VA and Prudential officials have not agreed, as stated in the draft report on page 21, that the target level of the contingency reserve can be set at $25 million. This would allow for only 250 additional deaths before Prudential and the reinsuring companies would be required to provide payment from their own company funds. Because of the fluctuations in death claims, reserves, expenses, and conversion pool costs from year to year, it would be administratively impossible to assure the reinsuring companies that a $25 million level of contingency reserve was being maintained.

Now on p. 13.

The contingency reserve is actually a balancing fund in that after all other reserves are fully funded the remaining balance is carried on the books as the contingency reserve at the end of the policy year. The SGLI Program Actuarial Director has advised us that the quote on page 21 attributed to his office does not fairly represent their position with regard to the need for the contingency reserve. They have provided us with a copy of their response to GAO that clarifies their position on the contingency reserve and states what the impact would be if the reserve were not maintained. Their response indicates that without the reserve, the risk charges would be increased to be commensurate with the higher risk and the premium rates would have to be increased to provide for the additional margin required.

Furthermore, we disagree with GAO's statistical analysis that there is less than 0.1 percent probability that the $25 million contingency reserve would be exceeded by higher-than-expected claims in a particular year. Our analysis, based on actual experience for the period 1984-1990, shows that there is considerable fluctuation in claims from year to year, as one would expect when the primary cause of deaths is accidents. We estimate the probability that excess claims will exceed 250 deaths to be 19 percent and the probability that excess claims will exceed 500 deaths to be 4 percent. Given the additional risk of fluctuations in reserves, expenses, and conversion pool costs, it becomes apparent that the target level for the contingency reserve cannot be lower than $50 million. We believe that most of the reinsuring companies would be unwilling to take on any further liability. Their ranks have already dwindled from 310 companies in 1984 to 161 companies today. A substantial increase in their potential liability would induce more companies to withdraw as reinsurers and, with too few companies to share the risk, jeopardize the reinsurance arrangement itself.

GAO also recommends that I compute and adjust each year the true premiums to be paid by SGLI participants. GAO says I should consider future excess funds in the contingency reserve as a program resource when making this computation.

Do not Concur - We believe that we are already in conformance with the intent of this recommendation. VA and Prudential currently do set "true premium" rates for the SGLI program and review the financial experience of the program annually to determine if any changes are required. Policyholders were not overcharged for SGLI insurance during the 1980's, as GAO claims. The basic SGLI premium rate was set below the break-even level (premium income minus claims and expenses) in 1984 when it was reduced to 8 cents per month per $1,000. This is producing the desired result of reducing the contingency reserve to its $50 million target level. In effect, the interest earned on the reserves has allowed us to continue to offer SGLI at less than the break-even level as described above.

Had GAO's methodology been followed in 1984, the premium rate would have been lowered to just 1 cent per month per $1,000 for one year and then raised to 11 cents per month per $1,000 the following year. This would have been unacceptable to the SGLI Advisory Council members and difficult to explain to service personnel. Frequent premium changes are not desirable from the perspective of any of the parties involved and may cause some service members to drop their coverage entirely. In addition, it puts an administrative burden on the service departments who are responsible for collecting these insurance premiums and forwarding them to VA. Deduction changes must be made in the financial and pay systems. All three million service personnel must be notified of the change. Many service members may request coverage amount changes as a result, requiring additional administrative processing.

Finally, authorizing legislation for the SGLI insurance program does not specifically require premium rates to be adjusted annually. Authorizing legislation requires the program to be self supporting, which GAO has interpreted to require annual adjustments of premiums to "true premium rates". GAO used the fact that premiums have not changed since 1984 and the increase of reserves since then, as prima facie evidence that "true premium rates" were not established and policyholders were overcharged. We believe this conclusion is flawed. Considering all program resources, including reserve funds, in establishing the current premium, we believe we met the intent and the letter of the law. We also believe the program is self supporting, as evidenced by the financial data presented in the GAO report.

While claiming that VA has been overcharging for SGLI coverage, the methodology recommended by GAO would actually now result in an increase in the basic premium rate above the 8 cents level. Their method does not account for the liquidation of the $191 million SGLI revolving fund, which they agree are excess funds.

Finally, GAO recommends that I negotiate with Prudential to amend the contract to explicitly state which party is responsible for paying claims in certain peacetime situations.

Do Not Concur - Again, we believe that we are already in conformance with the intent of this recommendation. The contract specifically states in Article I, Section 2: "Upon receipt by the Office of due proof in writing that any person died while insured under the Group Policy for Servicemen's Group Life Insurance or Veterans's Group Life Insurance, the Office shall, except as provided in Section 10 of this Article I and subject to the other terms of the Group Policy, pay the amount for which such person is insured under the Group Policy."

The term "Office" means the Office of Servicemen's Group Life Insurance which is the administrative office established by Prudential for the Group Policy. According to the contract, Prudential is responsible for the payment of all death claims. The only exception given in Section 10 refers to cases of mutiny, treason, spying, or desertion.

VA's only responsibility for claim expense reimbursement of Prudential is for the cost of claims attributable to the extra hazards of active military duty situations, such as in wartime. The last such reimbursement occurred in 1974 at the end of the Vietnam conflict. In order to make such reimbursement, VA would request funds from the various service departments as provided in 38 U.S.C. 1971 (b).

Under the terms of the contract VA is not responsible for the reimbursement of claims that do not involve the extra hazards of active military duty. Since both title 38 and the contract give the authority of making extra hazard determinations to the Secretary, we do not believe that a contract amendment is necessary. Although VA and Prudential have exchanged letters which identify various scenarios under which extra hazard payments would be appropriate, we believe the existing contract language in conjunction with past experience as well as the informal exchange of letters on the issue is sufficient to protect the interests of the insureds and the Government. Nevertheless, we would be more than willing to consider any specific contract language amendments that GAO recommends which would be consistent with 38 U.S.C. 1971 and 38 CFR 9.12. Should excess peacetime claims exhaust the contingency reserve held by Prudential, their recourse is to request reimbursement from the 161 reinsuring companies under the provisions of the reinsurance agreement they hold with these companies.

We offer the following comments to correct technical discrepancies in the report:

- On page 2, the report states that SGLI provides one year renewable term life insurance. SGLI actually provides group term life insurance coverage at a single premium rate to active duty and ready reservist personnel. It also provides coverage for group separatees and retired members at premium rates that increase with age. On page 3, GAO refers to those covered as policyholders. For the SGLI program, VA is the policyholder. No individual polices are issued to covered members, as was the case prior to the enactment of the SGLI program.

- On page 14, GAO states that VA is responsible for setting premium levels, as though this responsibility were unilateral. The SGLI contract specifically provides that premiums will be determined by "mutual agreement of the policyholder and the insurance company." GAO also states that there are over 250 reinsuring companies. For the current policy year, there are only 161 reinsurers.

- On page 19, GAO states the contingency reserve has never been used to pay unexpected increases in claims. This is not the case. While claims experience has generally improved over the program's 27 years of existence, there have been years when claims were higher than expected. This occurred in policy years 1969, 1970, 1975, and 1986. The higher-than-expected claims in those years were absorbed by the contingency reserve, which declined as a result.

Comments From The Prudential Insurance Company of America

ThePrudential

Catherine A. Smith
Actuarial Director

The Prudential Insurance Company of America
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May 5, 1992

Mr. Joseph F. DelFico, Director
Income Securities Issues
United States General Accounting Office
Human Resources Division
Washington, D.C. 20548

Dear Mr. DelFico:

I have received the GAO's draft report on the administration of the Servicemen's Group Life Insurance program.

The Prudential's comments on the GAO's report have been incorporated with the Veterans Administration's response to the GAO. We agree with the points that the Veterans Administration makes in its response.

Now on p. 12.

In addition, I would like to comment on the GAO's statement on page 21 of the draft report, that reads, "Prudential officials told us that they would not maintain such a reserve (the contingency reserve) were it not required by law."

This statement, I believe, is based on a letter dated July 18, 1990, from Prudential to the GAO, in which the various reserves The Prudential holds for OSGLI business are described.

The main point that is made in that letter with regard to the contingency reserve is that the contingency reserve is a contractual special reserve. Unlike other reserves that are determined on an actuarial basis to reflect insurance company liabilities at the end of each policy year, the contingency reserve is established in accordance with the agreement between The Prudential and the Veterans Administration to stabilize premium rates and experience fluctuations in succeeding policy periods. Since the agreement between The Prudential and the Veterans Administration was established by law, the contingency reserve has, in turn, also been established by law.

The fact that the contingency reserve is authorized by enabling legislation does not mean that The Prudential only holds it because it is required by law. The contingency reserve is necessary to absorb fluctuations in experience, and, thereby, reduce the risk of loss. By reducing the risk of loss, risk charges are minimized. If the contingency reserve did not exist, the risk charges would be increased to be commensurate with the higher risk. Furthermore, the premium rates would have to provide additional margin, since the current premium rates do not contain any margin. In fact, the current premium rates are set at a level low enough to reduce the contingency reserve.

Letter to Joseph F. DelFico
GAO Report
Page Two
May 5, 1992

I hope that the above explanation provides the GAO with the actual intent of the statement made by The Prudential in the July, 1990 letter.

Sincerely,

Catherine Smith

Catherine A. Smith, FSA
Actuarial Director
National Account Operations

cc: Daniel D'Andrea, The Prudential
Forsetta Mosley, The Prudential
Mike Tarzian, Veterans Administration

Comments From Hay/Huggins, Inc.

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May 13, 1992

Hay/Huggins Company

Mr. Joseph F. Delfico
Director, Income Security Issues
General Accounting Office
441 G Street N.W.
Room 6737
Human Resources Division
Washington, D.C. 20548

Dear Mr. Delfico:

As you requested in your letter of April 13, 1992, we have reviewed the draft General Accounting Office (GAO) report on the Servicemen's Group Life Insurance Program (SGLI) and we agree with the GAO conclusions related to the size of the reserve and the level of premium. We agree that the other conclusion (peacetime liability needs clarification) seems reasonable but our review was limited to the actuarial issues. SGLI is administered by the Department of Veterans Affairs (VA).

We agree that the reserves need only be large enough to cover known claims with a small margin for error. The GAO estimate of $25 million as the maximum needed for chance fluctuation is based on reasonable statistical methods. VA agreed that the $25 million was the maximum amount justified on an actuarial basis but presented six catastrophic events that would require more than $25 million in a given year. These are summarized in Appendix II of the draft report. In our opinion, those scenarios are too extreme to be considered in setting an appropriate contingency reserve.

See app. II.

VA had insurance in force of $347 billion for 3.8 million policyholders as of June 30, 1991. The reserves were held in the following three reserves totalling $432 million as of June 30, 1991.

- Operating reserves of $165 million maintained by the insurer for benefits not yet paid for deaths that had occurred before June 30, 1991.

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- Contingency reserves of $76 million held by the insurer.
- A revolving fund of $191 million held by the government.

Since the operating reserves are needed for obligations incurred before June 30, 1991, they cannot be used for future contingencies or rate adjustments.

The contingency reserve and revolving fund together are the total gain on operations, including interest, since the beginning of the system. In theory, amounts in these funds in excess of the true contingency reserve can be used to reduce future rates. In practice, the principal in the revolving fund may not be readily available for that purpose. Since the revolving fund is held in Federal accounts, any use of the fund to subsidize premiums would be an outlay from the Federal budget.

The operating reserves will have to be increased as a result of the increase in life insurance. VA has proposed that the increase be drawn from the revolving fund. However, the true source of the operating fund is the premiums. If premiums plus investment income are sufficient to finance the claims and administrative expenses, the operating reserves will grow naturally to the appropriate level. A requirement for additional funds is therefore best characterized as a subsidy for insufficient premiums.

The program produced a surplus on operations through 1991 but the increase in the life insurance from $50,000 to $100,000 will probably result in a deficit in operating income that will have to be drawn from the contingency reserve or revolving fund. Premiums will increase at the same rate as death claims. However, other items of income and expense will increase at different rates with an expected outcome of a loss on operations. For instance, the doubling of the life insurance had no impact on the reserves or the investment income on those reserves. The table summarizes the results.

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Summary of SGLI Operations as Reported by the Department of Veterans Affairs (Millions of Dollars)			
Item	Actual 1990	Expected 1993	Increase
Premiums	$158.2	$288.4	82%
Interest	30.4	30.0	(1%)
Total Income	188.6	318.4	69%
Death Claims	164.7	301.8	83%
Other Expenses	2.7	3.9	44%
Transfer to retiree reserves	5.2	30.0	476%
Total Expense	172.6	335.6	94%
Gain (loss) on operations	16.0	(17.3)	

GAO recommends that the VA determine premium rates that reasonably reflect the expected operations of the fund including the drawdown or buildup needed to attain the preferred $25 million contingency reserve level. If these rates vary significantly from the rates being charged then there should be periodic adjustments to permit a smooth progression to the recommended contingency reserve level. General practice is to adjust the rates, if needed, every three to five years. Annual adjustments would be unnecessary and needlessly confusing to the participants.

It is not possible to identify the true premium from information available to GAO. The projections provided by VA and extracted above support the fact that the current rate of 8 cents per month per $1,000 of insurance will in fact require a subsidy. If that is the case, then no rate adjustment will be needed until the contingency reserve is drawn down to $25 million. At that time the rates might have to be increased slightly to keep the contingency reserve near the $25 million goal. According to the VA projections, that would require an increase to around 8.5 cents in 1994.

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Our understanding of the intended result of the GAO recommendations is as follows:

- The maximum contingency reserve needed for unexpected claims is $25,000,000. The contingency reserve should not be projected to sink below that level.
- Rates should be set that are expected to gradually use up any excess in the contingency reserve above $25,000,000.
- If, as a result of favorable experience, the contingency reserve does not decline as expected, then the gains should stay in the contingency reserve until rates can be reduced to the point that the contingency reserve will definitely decline.
- If and when the contingency reserve drops below $25,000,000, the reserve should be built up through rate increases.

We agree that the adoption of policies and procedures to achieve the above results would be actuarially sound.

Sincerely,

Edwin C. Hustead
Senior Vice President

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