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☞ Details: An audit of state life insurance fund, November 1996

(FORM UPDATED: 08/11/2010)

WISCONSIN STATE LEGISLATURE ... PUBLIC HEARING - COMMITTEE RECORDS

1995-96

(session year)

Assembly

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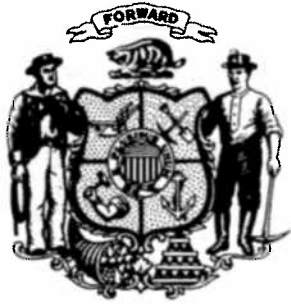
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STATE OF WISCONSIN
LEGISLATIVE AUDIT BUREAU

**AN AUDIT OF
STATE LIFE INSURANCE FUND**

NOVEMBER 1996

96-14

1995-96 Joint Legislative Audit Committee Members

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Brian Burke
Peggy Rosenzweig
Dale Schultz**

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November 4, 1996

Senator Kimberly M. Plache and
Representative Mary A. Lazich, Co-Chairpersons
Joint Legislative Audit Committee
State Capitol
Madison, Wisconsin 53702

Dear Senator Plache and Representative Lazich:


We have completed an audit of the financial statements of the State Life Insurance Fund for the period January 1, 1994 through December 31, 1995, as required by s. 13.94, Wis. Stats. The Fund, which was created in 1911 to provide low-cost life insurance policies to Wisconsin residents, is administered by the Office of the Commissioner of Insurance. As of December 31, 1995, the Fund had 30,980 life insurance policies in effect. The Fund is subject to the same regulatory requirements as any life insurance company licensed to operate in Wisconsin, as well as to other specific statutory restrictions, such as a prohibition on advertising and maximum coverage of \$10,000.

We provide an unqualified independent auditor's opinion on the regulatory-based financial statements and notes. The Fund, which is self-funded through premiums and investments, appears to be a financially sound insurance program. It realized net gains of \$3.7 million and \$3.9 million that it returned to policyholders as dividends in 1995 and 1994, respectively. The Fund adjusts the dividend rate to keep the surplus within suggested statutory parameters of between 7 and 10 percent of assets, with its most recent change in the dividend scale occurring in April 1995. The Fund's surplus-to-assets ratio was 10.7 percent as of December 31, 1995.

We are issuing a separate management letter to the Office of the Commissioner of Insurance, discussing several continuing control concerns. We found that Life Fund staff do not perform sufficient reconciliations to ensure that financial transactions are properly recorded in both the Fund's and the State's accounting systems. In addition, we identified several areas in which information system controls could be improved, including access to the Fund's computer system and data, and development of disaster-recovery and business resumption plans.

We appreciate the courtesy and cooperation extended to us by the staff of the Office of the Commissioner of Insurance.

Respectfully submitted,


Dale Cattanaach
State Auditor

DC/DA/ce

INDEPENDENT AUDITOR'S REPORT

We have audited the accompanying balance sheet—regulatory basis of the Wisconsin State Life Insurance Fund as of December 31, 1995, and December 31, 1994, and the related statements of operations and change in fund surplus—regulatory basis and cash flow—regulatory basis for the years then ended. These financial statements are the responsibility of the management of the State Life Insurance Fund. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note 1, the financial statements present only the State Life Insurance Fund and are not intended to present fairly the financial position of the State of Wisconsin and the results of its operations and changes in financial position of its proprietary fund types in conformity with generally accepted accounting principles.

As described in Note 2, these financial statements are prepared in conformity with the accounting practices prescribed or permitted by the Commissioner of Insurance of the State of Wisconsin, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the State Life Insurance Fund as of December 31, 1995, and December 31, 1994, and the results of its operations and change in fund surplus and its cash flows for the years then ended on the basis of accounting described in Note 2.

In accordance with *Government Auditing Standards*, we have also issued a report dated September 24, 1996, on our consideration of the State Life Insurance Fund's internal control structure and a report dated September 24, 1996, on its compliance with laws and regulations.

LEGISLATIVE AUDIT BUREAU

September 24, 1996

by



Diann Allsen
Financial Audit Director

Office of the Commissioner of Insurance
State Life Insurance Fund
Balance Sheet - Regulatory Basis
December 31, 1995 and December 31, 1994

Statement 1

Assets	<u>December 31, 1995</u>	<u>December 31, 1994</u>
Investments:		
Bonds, at amortized cost	\$33,709,508	\$32,862,318
Private placements, at amortized cost	17,498,956	15,991,124
Policy loans	3,745,623	3,674,086
Mortgage loans	0	34,391
Total investments	54,954,087	52,561,919
Cash and cash equivalents	5,811,917	5,408,725
Premiums receivable	147,399	133,565
Investment income receivable	1,302,460	1,354,286
Total assets	\$62,215,863	\$59,458,495
Liabilities and Fund Surplus		
Liability for future benefits:		
Life policies and contracts	\$42,634,463	\$41,203,477
Supplementary contracts without life contingencies	281,916	286,242
Total liability for future benefits	42,916,379	41,489,719
Policy claims payable	113,500	67,647
Dividends left to accumulate at interest	6,609,908	6,079,181
Dividends due and unpaid, plus those payable in the following year	3,718,661	3,912,238
Accrued deposits	1,004,332	939,710
Premiums received in advance	40,000	28,439
General expenses and taxes payable	14,614	28,826
Interest maintenance reserve	335,664	281,753
Asset valuation reserve	574,723	552,469
Other liabilities	222,132	121,582
Total liabilities	55,549,913	53,501,564
Surplus	6,665,950	5,956,931
Total liabilities and fund surplus	\$62,215,863	\$59,458,495

The accompanying notes are an integral part of this statement.

Office of the Commissioner of Insurance
State Life Insurance Fund

Statement 2

Statement of Operations and Change in Fund Surplus - Regulatory Basis
for the Years Ended December 31, 1995 and December 31, 1994

	<u>Year Ended</u> <u>December 31, 1995</u>	<u>Year Ended</u> <u>December 31, 1994</u>
Revenues		
Premiums and annuity considerations	\$2,953,895	\$2,973,536
Considerations for supplementary contracts and dividend accumulations	947,108	1,133,045
Net investment income	4,879,043	4,664,459
Amortization of interest maintenance reserve	51,670	60,798
Miscellaneous income	9,656	33,586
Total Revenues	8,841,372	8,865,424
Operating Expenses		
Benefits:		
Death benefits	648,587	511,129
Matured endowments	393,000	396,000
Disability benefits	13,756	11,351
Surrender benefits	249,406	205,576
Interest on policy or contract funds	69,203	63,522
Payments on supplementary contracts and dividend accumulations	726,890	682,563
Increase in aggregate liability for future benefits and payments	2,270,486	2,447,404
Total benefits	4,371,328	4,317,545
General expenses	356,577	448,754
Total Operating Expenses	4,727,905	4,766,299
Net Income from Operations before Dividends and Realized Capital Gains	4,113,467	4,099,125
Dividends to policyholders	(3,696,016)	(3,898,152)
Realized capital gains	840	25,527
Net income	\$ 418,291	\$ 226,500
Surplus at beginning of period	\$5,956,931	\$5,723,574
Net income	418,291	226,500
Change in asset valuation reserve	(22,254)	7,031
Change in basis of valuation	313,099	
Other items affecting surplus	(117)	(174)
Net change in surplus account	709,019	233,357
Surplus at end of period	\$6,665,950	\$5,956,931

The accompanying notes are an integral part of this statement.

Office of the Commissioner of Insurance
State Life Insurance Fund
Cash Flow Statement - Regulatory Basis
for the Years Ended December 31, 1995 and December 31, 1994

Statement 3

	<u>Year Ended</u> <u>December 31, 1995</u>	<u>Year Ended</u> <u>December 31, 1994</u>
Cash Provided from Operating Activities		
Premium and annuity considerations	\$2,965,209	\$3,012,106
Other premiums considerations and deposits	947,108	1,133,045
Decrease (increase) in policy loans	(71,537)	15,666
Net investment income	4,919,533	4,666,811
Other income received	173,572	225,865
Total receipts	<u>8,933,885</u>	<u>9,053,493</u>
Life claims paid	1,009,490	943,833
Surrender benefits paid	249,406	205,576
Other benefits paid	794,954	744,203
Total benefits paid	<u>2,053,850</u>	<u>1,893,612</u>
General expenses and taxes paid	384,378	439,842
Dividends paid	3,889,593	4,567,267
Total other expenses paid	<u>4,273,971</u>	<u>5,007,109</u>
Net cash provided by operating activities	<u>2,606,064</u>	<u>2,152,772</u>
Cash Provided from Investing Activities		
Cash received from sale of bonds	4,073,751	3,062,691
Cash received from mortgage payments	34,391	1,876
Cash paid for purchase of bonds	(6,311,014)	(3,604,870)
Net cash used by investing activities	<u>(2,202,872)</u>	<u>(540,303)</u>
Net change in cash and cash equivalents	403,192	1,612,469
Cash and cash equivalents at January 1	<u>5,408,725</u>	<u>3,796,256</u>
Cash and cash equivalents at December 31	<u><u>\$5,811,917</u></u>	<u><u>\$5,408,725</u></u>

The accompanying notes are an integral part of this statement.

NOTES TO THE FINANCIAL STATEMENTS

1. Description of the Fund

The State Life Insurance Fund, which is part of the State of Wisconsin financial reporting entity and is reported as an enterprise fund in the State's Comprehensive Annual Financial Report, was created in 1911 to provide life insurance policies to Wisconsin residents at the lowest possible cost. The Fund is administered by the Office of the Commissioner of Insurance.

The Fund's operation is similar to that of a mutual life insurance company, and the Fund is subject to the same regulatory requirements as any life insurance company licensed to operate in Wisconsin. The Fund is also subject to other specific statutory restrictions, such as a prohibition on advertising and a maximum coverage of \$10,000, that limit the competitive advantage the Fund may have over private insurance companies. The Fund offers two basic policies: whole life insurance and term insurance. As of December 31, 1995, the Fund had 30,980 life insurance policies in effect.

2. Basis of Presentation

The accompanying financial statements have been prepared in conformity with accounting practices prescribed or permitted by the State of Wisconsin's Commissioner of Insurance and vary in some respects from generally accepted accounting principles. The most significant differences include:

- acquisition costs are charged to current operations as incurred;
- an asset valuation reserve is established as a buffer against fluctuating asset prices caused by changes in the credit quality of the investment portfolio; changes in this reserve are charged directly to surplus, and the balance at year-end is reported as a liability;
- an interest maintenance reserve is established as a buffer against realized gains and losses caused by general interest rate changes; changes in this reserve are amortized over time, and the balance at year-end is reported as a liability; and
- unrealized capital gains and losses are reflected as direct credits or charges to surplus rather than as income.

3. Basis of Valuation of Invested Assets

Investments are carried at values on the following bases:

- all mortgage-backed securities are carried at amortized cost using the prospective scientific method; all other bonds are carried at amortized cost using the straight-line method of amortization;
- mortgage loan values are at outstanding indebtedness;
- policy loan values are at outstanding indebtedness, not in excess of policy cash surrender value; and
- investments in the State Investment Fund, which are reported as cash equivalents, are carried at the cost of the participating shares, which is also the realizable value as of December 31. Interest income, gains, and losses of the Investment Fund are allocated monthly.

4. Deposits and Investments

All cash is deposited with the State of Wisconsin Treasurer and is invested by the State of Wisconsin Investment Board through the State Investment Fund. Sections 25.17(3)(b), (ba), and (bd), Wis. Stats., enumerate the various types of securities in which the State Investment Fund may invest, which include direct obligations of the United States and Canada, securities guaranteed by the United States, unsecured notes of financial and industrial issuers, Yankee/Eurodollar issues, and certificates of deposit issued by banks in the United States and solvent financial institutions in the State. Any other investments must be approved by the trustees of the State of Wisconsin Investment Board.

As of December 31, 1995, the State of Wisconsin Investment Board utilized various derivative financial instruments in the State Investment Fund, including interest rate swap agreements, options, structured bonds with interest rate and redemption altering components, and interest only strips, for the purpose of increasing yield in the Fund. Derivative transactions involve, to varying degrees, market risk and credit risk. During 1995, the State of Wisconsin Investment Board determined that several of the derivative positions were not in compliance with the guidelines of the Board's Trustees and took steps to limit the risks of the positions.

Bonds purchased for the State Life Insurance Fund consist of U.S. Government obligations; other state, territory, or possession obligations; and public utility, railroad, industrial, and miscellaneous corporate obligations. The book values and market values of the Fund's investments at year-end are shown as follows:

<u>Bonds</u>	December 31, 1995		December 31, 1994	
	<u>Book Value</u>	<u>Market Value</u>	<u>Book Value</u>	<u>Market Value</u>
Government				
Not backed by loans	\$ 16,677,692	\$ 18,629,000	\$16,857,462	\$16,804,250
Backed by loans	<u>1,125,144</u>	<u>1,186,046</u>	<u>601,472</u>	<u>618,567</u>
Total Government	17,802,836	19,815,046	17,458,934	17,422,817
Utilities	6,995,080	7,537,476	7,016,687	6,701,026
Industrials and Others	<u>8,911,592</u>	<u>9,394,400</u>	<u>8,386,697</u>	<u>7,941,931</u>
Total Bonds	\$ 33,709,508	\$ 36,746,922	\$32,862,318	\$32,065,774

<u>Private Placements</u>	December 31 1995		December 31, 1994	
	<u>Book Value</u>	<u>Market Value</u>	<u>Book Value</u>	<u>Market Value</u>
Government				
Backed by loans	\$ <u>213,975</u>	\$ 217,998	\$ <u>227,492</u>	\$ <u>232,486</u>
Total Government	213,975	217,998	227,492	232,486
Utilities	2,697,276	2,788,453	1,854,781	1,949,018
Industrials and Others	<u>14,587,705</u>	<u>15,596,143</u>	<u>13,908,851</u>	<u>14,944,996</u>
Total Private Placements	\$17,498,956	\$18,602,594	\$15,991,124	\$17,126,500

All deposits and investments of the State Investment Fund that are required to be categorized by Governmental Accounting Standards Board Statement Number Three meet the criteria for risk category 1. Cash deposits in risk category 1 are insured or collateralized with securities held by the State or by its agent in the State's name. Investments and bonds in risk category 1 are insured or registered, or are held by the State or its agent in the State's name.

5. Investment Income

Net investment income for calendar years (CYs) 1995 and 1994 consisted of the following components:

	<u>1995</u>	<u>1994</u>
Bonds and Private Placements	\$4,368,324	\$4,227,485
Policy Loans	236,497	233,956
State Investment Fund	299,391	223,059
Mortgage Loans	<u>931</u>	<u>1,859</u>
Subtotal	\$4,905,143	\$4,686,359
Less Investment Expenses	<u>26,100</u>	<u>21,900</u>
Total	\$4,879,043	\$4,664,459

6. Interest Maintenance Reserve

The interest maintenance reserve (IMR) accumulates interest-related realized gains and losses and amortizes them into income over the remaining life of the investments sold. The State Life Insurance Fund uses the IMR method that amortizes groups of assets based on the average maturity dates using standard amortization tables developed by the National Association of Insurance Commissioners.

7. Premiums and Annuity Considerations

Premium revenues are reported as earned on the policy anniversary date. Related expenses are recognized when incurred.

Deferred and uncollected life insurance premiums and annuity considerations, all of which were for ordinary life insurance, as of December 31, 1995 and 1994, were:

	<u>1995</u>	<u>1994</u>
Gross Amount	\$179,620	\$179,373
Amount Net of Loading	\$147,399	\$133,565

8. Reinsurance

The State Life Insurance Fund has a reinsurance contract with Lincoln National Life Reinsurance Company for insuring those applicants considered high risk by the Fund. Under this reinsurance agreement, the Fund retains the reserves and related assets; pays the reinsurer premiums for the ceded business; and is reimbursed for benefits, unusual expenses, and adjustments to required reserves. The reinsurer has no obligation for the reimbursement of dividends related to the ceded business.

As of December 31, 1995, total life insurance in force was approximately \$225.33 million, of which \$2.53 million had been ceded. The Fund is contingently liable with respect to ceded insurance should the reinsurer be unable to meet its assumed obligations.

Revenues received from the reinsurer are treated as a reduction of benefit expense; payments to the reinsurer are treated as a reduction of premium income. Reinsurance transactions reported in the Fund's operations include \$26,871 in claims incurred and \$30,389 in premiums earned in 1994, and \$3,413 in claims incurred and \$24,955 in premiums earned in 1995.

9. Liability for Future Benefits

Insurance and annuity liabilities for future benefits for policies issued prior to 1977 are determined in accordance with the Net Level Premium Method, using the American Experience or 1958 Commissioners' Standard Ordinary (CSO) mortality tables and an interest rate of 3 percent. Reserves for policies issued between 1977 and 1986 are based on the Commissioners' Reserve Valuations Method, using the 1958 CSO mortality tables and an interest rate of 4 percent. Reserves for policies issued between 1986 and 1994 are based on a modified version of the Commissioners' Reserve Valuations Method, using the 1980 CSO mortality tables and an interest rate of 5 percent. Reserves for policies issued since January 1, 1995, are based on the Commissioners' Reserve Valuations Method, using the 1980 CSO mortality tables and an interest rate of 4 percent.

The following changes were made to the 1995 reserve bases:

- For policies issued after 1977 in which the gross premiums are less than the net premiums according to the standard valuation set by the State of Wisconsin, the basis for reserves was changed from the 1958 CSO mortality table and an interest rate of 4 percent to the 1958 CSO mortality table and an interest rate of 4.5 percent. This resulted in a reserve decrease of \$376,069.
- Disability active lives (waiver of premiums) reserves for term insurance were increased to reflect the automatic conversion from term to permanent coverage. This resulted in a reserve increase of \$36,257.
- Disability disabled lives (waiver of premium) reserves for term insurance were increased to reflect the automatic conversion from term to permanent coverage. This resulted in a reserve increase of \$26,713.

The Fund waives deduction of deferred fractional premiums upon the death of the insured and returns any portion of the final premium beyond the date of death. Surrender values are not promised in excess of the legally computed reserves.

The Fund cedes 100 percent of the risk on substandard policies to its reinsurer. The Fund holds the standard reserve in its financial statements and does not take reserve credits relating to the reinsurance. Therefore, actual reserves held by the Fund for substandard lives exceed the minimum reserve that is required for such policies.

As of December 31, 1994, the State Life Insurance Fund had an estimated \$52.5 million of insurance in force for which the gross premiums are less than the net premiums according to the standard valuation set by the State of Wisconsin. Additional reserves to cover this deficiency totaled \$509,836 for December 31, 1994, and are included in the Liability for Future Benefits.

As of December 31, 1995, the State Life Insurance Fund had an estimated \$13.6 million of insurance in force for which the gross premiums are less than the net premiums according to the standard valuation set by the State of Wisconsin. Additional reserves to cover this deficiency totaled \$120,162 for December 31, 1995, and are included in the Liability for Future Benefits. The decrease in insurance in force and reserves at December 31, 1995, for policies in which gross premiums are less than the net premiums resulted from a change in reserve law that allows the use of a higher interest rate for policies issued after 1977.

10. Deposit Fund Liabilities

Deposit fund liabilities for the Fund, which are subject to discretionary withdrawal without adjustment, are reported at book value and are not affected by reinsurance. The liability accounts reported for CYs 1995 and 1994 include:

	<u>1995</u>	<u>1994</u>
Supplementary Contracts		
without Life Contingencies	\$ 281,916	\$ 286,242
Dividends Left to Accumulate	6,609,908	6,079,181
Accrued Deposits	<u>1,004,332</u>	<u>939,710</u>
Total Deposit Fund Liabilities	\$7,896,156	\$7,305,133

11. Dividend Restrictions

One hundred percent of policies are participating. Dividends payable in the following year are charged to current operations, with 25 percent of the payable amount apportioned for payment between January 1 and March 31. The apportioned amount was \$1,160,057 for 1994, and \$917,722 for 1995.

Section 607.15, Wis. Stats., states that the surplus should be maintained at between 7 and 10 percent of assets, as far as is reasonably possible. The dividend formula was last changed in 1995 to maintain the State Life Insurance Fund's surplus-to-assets ratio, which had been decreasing because of lower-than-expected investment earnings. This change results in a decrease in dividends paid out.

12. Claims Payable

The liability for unpaid claims includes reported claims that were not paid at year-end, and estimates of claims that were incurred, but not reported, based on claims reported in January.

13. Employee Retirement Plan

State Life Insurance Fund employees are participants in the Wisconsin Retirement System, a cost-sharing, multiple-employer, defined benefit plan. Generally, the State's policy is to fund retirement contributions on a level-percentage-of-payroll basis to meet normal and prior service costs of the retirement system. Prior service costs are amortized over 40 years, beginning January 1, 1990. The retirement plan requires employee contributions equal to specified percentages of qualified earnings based on the employee's classification, plus employer contributions at a rate determined annually. The relative position of the State Life Insurance Fund in the Wisconsin Retirement System is not available since the System is a statewide, multiple-employer plan.

14. Audit Adjustments

The unaudited financial statements presented in the Commissioner of Insurance's annual reports to the Governor and the Legislature have been adjusted to reflect recommended audit adjustments.
