



Legislative Fiscal Bureau

One East Main, Suite 301 • Madison, WI 53703 • (608) 266-3847 • Fax: (608) 267-6873

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Joint Committee on Finance

Paper #452

Financial Analysis and Examinations Staff and Revenue Lapse to General Fund (Insurance)

[LFB 2005-07 Budget Summary: Page 312, #6 and Page 313, #7]

CURRENT LAW

Under current law, the Office of the Commissioner of Insurance (OCI) may examine the affairs and financial condition of any insurer doing business in Wisconsin whenever the Commissioner deems it necessary. In addition, OCI must examine an insurer when requested by verified petition signed by 25 persons interested as shareholders, policyholders or creditors. OCI administrative rules require that, with limited exceptions, OCI examine insurers licensed in Wisconsin every five years. OCI may access any books, records, files, securities, documents or property of an insurer necessary to complete an examination.

The Commissioner may require an insurer to maintain a compulsory surplus in an amount such that the insurer is not in a financially hazardous position. The Commissioner may order an insurer to take corrective action when OCI determines that the insurer is in a hazardous financial condition.

Program revenue from fees assessed for financial examinations of insurers, filing and license issuance fees, special assessments, and other miscellaneous fees support OCI's general program operations. Revenue from premium taxes assessed to insurers is deposited to the state's general fund.

GOVERNOR

Financial Examination Staff. Provide \$200,900 PR in 2005-06 and \$215,400 PR in 2006-07 to support 3.0 PR financial examiner positions, beginning in 2005-06. These positions

would audit interstate reciprocal premium tax returns, process a backlog of insurer license applications to do business in Wisconsin, and recapture prior year tax assessments credits.

Program Revenue Lapse. Lapse \$1,538,300 in 2005-06 and \$7,741,300 in 2006-07 to the general fund from OCI's general operations PR appropriation.

DISCUSSION POINTS

Staffing for Financial Examinations

1. OCI's current staffing for financial analysis and examinations functions consists of 37.0 FTE positions, including 1.0 bureau director, 3.0 supervisors, 6.0 advanced examiners, 23.0 examiners and 4.0 support staff positions.

2. There are approximately 10 domestic insurers doing business in Wisconsin for every OCI financial examiner position. Based on a 2002 National Association of Insurance Commissioners (NAIC) report, the national average of domestic insurers per state examiner position is three. Further, the report indicated that OCI's total budget per domestic insurer is just over one-fourth the national average.

3. By rule, with limited exceptions, OCI must examine every insurer licensed in Wisconsin every five years. OCI staff indicate that prudent examination cycles range from every three years for health maintenance organizations (HMOs), and every four years for fire, casualty, and life and health insurers, to every five years for town mutual insurers. The recommended cycles are based on the agency's experience with the susceptibility of various lines of insurance to financial problems, as well as the incidence of operational changes within the insurance industry. OCI has been able to maintain a three-year examination cycle for HMOs, and has been able to examine all other types of insurers every five years -- as opposed to OCI's preferred four-year cycle for fire, casualty, life, and health insurers. When insurers are part of larger groups domiciled in many states, Wisconsin typically examines a domestic insurer on the same timeline as other states in which the insurance group is domiciled, which is often shorter than Wisconsin's five-year cycle.

4. The NAIC accredits state insurance regulatory bodies. NAIC standards for financial analysis of insurers require that OCI have the resources to effectively examine on a periodic basis the financial condition of all domestic insurers. NAIC guidelines also dictate that each domestic insurance company be examined at least once every five years.

5. OCI was first accredited by the NAIC in 1991. NAIC periodically reevaluates the state for accreditation. NAIC last conducted an on-site accreditation review in October, 2003. Although OCI was again accredited by the NAIC in 2003, NAIC noted deficiencies in staffing resources and OCI's ability to issue timely examination reports. For example, NAIC noted high staff turnover, registered concern whether OCI had sufficient qualified staff to consistently perform all necessary tasks in a timely manner, and noted that workpaper review was not always performed on a timely basis. In its 2003 accreditation report for OCI, NAIC suggested that OCI reevaluate

staffing needs to ensure that it has enough qualified staff to perform appropriate and timely examinations of all Wisconsin domestic insurers. OCI staff indicate that NAIC accreditation is critical to the legitimacy of Wisconsin's examination of domestic insurance companies as perceived by other states in which Wisconsin companies do business. That is, other states require that a nondomestic insurer be examined by an NAIC accredited agency in its state of domicile.

6. In its 2005-07 biennial budget submission, OCI requested 12.0 positions (11.0 examiner positions and 1.0 program assistant position) for the Bureau of Financial Analysis and Examinations. OCI indicated that the additional positions would allow OCI to: (a) perform an appropriate level of financial analysis of insurers operating in the state; (b) perform appropriately timed financial field examinations of insurers domiciled in the state; (c) perform other miscellaneous functions such as auditing premium tax returns and reviewing insurer applications for licensure; and (d) provide examination teams with access to an investment expert to review insurance company investments.

Regulatory Workload

Financial Analyses and Examinations

7. The number of domestic insurers in Wisconsin increased from 346 in 1999 to 367 in 2004. Each of these insurers must undergo a financial examination at least once every five years.

8. NAIC financial regulation standards state that OCI's financial analysis procedures should ensure that domestic insurers receive "an appropriate level or depth of review commensurate with their financial strength and condition." Financial analyses involve, at a minimum, reviews of a company's annual statements, actuarial opinions, audited financial statements, and other financial data.

9. NAIC guidelines for financial examinations state that OCI should examine each domestic insurance company at least once every five years. Information material to a financial examination includes the results of the financial analysis, significant complaints data, legal actions taken against the company, rate and form changes, changes in the company's agents, and regulatory actions taken by other states against the company.

10. Financial examinations of insurance companies consist of several phases of work involving a number of OCI employees with particular areas of expertise. For workload control and monitoring purposes, OCI breaks the examinations down into several categories, including: (a) information technology (IT) review, which requires that insurance companies document all phases of their internal IT controls for each phase of their operations; (b) CPA workpaper review, which requires that OCI staff review all relevant financial or control issues with an insurance company's CPA; (c) actuarial review, which requires that an actuarial specialist examiner coordinate fieldwork on actuarial issues involving policy and claim reserves; and (d) examination fieldwork, which represents the most examination time and requires that financial examiners work on-site at the insurance company to review the company's internal controls, accounting records, and contracts.

Examination fieldwork varies from two person-weeks for the smallest insurance companies to nearly 100 person-weeks for the largest companies. In addition to these phases of review, OCI quality control specialists, on behalf of the Bureau Director, review the financial examiners' workpapers and statistical sampling procedures.

11. OCI staff indicate that the agency has enhanced its ability to effectively examine and analyze companies, despite its relatively low staffing, by maximizing the use of its IT resources and hiring contract staff for limited specialized functions. However, the agency asserts that these enhancements have allowed OCI to minimally keep pace with the increasingly complex laws and insurance products available in the market.

Other OCI Duties and Assignments

12. OCI staff indicate that, because the agency must devote such a high percentage of its staff time to financial analyses and examinations to meet the current law and NAIC standards for frequency of review of domestic insurance companies, it is not able to accomplish some important regulatory duties. These duties include financial analysis and regulation of nondomestic insurers, analysis and review of nondomestic insurer applications for licensure, review of mergers and consolidations among regulated insurers, thorough analyses of miscellaneous insurers such as warranty plans and gift annuities, and regular or significant review of premium tax filings.

13. Regular financial analyses of nondomestic insurers would allow OCI to identify those companies showing signs of financial instability. Identifying financial problems among nondomestic insurers operating in the state may enable OCI to take timely measures to protect Wisconsin policyholders. Due to its focus on analyses and examination of domestic insurers, OCI is unable to regularly review key financial data of a large percentage of nondomestic insurers in the state. Providing additional staff for this analysis and review would help to minimize the impact on Wisconsin policyholders of insurance company insolvencies and liquidations.

Revenue Generating Activities

14. OCI reports a current backlog of over 90 nondomestic insurance company license applications, 67 of which were submitted since 2001. Although many, or most, of these more recent applicants may be appropriate for licensure, OCI has been unable to prioritize its review of these applications because it must devote such a significant portion of its financial examiner staff time to meeting the required five-year examination cycle. OCI estimates that, over a two-year period, 67 companies could generate over \$1 million in premium tax revenue for the state. Because newly licensed insurers will, to some extent, compete with companies already doing business in Wisconsin, not all of the premium tax revenue attributable to newly licensed companies would be considered "new" revenue. Nonetheless, newly licensed nondomestic companies would expand Wisconsin's premium tax base, and offer additional insurance choices for consumers.

15. The administration has directed that, of the 3.0 additional financial examiner positions that would be created in the bill, 1.0 position would be used to address the backlog of

insurer license applications, and 2.0 positions would be used to recapture tax assessment credits from prior years and more closely audit interstate reciprocal premium tax returns. The administration projects that these activities would result in an additional \$4.7 million in revenues that would be deposited to the general fund by 2006-07.

16. In 1994 and 1995, approximately 500 insurance companies were assessed by the Wisconsin Insurance Security Fund (WISF) related to liquidations of the New Jersey Life and Consolidated National Life insurance companies. (The WISF, created by statute, protects Wisconsin residents for most claims of licensed insurers in liquidation. The WISF is funded by assessments of insurers licensed to do business in Wisconsin.) In 2004, the WISF refunded approximately \$4.1 million of the original assessments. In the interim from 1995 through 2004, the assessed companies had claimed approximately \$2.9 million, or 70%, of the refunded monies as premium tax credits, as allowed under Wisconsin law. OCI estimates that it can recoup the \$2.9 million in tax credits by recalculating the original tax returns for the affected companies and billing those companies for the tax credits taken that have now been refunded. The process of manually recalculating the original tax returns to recoup the credits is time consuming and would require additional staff resources.

17. OCI proposes to enhance its existing premium tax collection system to allow the agency to capture historical information on tax credits, making the recapture of those credits more effective and efficient. Taking into account the time necessary to design the database, accumulate the data, prepare the necessary letters, and respond to inquiries, OCI estimates that 2.0 additional positions would be required to recoup the \$2.9 million in assessment credits. Although the \$2.9 million would be recouped on a one-time basis, with an enhanced premium tax IT system, OCI would be in a position to recoup future tax credits with far less staff time.

18. In addition to the recapture of premium tax credits related to WISF refunds, OCI estimates that an enhanced premium tax system would allow it to: (a) more effectively calculate and pursue interest penalties related to insufficient or late payments, resulting in an estimated \$250,000 in additional annual revenue; and (b) assess premium taxes due from unlicensed insurers, resulting in an estimated \$125,000 in additional revenue. (Insurers not licensed in Wisconsin are assessed premium taxes when their policyholders move to the state.)

19. OCI staff indicate that adding staff positions to focus on premium taxes would also allow for better auditing of other complex tax issues related to Wisconsin's retaliatory and reciprocal system of premium tax collections. Generally, retaliatory taxation allows Wisconsin to collect premium taxes from a nondomestic insurer equivalent to the taxes paid by that insurer in its state of domicile, if those taxes are greater than those that would otherwise be paid by the nondomestic insurer in Wisconsin. Conversely, reciprocal taxation provides that, subject to certain minimums, nondomestic insurers are not required to pay premium taxes greater in the aggregate in Wisconsin than in their state of domicile, if insurers domiciled in Wisconsin do business in their states. As other states impose increasingly complex methods of premium taxation, OCI has been unable to allocate the staffing and resources to ensure that Wisconsin's retaliatory and reciprocal premium tax system is properly implemented in all cases. However, based on premium taxes collected from

insurers prior to tax law changes in their states of domicile, and based on aggregate tax levels in those states, OCI believes that if it had the resources to audit the issue in depth, it may collect additional premium taxes of between \$1 million and \$2 million annually.

20. In the bill, the Governor has proposed to lapse \$7,741,300 in 2006-07 from OCI's general program operations PR appropriation, \$4,703,000 of which is attributable to the premium tax collections referenced in Discussion Points 16 through 19. However, any premium tax revenue would be deposited directly to the general fund, rather than to OCI's program revenue appropriation and would, therefore, not be available to lapse from that appropriation. DOA staff agree that the \$4,703,000 should be characterized as revenue to the general fund, rather than program revenue to OCI.

21. Although additional financial examiner staff would assist in recouping excess premium tax credits, auditing complex tax issues related to premium tax collection, pursuing interest penalties for late premium tax payments, and collecting premium taxes from unlicensed insurers, it is uncertain that the estimates provided for these collections in the bill would materialize. In essence, the administration assumes that the additional positions will be able to generate additional revenue for deposit to the general fund.

22. If the 3.0 financial examiner positions recommended by the Governor are primarily engaged in recovering premium tax assessment credits owed to the state, addressing the backlog of insurer license applications, and conducting more comprehensive audits of interstate reciprocal premium tax returns, OCI would be unable to address the other regulatory duties previously described in this paper, such as conducting financial analyses and regulation of nondomestic insurers, reviewing mergers and consolidations among regulated insurers, and conducting thorough analyses of miscellaneous insurers such as warranty plans and gift annuities. Additionally, without additional staff, OCI will likely be unable to achieve what it considers to be a more prudent examination cycle of domestic insurers, rather than the five-year schedule considered the minimum frequency by the NAIC.

23. If the Committee determines that additional resources should be provided to the agency to perform these traditional regulatory functions, it could provide an additional \$158,800 PR in 2005-06 and \$173,300 PR in 2006-07 to support an additional 3.0 PR financial examiner positions, beginning in 2005-06, in addition to the funding and positions recommended by the Governor.

24. Finally, the Committee could provide OCI the financial examiner staff recommended by the Governor, but not lapse the \$4,576,600 PR to the general fund or recognize the \$4,703,000 in additional tax collections.

ALTERNATIVES

1. Adopt the Governor's recommendation to provide \$200,900 PR in 2005-06 and \$215,400 PR in 2006-07 and 3.0 PR financial examiner positions, beginning in 2005-06 and deposit

\$9,279,600 to the general fund (\$4,703,000 in tax collections and \$4,576,600 as a lapse from OCI's general operations PR account).

2. Modify the Governor's recommendation to delete the estimated \$4,703,000 in additional tax collections.

<u>Alternative 2</u>	<u>GPR-REV</u>
2005-07 REVENUE (Change to Bill)	- \$4,703,000

3. In addition to Alternative 1 or 2, modify the bill by providing an additional \$158,800 PR in 2005-06 and \$173,300 PR in 2006-07 to support an additional 3.0 financial examiner positions.

<u>Alternative 3</u>	<u>PR</u>
2006-07 POSITIONS (Change to Bill)	3.00

4. Adopt the Governor's recommendation to provide \$200,900 PR in 2005-06 and \$215,400 PR in 2006-07 and 3.0 PR financial examiner positions, beginning in 2005-06, but delete the PR lapse to the general fund and the tax collection estimate in the bill.

<u>Alternative 4</u>	<u>GPR-REV</u>
2005-07 REVENUE (Change to Bill)	- \$9,279,600

5. Delete provision.

<u>Alternative 5</u>	<u>GPR-REV</u>	<u>PR</u>
2005-07 REVENUE (Change to Bill)	- \$9,279,600	
2005-07 FUNDING (Change to Bill)		- \$416,300
2006-07 POSITIONS (Change to Bill)		- 3.00

Prepared by: Eric Ebersberger