



**STATE OFFICE OF RISK MANAGEMENT
SB 908, 80th R.S. STUDY**

**OPTIONS TO PREPARE STATE AGENCIES
FOR CATASTROPHIC CLAIMS**

SEPTEMBER 2008



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I.

Background

Prior to the 80th Session of the Texas Legislature, the Sunset Advisory Commission (Sunset) undertook a review of the operations of the State Office of Risk Management (SORM). Sunset reported that although SORM's cash-basis funding method keeps current expenditures low, SORM may not be structured to adequately protect the State against catastrophic claims.¹ Pursuant to Senate Bill 908, 80th R.S., as codified at Texas Labor Code § 412.0129, the Office was directed to report the findings of a study of options to prepare state agencies for catastrophic claims.² For the purposes of this report, catastrophic claims are defined as events (natural or manmade) that produce actual paid losses in excess of \$1 million per claim or events that produce a number of claims in excess of the average number of claims in a specific area, occurring within a certain amount of time following the event, and with a cumulative loss in excess of \$1 million.

SORM is responsible for administering the state's self-insured workers' compensation program that covers approximately 175,000 employees. The cost of compensable

¹ Sunset set forth recommendations in Issue 2, entitled "The State Needs to Be Better Prepared to Pay Workers' Compensation Claims Resulting From a Disaster," attached as Appendix A.

² Tex. Lab. Code § 412.0129. STUDY ON CATASTROPHIC CLAIMS.

- (a) The office shall study options to prepare state agencies for catastrophic claims.
- (b) The study must include information on:
 - (1) establishing a state employee workers' compensation catastrophe fund outside the state treasury;
 - (2) purchasing catastrophe reinsurance; and
 - (3) other options to prepare the state for catastrophic claims.
- (c) In performing duties under Subsections (a) and (b), the office:
 - (1) shall work with the workers' compensation research and evaluation group; and
 - (2) may contract with a consultant to:
 - (A) analyze predicted costs of potential disasters; and
 - (B) estimate the appropriate size for a catastrophe fund or level of reinsurance.

injuries is paid by SORM from funds collected by assessment from the agencies, courts, county operated community supervision and correction departments (CSCDs), and universities (collectively referred to as agencies) whose employees are protected by the program.

Under the current formula for risk allocation, SORM determines each agency's assessment based on the claims experience of each agency, the size of each agency's workforce, and the amount of each agency's payroll.³ Each year, SORM has a few expensive, catastrophic claims. In fiscal year 2003, SORM paid \$950,000 for medical and indemnity benefits on a single claim. In each of the last five years prior to December of 2006, SORM paid at least 10 claims costing more than \$100,000 resulting from a single event. SORM considers these expensive claims to be a normal part of its claims experience and anticipates these types of claims when making assessments. However, the current statute does not make provision for contingent, large scale catastrophic events nor permit a reserve to cover a significant catastrophic experience.

II.

Other States' Approaches to Catastrophic Claims Coverage

Methodology

SORM, working in conjunction with the Texas Department of Insurance, Workers' Compensation Research and Evaluation Group, surveyed state and political subdivision workers' compensation programs in Texas and other states to determine: 1) how these programs are funded; 2) their relative size and risk exposure as compared to SORM's current program; and 3) what strategy, if any, the programs employ for catastrophic claims.⁴ A total of 18 states responded to the survey as well as three large political subdivision risk pools in Texas (Texas Association of School Boards (TASB), Texas Association of Counties (TAC) and Texas Municipal League (TML)) and the other three workers' compensation programs for Texas state employees (Texas Department of Transportation, the Texas A&M University System, and the University of Texas System).⁵ The vast majority of these state government workers' compensation programs are self-insured like SORM. Only two of the respondents purchase workers' compensation insurance to cover their state employees.

³ Tex. Lab. Code § 412.0123.

⁴ A copy of the written survey instrument is included in Appendix B.

⁵ The following states responded to SORM's survey: Alabama, Arizona, Arkansas, Delaware, Florida, Georgia, Illinois, Iowa, Kentucky, Louisiana, Massachusetts, Maryland, Michigan, Minnesota, Montana, North Carolina, Oregon and Utah.

Type of Employees Covered by State Government Workers' Compensation Programs.

In Texas, SORM's program covers all state agency and public university employees with the exception of the Texas Department of Transportation (TXDOT), the University of Texas System (UT System) and the Texas A&M University System (A&M). SORM also administers claims for the Office of the Adjutant General under Section 431.001, Texas Government Code; members of Texas Task Force 1, as defined by Section 88.301; Texas Education Code; Community Supervision and Corrections staff employed by political subdivisions, and peace officers employed by political subdivisions if those peace officers are injured outside their jurisdiction while exercising authority granted under Article 12, or Sec. 14.03 (d) or (g), Texas Code of Criminal Procedure.

Many of the other states who responded to the survey indicated that, like SORM, their workers' compensation programs cover state agency employees as well as public university employees and state military/militia personnel. Some states such as Montana, Minnesota, and Illinois have separate workers' compensation programs for employees of specific public university systems, similar to Texas, while other states have coverage exceptions for volunteer firefighters, legislative employees, and certain temporary state employees (see Table 1).

Table 1
Workers' Compensation Coverage Provisions for State Government Employees in Other States

State	State Government Employees	Public University Employees	State Military or State Militia	Other Types of Covered Employees
Alabama	Yes			
Arizona	Yes	Yes	Yes	
Arkansas	Yes	Yes	Yes	
Delaware	Yes	Yes	Yes	Volunteer fire companies
Florida	Yes	Yes		Volunteers of state agencies and universities and individuals performing community service work due to a circuit court order and supervised by the Department of Corrections
Georgia	Yes	Yes		
Illinois	Yes	Yes	Yes	
Iowa	Yes	Yes		Inmates of state correctional

				institutions, including adult or juvenal community service
Kentucky	Yes	Yes	Yes	Some political subdivision employees
Louisiana	Yes	Yes	Yes	
Massachusetts	Yes	Yes		
Maryland	Yes	Yes	Yes	
Michigan	Yes			
Minnesota	Yes	Yes	Yes	
Montana	Yes			
North Carolina	Yes	Yes		
Oregon	Yes	Yes	Yes	Some state councils and boards
Utah	Yes			

Source: State Office of Risk Management and the Texas Department of Insurance, Workers' Compensation Research and Evaluation Group, Survey Regarding the Structures of State Government Employee Workers' Compensation Programs, 2008.

How Does SORM's Workers' Compensation Program Compare With Other States and Other Programs in Texas in Terms of Size, Claim Volume and Losses?

There is a wide variation in the size of the workers' compensation programs that responded to the survey. One state, Montana, currently covers approximately 14,000 employees, while the state of Florida covers more than 200,000 employees. More than half of the survey respondents, including other states and other government employee workers' compensation programs in Texas, currently cover between 50,000 and 100,000 employees. SORM currently covers approximately 175,000 employees. The other state workers' compensation programs that are similar in size to SORM's, include: the State of Louisiana (110,000), the State of North Carolina (167,000), the State of Florida (202,000), the State of Georgia (130,000), the Texas Association of School Boards Risk Management Fund (200,000) and the Texas Municipal League Intergovernmental Risk Pool (162,000).

Since workers' compensation programs that cover a large number of employees also tend to have a larger number of claims, it is important to understand how claim rates vary across various programs, regardless of size. To produce an estimated rate of new workers' compensation claims per 100 covered employees, the number of new workers' compensation claims reported in 2007 for each of the survey respondents was divided by the total number of employees covered by that workers' compensation program. Overall, most programs, including SORM, had less than 5 new reported injuries per 100 covered employees in 2007 (see Table 2).

Table 2

Number of New Reported Workers' Compensation Claims
Per 100 Covered Employees, 2007

State Program	Rate	State Program	Rate
Alabama	8	Minnesota	5
Arizona	6	Montana	6
Arkansas	6	North Carolina	5
Delaware	3	Oregon	4
Florida	5	Texas (SORM)	4
Georgia	6	Utah	5
Illinois	15	TXDOT	4
Iowa	6	UT	2
Kentucky	3	A&M	1
Louisiana	4	TML	3
Massachusetts	4	TASB	5
Maryland	10	TAC	6
Michigan	3		

Source: State Office of Risk Management and the Texas Department of Insurance, Workers' Compensation Research and Evaluation Group, Survey Regarding the Structures of State Government Employee Workers' Compensation Programs, 2008.

The average paid loss per covered employee provides another benchmark for understanding which states' or political subdivision's workers' compensation programs are similar to SORM's program. The average paid loss per covered employee is calculated by taking the total paid loss each program reported in the survey for 2007 and dividing it by the total number of covered employees.

Around half of the programs surveyed had an average paid loss of less than \$300 per covered employee in 2007, which is similar to SORM's average of \$242 per covered employee. The average paid losses for other workers' compensation programs that are similar in size to SORM in terms of total claim volume include: Louisiana (\$467), Florida (\$469), Georgia (\$419), North Carolina (\$322), and TML (\$279).

How Does SORM's Funding Structure and Claims Administration Method Compare with Other State and Political Subdivision Workers' Compensation Programs?

Virtually all of the workers' compensation programs surveyed indicated that their workers' compensation programs are self-insured (either individually self-insured or collectively self-insured as a risk pool) like SORM's. Two states, Montana and Utah, purchase workers' compensation coverage from a commercial insurance carrier and Oregon utilizes a 10 year retrospective plan in which claims costs are paid to an insurance carrier on a monthly basis and fees are paid on a quarterly basis.

Like SORM, the vast majority (18) of the state workers' compensation programs surveyed, are funded entirely or partially through assessments/premium contributions by

client state agencies/universities/political subdivisions. Three of the survey respondents (Massachusetts, UT System and Texas A&M) are funded by assessment and appropriation, and another three of the respondents (Illinois, Georgia, TXDOT) are funded by legislative appropriation only. North Carolina utilizes lapsed salary dollars to fund workers' compensation liabilities, although it receives premiums from its Department of Transportation and large university systems.

Most of the state workers' compensation programs surveyed utilize state government or political subdivision pool employees as claims adjusters similar to the method currently used by SORM for claims administration. In nine programs (Delaware, Georgia, Iowa, Kentucky, Michigan, North Carolina, Utah and the Texas Association of Counties), claims are adjusted by one or more third-party administrator(s) (TPA). Two of the programs utilize the state insurance fund as a TPA (Maryland and Oregon) and the Texas Association of School Boards' Risk Management Fund contracts with the Texas Association of School Boards for claims administration services.

How Does SORM's Historic Catastrophic Claim Experience Compare With Other State Workers' Compensation Programs?

What constitutes a "catastrophic claim" varies significantly from program to program. Most of the programs surveyed did not have a standard definition of "catastrophic claim." However, five of the programs (Georgia, Maryland, Delaware, the Texas Association of School Boards and the Texas Association of Counties) utilize some form of catastrophic claim indicator for claims identification purposes. Some of these indicators include (please note that not all of the five programs utilize all of these indicators):

- Fatalities;
- Severe head injuries;
- Amputations requiring prosthesis;
- Severe spinal cord injuries;
- Injuries resulting in blindness or loss of hearing;
- Injuries involving severe burns, electrical shock or chemical/smoke inhalation;
- Injuries requiring admission to critical care in a trauma center or helicopter transport to a trauma center;
- Occurrences that result in more than one injury at the same time.

None of the programs surveyed indicated that there was a specific monetary threshold that a claim must meet in order to be classified as a "catastrophic claim." In general, workers' compensation claims that meet any of the indicators previously listed are infrequent, but costly claims. For the purpose of gathering information on the frequency of catastrophic claims, the survey asked a series of questions geared towards understanding more about the frequency and cost of these types of claims.

Over the last 10 years, approximately how many workers' compensation claims had actual paid losses (medical and indemnity) that exceeded \$1 million per claim to date?

In general, claims with actual paid losses that exceed \$1 million per claim are extremely rare and the frequency of these claims does not necessarily relate to the number of workers covered by the program. Eight of the programs surveyed (Arizona, Kentucky, Massachusetts, Michigan, Utah, Texas A&M, Texas Association of Counties, and Texas Department of Transportation) said that they had no claims over the past 10 years that met this criteria. Fourteen of the programs surveyed (as well as SORM) reported having fewer than four of these claims and two of the programs surveyed (Louisiana and Montana) reported having six or seven claims with actual paid losses that exceeded \$1 million over the past 10 years.

What was the highest actual paid loss on a single workers' compensation claim your program has administered in the last 10 years to date?

The most expensive claim reported in the survey was approximately \$6 million; however, the vast majority of the programs surveyed (19) reported that their most expensive claims over the last 10 years have not exceeded \$2 million to date. Over the last 10 years, SORM's most expensive workers' compensation claim to date is approximately \$4.2 million.

What was the highest number of workers' compensation claims that were generated by a single event in the last 10 years?

Survey responses from the various state workers' compensation programs indicate that a wide variety of incidents can and have the capacity of generating multiple workers' compensation claims. These range from 2-3 claims generated by an automobile accident to 225 claims filed as a result of an exposure to viral meningitis. The various types of events that have generated the most workers' compensation claims in the last 10 years include:

- Automobile/bus/boat accidents involving multiple government employees;
- Chemical inhalation/exposure to toxic materials;
- Hurricane and other natural disaster relief efforts;
- Prison inmate disruptions and hostage situations;
- Exposure to certain occupational diseases; and
- Explosions involving state employees.

What Funding Mechanisms Do Other Workers' Compensation Programs Use To Pay For Catastrophic Claims?

Nine of the workers' compensation programs surveyed, including SORM, do not have claims reserves or reinsurance to assist in the payment of catastrophic claims or claims that result from a catastrophic incident. These programs generally pay losses as they

come in and if additional funds are needed, they can either: 1) borrow money from the state treasury; 2) institute additional surcharges to their clients in future years; or 3) request an emergency legislative appropriation. An additional nine programs have some sort of claims reserves, which include reserves for catastrophic claims. Six programs purchase excess insurance or reinsurance and one program (Arkansas) utilizes a catastrophe fund (*see* Table 3).

Table 3
Catastrophic Claim Funding Mechanisms for Other Workers' Compensation Programs

WC Program	Has Claim Reserves	Purchases Excess Insurance or Reinsurance	Uses a Catastrophe Fund	Other
Alabama	Yes			
Arizona		Yes		
Arkansas			Yes	
Delaware				Pays losses as they come in.
Florida				Utilizes premium assessments if additional funds are needed.
Georgia		Yes		
Illinois				Pays losses as they come in.
Iowa				Pays losses as they come in. May request emergency legislative appropriation if needed.
Kentucky				Pays losses as they come in.
Louisiana	Yes			If self-insurance fund reserves are exhausted – program may request emergency legislative appropriation.
Massachusetts				Pays losses as they come in. Has ability to borrow money from state treasury.
Maryland		Yes		
Michigan				Institutes additional surcharges if additional funds are needed.
Minnesota	Yes			
Montana				Purchases workers' compensation insurance.

North Carolina				Pays losses as they come in.
Oregon				Purchases workers' compensation insurance.
Texas (SORM)				Pays losses as they come in. Has ability to borrow money from state treasury and request emergency legislative appropriation.
Utah				Purchases workers' compensation insurance.
TASB	Yes	Yes		
Texas A&M	Yes			
UT System	Yes			
TAC	Yes	Yes		
TXDOT	Yes			
TML	Yes	Yes		

Source: State Office of Risk Management and the Texas Department of Insurance, Workers' Compensation Research and Evaluation Group, Survey Regarding the Structures of State Government Employee Workers' Compensation Programs, 2008.

Among the nine programs which have reserves, all reserves are managed directly by the workers' compensation program. For most of these programs that utilize reserves, the revenue source for the reserves comes from client agency/university/political subdivision assessments or surcharges or legislative appropriations. The actual amounts set aside in reserves are usually determined through actuarial estimates or by statutory requirements. Most of these programs review and adjust their reserves on at least an annual basis.

Six of the programs who responded to the survey reported that they purchase reinsurance or excess insurance to help pay for catastrophic claims. Three of these programs (TASB, TAC and TML) also have claims reserves and have set retention levels for their reinsurance/excess insurance between \$1 million and \$3 million. The other three workers' compensation programs that purchase reinsurance or excess insurance (Arizona, Georgia and Maryland) set risk retention levels (deductibles) between \$5 million and \$15 million. Premiums for reinsurance/excess insurance varies depending on the risk exposure of the insured and the amount of coverage being purchased, but generally the premium reported by the workers' compensation programs that purchased reinsurance or excess insurance varied between \$200,000 and \$1.9 million.

III.

Existing Appropriations Options To Pay for Catastrophic Claims

The following subsections present an overview of options for funding catastrophic losses currently available in existing Texas law. The options presented are not listed in order of benefit, preference or advisability for adoption. Although these options are currently available in law, no specific mechanism, process or procedure is in place at the respective entities for approving a request or transferring funds to cover catastrophic losses.

Current SORM Appropriations Options

In the event that assessments are insufficient to cover current losses, SORM may, pursuant to the General Appropriations Act and with the approval of the Legislative Budget Board, borrow up to 20 percent of the total assessment amount from the General Revenue Fund to cover claims.⁶ If SORM requires funding to cover claims in excess of the 20 percent borrowing limit, it would be necessary to request emergency or supplemental appropriations from General Revenue. However, specific deadlines for benefit payments mandated in the Texas Labor Code would likely be exceeded by the time such a request was considered and acted upon. Further, depending on the scope and nature of the catastrophe, SORM's request would likely arise at the same time that the Legislature would need to fund other emergency items, limiting available General Revenue for payment of statutory benefits.

Economic Stabilization Fund (Rainy Day Fund)

In the event of insufficient funds to cover an emergency appropriation to SORM from General Revenue, the Comptroller is empowered to transfer money from the Economic Stabilization Fund to general revenue to prevent or eliminate a temporary cash deficiency in General Revenue.⁷ There is Legislative authority to make appropriations from the Economic Stabilization Fund should the Comptroller fail to transfer those funds.⁸ It is unclear whether the Economic Stabilization Fund is an intended or appropriate vehicle for long-term catastrophic loss maintenance, as repayment requirements and necessary actions could interfere with short-term client agency stability and SORM compliance with statutory deadlines.

⁶ H.B. 1, 80th R.S., Sec. 15.02.

⁷ Tex. Const. art. III, § 49-g (2007), Economic Stabilization Fund, Subsection (j).

⁸ *Ibid.*, Subsection (m).

Legislature's Emergency Appropriations Powers to the Governor Under Texas Government Code §§ 401.061-401.065

Pursuant to Texas Government Code § 418.071, it is the intent of the Legislature and the policy of the state that funds to meet disaster emergencies always be available. Chapter 401, Subchapter D, of the Texas Government Code provides a mechanism for emergency appropriations to be requested through the Governor's office based on a Comptroller determination of non-availability of non-emergency funds.⁹ The Governor, by interagency contract, may authorize an agency of the executive branch of state government to administer emergency appropriations approved under this subchapter.¹⁰

Transfer Appropriations Under Texas Government Code, Chapter 317. Emergency Provisions

Chapter 317 of the Texas Government Code implements art. XVI, § 69, of the Texas Constitution (entitled: Prior Approval Of Expenditure Or Emergency Transfer Of Appropriated Funds).¹¹ Chapter 317 authorizes the Governor or the Legislative Budget Board, "after finding that an emergency exists," to "propose that the authority to spend, obligate the expenditure of, or distribute part or all of an appropriation made to a state agency: (1) be transferred to another state agency to be used for a specified purpose; or (2) be retained by the agency to which the appropriation was made but used for a purpose different from or additional to the purpose for which the appropriation was made."¹² The Legislative Budget Board may hold a public hearing on a proposal of the Governor and may adopt, reject, or recommend changes to the proposal.¹³

⁹ Tex. Gov't Code § 401.065(a)(1).

¹⁰ Tex. Gov't Code § 401.065(c).

¹¹ See also OAG opinion GA-0578, October 31, 2007.

¹² Tex. Gov't Code. § 317.002(b); see also § 317.004 -.005.

¹³ See Tex. Gov't Code § 317.005(a); OAG opinion JC-0501, May 6, 2002.

IV.

Options for Payment of Catastrophic Claims, Pursuant to Requirements of Texas Labor Code § 412.0129¹⁴

Establishing Procedures; Borrowing Authority

The primary weakness of the options for funding catastrophic losses available in existing law, discussed in Section III, relates to the lack of established procedures in the event of catastrophic workers' compensation losses. In planning for potential losses, specific procedures should be put in place at each entity involved in supplemental or emergency appropriations for the purpose of meeting statutory workers' compensation benefit obligations. Such procedures would delineate threshold levels for initiation of a request, timelines for the provision of supplemental funds, and processes and timelines for repayment of funds over an extended time, or forgiveness of debt for catastrophic losses to ensure continuity of operations. SORM's borrowing authority under the General Appropriations Act, currently limited to 20% of its assessments,¹⁵ should be increased to accommodate catastrophic losses in excess of that limitation.

SORM's current borrowing authority is intended as a mechanism for temporary cash flow and does not address sustained long-term increases due to significant catastrophic expenses. The amount borrowed must be collected from client agencies at the beginning of the next fiscal year, in addition to expected costs for that year, and repaid to the treasury. This would be sufficient to cover a single additional \$1 million claim but a situation involving twenty additional \$1 million claims would be outside the ability of most client agencies to absorb, particularly if the increased expenditures were sustained over a period of several years. In terms of financing catastrophic injuries, the ability to borrow simply delays the funding crisis until the following fiscal year.

A catastrophic event would likely impact SORM's administrative budget as well as its claims budget. In the event of a large scale catastrophe the influx of additional claims could overwhelm SORM's administrative resources to receive, adjust and process the large number of claims produced. No borrowing authority exists in SORM's administrative budget.

Reserves

Private insurance companies generally cover risk of loss against issued policies through collection of premium payments that are pooled into reserve funds. As covered losses are incurred, the reserve pools are drawn down to cover those losses, which are then

¹⁴ The following options are compiled in compliance with specific directives of Texas Labor Code § 412.0129, and in consultation with the Texas Department of Insurance.

¹⁵ H.B. 1, 80th R.S., Sec. 15.02(i).

replenished through additional, later premium payments. The Texas Department of Insurance generally requires private workers' compensation insurance companies to submit an annual actuarial opinion on reserves and to maintain sufficient reserves to cover anticipated future liabilities.¹⁶

Regarding state programs, the University of Texas System and the Texas A&M University System both operate a self-insured workers' compensation benefit program separate from SORM, and both have established reserves. Both systems annually assess component institutions to fund workers' compensation benefits. Both systems have an annual actuarial study done that evaluates claims experience and reserve levels. The UT System has approximately \$53 million in reserves covering approximately 99,000¹⁷ employees and the A&M System has about \$23 million in reserves covering approximately 53,000 employees¹⁸.

SORM does not have statutory authority to maintain reserves, and operates on an annual pay-as-you-go basis. The UT and A&M assessments are sufficient to cover the expected life-time cost of the claim, versus only the costs actually paid in the current year, as is the case in the program operated by SORM. Establishing a reserve system in SORM's program would require specific statutory authority and modification of the program for the collection and calculation of additional assessments to pay for these reserves, as well as modification of carry forward limitations in the General Appropriations Act. In addition, provisions for management and investment of the reserve would need to be specified. Amounts utilized by surveyed programs provide a baseline for comparison, but a specific actuarial study like that utilized by UT and A&M would be recommended for SORM exposures

While SORM has unexpended balance authority (UB) for the funds collected for medical cost containment within a biennium, there is none between biennia and there is no UB authority for the funds collected for the Risk Management program.

Funding a reserve could be provided by a GR appropriation for that purpose or from the existing assessment program in use by SORM. If the reserve were funded by assessments, the program could be structured to use a stated maximum amount of "excess" allowable funding, e.g. \$25 million, and a minimum percentage of the expected payments collected in cash each year, e.g. 90 or 95 percent, to smooth out the peaks and dips from one fiscal year to another. When the total excess exceeds the maximum amount established, SORM would return the excess amount to pool members in the same proportion as their assessment for the fiscal year of the transaction. These returns would be one time additional appropriations, not subject to increasing the agencies' appropriated baselines. (It is anticipated this would be necessary since negative expenditures would

¹⁶ Tex. Ins. Code § 426.001 and § 802.002.

¹⁷ See University of Texas Office of Risk Management Annual Report 2007, p. 14: http://www.utsystem.edu/orm/reports/annualreport_2007.pdf

¹⁸ Source: Kevin McGinnis, Texas A&M.

decrease the baseline appropriations but would not be a sustainable decrease in expenditures.) After several years and once the fund has reached its stated funding goal, monies collected could once again be returned to agencies.

Funding reserves in this manner would require a number of years to fully fund the reserve and would not adequately protect the state if catastrophic losses occur early in the program.

Establishing A State Employee Workers' Compensation Catastrophe Fund Outside The State Treasury

An alternative to a SORM-operated reserving program in the treasury would be a dedicated catastrophe fund. State agencies may be granted specific constitutional or statutory authority to keep state monies outside the state treasury.¹⁹ There are a variety of statutory schemes for agencies to hold state monies outside the treasury, i.e., as a trust fund held by a bank or by the comptroller or invested.²⁰ As discussed above, SORM has limited carry-forward authority and no authority to hold funds outside the state treasury, so establishing such a fund would require legislative action.

The Texas Windstorm Insurance Association (TWIA),²¹ in some funding-related respects, can serve as a case study model to illustrate how catastrophe funds held outside the state treasury may be treated. In essence, under the TWIA, all property insurers licensed in Texas are required to become TWIA members as a condition of doing business in Texas.²² The TWIA operates somewhat like an insurance company by issuing policies with statutorily-set limits adjusted on an annual basis. Normal claims and operating expenses are paid from premiums collected. Assessments for losses are indexed to an individual insurer's share of the overall Texas market.

The potential liability of the TWIA has grown from \$0.3 billion in 1971 to over \$59.8 billion in June of 2008.²³ As part of the TWIA, the 73rd Legislature established the

¹⁹ *c.f.*, Tex. Educ. Code § 54.5132, International Education Fee Fund; Tex. Gov't Code § 411.284, Department of Public Safety Historical Museum and Research Center; Tex. Gov't Code § 431.1235, Texas State Guard Uniform Fund; Tex. Gov't Code § 441.071, Texas Public Library Endowment Fund; etc.

²⁰ Examples of state funds held outside the treasury where investment is permitted are: The Catastrophe Reserve Trust Fund of the Texas Windstorm Insurance Association, *See* Tex. Ins. Code § 2210.056, 2210.452; the Capital Renewal Trust Fund, Gov't C. § 443.0103; the Spaceport Trust Fund, Gov't C. § 481.0069; and, the Texas Tomorrow Fund II (prepaid tuition), Tex. Educ. Code § 54.764.

²¹ *See* <http://www.tdi.state.tx.us/pubs/pc/pctwiabrief.ppt#256,1>, Report on the Texas Windstorm Insurance Association, July 2008, Prepared by Texas Department of Insurance; *See also* generally Sunset Advisory Commission Hearing Materials on TDI, June 2008: http://www.sunset.state.tx.us/81streports/tdi/tdi_hm.pdf

²² Tex. Ins. Code § 2210.051

²³ *See* <http://www.tdi.state.tx.us/pubs/pc/pctwiabrief.ppt#256,1>, Report on the Texas Windstorm Insurance Association, July 2008, Prepared by Texas Department of Insurance; *See also* generally Sunset Advisory Commission Hearing Materials on TDI, June 2008: http://www.sunset.state.tx.us/81streports/tdi/tdi_hm.pdf

Catastrophe Reserve Trust Fund (CRTF) to address catastrophic losses associated with a major wind storm. To fund the CRTF, the TWIA deposits excess funds on an annual basis. The CRTF funds are held by the comptroller outside the state treasury.²⁴

To date, the CRTF has only made two assessments to its members due to a major loss event: \$157 million related to Hurricane Alicia in 1983 and a second for \$100 million for Hurricane Rita in 2005. The initial balance of the CRTF in FY 1995 was \$122.7 million and, as of June of 2008, was approximately \$468 million.

Additionally, the TWIA has authority to purchase reinsurance in addition to the CRTF coverage,²⁵ discussed further below. Since TWIA has some reinsurance policies in place and authority to implement a mix of reinsurance and trust funding, the TWIA system is a hybrid system combining funds held outside the treasury with reinsurance.

Purchasing Catastrophe Reinsurance

The State is a self-insuring entity for workers' compensation purposes²⁶ and is not a member of the Texas Property and Casualty Insurance Guaranty Association. As stated above, in order to purchase excess insurance or reinsurance to mitigate risks above expected losses, a funding mechanism and authority to expend funds for the purchase of reinsurance would be required to implement this strategy.

Workers' compensation insurance carriers commonly mitigate the risk of high claims costs by reinsuring. Reinsurance is essentially insurance purchased by insurance companies to further spread risk. As discussed above, the TWIA participates in reinsurance, as does Texas Mutual, the largest workers' compensation carrier in Texas.²⁷

A premium for reinsurance might be collected as a surcharge on SORM's current assessment system or paid by separate appropriation as a hedge against the demand on General Revenue funding sources. In the case of SORM, a non-proportional reinsurance mechanism (in which losses exceeding a set amount are covered by one or more reinsurers, similar to stop-loss) may be appropriate. Such a policy or policies would set a deductible appropriate to fiscal viability, either tied to availability of emergency funds or set-asides, or reasonable borrowing amounts absorbable in future years (and considering potential increased premiums for taking against such a policy).

²⁴ See 28 Tex. Admin. Code § 5.4001 regarding Plan of Operation for CRTF where CRTF funds are held by the comptroller outside the state treasury on behalf of, and with legal title in, the Texas Department of Insurance.

²⁵ Texas Insurance Code, §§ 2210.053; 2210.453; 2210.505. See also: <http://www.tdi.state.tx.us/pubs/pc/pctwiabrief.ppt#346,30>, Exhibit F.

²⁶ Tex. Lab. Code § 412.0122.

²⁷ See <http://www.texasmutual.com/news/2008inserts-a/2008financial-a-sm.pdf>

SORM is not able to estimate the potential premium cost of reinsurance or its impact to the assessments collected from agencies without additional study.²⁸

V.

Conclusion

The State Office of Risk Management gratefully acknowledges the assistance of the Texas Department of Insurance, Workers' Compensation Research and Evaluation Group in researching this report and the voluntary participation of the states and programs who responded to our survey. The agency agrees with the Sunset Commission that the State should take steps to establish funding mechanisms to cover potential catastrophic losses. All of the options listed above are feasible, and the Legislature may consider a program incorporating elements of several approaches. The actual mechanism(s) chosen for this purpose should be determined by the Legislature after considering the impact on overall state operations, the costs associated with retaining the risk versus transferring the risk through reinsurance, and should provide clear procedures for identifying when and how funding will be made available in emergencies.

The Board of Directors and staff of the State Office of Risk Management are available to respond to any inquiries and to undertake all efforts respecting the matters herein. Any inquiries may be directed to Jonathan D. Bow, Executive Director, State Office of Risk Management, P.O. Box 13777, Austin, TX 78711-3777, by telephone to (512) 936-1502, or facsimile at (512) 472-0234.

²⁸ SORM did not receive the Sunset-recommended funding to contract with a third-party consultant to analyze predicted costs of potential disaster or estimate the appropriate size for a catastrophe fund or level of insurance; all figures herein are based on currently available information.

Appendix A

Excerpt, Staff Report on the State Office of Risk Management, Issue 2, *The State Needs to Be Better Prepared to Pay Workers' Compensation Claims Resulting From a Disaster*, Sunset Advisory Commission, September 2006.



The State Needs to Be Better Prepared to Pay Workers' Compensation Claims Resulting From a Disaster.

Summary

Key Recommendation

- ◆ Require SORM to study how the State could structure its workers' compensation program to be prepared for claims resulting from a disaster and to report options to the Legislature.

Key Findings

- ◆ SORM provides workers' compensation coverage for state employees on a pay-as-you-go funding basis.
- ◆ SORM is inadequately prepared to pay workers' compensation claims resulting from a catastrophic event.
- ◆ Self-insured companies and insurance carriers use many strategies to mitigate the risk of catastrophic claims.
- ◆ Other public, self-insured workers' compensation programs are better prepared to handle catastrophic events.

Conclusion

The Legislature provides funding for state employee workers' compensation to the State Office of Risk Management on a pay-as-you-go basis. Unlike the structure of private insurance carriers, SORM's funding does not include reserves for future obligations or as a cushion against a catastrophic event.

Sunset staff examined SORM's preparedness to pay the costs of catastrophic claims. Although SORM's funding method keeps current expenditures low, SORM is not structured to adequately protect the State against large claims that may arise from a natural or man-made disaster. In the event of a catastrophe, SORM would have to seek emergency appropriations to pay the cost of workers' compensation claims. However, these requests would arise at the same time that the Legislature would need to fund other emergency items.



SORM assesses client agencies for the cost of workers' compensation coverage based on past experience.



SORM does not build in costs for unforeseen claims from a disaster.

Support

SORM provides workers' compensation coverage for state employees on a pay-as-you-go funding basis.

- ◆ In 2002, the Legislature established an agency assessment program to cover the costs of workers' compensation claims. Annually, SORM estimates the expected costs of workers' compensation benefits in the upcoming year based on past experience. SORM uses a formula, set in rule, to apportion the total expected cost among agencies. SORM bases agency assessments on agency size, payroll, actual claims costs in the previous year, number of claims in the previous year, and the claims frequency rate. SORM can retain 10 percent of annual assessment funds in excess of actual claims to offset some of next year's costs. SORM returns amounts exceeding 10 percent to agencies.
- ◆ The General Appropriations Act also allows SORM some borrowing flexibility. If assessments are insufficient to cover claims in a year, SORM may, with the approval of the Legislative Budget Board, borrow up to 20 percent of the total assessment amount from the General Revenue Fund to cover claims. If SORM needs funding to cover claims in excess of the 20 percent borrowing limit, the agency must ask the Legislature for emergency or supplemental appropriations. SORM has not borrowed money under this provision.
- ◆ Each year, SORM has a few expensive, catastrophic claims. In fiscal year 2003, SORM paid \$950,000 for medical and indemnity benefits on a single claim. In each of the last five years, SORM has paid at least 10 claims costing more than \$100,000. SORM considers these expensive claims as a consistent part of its claims experience and anticipates these types of claims when making assessments.
- ◆ When SORM estimates workers' compensation claims costs for an upcoming year, SORM does not build in costs for unforeseen catastrophes or abnormally high claim volumes. SORM assumes that a few large claims will occur but does not anticipate numerous catastrophic claims that could result from a natural disaster or man-made disaster.
- ◆ Unlike SORM's pay-as-you-go financial structure, private insurance carriers maintain reserves sufficient to cover anticipated future liabilities from claims. Reserves allow insurers to pay future liabilities even if the company experiences financial troubles, but also provide insurers with a cushion to financially protect against abnormally high claims costs. Reserves are tapped to pay claims and replenished through increased premiums. The Texas Department of Insurance requires workers' compensation insurance companies to maintain sufficient reserves and submit an annual actuarial opinion on reserves.³

SORM is inadequately prepared to pay workers' compensation claims resulting from a catastrophic event.

- ◆ Unlike insurance carriers, SORM does not have reserves sufficient to cover future liabilities. SORM functions on a cash basis and calculates assessments to cover estimated costs for a fiscal year. Workers' compensation law entitles injured workers to up to seven years of indemnity benefits and lifetime medical benefits for treatment related to the compensable injury.
- ◆ SORM could be unable to pay workers' compensation claims resulting from a large-scale disaster, even with the flexibility to borrow up to 20 percent of total assessments from the General Revenue Fund. The table, *Workers' Compensation Funding Cushion*, shows the amount of funding SORM would have been able to access over the last five years to cover exceptional claims costs. Combining the excess assessments that were carried forward or refunded to agencies with the 20 percent of assessments that SORM may borrow from the General Revenue Fund, SORM has had a potential cushion ranging from \$14 million to \$38 million.
- ◆ While the amount of this cushion is substantial, it would prove insufficient to cover claims costs resulting from a large-scale disaster. For example, the 1995 bombing of the Alfred P. Murrah Federal Building in Oklahoma City killed 167 people and injured 684 people, most of whom were federal employees.³ In response, the federal government has paid a total of \$46 million in workers' compensation benefits on 500 claims.⁴ A similar attack on a state building could stretch SORM's funding beyond its capacities.
- ◆ In the event that high claims costs depleted both assessments and SORM's borrowing limit, the agency would have to seek emergency appropriations from the Legislature. Because a disaster that causes large state employee workers' compensation claims would also result in other demands for state resources for emergency management, facilities repair, and so forth, SORM's needs would compete against other financial demands.



Unlike private carriers, SORM's pay-as-you-go funding could leave the State ill-prepared to pay for a catastrophe.

*Workers' Compensation Funding Cushion*²

Fiscal Year	Total Assessment	Carried Forward to Next Year	Refunded to Agencies	Amount That can be Borrowed From GR (20% of Assessments)	Total Available Funding Cushion
2002	\$75,166,709	\$2,537,387	\$0	\$15,033,342	\$17,570,728
2003	\$71,515,548	\$6,931,259	\$0	\$14,303,110	\$21,234,369
2004	\$73,826,390	\$7,864,840	\$15,635,267	\$14,765,278	\$38,265,385
2005	\$52,066,514	\$3,650,000	\$0	\$10,413,303	\$14,063,303
2006	\$54,704,930	\$2,000,000*	\$7,550,000	\$10,940,986	\$20,490,986*

* Estimate



Private insurers and other state programs have reserves that may be used for catastrophic claims.

Self-insured companies and insurance carriers use many strategies to mitigate the risk of catastrophic claims.

- ◆ In the event of a disaster, self-insured companies and insurance carriers may tap their reserves to pay claims and then replenish reserves through increased premiums.
- ◆ The Division of Workers' Compensation (DWC) regulates companies that self-insure for workers' compensation. Companies must prove financial strength, post a security deposit of at least \$300,000, and purchase excess insurance coverage to be eligible for a certificate of self-insurance. Excess insurance covers losses in excess of a defined amount. DWC requires self-insurers to buy excess insurance to cover losses exceeding the security deposit up to at least \$5 million per occurrence. Finally, state law requires each self-insurer to join the Texas Certified Self-Insurer Guaranty Association (Guaranty Association). The Legislature established the Guaranty Association in statute as a means of spreading risk and paying workers' compensation claims from impaired self-insured companies. The Guaranty Association has access to \$500 million in pooled security deposits to pay an impaired self-insurer's claims after excess insurance is exhausted.
- ◆ Workers' compensation insurance carriers commonly mitigate the risk of high claims costs by reinsuring. Reinsurance is essentially insurance purchased by insurance companies to further spread risk. Texas Mutual, the largest workers' compensation carrier in Texas, reinsures to mitigate risk.

Like self-insurers, insurance carriers also have a guaranty association that would pay claims if a carrier became impaired. All workers' compensation insurance carriers in Texas are members of the Texas Property and Casualty Insurance Guaranty Association.

Other public, self-insured workers' compensation programs are better prepared to handle catastrophic events.

- ◆ The University of Texas System and the Texas A&M University System both operate a self-insured workers' compensation benefit program separate from SORM, and both have established reserves. Both systems annually assess component institutions to fund workers' compensation benefits. Unlike SORM, the UT and A&M assessments are sufficient to cover the expected cost of the life of a claim, not just costs incurred in the first year. Both systems have an annual actuarial study done that evaluates claims experience and reserve levels. The UT System has about \$53 million in reserves and the A&M System has about \$19 million in reserves.

Recommendation

Change in Statute

2.1 Require SORM to study how the State could structure its workers' compensation program to be prepared for claims resulting from a disaster and to report options to the Legislature.

This recommendation would require SORM to study various options, such as establishing a state employee workers' compensation catastrophe fund outside of the State Treasury; the purchase of catastrophe reinsurance, or other options which may be available to the State. SORM should work with TDI's Research and Evaluation Group to determine viable options on how the state can better prepare for workers' compensation claims resulting from a disaster. In addition, SORM may wish to contract with a consultant to analyze the costs of potential disasters, and estimate the appropriate size for a catastrophe fund or level of reinsurance needed. SORM should complete the study by September 1, 2008 and transmit it to the Lieutenant Governor, Speaker of the House, and appropriate and standing committees of each house with responsibility for oversight of SORM.

Fiscal Implication

The recommendation to study catastrophic event funding would not have a fiscal impact on the General Revenue Fund, as it would be paid for from state agency assessments. The study is estimated to cost \$20,000, which SORM would include in its annual assessment on state agencies.

¹ Texas Insurance Code § 426.001 and § 802.002.

² State Office of Risk Management, Assessments. Online. Available: www.sorm.state.tx.us/Legislative/assessments.php. Accessed: August 16, 2006; State Office of Risk Management, August 8, 2006.

³ Oklahoma State Department of Health, *Oklahoma City Bombing Injuries* (December 1998). Online. Available: www.health.state.ok.us/program/injury/Summary/bomb/OKCbomb.htm. Accessed: August 16, 2006.

⁴ Division of Federal Employees' Compensation, U.S. Department of Labor, September 6, 2006.

Appendix B

Survey Regarding the Funding Structures of State Government Employee Workers' Compensation Programs, developed by the Texas Department of Insurance, Workers' Compensation Research and Evaluation Group, with the State Office of Risk Management

Survey Regarding the Funding Structures of State Government Employee Workers' Compensation Programs

To better understand the strategies used by various state government workers' compensation programs to address catastrophes and to be better prepared for the payments of work-related claims resulting from an unexpected catastrophic event, the Texas Department of Insurance (TDI) is seeking information on behalf of the State Office of Risk Management (SORM) regarding the funding structures of other state government employee workers' compensation programs. SORM is the state agency responsible for administering the workers' compensation program for most Texas state government employees.

Please complete and return this survey by July 25, 2008. You can either email the survey to WCResearch@tdi.state.tx.us or fax the survey to (512) 322-4108. If you are not responsible for administering the state government workers' compensation program in your state, TDI would appreciate it if you forwarded this survey to the appropriate party with a concurrent notification to TDI of where the survey was sent.

Questions regarding this survey should be directed to WCResearch@tdi.state.tx.us or Amy Lee, Director, Workers' Compensation Research and Evaluation Group, Texas Department of Insurance, (512) 322-3461.

General Information

State: _____

Agency/Organization: _____

Contact Name: _____ Title: _____

Phone #: _____ Email: _____

Mailing Address:

Background Information

1. Generally, what types of employees are covered by your state government employee workers' compensation program? (Please place an "X" by all that apply)

- State government employees (e.g., state agency employees, state-elected officials)
- Public university employees
- State military or militia employees
- Political subdivision employees (e.g., city, county, school district employees)
- Other types of employees (please describe): _____

2. Are there any specific coverage exclusions that apply to the categories of state employees selected in question #1 (e.g., certain public university employees covered by a separate workers' compensation program)? If so, please describe these exclusions:

3. If the state government employee workers' compensation program was created by statute, please include the statutory citation for this program:

Statutory citation: _____

Internet URL (if available): _____

4. Approximately how many employees are currently covered by your state government employee workers' compensation program (please include an estimate of the number of employees covered by the program – not the number of injured workers whose claims are being serviced by your program)? _____

5. Approximately how many total workers' compensation claims (i.e., new and existing injuries) were active (open) in your program in 2007 (calendar year)? (Please estimate):

6. Approximately how many new workers' compensation claims (i.e., new work-related injuries) were reported to your program in 2007 (calendar year)? (Please estimate):

7. Total actual paid losses – the total amount of medical and indemnity losses paid out on workers' compensation claims, excluding claims administration and cost containment expenses.

What were the total actual paid losses paid out on all workers' compensation claims, including new and existing claims, for your state government employee workers' compensation program during calendar year 2007? (If an exact figure is not available please estimate): _____

8. In the last 10 years, approximately how many workers' compensation claims had actual paid losses (medical and indemnity losses) that exceeded more than \$1 million per claim to date? (If an exact figure is not available please estimate): _____

9. What was the highest actual paid loss on a single workers' compensation claim your program has administered in the last 10 years to date?

10. What was the highest number of state government employee workers' compensation claims that were generated by a single event in the last 10 years? Please briefly describe the event that caused these work-related injuries (e.g., a car accident that generated 5 workers' compensation claims)?

Funding Structure for State Government Employee WC Program

11. This state government employee workers' compensation program:

(Please place an "X" by all that apply)

- is self-insured
- purchases workers' compensation coverage from a commercial insurance company or state fund
- other (please briefly describe): _____

12. How is this state government employee workers' compensation program funded? (Please place an "X" by all that apply)

- Legislative appropriations
- Assessments/premium paid by client state agencies/universities
- Other funding source (please briefly describe): _____

13. How are state government employee workers' compensation claims adjusted? (Please place an "X" by all that apply)

- by other state government employees who serve as claim adjusters
- by one or more third-party administrator(s) (TPAs) who are contracted to administer state government employee claims
- some other way (please briefly describe) _____

14. If your state government employee workers' compensation program is self-insured, approximately how much was spent in calendar year 2007 to cover total paid losses, incurred losses and claims management/cost containment expenses? (please estimate) _____

15. If your program purchases workers' compensation coverage for state government employees, please estimate the total premium paid for this coverage in calendar year 2007 (or the last policy year available)? (please estimate) _____

Catastrophic Claims Strategy

The next few questions will focus what type of strategy your program has in place for catastrophic claims involving state government employees.

16. Workers' compensation programs may utilize different definitions of what constitutes "catastrophic claims" involving state government employees. If your state government employee workers' compensation program utilizes a specific definition for "catastrophic claims," please describe it here and include any statutory, rule or statistical plan citations for this definition, if any. If your program does not have a working definition for "catastrophic claims," please insert "N/A":

For the purposes of this survey, “catastrophic claims” is defined as an event (natural or manmade) that produces actual paid losses in excess of \$1 million per claim or an event that produces a number of claims in excess of the average number of claims in a specific area, occurring within a certain amount of time following the event, and with a cumulative loss in excess of \$1 million.

17. Generally, how does your workers’ compensation program pay for catastrophic claims involving state government employees? (Please place an “X” by all that apply)

- This program purchases workers’ compensation coverage, which covers losses resulting from all work-related injuries, including catastrophic claims
- This program has a catastrophe fund which provides the necessary funds to pay the losses
- This program purchases excess insurance or reinsurance
- This program has a reserve set aside for all incurred losses, including losses resulting from catastrophic claims
- This program has the authority to borrow money from the state treasury to pay for catastrophic claims
- Other (please briefly describe how losses resulting from catastrophic claims are paid)_____

18. If your state government employee workers’ compensation program has claims reserves set aside for incurred losses:

a. Who manages these reserves? (please describe)

b. What was the original revenue source for the creation of these reserves (e.g., one-time legislative appropriation, surcharge from client state agencies/universities, etc.)_____

c. How are these reserves calculated? Are there statutory rules as to how much is set aside (e.g., statute or state rules requires 125% of incurred losses to be set aside) or are reserves based on actuarial estimates of incurred losses or something else?

d. How often are these reserves reviewed and adjusted? What general types of information are used to review the adequacy of reserves?_____

19. If your state government employee workers’ compensation program has a catastrophe fund:

a. Who manages this fund? (please describe)

- b. What was the original revenue source for the creation of this fund (e.g., one-time legislative appropriation, surcharge from client state agencies/universities, etc.) _____
- c. How is the amount of money set aside in this fund calculated? Are there statutory rules as to how much is set aside or is the fund amount based on actuarial estimates of catastrophic claims losses or something else?

- d. Is there an amount of money that the fund must maintain so if the fund dips below that amount, additional revenue must be collected to restore the fund? If yes, how is that threshold determined and how is additional revenue collected to replenish the fund? _____
- e. Are there rules or limits as to when losses may be paid out of this fund (e.g., only claims that meet catastrophic claims definition, only when current claims reserves have been exhausted, etc)? _____
- f. Who has the authority to pay losses out of the fund?

20. If your state government employee workers' compensation program has purchased excess insurance/reinsurance, what was the estimated premium for this excess insurance/reinsurance in 2007? (Please estimate)

21. If your state government employee workers' compensation program has purchased excess insurance/reinsurance, what are the retention/deductible and the maximum limits per occurrence in the policy?

Retention _____ Maximum _____

22. In the event of one or more catastrophic claims, if the losses are beyond your state government employee workers' compensation program's solvency capability (i.e. catastrophe fund is exhausted and /or excess insurance cannot cover all expected losses) what other possible resources do you have to pay the claims? (please briefly describe) _____

23. Does your organization administer/purchase other lines of insurance (e.g., other property and casualty insurance or life and health insurance) for state government employees? If so, please list these other lines of insurance and briefly describe whether your state is self-insured

or purchases commercial coverage for these lines of insurance? _____
