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An Evaluation:

Local Government Property
Insurance Fund

October 2005

Report Highlights

Our auditor's report is unqualified.

The Property Fund's surplus declined to $15.3 million at the end of FY 2002-03, but it has since rebounded.

Since the end of FY 2003-04, participation in the Property Fund has declined from 1,203 to 1,160 local units of government.

Most claim files for FYs 2000-01 and 2001-02 were destroyed by a subcontractor.

The Local Government Property Insurance Fund was created by the State to make reasonably priced property insurance available to counties, cities, towns, villages, school districts, and other local units of government. It insures buildings, motor vehicles, libraries, and other property. The Property Fund must accept any local government that wishes to participate, and it cannot place restrictions on the type of property covered. As of June 30, 2004, it insured approximately $35.9 billion in property owned by 1,203 policyholders.

The Office of the Commissioner of Insurance (OCI) has statutory responsibility for administering the Property Fund. However, policies are issued, premiums are collected, and claims are paid primarily through private contractors. Both claims and administrative expenses are financed through policyholder premiums and investment earnings.

Section 13.94(1)(de), Wis. Stats., requires the Legislative Audit Bureau to audit the Property Fund. As part of this financial audit, we:

- reviewed financial records, supporting documentation, and control procedures;
- assessed the fair presentation of financial statements for fiscal years (FYs) 2003-04, 2002-03, 2001-02, and 2000-01;
- reviewed compliance with statutory provisions; and
- discussed various issues with OCI staff and the fund administrator.

We have provided an unqualified auditor's report on the Property Fund's financial statements but reported a material weakness in internal controls related to the premature destruction of claim files.

Financial Status

Increases in claims and changes in reinsurance terms and costs caused the Property Fund to incur net losses in three of the four years we audited. These losses totaled $8.1 million. However, increases in policyholder premium rates allowed the Property Fund to earn net income of $9.2 million for FY 2003-04. Premium rates have been reduced since our audit period ended.

Net Income (Loss)	
Fiscal Year	Net Income (Loss)
2000-01	$(2,078,946)
2001-02	(3,553,756)
2002-03	(2,483,591)
2003-04	9,236,418

Key Facts and Findings

The Property Fund provides insurance to counties, cities, towns, villages, and school districts.

The value of property insured was $35.9 billion at the end of FY 2003-04.

Premium rates for property insurance were increased three times during our audit period.

The Property Fund surplus balance was $24.5 million at the end of FY 2003-04 and reached $34.5 million as of June 30, 2005.

OCI should ensure that its contracts clearly define retention periods for Property Fund documentation.

From FY 2000-01 through

The Property Fund experienced a significant increase in policyholder claims. Total claims averaged $14.4 million per year from FY 1997-98 through FY 2003-04, compared to $6.5 million per year from FY 1989-90 through FY 1996-97. Increases in both the number of policyholders and the value of property insured have contributed to the increase in claims.

To mitigate the risk of large claims, the Property Fund purchases reinsurance. From FY 1997-98 through FY 1999-2000, reinsurance significantly limited the effects of large losses by paying $19.2 million in claims. During that same three-year period, the Property Fund paid $4.0 million in premiums to reinsurers. However, the lead reinsurer cancelled its contract with the Property Fund effective January 5, 2001. A new reinsurer was selected, but reinsurance terms were less favorable.

The terrorist attacks of September 11, 2001, caused additional changes in the reinsurance market, and the terms of the Property Fund's contract were again changed. Premiums paid to reinsurers increased from $1.1 million in FY 1999-2000 to $5.7 million in FY 2003-04.

In addition, reinsurance did not begin to cover claims until the Property Fund had incurred significantly higher claims. For example, between 2001 and 2003, the aggregate annual threshold after which reinsurance would pay claims rose from $6.0 million to $18.0 million annually.

Because of the changes in reinsurance contract terms, the Property Fund began to pay a larger percentage of claims directly. From FY 1997-98 through FY 1999-2000, reinsurers paid 45.1 percent of total claims. From FY 2000-01 through FY 2003-04, they paid only 11.0 percent of total claims.

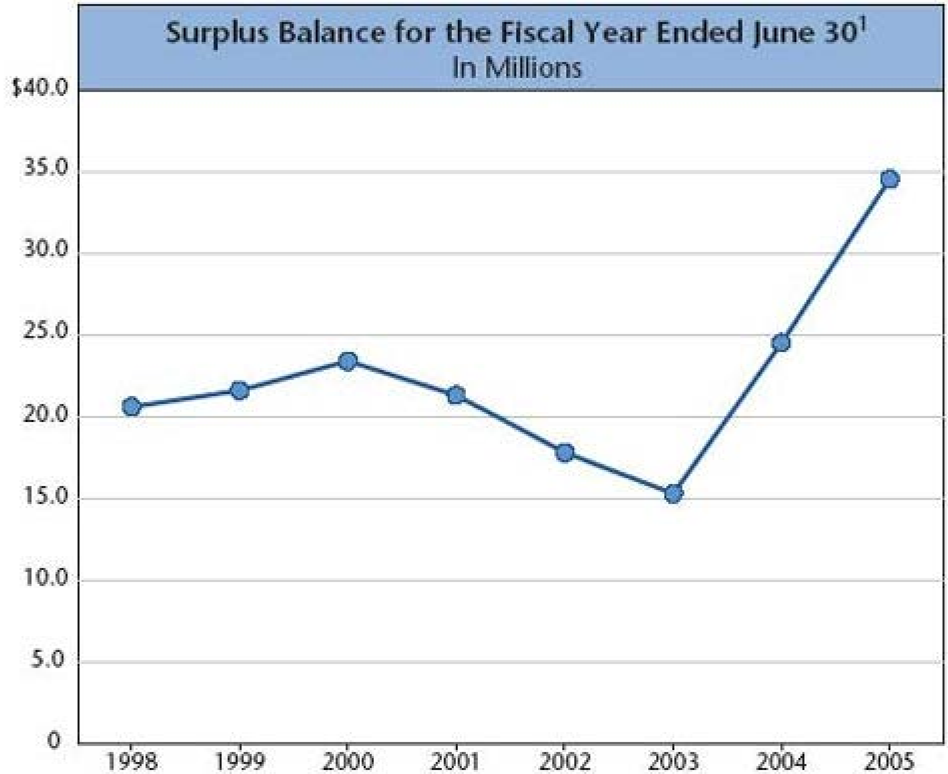
Although the Property Fund now pays a larger portion of claims, reinsurance continues to serve the same purpose it had in the past: providing coverage when unusually high or unexpected losses occur. OCI continues to monitor reinsurance use and the terms of its reinsurance contracts.

To ensure that policyholder premiums were adequate to cover the Property Fund's increased reinsurance costs and loss exposure, OCI increased them three times between July 1, 2001 and July 1, 2003. As a result, revenues from premiums paid by policyholders increased from $11.4 million in FY 2000-01 to $26.7 million in FY 2003-04.

FY 2003-04, total premiums collected from policyholders increased 134.7 percent, from $11.4 million to $26.7 million.

Surplus Balance

The premium rate increases implemented by OCI allowed the Property Fund to improve its financial position in FY 2003-04. Net income was $9.2 million, and the year ended with a surplus balance of $24.5 million.



[1]For 2005, the balance reported is based on unaudited financial statements.

Unaudited financial statements for FY 2004-05 show a surplus balance of $34.5 million. An adequate surplus balance is important for the Property Fund's financial stability. OCI has established a target surplus of at least $20 million, with a premium-to-surplus ratio of 1 to 1. That is, for every $1 of premiums written, the Property Fund should have $1 of surplus. As of June 30, 2005, the Property Fund's premium-to-surplus ratio was 1 to 1.37.

The Property Fund is different than private insurance companies in that it cannot diversify its insurance program across different types of insurance or outside of Wisconsin. This creates different risks, which may justify maintaining the surplus at a higher level.

OCI believes the surplus balance is appropriate given the recent changes in premium rates and reinsurance, and the unique characteristics of the Property Fund. However, it should continue to monitor the surplus balance to ensure it is not too large, especially given the fiscal constraints currently faced by participating local governments.

Property Fund Participation

Participation in the Property Fund increased over the four-year period of our audit, from 1,113 policyholders at the beginning of FY 2000-01 to 1,203 at the end of FY 2003-04. However, participation has since declined. As of June 30, 2005, 1,160 local governments purchased insurance through the Property Fund.

Some of the decline in participation may be attributable to increases in policyholder premium rates. However, increased competition in the insurance market could also be affecting the Property Fund.

Under 2003 Wisconsin Act 78, which took effect in December 2003, municipal mutual insurance carriers may sell property insurance. Previously, they could sell only worker's compensation insurance, liability insurance, and risk management services. OCI should continue to monitor trends in Property Fund participation.

Destruction of Claim Files

During the course of our fieldwork, we found that a subcontractor hired by the Property Fund's previous administrator had destroyed nearly all documentation to support claims paid in FYs 2000-01 and 2001-02.

Claim files are important because they provide the documentation necessary to support paid claims. Without this information, the Audit Bureau could not provide an opinion on the Property Fund's financial statements. Working with the current fund administrator and local governments, OCI re-created the missing claim files. However, the process delayed our audit significantly, and extra costs were incurred by both OCI and this office. According to OCI, these extra costs will be paid by the previous fund administrator.

We note that the claim files were destroyed in violation of the State's record-retention rules. The destruction of the files occurred two years after the transition to the new fund administrator. OCI could have been expected to take additional steps to ensure that claim files were properly safeguarded.

In a separate management letter, we make recommendations for OCI to include specific language in its contract with the current fund administrator to define the State's requirements for retaining Property Fund documents. We also recommend that steps be taken to ensure any additional claim files held by the previous fund administrator or its subcontractor be properly maintained.

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