STATE OF ILLINOIS

OFFICE OF THE AUDITOR GENERAL

MANAGEMENT AUDIT

GROUP WORKERS' COMPENSATION SELF-INSURED POOLS

JANUARY 2003

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OFFICE OF THE AUDITOR GENERAL
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To the Legislative Audit Commission, the Speaker and Minority Leader of the House of Representatives, the President and Minority Leader of the Senate, the members of the General Assembly, and the Governor:

This is our report of the Management Audit of the Department of Insurance with regard to its responsibilities pertaining to Group Workers' Compensation Self-Insured Pools.

The audit was conducted pursuant to Legislative Audit Commission Resolution Number 121, which was adopted June 26, 2001. This audit was conducted in accordance with generally accepted government auditing standards and the audit standards promulgated by the Office of the Auditor General at 74 Ill. Adm. Code 420.310.

The audit report is transmitted in conformance with Section 3-14 of the Illinois State Auditing Act.

WILLIAM G. HOLLAND
Auditor General

Springfield, Illinois
January 2003

REPORT DIGEST

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State of Illinois
Office of the Auditor General

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SYNOPSIS

Since the first pool was licensed in 1981, the Department of Insurance has had the statutory responsibility to regulate group workers' compensation self-insured pools. This included the authority to establish standards related to the adequacy of the pools' financing and administration, and to collect assessments to cover pool shortfalls. In 1999 and 2000, four pools were ordered into receivership.

From 1981 to 1999, the Department took no formal action against these pools, even though the Department had identified serious concerns about their operations and/or financial viability:

- The Department's review of annual financial statements and actuarial opinions raised concerns about surpluses, reserve deficiencies, and qualified actuarial opinions.
- Department examinations identified problems with the organization and membership of the boards of trustees and accuracy of annual financial statements.

The pooling law has been amended at least three times since 1981. In its response to this audit report, the Department cited that it lacked the tools needed to effectively regulate these pools. However, the Department did not provide the auditors with documentation to show that it proposed legislation to correct their perceived "shortcomings" in the law.

The Department increased monitoring of the pools in 1999. Between July 1999 and February 2000, the Department issued corrective orders to three of the four pools. The corrective orders were not effective because the administrator of the pools did not comply with them. Within months, the Department began receivership proceedings against the pools.

The Department's current regulation of pools could be further strengthened, including more effective monitoring of pools' boards of trustees, administrative costs, and rate setting practices.

At the time the four pools went into liquidation, there were a total of 628 claims for $18,128,552 outstanding or an average claim amount of $28,867. As of June 25, 2002, the combined assets of the four pools were $4,187,701.

The Group Workers' Compensation Pool Insolvency Fund, as of June 30, 2002, had a balance of $152,051 and outstanding claims of $1.1 million.

REPORT CONCLUSIONS

Since 1981, the Department of Insurance (DOI) has issued certificates of authority (licenses) to group workers' compensation self-insured pools to operate in the State. During 1999 and 2000, four of these pools were placed into court-ordered receivership with the Director of the Department of Insurance because the pools had become insolvent. All four of these pools are now in the process of liquidation with the Office of Special Deputy Receiver (OSD). At the time the four pools went into liquidation, there were a total of 628 claims for $18,128,552 outstanding or an average claim amount of $28,867.

The laws and administrative rules that apply to group workers' compensation self-insured pools contained provisions that gave DOI the authority to regulate pool operations prior to the insolvency of the four pools. Although new legislation was passed effective January 1, 2001, some of the provisions of the new law were already contained in either the existing law or the administrative rules. Under the new law, the pools are considered assessable domestic mutual insurance companies and are subject to many of the same provisions of the Insurance Code. Provisions added by the new law included, among others, those which:

- Clarified DOI's statutory authority to take corrective action;
- Redefined the reserve requirement;
- Required all pool members to have homogeneous risk characteristics;
- Required pool trustees to be an employee, officer, director, or owner of a pool member; and
- Added medical service payments to the amount on which pools are assessed for the Insolvency Fund.

The four pools currently in liquidation filed most required financial reports with the Department of Insurance in a timely manner. This included annual financial statements, actuarial opinions, and audits. While some financial reports contained inaccurate or incomplete information, DOI had financial information that showed the financial condition of these pools.

Effective July 7, 1995 (Public Act 89-97), State law requires that each pool be examined at least every five years. Two of the four pools in liquidation had examinations that were adopted by the Director of Insurance prior to the requirement becoming effective. The law also contained time requirements for filing the examinations, transmitting the report to the pool, and adoption of the examination. We reviewed financial examinations with start dates after July 1995 and found that some were not filed in accordance with statutory requirements. Of the 36 examinations reviewed, 10 took longer than 60 days to be adopted and 13

were never adopted. According to the Department, five of the exams that were initiated but not adopted were for the sole purpose of monitoring pools administered by a service agent that was going out of business. Some examinations conducted of the four pools currently in liquidation identified problems such as the organization and membership of boards of trustees and the accuracy of annual financial statements.

The Actuarial Unit at DOI conducted reviews of the pools' annual financial statements and actuarial opinions prior to their insolvency and identified several problems including concerns about surpluses, reserve deficiencies, and qualified actuarial opinions. However, no formal corrective actions, such as issuing corrective orders or assessment orders, were taken by DOI prior to July 1999.

The Illinois Department of Insurance increased monitoring of the pools in 1999; however, the increase in monitoring did not occur until after the pools' financial problems had occurred. Beginning in mid-1999, all the pools were required to file interim financial statements. DOI has also increased the length and comprehensiveness of the annual financial statement filings as of the year ended December 31, 2001.

DOI's current regulation of pool operations could be further strengthened. DOI does not effectively monitor the pools' boards of trustees, administrative costs, or rate setting practices.

Between July 1999 and February 2000, DOI issued corrective orders to three of the four pools currently in liquidation. These corrective orders required steps such as discontinuing issuance and renewal of insurance, considering whether the amount of administrative fees and/or agents' fees were excessive, increasing financial reporting, and submitting a general plan for improving the financial condition of the pool. The corrective orders issued were not effective because the administrator of the pools did not comply with the orders and questioned DOI's authority to issue corrective orders. The fourth pool did not receive a corrective order before being placed into receivership. None of the four pools currently in liquidation received an assessment order before being placed into receivership.

We also reviewed corrective orders and assessment orders issued to other pools that are currently solvent and found that DOI conducts limited tracking of whether all required information is received. Based on documentation DOI provided, four of eight pools that were issued an assessment order in 2001 improved their financial conditions between December 31, 2000 and the most recent quarterly statement. Of those four, two pools improved their financial condition based on factors that did not involve assessment collection.

Although court ordered receivership has resulted in the collection of additional assessments, it has not been successful in making the pools viable again. All four of the pools that entered receivership (conservation or rehabilitation) in 1999 and 2000 are now in the process of liquidation. One pool was ordered directly into rehabilitation while another was ordered from conservation into liquidation without an attempt at rehabilitation.

The process for liquidating the four group workers' compensation self-insured pools is ongoing and will not be completed until at least sometime in 2003. As of July 2002, OSD had not completed the review of proofs of claim for three of the four pools. The last bar date (date to return a proof of claim) passed in March 2002. The last date to file evidence in support of contingent claims against the four pools is March 2003 (contingent claims due date).

According to OSD, there is an estimated $18 million in claims related to these four pools. In addition, according to OSD court reports, as of June 30, 2002, a total of $3,120,918 in expenses and claim payments have been incurred in administering the pools while in rehabilitation and liquidation. OSD has issued $15,923,416 in assessments and collection notices to the four pools in liquidation. However, only $4,547,028 had been collected (29%) as of July 2002. As of June 25, 2002, the combined assets of the four pools, including assessments collected and expenses paid while in receivership, was $4,187,701.

The Group Workers' Compensation Pool Insolvency Fund, as of June 30, 2002, had a balance of $152,051 and outstanding claims of $1.1 million. DOI has levied additional assessments to two of the four pools in liquidation and to all remaining solvent pools; however, most of the pools protested the assessment and litigation is ongoing. (pages 1-3)

BACKGROUND

On June 26, 2001, the Legislative Audit Commission adopted Resolution Number 121, which directed the Auditor General to conduct a management audit of the Illinois Department of Insurance, the Office of Special Deputy, the Illinois Industrial Commission, and any other State agency with regard to their responsibilities pertaining to group workers' compensation self-insured pools in the State of Illinois.

The Resolution asked the Auditor General to determine with regard to the group workers' compensation self-insured pools (Pools) in liquidation:

- What activities are or were undertaken by any State agency to regulate, oversee, manage, or monitor the Pools;
- What information was available to those agencies concerning the financial condition of the Pools and the frequency, timeliness, and comprehensiveness of such information;
- The process for reviewing financial reports and other information provided by the Pools in the years prior to their default and any actions undertaken by State agencies in response to that information prior to the Pools' insolvencies;
- What methods are available to the State to identify and cure deficiencies in the financial condition of Pools prior to their being placed in liquidation and whether those methods are effective; and
- The process for liquidating insolvent Pools, including asset protection, allocation of losses and payment of claims.

Since the first pool was licensed in June 1981, a total of 39 group workers' compensation self-insured pools have received a certificate of authority (license) to operate.

Since the first pool was licensed in June 1981, a total of 39 group workers' compensation self-insured pools have received a certificate of authority (license) to operate from the Illinois Department of Insurance. (pages 3-8)

STATE AGENCIES INVOLVED IN ADMINISTERING GROUP WORKERS' COMPENSATION SELF-INSURED POOLS

Prior to January 1, 2001, there were two State agencies involved in the administration of group workers' compensation self-insured pools: the Illinois Department of Insurance (DOI) including the Office of Special Deputy Receiver (OSD), and the Illinois Industrial Commission. OSD assists the Director with his duties in receivership matters. The Commission's only responsibility related to self-insured pools was administering the Group Self-Insurers' Insolvency Fund. This responsibility was transferred to DOI by Public Act 91-757, effective January 1, 2001. (page 8)

POOLS IN LIQUIDATION

As of March 2001, there were four group workers' compensation self-insured pools in the process of liquidation proceedings with the OSD. Digest Exhibit 1 shows the four pools and the dates that they were placed into the various stages of receivership (conservation, rehabilitation, and liquidation). (pages 10-13)

Digest Exhibit 1
GROUP WORKERS' COMPENSATION SELF-INSURED POOLS IN LIQUIDATION
TIMELINE OF EVENTS

Name of Pool	License Date	Conservation	Rehabilitation	Liquidation
Back of Yards Risk Management Association	5/8/92	4/21/99	12/20/99	1/22/01
Illinois Earth Care Workers' Compensation Trust	2/24/93	8/19/99	10/21/99	10/26/00
Illinois Electrical Workers' Compensation Association Inc.	1/25/95	N/A	12/20/99	11/3/00
Illinois Environmental Services Workers' Compensation Trust	12/1/91	7/31/00	N/A	3/22/01

Source: Office of Special Deputy Receiver.

POOL REGULATION

Group workers' compensation self-insured pools are regulated primarily by the laws establishing the pools and the administrative rules that have been promulgated by the Department of Insurance (DOI). The laws and administrative rules regulating group workers' compensation self-insured pools contained provisions that gave DOI the authority to regulate pool operations prior to the insolvency of the four pools. Although new legislation was passed effective January 1, 2001, some of the provisions of the new law were already contained in either the existing law or the administrative rules. The laws and rules also contain requirements for pool administrators.

Some of the provisions of the new law were already contained in either the existing law or the administrative rules.

Each group workers' compensation self-insured pool has an appointed board of trustees that exercises management control of the pool. Administration of the pools, which includes such items as risk management and claims administration, are generally delegated to an independent service company. Most of the group workers' compensation self-insured pools, including the four pools in liquidation, had a third party administrator.

Boards of Trustees

Boards are responsible for such critical functions as hiring the pool administrator to manage the pool and also hiring the auditors and actuaries that review the pool's operations.

Having an active and informed board of trustees can play a vital role in the success or failure of any organization. These boards are responsible for such critical functions as hiring the pool administrator to manage the pool and also hiring the auditors and actuaries that review the pool's operations. Several of the boards for the four pools currently in liquidation did not have full membership, were not meeting on a regular basis, and had non-members on the board.

The Department's monitoring of board activities could be improved. We recommended that the Department should ensure that each pool maintains a board of trustees in accordance with each pool's trust agreement and should consider promulgating rules that require these boards to file meeting minutes and board resolutions with the Department so that their activities can be better monitored.

Rate Setting

Rate setting can be a major factor in the financial success or failure of a pool. Determination of pool participants' standard premium and risk classification is to be done in accordance with the National Council on Compensation Insurance (NCCI) Workers' Compensation Manual. Rates used for workers' compensation insurance are to be filed with DOI.

Three of the four pools currently in liquidation had the same service agent.

Three of the four pools currently in liquidation had the same administrator. On November 4, 1999, the Director of the Illinois Department of Insurance filed an Order of Revocation to revoke the service company license of this administrator. Among other things, the Order alleged that the administrator failed to adequately document the basis of premium discounts given to some clients and that this jeopardized the financial status of the pool. The service agent voluntarily surrendered his license.

Under the new law effective January 1, 2001, these pools are considered assessable domestic mutual insurance companies and are required to file with DOI every manual of classifications, rules and rates, rating plan, and related modifications. We recommended that the Department should monitor and review the rate setting practices of group workers' compensation self-insured pools.

Administrative Costs

Three of the pools currently in liquidation may have paid significantly higher amounts for administrative costs than the other pools.

Three of the pools currently in liquidation may have paid significantly higher amounts for administrative costs than the other pools. Service agreements show that the pool administrator for these three pools was charging 39 percent of standard premium for administering the pool. The other pool currently in liquidation (BYRMA) was paying 14 percent of actual premiums as of 1998.

Administrative costs being paid by the remaining active pools were well below the 39 percent of standard premium paid by the three pools. We recommended that the Department should review administrative service agreements between the pools and their prospective administrators for reasonableness of administrative fees.

Pools With Dissimilar Risk Characteristics

Several of the pools currently in liquidation included members that did not have similar or homogeneous risks.

Several of the pools currently in liquidation included members that did not have similar or homogeneous risks. These employers were allowed to join the pool because they were members of the sponsoring organization. For example, BYRMA membership included employers from Chicago's western suburbs to as far away as Cairo, Illinois. It also included members with risks as different as fast food restaurants and lumberyards.

Having similar risks in these pools is important because it is easier to accurately predict loss experience when determining the basis for premiums. While the Department does receive a list of the initial membership and applications of new members, they could not provide a list of the current members of each pool or the amount of total payroll.

The laws governing the group workers' compensation self-insured pools that went into effect January 1, 2001 require that all pools have members with homogeneous risks. The statutes and rules do not define homogeneous. We recommended that the Department should promulgate rules that define the term "homogeneous" for pool membership before issuing any new certificates of authority and monitor pools for members that do not have homogeneous risks.

Reserve Requirements

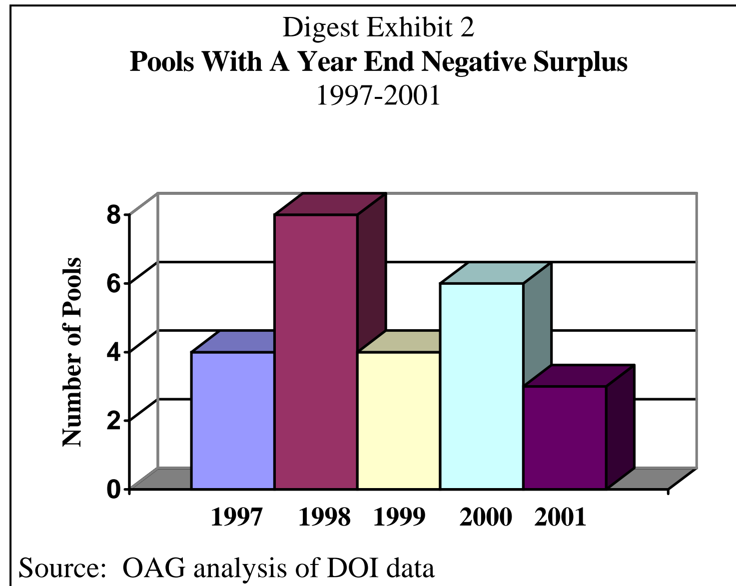
From 1983 until the new pooling law became effective January 1, 2001, the pooling law required that every group self-insurer maintain reserves which are actuarially sufficient, as determined by the Director of Insurance, to provide for the payment of all losses and claims incurred (P.A. 83-1005). It also stated that the Department shall promulgate rules that establish standards and guidelines to assure the adequacy of the

financing and administration of group self-insurance plans. Although the Department promulgated rules, the rules did not include a specific surplus or reserve requirement.

Several pools had a negative surplus in the years preceding the four pools being placed into receivership.

Several pools had a negative surplus in the years preceding the four pools being placed into receivership. These include pools that are currently in liquidation as well as some that are still in operation. Digest Exhibit 2 shows that as of the end of 1997 there were four pools reporting a negative surplus in their annual financial statements submitted to DOI. By the end of 1998, this had doubled to eight pools.

Digest Exhibit 2
Pools With A Year End Negative Surplus
1997-2001



Source: OAG analysis of DOI data

Under the current reserve requirement, the Director is required to order the pool trustees to assess the individual pool participants in an amount not less than necessary to correct the deficiency when he determines by means of audit, annual certified statement, actuarial opinion, or otherwise that the assets possessed by the pool are less than the reserves required together with any other unpaid liabilities (215 ILCS 5/107a.14). According to DOI officials, the current requirement means that no pool can have less than a $0 surplus. In May 2001, DOI began issuing assessment orders to the pools with a negative surplus. As of December 31, 2001, 3 of the remaining 23 pools reported a negative surplus. All three of these pools are no longer writing business. We recommended that the Department should take available regulatory actions to ensure that each group workers' compensation self-insured pool maintains adequate reserves. (pages 15-32)

FINANCIAL OVERSIGHT AND MONITORING OF POOLS

DOI has a system of financial reporting and monitoring in place, most of which was in effect prior to the four pools being ordered into liquidation. Pools are required to file annual financial statements, audits, and actuarial opinions.

The current process contains adequate controls for DOI to detect problem financial conditions of pools.

Financial Reporting Review Process

The current process contains adequate controls for DOI to detect problem financial conditions of pools. In July 1998, the Regulatory Action Unit (RAU) was assigned to review the annual financial statements of the group workers' compensation self-insured pools and effective January 1, 1999, the pools were assigned to the RAU. Prior to July 1998, the Financial/Corporate Regulatory Division was responsible for overseeing the pools.

DOI Analysis of Financial Information

The required financial reports include information that is central to the monitoring function, for example, the amount of surplus and premium, assets, liabilities, number of members in the pool, and the estimated total annual payroll. DOI's Actuarial Unit conducts a review of annual financial statements and actuarial opinions, which includes a summary of surplus, premium, net underwriting gain (loss), findings of reserve adequacy, and reviewer comments. DOI's Regulatory Action Unit prepares a number of ratios when analyzing a pool's annual statement. Prior to the four pools being placed into receivership, these reviews identified several problems including concerns about surpluses, reserve deficiencies, and qualified actuarial opinions.

Prior to the four pools being placed into receivership, these reviews identified several problems including concerns about surpluses, reserve deficiencies, and qualified actuarial opinions.

Timeliness and Comprehensiveness of Financial Information

DOI had sufficient information regarding the financial condition of the pools to identify those that were in hazardous financial condition. We determined that solvent and liquidated pools alike were submitting most of the required reports in a fairly timely basis prior to any of the pools becoming insolvent.

Digest Exhibit 3 shows the amount of surplus for each of the pools currently in liquidation for calendar year 1995 through 1999. The exhibit shows that in 1998, three of the four pools had a negative surplus. It also shows that BYRMA had a large negative surplus in 1997 and 1998 before going into conservation in April 1999. The Illinois Electrical pool had a negative surplus from 1995 through 1998.

Digest Exhibit 3
SURPLUS FOR POOLS IN LIQUIDATION
YEAR END BALANCE
Calendar Years 1995-1999

	CY 95	CY 96	CY 97	CY 98	CY 99
BYRMA	$171	$30,342	$(1,179,412)	$(2,100,151)	See notes
IL Earth Care	$267,826	$289,098	$227,069	$(1,216,470)	See notes
IL Electrical	$(52,480)	$(74,837)	$(69,722)	$(128,518)	See notes
IL Environmental	$(73,859)	$124,579	$236,137	$170,881	$(610,446)

Notes: These figures are self-reported by each pool in their annual financial statements. DOI financial examinations found that these amounts were not always accurate. For example, the 1997 year-end balances for the Illinois Electrical and Illinois Earth Care pools should have been ($237,668) and ($850,931) respectively according to DOI examinations. The examination reports for these two pools were completed in October 1999 but were never adopted.

*BYRMA went into conservation on April 21, 1999.
*IL Earth Care went into conservation on August 19, 1999.
*IL Electrical went into rehabilitation on December 20, 1999.
*IL Environmental went into conservation on July 31, 2000.

Source: OAG analysis of annual financial statements submitted to DOI.

Additional Financial Statement Requirements

DOI has expanded the information required in the annual financial statement filings.

The Illinois Department of Insurance increased monitoring of the pools in 1999; however, the increase in monitoring did not occur until after the pools' financial problems had occurred. In addition, DOI has expanded the information required in the annual financial statement filings. Workers' compensation self-insured pools as of the year end 2001 statement are now required to file a statement that is approximately 40 pages in length as opposed to the shorter 10 page filing that had been used in the past. The year end 2001 annual statements require additional information for an expanded time frame regarding premiums, losses, expenses, investments, cash, and reinsurance. Interrogatories, which contain pool membership information, are also required. (pages 33-41)

DOI FINANCIAL EXAMINATIONS

Effective July 7, 1995 (Public Act 89-97), State law requires that each pool is examined at least every five years. It also contains time requirements for filing the examinations, transmitting the report to the pool, and adoption of the examination.

Examinations of Pools in Liquidation

Illinois Earth Care Workers' Compensation Trust and Illinois Environmental Services Workers' Compensation Trust were both examined for the period ended December 31, 1993, prior to the statutory requirement for the examinations. These examinations were not adopted by the Director of the Department of Insurance until June 1996, 2 ½ years later. Other examinations were also conducted but not filed. According to DOI officials, instead of adopting the examination, corrective orders were issued. Digest Exhibit 4 illustrates the financial examinations conducted of the pools in liquidation.

Digest Exhibit 4
Financial Examinations of Pools in Liquidation

	Time period covered by examination	Status
BYRMA	No exams conducted	No exams conducted
IL Earth Care	12-15-92 to 12-31-93 1-1-94 to 12-31-97	Adopted 6-19-96 Not filed
IL Electrical	8-1-95 to 12-31-97	Not filed
IL Environmental	11-1-91 to 12-31-93 1-1-94 to 12-31-97	Adopted 6-19-96 Not filed

Source: OAG analysis of DOI data

Financial examinations of two of the pools in liquidation noted some considerable differences between the reporting of fund balances in the annual financial statements and the examinations. For example, an examination for the period ended December 31, 1997 found that Illinois Electrical underestimated liabilities by $150,000 and over reported assets by $17,946. As a result, the surplus was overstated in the pool's annual financial statement by $167,946. Illinois Earth Care reported a surplus of $227,069 in its 1997 annual statement; however, DOI's financial examination discovered that the surplus was actually a negative $850,931, or $1,078,000 less than reported by the pool in the annual statement. Illinois Earth Care had over reported assets by $228,000 and underestimated liabilities by $1,000,000.

Financial examinations of two of the pools in liquidation noted some considerable differences between the reporting of fund balances in the annual financial statements and the examinations.

Examinations of All Pools

Financial examinations of the pools were not filed in accordance with statutory requirements. DOI provided complete data for 36 examinations of group workers' compensation self-insured pools that had been performed. Of the 36 examinations:

- 10 were adopted within 60 days;
- 10 took longer than 60 days to be adopted;

- 13 were never adopted; and
- 3 were not yet completed.

According to the Department, 5 of the 13 exams never adopted were related to a pool administrator who surrendered his license. These were conducted for the purpose of having an examiner on site to monitor the pools and no exams were actually conducted or intended so no reports were ever prepared.

Financial examinations can provide confidence in financial information reported by the pools as well as correct annual statement surplus fund balances. As a result of issues identified during the audit, DOI recently updated its examination report processing policies and procedures in November 2002. We recommended that the Department should conduct all required financial examinations and adopt them in a timely manner to comply with statutory requirements. (pages 41-46)

CORRECTIVE ACTIONS

There are two general categories of corrective actions that can be taken prior to liquidation of a group workers' compensation self-insured pool: 1) Departmental supervised actions (such as corrective orders and assessment orders); or 2) Court supervised actions such as receivership.

Since July 26, 1999, DOI has issued corrective orders to seven pools and stipulation and consent orders to two pools.

Corrective Orders

Since July 26, 1999, DOI has issued corrective orders to seven pools and stipulation and consent orders to two pools. Corrective orders recommend that pools take certain steps to improve operations, including ordering the pool not to write new business or spend money on advertising. Of the four pools currently in liquidation, three were issued a corrective order. However, none of the four pools were issued an assessment order. One of the pools now in liquidation did not receive either a corrective order or an assessment order from the Department before receiving an order of conservation through the Illinois courts. Some of the issues that may have contributed to the ineffectiveness of the corrective orders include: pool administrator protests to corrective orders asserting that the pool was not an assessable domestic mutual insurance company and not subject to corrective orders and untimely issuance of corrective orders.

Public Act 91-757 (effective January 1, 2001) includes a section that now clarifies pools as assessable domestic mutual insurance companies and contains a section that specifically gives DOI authority to issue corrective orders. These revisions of the law should assist DOI in executing future corrective orders. However, based on rules and statutes,

DOI had authority to regulate the pools dating back a number of years prior to the four pools being placed into liquidation, both preventative and curative. Provisions either in statute or rule have, for example, allowed DOI to:

- obtain financial information,
- require loss reserves,
- monitor/audit loss reserves, and
- order assessments on members of all pools.

Assessment Orders

DOI did not issue assessment orders to the pools currently in liquidation prior to them being placed into receivership. Assessment orders are issued to pools with the intent of having pool members contribute additional funds to the pool to correct any deficit.

Four of eight pools that were issued an assessment order in 2001 improved their financial conditions between December 31, 2000 and the most recent quarterly statement. Of those four, two pools improved their financial condition based on factors that did not involve assessment collection. The financial condition of the four other pools worsened.

DOI did not issue assessment orders to the pools currently in liquidation prior to them being placed into receivership.

While assessments have resulted in pools obtaining additional funding, it is difficult to measure the degree to which the assessment alone had an effect on improving pools' financial conditions because: 1) assessments are not always collected by the due date, and 2) external factors can affect pool surpluses. We recommended that the Department should continue to issue corrective orders and assessment orders to pools in hazardous financial condition as well as monitor the collection of assessments.

Court Ordered Corrective Actions

Although court ordered receivership has resulted in the collection of additional assessments, it has not been successful in making the pools viable again. If DOI finds that the financial condition of a pool is hazardous the Director can, through the Illinois Attorney General's Office, seek a court order of conservation or rehabilitation prior to a court order for liquidation. These receivership proceedings are handled by the Director, who is assisted by the Office of Special Deputy Receiver (OSD).

OSD is notified when the Department determines that an insurance company or pool is in need of receivership. The Attorney General petitions the court to appoint the Director of Insurance as the receiver, as

specified in statute. Once the court signs the order, the Director may appoint a special deputy to assist him.

Digest Exhibit 5
CLAIMS BY POOL
At OSD Takeover

	BYRMA	IL Electrical	IL Environmental	IL Earth Care	Total
Total Number of Claims	203	25	128	272	628
Total Dollar Amount of Claims	$6,556,907	$1,150,862	$3,781,331	$6,639,453	$18,128,552
Average Claim Amount	$32,300	$46,034	$29,542	$24,410	$28,867

Note: Totals do not add due to rounding

Source: OAG analysis of DOI data

Digest Exhibit 5 shows the initial claims data obtained by OSD at takeover. The takeover data shows that there were more than 600 claims for a total of over $18 million at that time. According to OSD officials, this is the most accurate estimate of the total claims liability of these pools. (pages 47-59)

LIQUIDATION PROCESS

Once a pool has been placed in liquidation, there are many steps before the final liquidation and claims are paid. OSD has an established liquidation process, some of which is specified in statutes, for all insurance companies, including the group workers' compensation self-insured pools.

The statutes contain a priority for paying claims during a final distribution. Administration expenses, which include OSD expenses, are the highest priority in the statutes. Therefore, costs of administration will be the first priority to be paid out of a pool's remaining funds. If the cost for administering the pools uses up all a pool's funds, there will be no funds to pay claimants. In these cases the claimants would have to go to the Insolvency Fund for payment.

According to OSD, there is an estimated $18 million in claims related to the four pools that are currently in liquidation.

According to OSD, there is an estimated $18 million in claims related to the four pools that are currently in liquidation. As of July 2002, adjudicated claims totaled $13.8 million. As of July 2002, the review of proofs of claim had only been completed for one of the four pools. Each pool also has a contingent claims cut-off date that must pass before liquidation can be completed. The last bar date (date to return a proof of

claim) passed in March 2002. The last of the four pools contingent claim cut-off date is in March 2003.

OSD has issued $15,923,416 in assessments and collection notices to the four pools in liquidation. However, only $4,547,028 (29%) has been collected as of July 2002. As of June 30, 2002, OSD had disbursed from the four pools' estates a total of $3,120,918 in claim payments and expenses in administering the pools while in liquidation. As of June 25, 2002 the combined assets for the four pools, including assessments collected and expenses paid while in receivership, was $4,187,701. (pages 59-64)

INSOLVENCY FUND

As of June 25, 2002 the combined assets for the four pools, including assessments collected and expenses paid while in receivership, was $4,187,701.

The purpose of the Group Workers' Compensation Pool Insolvency Fund is to compensate eligible employees when their group workers' compensation self-insured pool is unable to pay compensation and medical service payments due to financial insolvency. As of January 1, 2001, the Department of Insurance (DOI) is responsible for collecting semi-annual assessments for the Insolvency Fund. Prior to that date, the Illinois Industrial Commission had that responsibility.

Statutory Semi-Annual Assessments

The Workers' Compensation Pool Law (215 ILCS 5/107a.13a) requires all qualified group workers' compensation pools to pay a sum equal to 0.5 percent of all compensation and medical service payments, into the Group Workers' Compensation Pool Insolvency Fund. Payments are due on January 1st and July 1st for the preceding six months.

The pools previously paid 0.5 percent on compensation payments prior to January 1, 2001, but now they pay 0.5 percent on both medical and workers' compensation payments. The Insolvency Fund Balance as of June 30, 2002 was $152,051. The estimated amount of outstanding claims against the fund as of June 30, 2002 was $1.1 million dollars. Some claims have been waiting to be paid since November 2001.

The Insolvency Fund Balance as of June 30, 2002 was $152,051. The estimated amount of outstanding claims against the fund as of June 30, 2002 was $1.1 million dollars.

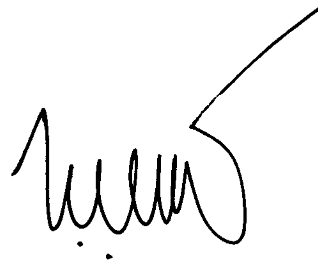
Insolvency Fund Special Assessments

The Director can issue special assessments of pools to pay claims against the Insolvency Fund. The Director of Insurance ordered several special assessments on December 21, 2001. These special assessments included an assessment of $257,851.27 to members of the Illinois Earth Care Workers' Compensation Trust and an assessment of $82,596.88 to members of BYRMA. As of June 30, 2002, DOI had collected $87,843.27, or 34 percent, of Earth Care's special assessment. DOI also collected $40,318.51, or 49 percent, of BYRMA's special assessment.

In addition, DOI sent a letter to the remaining pools assessing them a total of $1,000,000. As of June 30, 2002, DOI had received $52,044, or 5 percent, of this special assessment. Of the 25 pools, 3 paid their total amounts due, 20 filed for an administrative hearing, and 2 did not pay or request a hearing. In October 2002, the pools obtained a Motion to Stay the administrative proceeding pending before the Illinois Department of Insurance from the Circuit Court because they are challenging the constitutionality of the statute. We recommended that the Department should consider whether the statutory percentage of semi-annual assessment paid by the pools should be increased to raise the fund's balance and seek legislation to assist in preventing future shortfalls. We also recommended that the Department ensure that each pool is paying the correct amount of semi-annual assessment and that it is collected in a timely manner. (pages 64-69)

RECOMMENDATIONS

The audit report contains nine recommendations to the Illinois Department of Insurance for which the Department provided extensive responses. Appendix E to the audit report contains the agency responses.



WILLIAM G. HOLLAND
Auditor General

WGH\MP
January 2003

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GLOSSARY OF TERMS

Assessment Order – A formal document that the Department of Insurance issues to a pool's Board of Directors when the Department determines that the pool's liabilities exceed its assets. Such an order requires the pool to correct its net worth deficiency by levying an assessment on pool participants.

Conservation – A form of court-ordered receivership wherein the company's operations are supervised by the Director, while the Director ascertains the financial condition and situation of the company.

Corrective Order – A formal document that the Department of Insurance issues at its discretion to pools that are operating in a manner that could lead to a financial condition which, if continued, would make it hazardous to its policyholders. Corrective orders may require, for example, that pools cannot exchange assets without DOI approval; estimate amounts necessary to cover claims; and/or provide DOI with monthly financial statements.

Experience Modification Factor – A multiplier of the actual reported loss for a particular employer compared with average loss of employees in that state who are also in the same classification codes.

Liquidation – A form of court-ordered receivership in which an insolvent company's assets are marshalled and converted to cash by the Director, claims are presented and adjudicated, and assets are distributed upon approval of the court.

NCCI (National Council on Compensation Insurance) – A workers' compensation insurance rating organization that collects, manages, and distributes information that serves the workers' compensation industry and its stakeholders.

OSD (Office of Special Deputy Receiver) – An entity designated by the Director of the Department of Insurance to assist with his capacity as the liquidator, rehabilitator, or conservator of a company in liquidation, rehabilitation, or conservation.

Pooling agreement – A contractual agreement between a pool and employer, defining issues such as coverage, payment, and exclusions.

Premium (Standard) – The premium rate as determined by a rating agency for a specific job or experience classification.

Premium (Actual) – The rate that an insured is charged reflecting his or her expectation of loss or risk or the calculated premium after discounts to the standard premium.

Rehabilitation – A form of court-ordered receivership in which the Director takes possession and control of an insolvent insurance company's assets and operations. Certain operations may be continued pursuant to Court Order and the Director's recommendations

Service Administrator – A third party responsible for managing a pool's day-to-day operations. Duties can vary but may include among others, handling claims, claim payments, and loss prevention safety engineering.

Surplus – The difference between a pool's assets and reserve required together with any other unpaid liabilities.

Chapter One

INTRODUCTION AND BACKGROUND

REPORT CONCLUSIONS

Since 1981, the Department of Insurance (DOI) has issued certificates of authority (licenses) to group workers' compensation self-insured pools to operate in the State. During 1999 and 2000, four of these pools were placed into court-ordered receivership with the Director of the Department of Insurance because the pools had become insolvent. All four of these pools are now in the process of liquidation with the Office of Special Deputy Receiver (OSD). At the time the four pools went into liquidation, there were a total of 628 claims for $18,128,552 outstanding or an average claim amount of $28,867.

The laws and administrative rules that apply to group workers' compensation self-insured pools contained provisions that gave DOI the authority to regulate pool operations prior to the insolvency of the four pools. Although new legislation was passed effective January 1, 2001, some of the provisions of the new law were already contained in either the existing law or the administrative rules. Under the new law, the pools are considered assessable domestic mutual insurance companies and are subject to many of the same provisions of the Insurance Code. Provisions added by the new law included, among others, those which:

- Clarified DOI's statutory authority to take corrective action;
- Redefined the reserve requirement;
- Required all pool members to have homogeneous risk characteristics;
- Required pool trustees to be an employee, officer, director, or owner of a pool member; and
- Added medical service payments to the amount on which pools are assessed for the Insolvency Fund.

The four pools currently in liquidation filed most required financial reports with the Department of Insurance in a timely manner. This included annual financial statements, actuarial opinions, and audits. While some financial reports contained inaccurate or incomplete information, DOI had financial information that showed the financial condition of these pools.

Effective July 7, 1995 (Public Act 89-97), State law requires that each pool be examined at least every five years. Two of the four pools in liquidation had examinations that were adopted by the Director of Insurance prior to the requirement becoming effective. The law also contained time requirements for filing the examinations, transmitting the report to the pool, and adoption of the examination. We reviewed financial examinations with start dates after July 1995 and found that some were not filed in accordance with statutory requirements. Of the 36 examinations reviewed, 10 took longer than 60 days to be adopted and 13 were never adopted. According to the Department, five of the exams that were initiated but not adopted were for the

sole purpose of monitoring pools administered by a service agent that was going out of business. Some examinations conducted of the four pools currently in liquidation identified problems such as the organization and membership of boards of trustees and the accuracy of annual financial statements.

The Actuarial Unit at DOI conducted reviews of the pools' annual financial statements and actuarial opinions prior to their insolvency and identified several problems including concerns about surpluses, reserve deficiencies, and qualified actuarial opinions. However, no formal corrective actions, such as issuing corrective orders or assessment orders, were taken by DOI prior to July 1999.

The Illinois Department of Insurance increased monitoring of the pools in 1999; however, the increase in monitoring did not occur until after the pools' financial problems had occurred. Beginning in mid-1999, all the pools were required to file interim financial statements. DOI has also increased the length and comprehensiveness of the annual financial statement filings as of the year ended December 31, 2001.

DOI's current regulation of pool operations could be further strengthened. DOI does not effectively monitor the pools' boards of trustees, administrative costs, or rate setting practices.

Between July 1999 and February 2000, DOI issued corrective orders to three of the four pools currently in liquidation. These corrective orders required steps such as discontinuing issuance and renewal of insurance, considering whether the amount of administrative fees and/or agents' fees were excessive, increasing financial reporting, and submitting a general plan for improving the financial condition of the pool. The corrective orders issued were not effective because the administrator of the pools did not comply with the orders and questioned DOI's authority to issue corrective orders. The fourth pool did not receive a corrective order before being placed into receivership. None of the four pools currently in liquidation received an assessment order before being placed into receivership.

We also reviewed corrective orders and assessment orders issued to other pools that are currently solvent and found that DOI conducts limited tracking of whether all required information is received. Based on documentation DOI provided, four of eight pools that were issued an assessment order in 2001 improved their financial conditions between December 31, 2000 and the most recent quarterly statement. Of those four, two pools improved their financial condition based on factors that did not involve assessment collection.

Although court ordered receivership has resulted in the collection of additional assessments, it has not been successful in making the pools viable again. All four of the pools that entered receivership (conservation or rehabilitation) in 1999 and 2000 are now in the process of liquidation. One pool was ordered directly into rehabilitation while another was ordered from conservation into liquidation without an attempt at rehabilitation.

The process for liquidating the four group workers' compensation self-insured pools is ongoing and will not be completed until at least sometime in 2003. As of July 2002, OSD had not completed the review of proofs of claim for three of the four pools. The last bar date (date to

return a proof of claim) passed in March 2002. The last date to file evidence in support of contingent claims against the four pools is March 2003 (contingent claims due date).

According to OSD, there is an estimated $18 million in claims related to these four pools. In addition, according to OSD court reports, as of June 30, 2002, a total of $3,120,918 in expenses and claim payments have been incurred in administering the pools while in rehabilitation and liquidation. OSD has issued $15,923,416 in assessments and collection notices to the four pools in liquidation. However, only $4,547,028 had been collected (29%) as of July 2002. As of June 25, 2002, the combined assets of the four pools, including assessments collected and expenses paid while in receivership, was $4,187,701.

The Group Workers' Compensation Pool Insolvency Fund, as of June 30, 2002, had a balance of $152,051 and outstanding claims of $1.1 million. DOI has levied additional assessments to two of the four pools in liquidation and to all remaining solvent pools; however, most of the pools protested the assessment and litigation is ongoing.

BACKGROUND

On June 26, 2001, the Legislative Audit Commission adopted Resolution Number 121, which directed the Auditor General to conduct a management audit of the Illinois Department of Insurance, the Office of Special Deputy, the Illinois Industrial Commission, and any other State agency with regard to their responsibilities pertaining to group workers' compensation self-insured pools in the State of Illinois (see Appendix A).

The Resolution asked the Auditor General to determine with regard to the group workers' compensation self-insured pools (Pools) in liquidation:

- What activities are or were undertaken by any State agency to regulate, oversee, manage, or monitor the Pools;
- What information was available to those agencies concerning the financial condition of the Pools and the frequency, timeliness, and comprehensiveness of such information;
- The process for reviewing financial reports and other information provided by the Pools in the years prior to their default and any actions undertaken by State agencies in response to that information prior to the Pools' insolvencies;
- What methods are available to the State to identify and cure deficiencies in the financial condition of Pools prior to their being placed in liquidation and whether those methods are effective; and
- The process for liquidating insolvent Pools, including asset protection, allocation of losses and payment of claims.

GROUP WORKERS' COMPENSATION SELF-INSURED POOL LAWS

Illinois law requires employers to insure themselves for their workers' compensation liabilities (820 ILCS 305 *et seq*.). Employers can purchase a plan from an insurance company, join a pool, or receive approval from the Illinois Industrial Commission (IIC) to self-insure. The Workers' Compensation Act (820 ILCS 305/4a) was amended in 1980 to allow employers to form group workers' compensation self-insured pools with the approval of the Illinois Department of Insurance (Public Act 81-1482).

Since 1981, the Department of Insurance (DOI) has issued certificates of authority (licenses) to 39 group workers' compensation self-insured pools to operate in the State. During 1999 and 2000, four of these pools were placed into court-ordered receivership with the Department of Insurance because the pools had become insolvent. All four of these pools are now in the process of liquidation with the Office of Special Deputy Receiver (OSD).

Statutory Requirements for Pools Prior to January 1, 2001

Prior to January 1, 2001, the authority to form a group workers' compensation self-insured pool was provided for in the Workers' Compensation Act (820 ILCS 305/4a.). The law contained several provisions related to licensing and regulating these pools. It required that:

- Administrative and service agency licenses (pool administrators) be renewed every two years and allowed DOI to adopt rules related to service agencies;
- Every group self-insurer maintain at all times reserves which are actuarially sufficient, as determined by the Director of Insurance, to provide for the payment of all losses and claims incurred; and
- DOI adopt rules permitting two or more employers with similar risk characteristics or that are members of a professional, commercial, industrial, or trade association to pool their liabilities including:
    - Establishing standards and guidelines to assure the adequacy of the financing and administration of group self-insurance plans, including bonding or security provisions;
    - Establishing standards, including but not limited to, minimum terms of membership in self-insurance plans, as necessary to provide stability for those plans;
    - Establishing standards or guidelines governing the formation, operation, administration, and dissolution of self-insurance plans; and
    - Establishing other reasonable requirements.

The statutes prior to January 1, 2001 also required every group self-insurer to maintain reserves that were actuarially sufficient, as determined by the Director of Insurance, to provide for the payment of all losses and claims incurred. Effective July 7, 1995 (Public Act 89-97) the Director of Insurance also had, with respect to group workers' compensation self-insured pools established under this Act, the powers of examination conferred upon him relative to insurance companies by Sections 132 through 132.7 of the Illinois Insurance Code (financial examinations). The group workers' compensation self-insured pool that is examined pays for the

cost of the examination. The law also allowed DOI to audit the reserves of group self-insurers to determine whether the reserves were sufficient.

The statute contained provisions for an insolvency fund to pay claims in the event that a pool became unable to pay compensation due to financial insolvency. Since January 1984, each workers' compensation self-insured pool has been required to pay into the Group Self-Insurers' Insolvency Fund a semiannual assessment equal to .5 percent of all compensation payments made during the previous six months. Prior to January 1, 2001, the Illinois Industrial Commission was responsible for collecting and depositing the semiannual assessment.

Statutory Requirements for Pools Effective January 1, 2001

Effective January 1, 2001, Public Act 91-757 repealed the existing provisions governing group workers' compensation self-insured pools, which were contained in the Workers' Compensation Act (820 ILCS 305/4a) and the Workers' Occupational Diseases Act (820 ILCS 310/4a). The new law created the Workers' Compensation Pool Law within the Insurance Code (215 ILCS 5/107a). In addition to adding language requiring pools to have homogeneous risk groups, the Act added provisions regarding minimum payroll requirements and financial reporting. However, some of the provisions of the new law were already contained in either the existing law or the administrative rules promulgated by the Department of Insurance (DOI) to implement the statutory requirements in the previous law. Under the new law the pools are considered assessable domestic mutual insurance companies and are subject to many of the same provisions of the Insurance Code.

The new pooling law (Public Act 91-757) added several provisions including, among others, those which:

- Clarified DOI's authority to take corrective action;
- Redefined the reserve requirement;
- Required all pool members to have homogeneous risk characteristics;
- Required pool trustees to be an employee, officer, director, or owner of a pool member; and
- Added medical service payments to the amount on which pools are assessed for the Insolvency Fund.

One important change that was made was in regard to pool membership requirements. The previous law permitted two or more employers with **similar** risk characteristics ***<u>or</u>*** that were members of a bona fide professional, commercial, industrial or trade association to form a pool. This allowed members with dissimilar risk characteristics to join a pool as long as they were members of the sponsoring organization. The pooling law now requires that members either have **homogeneous** risk characteristics or be members of a bona fide professional, commercial, industrial, or trade association, with **homogeneous** risk characteristics to pool their workers' compensation and employers' liability exposures and form group workers' compensation self-insured pools (215 ILCS 5/107a.3). Pool membership is discussed in more detail in Chapter Two of this report.

Public Act 91-757 also changed the reserve requirement. Effective January 1, 2001 the assets possessed by a pool cannot be less than the reserves required together with any other

unpaid liabilities. According to DOI officials, this means that a pool cannot have a negative surplus.

Public Act 91-757 also made changes to the Insolvency Fund. Prior to January 1, 2001, pools were required to pay the .5 percent assessment on workers' compensation payments only. Now the pools are required to include paid medical benefits in the amount that is used to calculate the assessment which should increase the amount of funds being deposited into the fund. The Act also transferred the responsibility for collecting and depositing the assessment from the Illinois Industrial Commission to the Illinois Department of Insurance. Effective January 1, 2001, the fund was renamed the Group Workers' Compensation Pool Insolvency Fund and the balance from the old fund was transferred to the new fund. The Insolvency Fund is discussed in more detail in Chapter Five of this report.

POOL DEVELOPMENT

Since the first pool was licensed in June 1981, a total of 39 workers' compensation self-insured pools have received a certificate of authority (license) to operate from the Illinois Department of Insurance. However, only about a quarter of the pools that have been licensed were still active as of June 2002. According to DOI, the current status of the 39 pools as of June 2002 is as follows:

- 11 are active;
- 9 are in runoff (not writing new business);
- 3 obtained a loss portfolio transfer (not writing business and have transferred existing losses to an insurance company);
- 12 are out of business; and
- 4 are in liquidation (for a full listing of pools licensed see Appendix B).

The Workers' Compensation Insurance Market

The creation and development of these pools was in large part a result of the "hard" market of the 1980s (availability of coverage at a reasonable price was scarce) and to provide a more stable market for members of bona fide trade associations. Creation of these pools also created new opportunities for the business of being pool administrators.

Exhibit 1-1 shows the number of pools licensed each year. It shows a surge of new pools being licensed from 1987 through 1996. According to A.M. Best, the last several years have not been good for insurance carriers in general because of high accident rates and underpricing. Illinois' group workers' compensation self-insured pools are not the only workers' compensation carriers that have experienced financial problems. In 2001, several large workers' compensation insurance companies have also experienced problems with solvency, including Reliance Insurance Company and Freemont General Insurance Company.

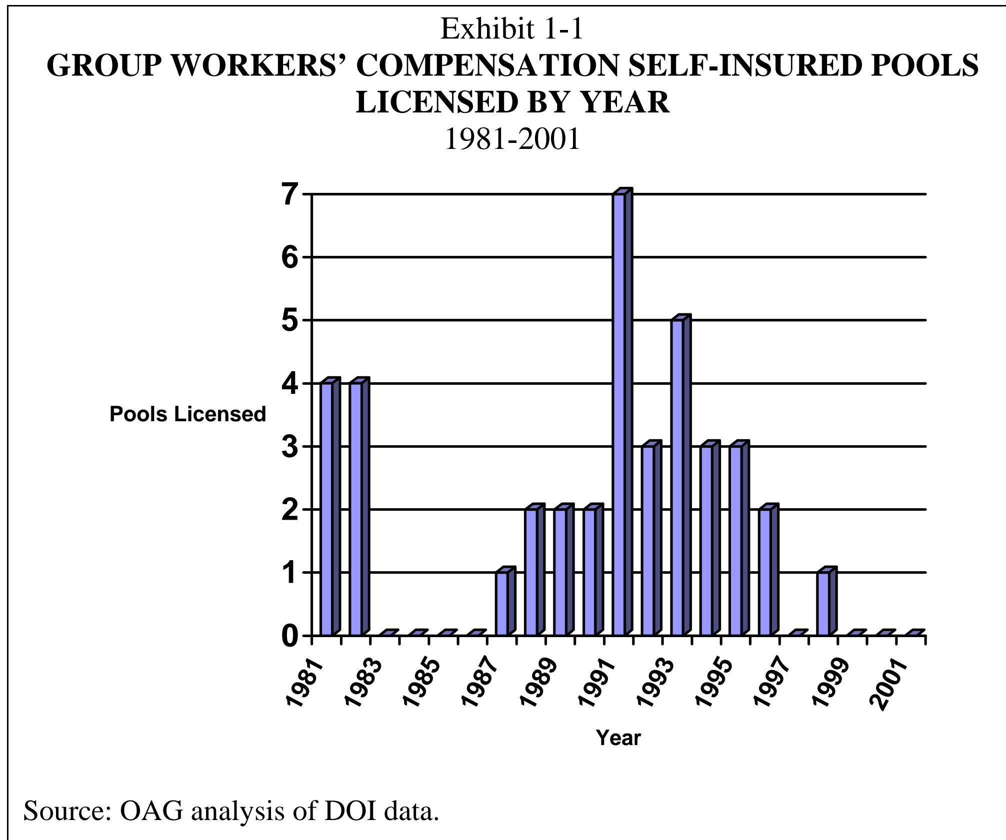


Exhibit 1-1
GROUP WORKERS' COMPENSATION SELF-INSURED POOLS LICENSED BY YEAR
1981-2001

Source: OAG analysis of DOI data.

Environmental Factors Affecting Pools

In assessing the operations of group workers' compensation self-insured pools, there are certain environmental factors that come into play. One factor is the "long tail" nature of workers' compensation claims in general. This makes it hard to predict the cost of a claim because some claims may require payments over several years. This situation also makes it difficult to reallocate capital.

The environment in which group workers' compensation self-insured pools operate is also somewhat different from a commercial carrier for several reasons.

- These pools are **monoline**, meaning they can only offer one line of insurance. Other property and casualty insurance companies may have several lines of insurance to rely on such as auto, homeowners, commercial peril or medical malpractice.
- Workers' compensation pools have **no profit motive**. Since these pools are generally formed by trade associations, the employers participating in the pool want the lowest premium possible.
- Pools have **few assets** and pool members are sometimes **smaller employers** (mom and pop operations) that no one else wants to insure or are sometimes **high-risk employers**, such as construction employers.

- There is **no surplus requirement** for pools. Commercial carriers are required to maintain a $1.5 million surplus. Because pools have no surplus requirement, a bad claims year may have a devastating effect on their balance sheets.
- Pooling agreements include clauses that allow a pool to make **extra assessments** of members to meet its obligations to the participants.

STATE AGENCIES INVOLVED IN ADMINISTERING GROUP WORKERS' COMPENSATION SELF-INSURED POOLS

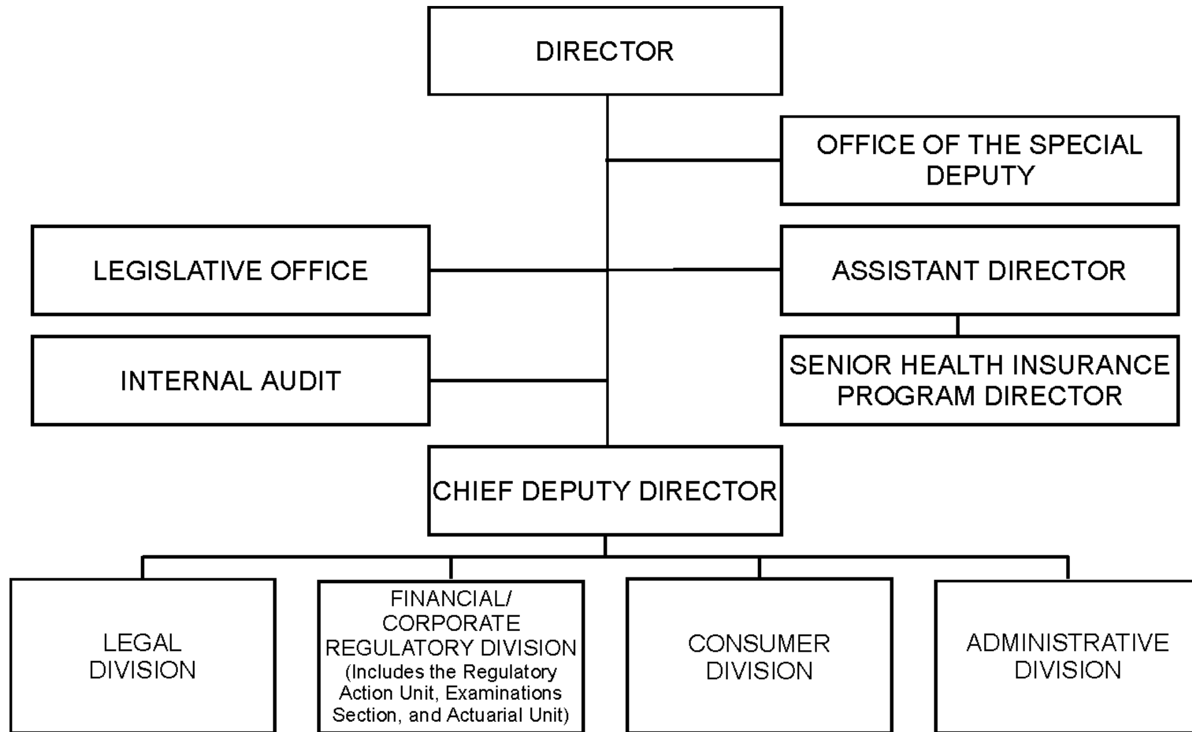
Prior to January 1, 2001, there were two State agencies involved in the administration of group workers' compensation self-insured pools: the Illinois Department of Insurance (DOI) including the Office of Special Deputy Receiver (OSD), and the Illinois Industrial Commission. OSD assists the Director with his duties in receivership matters. The Commission's only responsibility related to self-insured pools was administering the Group Self-Insurers' Insolvency Fund. Public Act 91-757, effective January 1, 2001, transferred the responsibilities that the Illinois Industrial Commission had related to the Group Self-Insurers' Insolvency Fund to the Department of Insurance and the fund was re-established as the Group Workers' Compensation Pool Insolvency Fund. DOI is now the only State agency with responsibilities related to group workers' compensation self-insured pools.

ILLINOIS DEPARTMENT OF INSURANCE

The Illinois Department of Insurance is statutorily responsible for monitoring the financial solvency of all regulated insurance entities through administration and enforcement of the Illinois Insurance Code, the Illinois Pension Code, and related laws and regulations. As seen in Exhibit 1-2, the Department is organized into four divisions. Although other divisions have some responsibilities related to the pools, the primary responsibilities related to the licensing, regulation, monitoring, and financial oversight of group workers' compensation self-insured pools rest with the Financial/Corporate Regulatory Division. Below is a brief description of the divisions involved in administering the group workers' compensation self-insured pools.

<u>The Financial/Corporate Regulatory Division</u> is responsible for analyzing and monitoring the financial condition of insurance companies and pools. The division licenses insurers and conducts financial examinations and intervenes when developing problems are identified. This division is most responsible for oversight of the management and operations of Illinois insurers. The Regulatory Action Unit (RAU) has been responsible for the direct oversight of the pools since July 1998. As of July 2002, there were 5 staff and a supervisor in the RAU. There is also an Actuarial Unit in the division that conducts an annual analysis of the financial conditions of each pool. The Actuarial Unit had 7 staff. The Examinations Section also conducts financial exams of pools and insurance companies. The Examination Section had 40 staff, including three claims examiners that are utilized on pool examinations.

Exhibit 1-2
ORGANIZATIONAL CHART FOR THE ILLINOIS DEPARTMENT OF INSURANCE
as of August 2001



Source: Illinois Department of Insurance.

The Administrative Division provides staff support for information technology, personnel management, record and mail services, word processing, and all fiscal operations. The Division's Tax and Fiscal Services Section receives the semiannual assessments from the pools for deposit into the Group Workers' Compensation Pool Insolvency Fund. This section also authorizes payments and reconciles the fund balance.

The Legal Division provides a variety of services to the regulatory units, including responding to external inquiries from the Office of the Special Deputy Receiver. The Legal Division also responds to requests and holds administrative hearings. However, the DOI Legal Division usually does not represent the agency in matters before the courts, but acts as the liaison with the Attorney General's staff and other outside counsel on litigation in which the Department has an interest.

OFFICE OF SPECIAL DEPUTY RECEIVER

The Director of the Illinois Department of Insurance is empowered to act as the conservator, rehabilitator, and liquidator of Illinois insurance companies found to be operating in a manner detrimental to the interest of the policyholders, creditors, or the public. By law, to fulfill this responsibility the Director may appoint a special deputy. The Director has appointed a

Special Deputy to administer the duties of receivership. This office is called the Office of Special Deputy Receiver (OSD). As of October 2001, the OSD had a total of 187 staff and 22 administrative employees. The functions of the Special Deputy are funded from the proceeds of the insurance estates in receivership.

When the Director of the Department of Insurance finds that a group workers' compensation self-insured pool has become insolvent, he can, through the Illinois Attorney General's Office, seek a court order of conservation or rehabilitation prior to a court order for liquidation. These processes are handled through the OSD and are discussed in more detail in Chapters Four and Five of this report. The duties delegated to the OSD may vary depending upon which type of receivership is appropriate.

Below is a brief description of each type of order:

Order of Conservation – The Director takes possession of assets and monitors the operations of a company while a confidential evaluation of the company's status takes place. However, the Director does not have title to the company and can only approve or disapprove disbursements and recommend corrective actions to the company or pool in receivership.

Order of Rehabilitation – The Director is vested with the title to all property, contracts and rights of action of the company. The Director proceeds to conduct the business of the company and to take appropriate steps, if possible, to remove the causes and conditions which made rehabilitation necessary. Companies continue all or some operations, but control of assets and management are taken over by the Director and OSD.

Order of Liquidation **–** The Director, as liquidator, takes ownership of a company's assets for the purpose of marshalling and liquidating those assets and distributing the proceeds to policyholders and creditors of the company pursuant to statue. The process of liquidating assets and distributing the proceeds is undertaken by the Director and OSD.

The general process of liquidation and the duties of the Director of DOI are delineated in the Illinois Insurance Code (215 ILCS 5/193 through 5/212). The statutes include provisions for the rights and liabilities of creditors, examinations, appointment of special deputies and other staff. The statutes also include provisions for financial reporting to the courts, the priority of distribution of assets, and claims filing deadlines. The process of liquidation is discussed in Chapter Five of this report.

POOLS IN LIQUIDATION

As of March 2001, there were four group workers' compensation self-insured pools in the process of liquidation proceedings with the OSD. Exhibit 1-3 shows the four pools and the dates that they were placed into conservation, rehabilitation, and liquidation. The exhibit also shows the "Bar Date" and the "Contingent Claim Cut-Off Date" for each pool. The bar date is the date

by which all outstanding claims against the pool must be filed with the OSD. Contingent claims are those claims where the liability was not established prior to the date of liquidation.

OSD officials stated that these four pools represent the first time they had undertaken proceedings for liquidating a self-insured pool. OSD officials stated that generally the only assets that these pools have are premiums and the ability to assess their members.

Exhibit 1-3 shows that the Illinois Electrical Workers' pool was never issued an order of conservation. Also, the Illinois Environmental Services Workers' pool went from conservation to liquidation without an attempt being made at rehabilitation. OSD officials stated that the Illinois Environmental Services Workers' pool was the most recent pool to go into receivership and based on its inability to collect assessments from its members, as well as its overall poor financial condition, it was placed directly into liquidation. As for Illinois Electrical, by the time OSD got the pool, it was in very poor financial condition. OSD officials were not sure from week to week whether they were going to have enough to pay the weekly temporary disability amounts for that week. As a result, it moved straight to rehabilitation. The following is a brief description of the history and background for each of these pools. Appendix D has a more detailed history of each of the four pools.

Exhibit 1-3
GROUP WORKERS' COMPENSATION SELF-INSURED POOLS IN LIQUIDATION
TIMELINE OF EVENTS

Name of Pool	License Date	Conservation	Rehabilitation	Liquidation	Bar Date	Contingent Claim Cut-Off
Back of Yards Risk Management Association Inc.	5/8/92	4/21/99	12/20/99	1/22/01	1/22/02	1/22/03
Illinois Earth Care Workers' Compensation Trust	2/24/93	8/19/99	10/21/99	10/26/00	10/26/01	10/28/02
Illinois Electrical Workers' Compensation Association Inc.	1/25/95	N/A	12/20/99	11/3/00	11/5/01	11/4/02
Illinois Environmental Services Workers' Compensation Trust	12/1/91	7/31/00	N/A	3/22/01	3/22/02	3/22/03

Note: The bar date is the date by which all outstanding claims against the pool must be filed with OSD. The contingent claim cut-off date is the date by which all outstanding claims which were contingent when filed must be liquidated.

Source: Office of Special Deputy Receiver.

Back of Yards Risk Management Association (BYRMA)

Back of Yards Risk Management Association Inc. (BYRMA) was originally licensed by the Department of Insurance on May 8, 1992 to operate a group workers' compensation self-insured pool. BYRMA was derived from Back of the Yards Neighborhood Council, which was founded in 1939. This neighborhood is located on the Southwest side of Chicago and encompasses a 9 square mile area known as the "Back of the Yards" because of its location near the Chicago stockyards. The pool included a wide array of members. As of 1995, BYRMA had 150 active companies, ranging from milk distributors to real estate companies. The number of active companies fluctuated greatly during BYRMA's existence. In 1996, there were 488 pool members; in 1997 there were 426; and in 1998 there were 306 active pool members in the BYRMA pool with an annual estimated payroll of $139,272,640. BYRMA was ordered into conservation in April 1999 followed by rehabilitation in December 1999. The pool has been in liquidation since January 2001.

Illinois Earth Care Workers' Compensation Trust (Earth Care)

On February 24, 1993 the Department of Insurance issued a certificate of authority to the Illinois Earth Care Workers' Compensation Trust (Earth Care) to operate a group workers' compensation self-insured pool. Earth Care was sponsored by the Land Improvement Contractors of America. The 30 original Land Improvement Contractor classifications included employers in a variety of fields, such as landscape gardening, concrete work, plumbing, sewer construction, claim adjusters, and clerical office employees. Earth Care had a total of 163 members in 1998 and an estimated annual payroll of $55,845,216. Earth Care was ordered into conservation in August 1999 and rehabilitation in October 1999. The pool has been in liquidation since October 2000.

Illinois Electrical Workers' Compensation Association, Inc. (Electrical)

The Illinois Electrical Workers' Compensation Association was issued a certificate of authority January 25, 1995 by the Department of Insurance to operate a group workers' compensation self-insured pool. The pool was sponsored by the Professional Electrical Contractors Association of Illinois. The pool had 13 participants upon start up and prior to receivership had 18 employer members and a 1998 total annual payroll of $14,898,068. This pool did not go through conservation. The pool was ordered into rehabilitation in December 1999 and has been in liquidation since November 2000.

Illinois Environmental Services Workers' Compensation Trust (Environmental)

The Department of Insurance issued a certificate of authority to the Illinois Environmental Services Workers' Compensation Trust (Environmental) on December 1, 1991 to operate a group workers' compensation self-insured pool. The Illinois Association of Environmental Service Companies sponsored the pool and it was composed of employers in the waste management and environmental services industry. Participants were to be members in good standing of the Illinois Solid Waste Association. In 1998, the Illinois Environmental Services Workers' Compensation Trust reported a total of 88 members and a total annual payroll

of $38,837,066. The pool was ordered into conservation in July 2000. However, no attempt was made at rehabilitation and the pool was ordered into liquidation in March 2001.

AUDIT SCOPE AND METHODOLOGY

This audit was conducted in accordance with generally accepted government auditing standards and the audit standards promulgated by the Office of the Auditor General at 74 Ill. Adm. Code 420.310.

In conducting the audit, we met with officials from the Illinois Department of Insurance, the Office of Special Deputy Receiver, and the Illinois Industrial Commission to review the licensing, regulation, and reporting mechanisms in place for group workers' compensation self-insured pools.

We reviewed applicable State statutes and administrative rules governing group workers' compensation self-insured pools. We reviewed compliance with those laws and rules to the extent necessary to meet the audit's objectives. Instances of non-compliance are discussed in this report.

We reviewed files at the Department of Insurance for the four pools currently in liquidation including annual financial statements, actuarial opinions, audits, and reviews conducted by the Department. We also reviewed management controls relating to the audit's objectives which were identified in Legislative Audit Commission Resolution Number 121 (see Appendix A). Any significant weaknesses in those controls are included as recommendations in this report.

During the audit we also collected information to assess the financial review process and the effectiveness of corrective actions taken by the Department. We also met with the service administrator that was assisting the OSD in liquidating the four group workers' compensation self-insured pools.

The pooling law has been amended at least three times since 1981. In its response to this audit report, the Department cited that it lacked the tools needed to effectively regulate these pools. However, the Department did not provide the auditors with documentation to show that it proposed legislation to correct their perceived "shortcomings" in the law.

REPORT ORGANIZATION

The remainder of this report is organized into the following chapters:

- **Chapter Two** examines pool operations requirements;
- **Chapter Three** discusses the financial reporting and review process;
- **Chapter Four** reviews corrective actions; and
- **Chapter Five** discusses the liquidation process including the Insolvency Fund.

Chapter Two

POOL OPERATIONS REQUIREMENTS

CHAPTER CONCLUSIONS

The laws and administrative rules regulating group workers' compensation self-insured pools contained provisions that gave DOI the authority to regulate pool operations prior to the insolvency of the four pools. Although new legislation was passed effective January 1, 2001, some of the changes regarding the regulation of these pools were already contained in either the existing law or the administrative rules.

DOI's current regulation of pool operations could be further strengthened. DOI does not effectively monitor:

- Pools' boards of trustees,
- Administrative costs, or
- Rate setting practices.

Although the statutes contained a general reserve requirement prior to the four pools being placed into receivership, the Department of Insurance did not ensure that every pool had sufficient reserves on an actuarial basis to pay losses and claims. Some of the pools currently in liquidation contained members that did not have similar risks. The law regarding these pools now requires that all members have homogeneous risk characteristics. DOI officials have stated that they are currently working on a definition of homogeneous.

POOL REGULATION

Group workers' compensation self-insured pools are regulated primarily by the laws establishing the pools and the administrative rules that have been promulgated by the Department of Insurance (DOI). The laws and administrative rules regulating group workers' compensation self-insured pools contained provisions that gave DOI the authority to regulate pool operations prior to the insolvency of the four pools. Although new legislation was passed effective January 1, 2001, some of the provisions of the new law were already contained in either the existing law or the administrative rules. The laws and rules also contain requirements for pool administrators.

The Department of Insurance has promulgated administrative rules regarding group workers' compensation self-insured pools (50 Ill. Adm. Code 2901). These rules, which have been in effect since 1981 and were amended in 1994, require specific information to be filed with the Department in order to obtain a certificate of authority. They also contained financial requirements, for example to establish and operate a pool, the pool must have a gross annual

payroll for all members of at least $10 million. The rules also require that whenever a new member joins the pool, the pool administrator must notify DOI within five days. The Department of Insurance has not licensed a new pool since 1998.

POOLING PROCESS REQUIREMENTS

If a professional, commercial, industrial, or trade association wants to form a group workers' compensation self-insured pool, they must file with the Department of Insurance for a certificate of authority. Exhibit 2-1 shows an overview of the pooling process. By administrative rule the application must contain information regarding the pool administrator including:

- Biographical information of the risk manager, corporate officers and directors.
- Size of staff and other information to demonstrate that the administrator has the resources to administer the self-insured program.
- Most recent financial statement of the administrator. (If a publicly held company, a copy of the last 10-K filed with the Securities and Exchange Commission.)
- Compensation of the administrator.

The application must include a copy of the pooling agreement (the agreement that individual employers sign to become pool members). The pooling agreement must include:

- Services to be provided by the administrator.
- How costs are to be proportioned among members.
- Initial premium deposit.
- Assessment provisions.
- Termination provisions and minimum term of membership (the minimum term of membership is not less than one year).
- Duration of liability for additional assessments following terminal of membership (not less than three years).
- Deductibles, if any, to be retained by individual members.
- Limitations, if any, on risk insured.
- Prerequisites for membership.

The application for certificate of authority must also include a plan of operations. The plan must disclose:

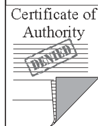
- A listing of initial members.
- Initial annual rate(s) to be charged members and an explanation of how the rate(s) were developed.
- Anticipated first year premium and losses.
- Aggregate loss history of initial members for each of the last three years.
- The aggregate premium that would have been received at the proposed rate for each of the last three years assuming the losses of initial members for each of the last three years.
- Net retention of pool and list of initial insurers.

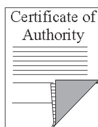
Exhibit 2-1
OVERVIEW OF THE POOLING PROCESS

A professional, commercial, industrial, or trade association wants to form a Workers' Compensation Self-Insured Pool.

An application for a Certificate of Authority is filed with the Department of Insurance (DOI) including information regarding its pool administrator, pooling agreement, plan of operation, and membership.

DOI denies the Certificate of Authority.



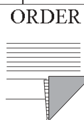


DOI issues a Certificate of Authority.

If a member employee is injured, he/she submits medical bills to the employer, who will then file a claim for reimbursement from the pool.

The pool administrator handles or oversees the claim process to ensure payment of the claim. For this service, the pool administrator generally charges an administration fee.

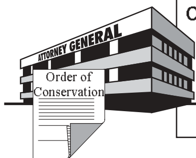
If the pool is in financial trouble:



DOI can issue a corrective order or assessment order to attempt to help correct the financial condition.

OR

The Board of Trustees can voluntarily levy an assessment to raise more money to improve the pool's financial condition. The Board can also raise rates on renewals and cut expenses.



If the pool defaults on payment of claims, DOI may obtain an order of conservation or rehabilitation through the Attorney General's Office who represents the Department in court proceedings. These orders are a means of protecting pool assets for purposes of preserving them and determining solvency.

Office of Special Deputy assists the Director in carrying out his responsibilities as the statutory conservator, rehabilitation or liquidator of insurance companies that are declared insolvent or are otherwise impaired from managing their own affairs.

Conservation
Possession and control of assets are taken, financial condition determined and business transacted only with consent of Receiver.

Rehabilitation
The Receiver takes title of the assets, develops a plan of rehabilitation subject to court approval and runs company until it regains solvency.

Liquidation
The assets are reduced to cash and distributed in accordance with priority to creditors.

Source: OAG analysis of DOI pooling process.

- Names of all entities which will provide services for the pool and copies of the proposed contracts.
- Safety and loss control programs to be provided or required.
- Plans for expansion of pool and anticipated future membership.

An application for certificate of authority to operate a group workers' compensation self-insured pool must also contain written evidence from a surety company authorized to transact business in the State that the administrator has or can secure the fidelity bond required in the rules. For a schedule of assets in relation to required bond amount, see Exhibit 2-2.

When the Department of Insurance receives an application for certificate of authority to operate a group workers' compensation self-insured pool, DOI evaluates the financial strength of the pool. The evaluation takes into consideration factors such as the number of employees covered by the pool, the particular industry(ies) participants are engaged in, combined net worth of the pool participants, any excess insurance coverage, the combined workers' compensation experience for the group for the last three years, the gross annual payroll, and the pool's administrator. DOI then either issues a certificate of authority or denies the request.

Generally, each pool has a service company that is hired as the pool administrator. If an employee of a pool member is injured, the pool member files forms with the pool administrator. The administrator then acts in the member's behalf to file reports, to make or arrange for payment of claims, medical expenses, and other things required or necessary to the extent that they affect the member's liability.

If the pool is in poor financial condition or becomes unable to pay the claims of members, the pool's board of trustees can assess current and past members for additional contributions. DOI can also issue a corrective order or assessment order that requires a pool to take certain actions to improve its financial condition or assess its membership for additional contributions.

If a pool can no longer pay claims or is in default of claims, the Director can petition the courts through the Illinois Attorney General for an order of conservation, rehabilitation, or liquidation. If a pool is ordered into receivership, the Office of Special Deputy Receiver (OSD) reviews the financial condition of the pool, recommends actions or assists the Director in taking control of the pool. If the pool cannot be rehabilitated, then the pool is liquidated.

POOL MANAGEMENT AND ADMINISTRATION

Each group workers' compensation self-insured pool has an appointed board of trustees that exercises management control of the pool. Administration of the pools, however, is generally delegated to an independent service company. The pool administrator's duties vary but may include such items as administration, risk management, claims administration, claims adjusting, loss control, safety services, loss reporting, loss information services, and data management. Most of the group workers' compensation self-insured pools have a third party administrator. As of December 31, 2001 only two pools were self-administered. Each of the

four pools in liquidation was administered by a service company. Three of these four pools had the same administrator.

BOARDS OF TRUSTEES

Having an active and informed board of trustees can play a vital role in the success or failure of any organization. These boards are responsible for such critical functions as hiring the pool administrator to manage the pool and also hiring the auditors and actuaries that review the pool's operations.

Several of the boards for the four pools currently in liquidation did not have full membership, were not meeting on a regular basis, had non-members on the board, and in at least one case, a board member alleged he was not receiving information from the administrator.

For example, from the onset of the formation of the Illinois Earth Care Workers' Compensation Trust, there were problems with the board of trustees. A financial examination conducted by the Department of Insurance for the period ended December 31, 1993 noted that:

- Examiners could not find documentation of which trustees were appointed;
- There appeared to be three trustees, only one of which was appointed. As of December 31, 1993, there may have been only one or two trustees;
- There was no organizational meeting;
- There did not appear to be any officers elected; and
- There did not appear to be any formal minutes of meetings.

A financial exam for the period ended December 31, 1997 also noted problems in that there was no annual meeting in 1995.

In July 1997, one trustee resigned his appointment as a trustee for one of the four pools currently in liquidation because he was excluded from any participation or knowledge of the trust's activities. The resignation letter alleged that:

- Requests for documentation had consistently been ignored by the administrator;
- The trustee's participation and involvement were intentionally excluded; and
- The trust continues to operate in a "shroud of secrecy."

Correspondence in May and June 1997 between another one of the four pools currently in liquidation, the pools' members, and the Illinois Department of Insurance indicated that the board of trustees:

- was in disarray;
- never had full membership;
- may not have been properly elected; and
- tried to place non-members on the board.

When we asked DOI officials how they monitored the pools' boards, they stated that they had little statutory authority over the boards. Having a vigilant board of trustees is an important management control in order to provide needed oversight in the administration of the pool. Prior

to January 1, 2001, neither the statutes nor agency rules contained any provisions regarding requirements for these boards. The new pooling law added a requirement that pool trustees be an employee, officer, director, or owner of a pool member. The changes in the pooling law effective January 1, 2001 also made pools subject to many of the same provisions that are applicable to assessable domestic mutual insurance companies. Some of the applicable sections make references to the boards including:

- All pools licensed to do business in the State must notify the Director within 30 days of the appointment or election of any new officers or directors.

- The Director of the Department of Insurance can order the removal of any pool officer or director and if the pool does not comply with the removal order within 30 days, the Director shall suspend the certificate of authority until such time as the order is complied with.

The boards of trustees for group workers' compensation self-insured pools are not required to submit meeting minutes or resolutions to the Department of Insurance. This makes it difficult for the Department to monitor board activities and ensure that actions the pool administrators are taking are being reviewed and approved by the boards.

BOARDS OF TRUSTEES	
RECOMMENDATION 1	***The Illinois Department of Insurance should ensure that each pool maintains a board of trustees in accordance with each pool's trust agreement and should consider promulgating rules that require these boards to file meeting minutes and board resolutions with the Department so that their activities can be better monitored.***
DEPARTMENT OF INSURANCE RESPONSE	The DOI agrees that Pools should be monitored to determine whether they maintain an active board of trustees consistent with their Pool trust agreements. The DOI currently does this as part of its current examination scopes. Illinois does not require standard insurance companies to file meeting minutes. Therefore, this requirement would be regulating less than **¼th of 1%** of the insurance market beyond our current authority with respect to standard insurance companies.

RATE SETTING

Rate setting can be a major factor in the financial success or failure of a pool. Determination of pool participants' standard premium and risk classification is to be done in accordance with the National Council on Compensation Insurance (NCCI) Workers' Compensation Manual. Rates used for workers' compensation insurance are to be filed with DOI, and all

experience modification factors as computed by the NCCI are to be used. The NCCI establishes standard premiums recommended for each risk classification. However, in order to determine a final premium (pool member contribution), experience modification factors must be considered and any discounts applied to the standard premium.

When issuing a quote to a prospective client, insurers should take into account the employer's experience or losses over the last several years (experience factor). The experience modifier compares the actual reported loss information for that particular employer with average loss data for all employers in that state who are also in the same classification codes. A factor below 1.0 would indicate a credit for good loss experience while an experience modification factor above 1.0 would indicate a loss experience that exceeds expected loss ratios for that classification. An appropriate experience modification factor must be used in the calculation of the final estimated annual premium in order to provide an accurate review of the risk loss experience.

Three of the four pools currently in liquidation had the same service agent. On November 4, 1999, the Director of the Illinois Department of Insurance filed an Order of Revocation to revoke the service company license of this administrator. Among other things, the Order alleged that the service agent failed to adequately document the basis of premium discounts given to some clients and that this jeopardized the financial status of the pool and demonstrated a lack of organizational skill. The service agent voluntarily surrendered his license. For the pools currently in liquidation, examples of undocumented rate discounts included:

- A construction firm with an experience modification factor of 1.62 received a 30 percent discount.
- A moving company with an experience modification factor of 1.44 received a 20 percent discount.
- A temporary help service with an experience modification factor of 1.47 received a 45 percent discount.

In December 2001, the Department of Insurance's Regulatory Action Unit conducted a rate review of a pool with a deteriorated financial condition. This is the only formal review that has been conducted of a pool by DOI to assess rate setting procedures. The review found that the administrator could not provide complete documentation of all ratemaking procedures for several years and that pricing inadequacy was a major factor in the financial deterioration of the pool.

Under the new law effective January 1, 2001, these pools are considered assessable domestic mutual insurance companies and are required to file with DOI every manual of classifications, rules and rates, rating plan, and every modification of these manuals.

<table>
<tr><th colspan="2">RATE SETTING REVIEW</th></tr>
<tr><td>RECOMMENDATION
2</td><td>The Illinois Department of Insurance should monitor and review the rate setting practices of group workers' compensation self-insured pools.</td></tr>
<tr><td>DEPARTMENT OF INSURANCE RESPONSE</td><td>The Department agrees that rates of Pools should be monitored. The DOI currently monitors them internally as part of the financial analysis of Pools as well as in the examination process under the standards of Section 5/456 of the Illinois Insurance Code. Even before 2001, when the DOI was given expanded authority regarding solvency regulation, rates were often taken into consideration.

Although Illinois is a so-called use and file state, i.e., requires no prior approval of such rates, when the actuarial unit became aware of a proposed rate decrease in 1996 by Back of the Yards Risk Management Association, a letter was sent to the Pool stating that their proposed rate decrease was unacceptable to the DOI. DOI also has identified records showing that rates were reviewed for Illinois Electrical Employers' Workers' Compensation Association in 1995, for Illinois Cooperative Workers' Compensation Group in 1993, and for Homebuilders of IL in 1996.

Property and casualty insurance companies across the nation are subject to extensive review and monitoring of rates. Even with this regular and stringent rate regulation, companies become insolvent. For instance, in Pennsylvania, a state which requires prior approval of loss costs, an estimated $1.05 billion insolvency occurred when Reliance Insurance Company was determined financially impaired.</td></tr>
</table>

REGULATION OF ADMINISTRATORS

The service administrators for group workers' compensation self-insured pools must be licensed under the Illinois Insurance Code (215 ILCS 5/107a.9). Service agencies receive authorization to provide certain services such as administration, claims adjustment, or risk management, among others. These service agencies must renew their licenses with DOI every two years. Service agencies for group workers' compensation self-insured pools are also subject to the supervision and examination of DOI.

The group workers' compensation self-insured pool law also allowed DOI to promulgate rules for service agencies establishing reporting requirements, bonding requirements, and other

reasonable requirements related to the article. DOI promulgated rules for these organizations at 50 Ill. Adm. Code 2901 that include bonding, investment, and reporting requirements. The administrative rules were in effect at least since 1994. These requirements are also now included in the law that became effective January 1, 2001.

The statutes and rules outline the bond requirements (215 ILCS 5/107a.10 and 50 Ill. Adm. Code 2901.30). An administrator shall obtain and maintain in force fidelity bonds on employees, officers, or positions in an amount not less than the amount set forth in "Minimum Amount of Bond." The schedule of assets in relationship to amount of bond is shown in Exhibit 2-2.

Exhibit 2-2
SCHEDULE OF ASSETS IN RELATIONSHIP TO BOND AMOUNT

Total Assets	**Minimum Amount of Bond**
$500,000 or less	$20,000 plus 6% of total assets
More than $500,000, and not more than $1,000,000	$50,000 plus 4% of assets over $500,000
More than $1,000,000, and not more than $3,000,000	$70,000 plus 3% of assets over $1,000,000
More than $3,000,000, and not more than $5,000,000	$130,000 plus 2% of assets over $3,000,000
More than $5,000,000, and not more than $10,000,000	$170,000 plus 1.5% of assets over $5,000,000
More than $10,000,000	$245,000 plus .75% of assets more than $10,000,000

Source: 215 ILCS 5/107a.10 (d) and 50 Ill. Adm. Code 2901.30.

Additionally, 215 ILCS 5/107a.11 lists more requirements which are also in the administrative rules regarding accounting and investment practices, such as:

- Not more than 5% of a pool's admitted assets may be assessment receivables.
- In order to be an admitted asset, an assessment receivable cannot be more than 60 days past due.
- Not more than 10% of a pool's admitted assets may be reinsurance receivables.
- In order to be an admitted asset, a reinsurance receivable cannot be more than 90 days past due.
- A pool may not invest under this Section more than 5% of its assets in the obligations of any one corporation.

ADMINISTRATIVE COSTS

Three of the pools currently in liquidation may have paid significantly higher amounts for administrative costs than the other pools. Service agreements show that the pool administrator for these three pools was charging 39 percent of **standard premium** for administering the pool. Not only was the rate higher than what other group workers' compensation self-insured pools were paying, but paying a rate based on the amount of standard premium magnified the high cost of administration because of the administrator's discounting practices. The other pool currently in liquidation (BYRMA) was paying 14 percent of **actual premiums** as of 1998.

Three of the four pools currently in liquidation had the same service administrator. Some employer members of the pools managed by this administrator were given substantial discounts. The effect of discounting the standard premium rate by 50 percent, which was not uncommon, is significant to the real cost of administration. For example, when a pool member received a 50 percent discount on the standard NCCI premium, the 39 percent administrative cost actually becomes 78 percent of the actual premium. The combination of a 50 percent discount along with an administrative fee of 39 percent of standard premium would leave only 22 percent of the actual premium dollars available to pay claims.

We reviewed the administrative costs being paid by the remaining active pools. Although the services provided may vary somewhat, the administrative cost for active pools as of April 2002 was well below the 39 percent of standard premium paid by the three of the four pools currently in liquidation. Exhibit 2-3 shows examples of the administrative fees that other active pools were paying. One industry source we identified stated that about 70 cents of each premium dollar should go toward paying workers' compensation claims with the other 30 cents being used for administration and other costs.

Exhibit 2-3
EXAMPLES OF ADMINISTRATIVE FEES PAID BY ACTIVE POOLS

Pool Name	**Administrative Fees**
Workers Compensation Trust of Illinois	10.25% of standard premium. Reduced to 10.0% when standard premium exceeds $10 million
Nursing Homes Risk Management Association	Claims administration fee of 12.5% of premiums
Consolidated Construction Safety Fund	11% of standard premium
Midwest Truckers	16% of standard premium
Illinois Restaurant Risk Management Association	16% of standard premium

Source: Illinois Department of Insurance.

We obtained a complaint letter sent to DOI in July 1999 by a pool member of one of the four pools in liquidation. The letter asked DOI to review the 39 percent of standard premium administrative fee being charged by the administrator of the pool. The letter alleged that the administrative costs were the underlying cause of the pool's present financial problems and a "probable disaster."

We asked DOI officials if they ever questioned the amount these pools were paying for administration or asked the administrator to justify the amount being charged. DOI officials responded that although the Department had, and continues to have, no authority to disapprove such charges, the administrator was questioned regarding these charges, as with other matters. DOI officials also stated that administrative costs only have an indirect effect upon pool solvency and financial analysis.

Under the new law effective January 1, 2001, these pools are considered assessable domestic mutual insurance companies and are required to file all agreements under which any person, organization or corporation is delegated management duties or controls on or before the date

it becomes effective (215 ILCS 5/141.1). Under this provision, DOI can also revoke the pools' certificates of authority.

ADMINISTRATIVE COSTS	
RECOMMENDATION 3	***The Illinois Department of Insurance should review administrative service agreements between the pools and their prospective administrators for reasonableness of administrative fees.***
DEPARTMENT OF INSURANCE RESPONSE	The DOI agrees that under the current law, such fees can and should be reviewed for approval or disapproval under Sections 141.1 and 141.2 of the Illinois Insurance Code. This review is currently done by internal analysis of filings and as part of the ongoing examination process. Prior to the existence of authority to disapprove such fees in 2001, at least one such agreement for a Pool administered by E.C. Fackler was reviewed by the actuarial section prior to 1998, as documented by a note from a member of the actuarial section. The current Illinois law requires that these contracts for insurance companies be filed with the DOI, unless they are with "affiliated companies on a "Pooled" funds basis or service company management basis, where costs to the individual member companies are charged on an actually incurred or closely estimated basis."

POOL MEMBERSHIP REQUIREMENTS

Several of the pools currently in liquidation included members that did not have similar or homogeneous risks. Having similar risks in these pools is important to their success because it is easier to accurately predict loss experience when determining the basis for premiums. While the Department of Insurance does receive a list of the initial membership and applications of new members of these pools, they could not provide a list of the current members of each pool or the amount of total payroll.

The pooling laws for group workers' compensation pools prior to January 1, 2001 required the Department of Insurance to promulgate rules permitting two or more employers with similar risk characteristics or that are members of a bona fide professional, commercial, industrial, or trade associations to pool their liabilities. The Department also established standards for determining whether pools contained similar risks in its administrative rules (50 Ill. Adm. Code 2901.40). These rules were last revised in 1994. The Director must consider the following in determining whether the pool exhibits similar risk characteristics among members:

- The loss frequency inherent in the occupational framework of group members.
- The loss severity inherent in the occupational framework of group members.
- The occupational disease potential inherent in the occupational framework of group members.
- The occupational tasks of member employees.
- Any other relevant fact the group members present to the Director that has reference to the classification of similar risks.

By rule, whenever a pool receives a new member, it is required to notify DOI within five days. Eligibility as a pool participant by rule is based upon having a minimum of:

- Twenty employees and $250,000 gross annual payroll; or
- Ten employees and $125,000 gross annual payroll for participants who have engaged actively in business for a minimum period of three years in Illinois; or
- Five employees and $62,500 gross annual payroll for participants who have engaged actively in business for a minimum period of five years in Illinois.

Exceptions to the above may be allowed by any pool whenever the following conditions are met:

- The participant has been actively engaged in business for a minimum period of five consecutive years in Illinois;
- The participant agrees to make all its financial records available to the Director of Insurance for reasonable inspection during the period of his membership; and
- The Pool Administrator certifies to the Director that he examined the financial records of the pool participant prior to the participant's admission to the pool and found the participant to be solvent and financially stable.

Pools With Dissimilar Risk Characteristics

In our review of pool membership we found that there were pools in liquidation and some that are still active that had members with dissimilar risk characteristics. The Illinois Electrical Pool is one example of a pool with dissimilar risks that is currently in liquidation. The Illinois Electrical Pool (sponsored by the Professional Electrical Contractors Association) included members such as a moving company, a sign and banner painting company, a temporary help service, and a company that installed heavy machinery. These employers were allowed to join the pool because they were members of the sponsoring organization.

Another example of members with dissimilar risks is the Back of Yards Pool (BYRMA). BYRMA was to originally provide coverage to those businesses that were located in the back of the stockyards area. However, BYRMA membership included employers from Chicago's western suburbs to as far away as Cairo, Illinois. It also included members with risks as different as fast food restaurants and lumberyards. We obtained Department letters/memos from DOI that expressed much concern over the formation of BYRMA (a heterogeneous pool). According to documentation obtained from DOI files, one Department official tried to stop the formation of the pool and DOI had refused BYRMA's request to extend its membership outside the neighborhood as early as 1994. However, because of the way the law was written, the pool either had to be two or more employers

with similar risks ***or*** that were members of a bona fide professional, commercial, industrial or trade association to form a pool. Because BYRMA was an industrial organization, it was allowed to form a group worker's compensation self-insured pool.

In order to become a pool member, an employer becomes a member of the sponsoring organization. For example, to become a member of the Illinois Green Pool an employer had to become a member of the Illinois State Florists Association. By becoming a member of the sponsoring organization the employer was entitled to obtain workers' compensation coverage from the pool.

Some of the pools not in liquidation also had members with dissimilar risks that were allowed to join the pool. The Illinois Green Pool (represented members of the Illinois State Florists Association) was accepting members classified as Horticulture Associates. These members included, among others, nightclubs, adult entertainment clubs, temporary help agencies, an excavation company, and ambulance service companies. DOI asked this pool to terminate all clients in the Associate Member category in January 1998. The pool subsequently dropped those members and the sponsoring organization eliminated the Horticulture Associate category.

On the topic of similar risks one DOI official stated in an April 1995 e-mail that:

> *"When there are similar risks exposed to the same peril(s) fairly accurate loss prediction becomes possible as probable deviation in loss experience from that expected in the chance of loss statistics will be much less. It is impossible to accurately predict losses when the subjects for coverage present a virtual potpourri of risks and exposures thereby undermining the credibility of available statistics regarding frequency and severity of losses. There must be an orderly classification of similar risks or the underwriting results would be disastrous. The risks must be relatively similar or the insurance becomes impractical when the probable deviation from the predicted loss is so large that it must be offset by a much higher premium thereby destroying the purpose of creating the group in the first place."*

Although pools are required to submit the applications of new members within five days of accepting them into the pool, DOI does not track members of these pools or the amount of payroll a pool has at any one time. We requested from DOI a list of all members of all pools and the amount of payroll for each. DOI officials responded that the Department does not maintain a running listing of the insured members of each group workers' compensation self-insured pool or the total payroll of each pool because such information is not received in a computer processable form and maintenance of such lists would be highly labor intensive.

The laws governing the group workers' compensation self-insured pools that went into effect January 1, 2001 require that all pools have members with **homogeneous** risks. Although this requirement was added to the law, the statutes and rules do not define homogeneous. DOI officials stated that they are currently considering a definition for homogeneous.

POOL MEMBERSHIP REQUIREMENTS	
RECOMMENDATION 4	***The Illinois Department of Insurance should promulgate rules that define the term "homogeneous" for pool membership before issuing any new certificates of authority. DOI should also monitor pools for members that do not have homogeneous risks.***
DEPARTMENT OF INSURANCE RESPONSE	The DOI is in general agreement with this recommendation and has provided information regarding post 2001 efforts to resolve an issue regarding non homogeneous risks presented by a currently solvent Pool. The circumstance presents the difficulty associated with enforcement. Assuming the Pool does not become insolvent the remedy available is provided by Section 107a.15 of the Illinois Insurance Code which allows the DOI to issue a compliance order. If the order is violated, the Pool would then be considered "hazardous" and ultimately subject to liquidation. This is a one size fits all penalty, which our experience in receiverships indicates will be very difficult if not impossible to enforce in the absence of an insolvency. --- *AUDITOR COMMENT: If, in the Department's experience, it would be impossible to enforce these provisions, we are unaware of any alternative legislative proposals put forth by the Department to rectify this situation.*

Payroll Requirements

The Department of Insurance administrative rules require that in order to receive a certificate of authority to operate a group workers' compensation self-insured pool, the gross annual payroll of all members must be at least $10 million (50 Ill. Adm. Code 2901.30). The new pooling law, effective January 1, 2001, also includes a payroll requirement but goes a step further by requiring that all pools must maintain this amount of gross payroll in order to keep a certificate of authority. Below is the section of the law that discusses the payroll requirement.

215 ILCS 5/107a.07. Standards for issuing and maintaining pool certificates of authority

(a) The Department shall consider the following in evaluating the financial strength of the pool:

(1) The number of employees covered by the pool.
(2) The particular industries in which the participants are engaged.
(3) The combined net worth of pool participants.
(4) Any excess insurance purchased from authorized insurers.

> *(5) The gross annual payroll of members,* ***which must be at least $10,000,000*** *(emphasis added).*

There are currently several pools in runoff or in loss portfolio transfer status (i.e. no longer writing new business) that hold a valid certificate of authority but do not have $10 million in gross annual payroll. According to DOI, as of June 2002 there were 23 pools with a certificate of authority. We reviewed the annual financial statements filed by the pools for the year ended December 31, 2001. The annual financial statements showed that, of the 23 pools:

- 11 pools reported estimated gross annual payrolls between $30.7 million and $256.9 million (10 were active and 1 was in runoff)
- 3 pools reported $0 as their estimated gross annual payroll (2 were in runoff; 1 had a Loss Portfolio Transfer)
- 9 pools either noted that they were in runoff or did not disclose their estimated total annual payroll (6 were in runoff, 2 had a Loss Portfolio Transfer, and 1 was active).

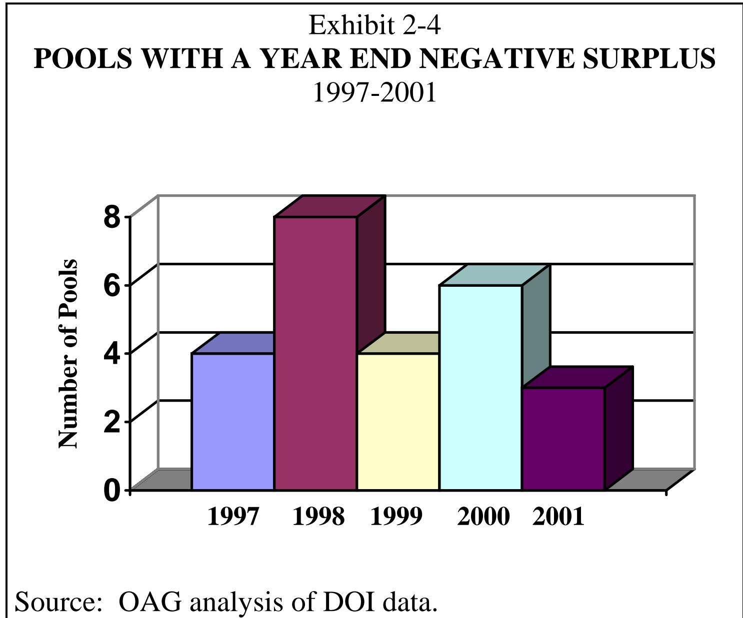
The amount of payroll is used as an indicator of the financial strength of a pool in the statutes and rules. The primary reason for this is because pools with larger payrolls can more easily absorb and spread risk in the event of a substantial claim. Therefore, this is an important factor in the continued solvency of the remaining pools.

PAYROLL REQUIREMENTS	
RECOMMENDATION 5	***The Illinois Department of Insurance should ensure that pools maintain $10,000,000 of gross annual payroll and should promulgate rules that set forth a process to follow in the event that a pool has less than the required payroll.***
DEPARTMENT OF INSURANCE RESPONSE	The DOI agrees that payroll status must be monitored and does so by written interrogatories to the Pools which showed that the eleven active pools met this requirement. We believe there is little utility in rulemaking to establish a remedy here in that the statutory remedy of Section 107a.15 would already be applicable. [see, also, **DOI Response 4,** above] The DOI suggests that a more flexible statutory authority, including the ability to impose civil forfeitures would be more appropriate.
	AUDITOR COMMENT: Twelve of the remaining 23 pools that continue to hold a certificate of authority either had less than the $10 million payroll or did not disclose the amount of payroll in their annual statements for the year ended December 31, 2001. Given that these pools still hold a certificate of authority, but have less than the statutorily required $10 million in payroll, administrative rules may be desirable to address this situation. If the Department is suggesting that they need more flexible statutory authority, the Department provided no documentation of legislation proposed to rectify this problem.

RESERVE REQUIREMENTS

From 1983 until the new pooling law became effective January 1, 2001, the pooling law has required that every group self-insurer maintain reserves which are actuarially sufficient, as determined by the Director of Insurance, to provide for the payment of all losses and claims incurred (P.A. 83-1005). It also stated that the Department shall promulgate rules that establish standards and guidelines to assure the adequacy of the financing and administration of group self-insurance plans. Although the Department promulgated rules, the rules did not include a specific surplus requirement.

Exhibit 2-4
POOLS WITH A YEAR END NEGATIVE SURPLUS
1997-2001



Source: OAG analysis of DOI data.

Several pools had a negative surplus in the years preceding the four pools being placed into receivership. These include pools that are currently in liquidation as well as some that are still in operation. Exhibit 2-4 shows that as of the end of 1997 there were four pools reporting a negative surplus in their annual financial statements submitted to DOI. By the end of 1998, this had doubled to eight pools. Although this number dropped to three in 2001, there were also four pools in receivership by that time.

Although DOI was reviewing the annual financial statements and actuarial opinions that showed concerns regarding inadequate reserves, qualified opinions, and suspect data, they did not issue corrective actions until 1999. We could not obtain a review of the 1996 annual statements and actuarial opinions. According to DOI officials, an actuarial review was not conducted in 1996 because of staff turnover. We asked DOI officials why they do not have a specific surplus requirement for these pools. Officials stated that the pools argue that having a surplus standard might lead to pools having to charge higher rates or the same rates as commercial insurers and thereby defeating the purpose of having the pools. However, if there had been a minimum surplus requirement, some of the pools currently in liquidation may not have become insolvent. Commercial insurance companies are generally required to maintain a surplus of at least $1.5 million.

The current surplus requirement for group workers' compensation self-insured pools is:

When the Director determines by means of audit, annual certified statement, actuarial opinion, or otherwise that the assets possessed by the pool are less than the reserves required together with any other unpaid liabilities, he or she shall order the pool trustees to assess the individual pool participants in an amount not less than necessary to correct the deficiency. (215 ILCS 5/107a.14)

According to DOI officials, the current requirement means that no pool can have less than a $0 surplus. In May 2001, DOI began issuing assessment orders to the pools with a negative surplus. These and other actions are discussed in Chapter Four of this report. As of December 31, 2001, three pools reported a negative surplus. All three of these pools are now in runoff.

SUFFICIENT POOL RESERVES	
RECOMMENDATION 6	***The Illinois Department of Insurance should take available regulatory actions to ensure that each group workers' compensation self-insured pool maintains adequate reserves.***
DEPARTMENT OF INSURANCE RESPONSE	Although this recommendation is obviously well intentioned, it is technically impossible to *"ensure"* reserve adequacy. Nor can static dollar values or ranges be assigned as standards. As stated under **"Regulatory Resources and 'Ensuring' Solvency,"** above, reserves are estimates of future losses. As the workers' compensation market changes and as litigation changes, the reserves will also change. Because the workers' compensation Pools are relatively small, have no other lines to counteract bad loss years in the workers' compensation line, and have no positive surplus requirement, one large claim could literally cause an insolvency. Such an instant is impossible to "ensure" against. Moreover the DOI has, both before and after, the statutory changes of 2001, taken all available regulatory actions to address reserve inadequacies. This was, and is, done using a standard of review comparable to that permitted today by Section 5/378 of the Illinois Insurance Code, which states in part, *"every such company shall, at all times, maintain reserves in an amount* ***estimated*** *in the aggregate to provide for the payment of all losses and claims incurred, whether reported or unreported, which are unpaid and for which such company may be liable…"* The remedies of revocation of authority and liquidation existed prior to 2001. But in contested circumstances they required a very high burden of proof, and challenges to DOI's legal authority may have been made. Today remedies have been expanded by authority to enter corrective orders and limitations on continued operations – with or without the consent of the deficient Pool. This is significant in view of the DOI's need to rely on Pool records and the difficulties of proof regarding the adequacy of reserves when a Pool's management and independent actuary are prepared to assert that their reserves are adequate. At least as far back as 1995, the DOI has requested the actuarial

	workpapers of the opining actuary from Pools with questionable reserves. Forecast models and loss runs have also been reviewed by the DOI. Even with these reviews being performed, the volatility associated with Pool loss reserves is so great that reserve inadequacies are impossible to "ensure" against.
	*AUDITOR COMMENT: The auditor's recommendation merely reiterates the mandate given to the Department directly by the Legislature in 1980. Prior to January 1, 2001, the pooling law required that every group self-insurer maintain at all times reserves which are actuarially sufficient, as determined by the Director of Insurance, to provide for the payment of all losses and claims incurred. It also stated that the Director of Insurance shall audit, as he deems necessary, the reserves of group self-insurers to **"ensure"** their sufficiency.*

Chapter Three

FINANCIAL REPORTING AND REVIEW

CHAPTER CONCLUSIONS

The four pools currently in liquidation filed most required financial reports with the Department of Insurance in a timely manner. This included annual financial statements, actuarial opinions, and audits. While some financial reports contained inaccurate or incomplete information, DOI had financial information that showed the financial condition of these pools.

The Actuarial Unit at DOI conducted reviews of the pools' annual financial statements and actuarial opinions prior to their insolvency and identified several problems including concerns about surpluses, reserve deficiencies, and qualified actuarial opinions. Although the Actuarial Unit still conducts an annual review, DOI assigned the responsibility for monitoring all group workers' compensation self-insured pools to the Regulatory Action Unit (RAU) in July 1998. DOI has increased the frequency of financial reporting times to a quarterly and monthly basis for the solvent pools. DOI has also increased the length and comprehensiveness of the annual financial statement filings as of the year ended December 31, 2001. Prior to July 1998, the Financial/Corporate Regulatory Division had the general responsibility for overseeing these pools.

Effective July 7, 1995 (Public Act 89-97), State law requires that each pool is examined at least every five years. Two of the four pools in liquidation had examinations that were adopted by the Director of Insurance prior to the statutory requirement for the financial examinations. The law also contained time requirements for filing the examinations, transmitting the report to the pool, and adoption of the examination. We reviewed financial examinations with start dates after July 1995 and found that some were not filed in accordance with statutory requirements. Of the 36 examinations reviewed, 10 took longer than 60 days to be adopted and 13 were never adopted. Examinations that were conducted found that the surpluses reported in annual financial statements were not always accurate. For example, Illinois Earth Care reported a surplus of $227,069 in its 1997 annual statement; however, DOI's financial examination discovered that the surplus was actually a negative $850,931.

FINANCIAL OVERSIGHT AND MONITORING OF POOLS

DOI has a system of financial reporting and monitoring in place, most of which was in effect prior to the four pools being ordered into liquidation. Prior to January 2001, each pool was required by administrative rule to submit annual financial statements and an annual audit to DOI. These reports were filed with the Financial/Corporate Regulatory Division at DOI. The

administrative rules also allowed DOI to request an actuarial opinion. The reports and opinions were reviewed annually for problems by employees of the Actuarial Unit.

In July 1998, the Regulatory Action Unit (RAU) was assigned to conduct a review of the pools. This review involved conducting an analysis of each pool's financial solvency. The RAU was also assigned the responsibility of monitoring the pools. In addition to these reviews, DOI has a unit that conducts financial examinations including those of workers' compensation self-insured pools.

Exhibit 3-1 is a summary of the financial information that workers' compensation self-insured pools are required to submit to the Illinois Department of Insurance including a detailed description of the types of information included in the report and the due dates. Pools are required to file:

- **Annual Financial Statements** – Annual Financial Statements are required to be filed by each pool by March 1 each year for the prior calendar year. Prior to January 1, 2001, these were due by April 1 each year.
- **Audits** – Audits are required to be filed by June 1 of each year for the prior calendar year.
- **Actuarial Opinions** – Prior to January 1, 2001, actuarial opinions were not required but the Director of Insurance could request them. According to a DOI memo, the first year an actuarial opinion was due was for the year-end 1994. Now they are required by law and must be filed by June 1 each year.

Enforcement Provisions

As a result of the statutory changes enacted effective January 1, 2001, DOI has authority and is assessing fees for late filings of annual financial statements. Prior to this, DOI did not have explicit authority to assess late filing fees. The new law (215 ILCS 5/139) grants DOI the authority to assess a penalty of up to $1,000 for each day's delay. DOI is currently assessing a penalty of $25 for each day the annual statement is late.

FINANCIAL REPORTING REVIEW PROCESS

Overall it appears that the current process contains adequate controls for DOI to detect problem financial conditions of pools. In July 1998, the Regulatory Action Unit (RAU) was assigned to review the annual financial Statement of the group workers' compensation self-insured pools and effective January 1, 1999, the pools were assigned to the RAU. Prior to July 1998 the Corporate Regulation Section was responsible for overseeing the pools.

Exhibit 3-1
GROUP WORKERS' COMPENSATION SELF-INSURED POOLS
REQUIRED FINANCIAL REPORTS

Report	Description	Due Date
Annual Financial Statements	Self reported statement of the financial condition of the pool. It includes: • Balance Sheet; • Income Statement; • Cash Flow Analysis; • Schedule P; • Excess Insurance Schedule (no longer required); • Interrogatories; and • Investment Schedules, Schedule F and Underwriting Exhibits were added in 2001.	Prior to January 1, 2001 due April 1 annually (50 Ill. Adm. Code 2901.30). After January 1, 2001 required by law by March 1 annually (215 ILCS 5/107a.12 (a)).
Annual Audit	Audited financial statements reporting the financial condition of the pool as of the end of the most recent calendar year and changes in the surplus funds. Includes: • Report of an independent certified public accountant; • Balance sheet reporting assets, liabilities, and surplus funds; • Statement of gain and loss from operations; • Statement of changes in financial position; • Statement of changes in surplus funds; and • Notes to financial statements.	Prior to January 1, 2001 due June 1 annually (50 Ill. Adm. Code 2901.30). After January 1, 2001 required by law (215 ILCS 5/107a.12 (c)).
Actuarial Opinion	Independent actuarial opinion as to the sufficiency of the loss and loss adjustment expenses reserves.	Prior to January 1, 2001 the Director **may** require (50 Ill. Adm. Code 2901.30). After January 1, 2001 required by law June 1 annually (215 ILCS 5/107a.12 (d)).
Quarterly Financial Statements	Self reported statement of the financial condition of the pool. It includes: • Balance Sheet; • Income Statement; and • Cash Flow Analysis.	Prior to January 1, 2001 the Director **may** require quarterly supplementary summary statements to be filed not less than 60 days after the end of each quarter (50 Ill. Adm. Code 2901.30(c) (6)). After January 1, 2001, allowed by law (215 ILCS 5/107a.12)

Source: 50 Ill. Adm. Code 2901.30 and 215 ILCS 5/107a.12.

DOI Analysis of Financial Information

As shown in Exhibit 3-1, there are many components of the required financial reports. These reports include information that is central to the monitoring function, for example, the amount of surplus and premium, assets, liabilities, number of members in the pool, and the estimated total annual payroll. DOI's Actuarial Unit conducts a review of annual statements and actuarial opinions, which includes a summary of surplus, premium, net underwriting gain (loss), findings of reserve adequacy, and reviewer comments. DOI's Regulatory Action Unit prepares a number of ratios when analyzing a pool's annual statement. DOI also filled out compliance checklists for several of the pools. The checklist provided a list of items to review, including invested and admitted assets and reinsurance practices. Also, if any of the main schedules are not completed, it should be noted and the pool should be contacted.

Regulatory Action Unit

Exhibit 3-2 shows the financial reporting review process both prior to and after July 1998. Prior to the RAU monitoring that began in July 1998, the pools were monitored by the Corporate Regulation Section, Actuarial Unit, and the Financial Examination Section of DOI.

As can be seen in the exhibit, the workers' compensation pools have been monitored by the Regulatory Action Unit of the Department of Insurance since July 1998. At that time, two analysts within the unit were assigned the task of reviewing all of the pools' calendar year 1997 financial statements. The pools were prioritized based on surplus relative to liabilities. According to DOI, beginning in mid 1999, all the pools were required to file interim financial statements; 6 pools were required to file monthly, 6 quarterly, and 14 semiannually. Two pools, BYRMA and Illinois Earth Care were placed into conservation during 1999. The calendar year 1998 statements and all 1999 interim statements were reviewed by the RAU. Pursuant to a May 20, 1999 memo, the RAU supervisor recommended (1) certain action plans for seven of the pools and (2) prescribed statement formats for the June semiannual statements to be filed as of June 30, 2000.

The RAU runs several ratios, many incorporating the amount of surplus and liabilities (to determine how leveraged a pool is), when analyzing the pools' annual statements and evaluating a pool's financial condition. A narrative memo is written to summarize the findings of the analyst review and is forwarded to the RAU supervisor for review. If a pool is thought to be in "hazardous financial condition," DOI may issue a corrective order. Corrective orders are discussed in Chapter Four of this report.

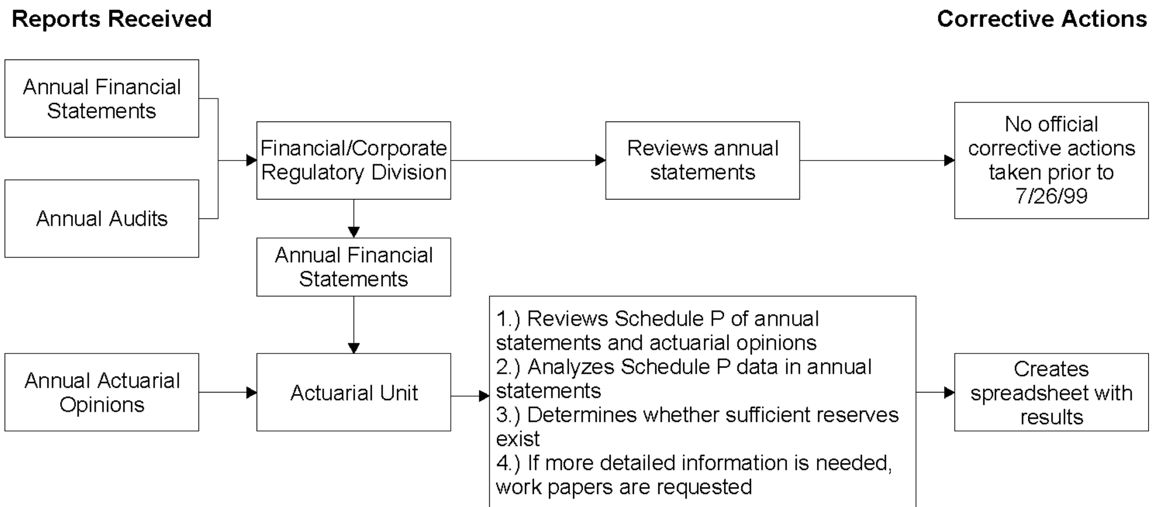
Actuarial Unit

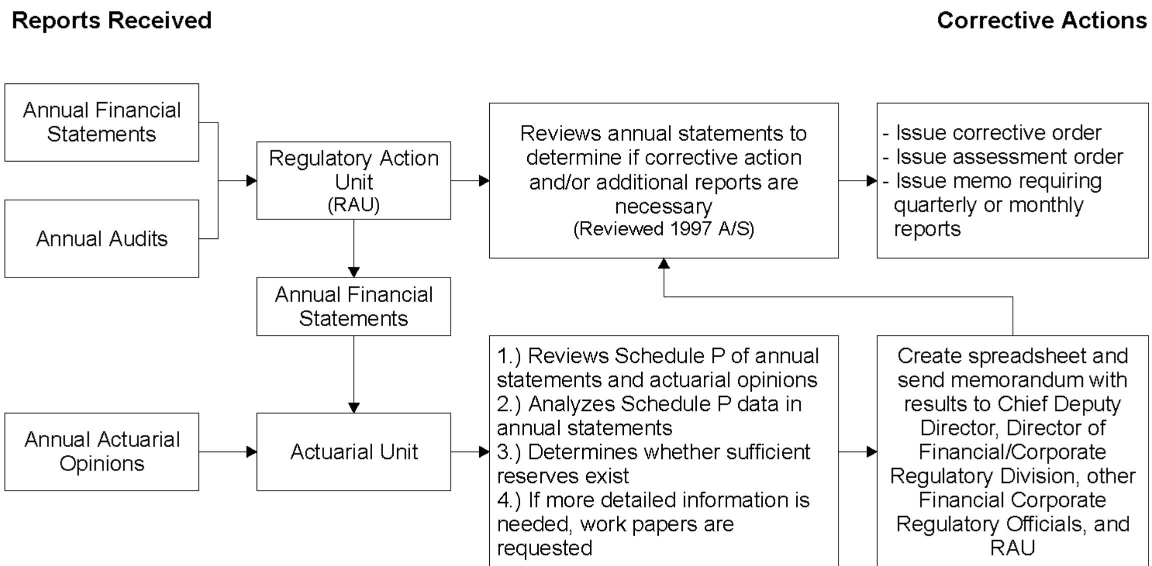
The Actuarial Unit also conducts an annual review of the group workers' compensation self-insured pools. This review is comprised of the following procedures:

1. The actuarial opinion is read for thoroughness, accuracy, and content.
2. The consistency of year-to-year appointed actuaries and management firms is noted.
3. The premium-to-surplus ratio is calculated and noted.

Exhibit 3-2

DOI FINANCIAL REPORTING REVIEW PROCESS FOR GROUP WORKERS' COMPENSATION SELF-INSURED POOLS





Notes:
1) DOI is also required to conduct a financial examination of each pool every five years.
2) Effective with the 2000 annual financial statements, the due date changed from April 1 to March 1.
3) Interim financial statements were required for the second half of 1999 (frequency was based on financial condition).
4) Quarterly financial statements were required beginning with March 31, 2000 period.

Source: OAG analysis of DOI financial reporting review process.

4. The number of years of Schedule P data is considered for credibility purposes in the reserve analysis.
5. The net underwriting gain/loss is considered in the overall evaluation of the pool.
6. Schedule P is checked for accuracy and proper completion.
7. The adequacy of the loss reserves is determined based upon an analysis of historical and/or NCCI (National Council on Compensation Insurance) data, NCCI discount factors, and other reserving issues facing each individual pool.
8. Complete loss reserve analysis is performed if required by management.

The review includes a summary of surplus, premium, net underwriting gain (loss), findings of reserve adequacy, and reviewer comments. The review also indicates the pools that need follow-up and those that have a surplus to premium ratio of less than 2 to 1. Prior to the four pools being placed into receivership, these reviews identified several problems including concerns about surpluses, reserve deficiencies, and qualified actuarial opinions.

TIMELINESS AND COMPREHENSIVENESS OF FINANCIAL INFORMATION

It appears that DOI had sufficient information regarding the financial condition of the pools to identify those that were in hazardous financial condition. We determined that solvent and liquidated pools alike were submitting most of the required reports in a fairly timely basis prior to any of the pools becoming insolvent. Following are the results of our testing related to the availability and timeliness of financial information for both the pools in liquidation and the solvent pools.

POOLS IN LIQUIDATION

We collected annual statements, actuarial opinions, and audited financial statements for the four pools in liquidation for the period 1995 – 1999. One annual statement, one actuarial opinion, and one audited financial statement, which were all 1999 financials, were not received by DOI. All other financials were either received or DOI responded that they were not necessary after the pools entered receivership. Interrogatories, a supplement to annual statements that summarizes service administrator information as well as reports on the number of employers participating in the pool and the estimated total annual payroll, were available for most

Exhibit 3-3
FINANCIAL REPORTS RECEIVED BY DOI FOR POOLS IN LIQUIDATION
1995-1999

	Received	Not received - pool entered receivership	Not received
Annual Statements	17	2	*1
Actuarial Opinions	17	2	*1
Audited Financials	16	3	*1

* Illinois Electrical did not submit 1999 reports. Illinois Electrical entered receivership in December of 1999.

Source: OAG analysis of DOI data.

pools for which an annual statement was provided. Although reports were not always date stamped, generally it appeared that financial information for the pools in liquidation was received on a timely basis. Exhibit 3-3 shows the number of reports received and the number of reports filed by the four pools.

Some pools operated for years with a negative surplus before entering receivership. The Back of Yards Risk Management Association Inc. (BYRMA*)* first went into receivership in April 1999. As of March of 2001, four pools were in the process of liquidation. Although the first of the four pools currently in liquidation did not enter receivership until 1999, we obtained memos and reports from DOI that showed Department officials were aware of the problems regarding the financial solvency of these pools before 1999.

Exhibit 3-4 shows the amount of premiums earned for each of the pools for calendar years 1995 through 1999. This data was obtained from the annual financial statements that each pool is required to file with the Illinois Department of Insurance. As can be seen in the exhibit, the amount of earned premium for these four pools, overall, declined over this time period. Illinois Earth Care, for instance, had earned premiums of $7,065,542 in calendar year 1995 but by 1998 this pool's earned premiums were only $2,939,168 (a 58% decrease). The Illinois Electrical pool did not see a decline in premiums until 1998. However, this pool also had a smaller amount of premiums than the other three pools to begin with.

Exhibit 3-4
EARNED PREMIUMS FOR POOLS IN LIQUIDATION
YEAR END BALANCE
Calendar Years 1995-1999

	CY 95	CY 96	CY 97	CY 98	CY 99
BYRMA	$5,111,062	$6,200,880	$4,623,803	$3,305,044	See notes
IL Earth Care	$7,065,542	$6,400,014	$4,382,376	$2,939,168	See notes
IL Electrical	$174,851	$745,477	$749,053	$432,002	See notes
IL Environmental	$4,824,845	$4,362,750	$2,005,693	$1,626,231	$1,400,860

Notes: These figures are self-reported by each pool in their annual financial statements.
*BYRMA went into conservation on April 21, 1999.
*IL Earth Care went into conservation on August 19, 1999.
*IL Electrical went into rehabilitation on December 20, 1999.
*IL Environmental went into conservation on July 31, 2000.

Source: OAG analysis of annual financial statements submitted to DOI.

Exhibit 3-5 shows the amount of surplus for each of the pools currently in liquidation for calendar years 1995 through 1999. The exhibit shows that in 1998, three of the four pools had a negative surplus. It also shows that BYRMA had a large negative surplus in 1997 and 1998 before going into conservation in April 1999. The Illinois Electrical pool had a negative surplus from 1995 through 1998.

Exhibit 3-5
SURPLUS FOR POOLS IN LIQUIDATION
YEAR END BALANCE
Calendar Years 1995-1999

	CY 95	CY 96	CY 97	CY 98	CY 99
BYRMA	$171	$30,342	$(1,179,412)	$(2,100,151)	See notes
IL Earth Care	$267,826	$289,098	$227,069	$(1,216,470)	See notes
IL Electrical	$(52,480)	$(74,837)	$(69,722)	$(128,518)	See notes
IL Environmental	$(73,859)	$124,579	$236,137	$170,881	$(610,446)

Notes: These figures are self-reported by each pool in their annual financial statements. DOI financial examinations found that these amounts were not always accurate. For example, the 1997 year-end balances for the Illinois Electrical and Illinois Earth Care pools should have been ($237,668) and ($850,931) respectively according to DOI examinations. The examination reports for these two pools were completed in October 1999 but were never adopted.

*BYRMA went into conservation on April 21, 1999.
*IL Earth Care went into conservation on August 19, 1999.
*IL Electrical went into rehabilitation on December 20, 1999.
*IL Environmental went into conservation on July 31, 2000.

Source: OAG analysis of annual financial statements submitted to DOI.

The surplus amounts shown in Exhibit 3-5 are self-reported in the annual financial statements submitted by each pool. As discussed later in this chapter, DOI financial exams found that these amounts were not always accurate and, in some cases, the surplus was overstated. For example, an examination for the period ended 1997 found that Illinois Electrical underestimated liabilities by $150,000 and over reported assets by $17,946. As a result, the surplus was overstated in the pool's annual financial statement by $167,946 and should have been a negative $237,668. Illinois Earth Care reported a surplus of $227,069 in its 1997 annual statement; however, DOI's financial examination discovered that the surplus was actually a negative $850,931, or $1,078,000 less than reported by the pool in the annual statement. DOI's financial examination discovered that Illinois Earth Care had over reported assets and underestimated liabilities.

SOLVENT POOLS

We collected annual statement information (including interrogatories when available) for the remaining 23 solvent pools for the two years preceding and the two years after pools entered receivership (1997 – 2001). Four annual statements could not be located out of a possible 115. DOI provided the following response:

- two 2000 annual statements were not necessary because the pools were in run-off,
- one 2000 annual statement missing was the result of a change in service provider, and
- one 1999 annual statement was not received.

Interrogatories were available for most pools for which an annual statement was provided. In the years prior to the four pools entering receivership, many pools were submitting annual statements in a timely manner.

Additional Financial Statement Requirements

The Illinois Department of Insurance increased monitoring of the pools in 1999; however, the increase in monitoring did not occur until after the pools' financial problems had occurred. According to DOI, beginning in mid 1999, all the pools were required to file interim financial statements; 6 pools were required to file monthly, 6 quarterly, and 14 semiannually. At the outset, there was no set format for the quarterly financial statements; however, in April 2002, DOI notified the pool administrators of the prescribed format for the 2002 quarterly statements.

DOI has expanded the information required in the annual financial statement filings. Workers' compensation self-insured pools as of the year end 2001 statement are now required to file a statement that is approximately 40 pages in length as opposed to the shorter 10 page filing that had been used in the past. The year end 2001 annual statements require additional information for an expanded time frame regarding premiums, losses, expenses, investments, cash, and reinsurance. Interrogatories, which contain pool membership information, are also required.

DOI FINANCIAL EXAMINATIONS

Effective July 7, 1995 (Public Act 89-97), State law requires that each pool is examined at least every five years. It also contains time requirements for filing the examinations, transmitting the report to the pool, and adoption of the examination.

> (b) Filing of examination report. No later than 60 days following completion of the examination, the examiner in charge shall file with the Department a verified written report of examination under oath. Upon receipt of the verified report, the Department shall transmit the report to the company examined, together with a notice that affords the company examined a reasonable opportunity of not more than 30 days to make a written submission or rebuttal with respect to any matters contained in the examination report.
>
> (c) Adoption of the report on examination. Within 30 days of the end of the period allowed for the receipt of written submissions or rebuttals, the Director shall fully consider and review the report, together with any written submissions or rebuttals and any relevant portions of the examiners work papers and enter an order…. (215 ILCS 5/132.5)

Examinations of Pools in Liquidation

DOI provided a list of examinations conducted and the filed date for the four pools in liquidation and 23 pools currently licensed to operate. Two of the four pools in liquidation had examinations that were adopted by the Director of Insurance. Illinois Earth Care and Illinois Environmental were both examined for the period ended December 31, 1993, prior to the statutory requirement for the examinations. These examinations were not adopted until June 1996, 2 ½ years later.

Exhibit 3-6
FINANCIAL EXAMINATIONS OF POOLS IN LIQUIDATION

	Time period covered by examination	Status
BYRMA	No exams conducted	No exams conducted
IL Earth Care	12-15-92 to 12-31-93 1-1-94 to 12-31-97	Adopted 6-19-96 Not filed
IL Electrical	8-1-95 to 12-31-97	Not filed
IL Environmental	11-1-91 to 12-31-93 1-1-94 to 12-31-97	Adopted 6-19-96 Not filed

Source: OAG analysis of DOI data.

Both pools were also examined for the period from January 1, 1994 to December 31, 1997; however, the reports were never filed. According to DOI officials, instead of adopting the Illinois Environmental examination, the Director issued a corrective order in February 2000. Illinois Environmental was ordered into conservation in July 2000. DOI issued corrective orders for Earth Care in July and August 1999, and the pool was ordered into conservation in August 1999.

Illinois Electrical was also examined, but never had a final report filed. According to DOI officials, instead DOI issued a corrective order for Illinois Electrical in August 1999. Illinois Electrical was ordered into rehabilitation in December 1999. BYRMA was not examined before entering conservation in April 1999. Exhibit 3-6 illustrates the financial examinations conducted of the pools in liquidation.

DOI officials noted that some filing problems are a result of the exams having to go back to the administrator in order to be filed and others are a result of an exam not making it through the routing process at DOI. The financial examinations are performed in Chicago, sent to Springfield, back to Chicago, then to the pool, and finally to Springfield for adoption. Seven examinations with start dates after July 1995 were noted as not being filed per a DOI official. DOI did not know why these examinations were noted as such.

Financial examinations of two of the pools in liquidation noted some considerable differences between the reporting of fund balances in the annual financial statements and the examinations. For example, an examination for the period ended 1997 found that Illinois Electrical underestimated liabilities by $150,000 and over reported assets by $17,946. As a result, the surplus was overstated in the pool's annual financial statement by $167,946. Illinois Earth Care reported a surplus of $227,069 in its 1997 annual statement; however, DOI's financial examination discovered that the surplus was actually a negative $850,931, or $1,078,000 less than reported by the pool in the annual statement. Illinois Earth Care had over reported assets by $228,000 and underestimated liabilities by $1,000,000.

Examinations of All Pools

Financial examinations of the pools were not filed in accordance with statutory requirements. Exhibit 3-7 provides a breakdown of the examinations begun each year (July 1995 – February 2002) and when the final reports were adopted. DOI provided complete data for 36 examinations of group worker's compensation self-insured pools that had been performed. Of the 36 examinations:

- 10 were adopted within 60 days;
- 10 took longer than 60 days to be adopted;
- 13 were never adopted; and
- 3 were not yet completed.

Effective July 7, 1995, the Director is required by statute to enter an order adopting or rejecting the final examination report or calling for an investigative hearing to obtain more information from the pool (215 ILCS 5/132.5.c). However, records provided by the Department did not always show whether the Director had entered an order for all the examinations performed of the pools. According to the Department, 5 of the 13 exams never adopted were related to a pool administrator who surrendered his license. These were conducted for the purpose of having an examiner on site to monitor the pools and no exams were actually conducted or intended so no reports were ever prepared.

Exhibit 3-7
FINANCIAL EXAMINATIONS OF ALL POOLS
July 1995 – February 2002

	Exams with start dates during the period	Adopted within 60 days after sent to pool	Adopted more than 60 days after sent to pool	No final report ever adopted
July 1995 – CY 1998	11	0	4	7
CY 1999	9	5	3	1
CY 2000	13	5	3	5
CY 2001	2	*	*	*
February 2002	1	*	*	*
Totals	36	10	10	13

Notes:
*Examinations not completed as of February 2002.
According to the Department, of the 13 exams that were not adopted, 7 were not adopted because the Department brought a revocation action against the service company, 1 was rescheduled, and 5 were for the purpose of having an examiner on site to monitor the pools and no exams were actually conducted.

Source: OAG analysis of DOI data.

Financial examinations can be an effective control for ensuring the accuracy of the annual statements filed by the pools. Examinations of two of the pools currently in liquidation uncovered significant overstatements of surplus on the pools' filing of their annual statements. As mentioned previously, the surplus amount reported in the annual statement is used by DOI to

determine the financial strength of a pool and it is therefore important for this number to be reliable. Financial examinations can provide confidence in financial information reported by the pools as well as correct annual statement surplus fund balances. As a result of issues identified during the audit, DOI recently updated its examination report processing policies and procedures in November 2002.

FINANCIAL EXAMINATIONS	
RECOMMENDATION 7	***The Illinois Department of Insurance should conduct all required financial examinations and adopt them in a timely manner to comply with statutory requirements.***
DEPARTMENT OF INSURANCE RESPONSE	Records of the DOI indicate that its examinations have exceeded the statutory requirements with respect to their timing in that this regulatory tool was applied prior to the receipt of statutory authority to require full financial examinations by the adoption of P.A. 89-97 which became effective July 7, 1995. Moreover, the only examination reports which were not filed within the 60 day time frame established by P.A. 89-97 were reports on Pools which the DOI believed to be in financial difficulty, and demonstrated anomalous financial information for which adoption was not appropriate. Also, DOI resources for supervisory review of the reports were also quite limited as has been mentioned previously in this document. Regardless of the reasons for such delays, the pools were made aware of appropriate findings, both major and minor, so corrective action could be taken. It is DOI's view that it is better to take greater time in adopting the exam reports, resulting in a better work product, than to shortcut the process and adopt an inferior or inadequately reviewed report. In particular the inferences and finding of Exhibit 3-7, at page 43, of the Audit Report are simply incorrect and misleading. The exhibit also shows that 13 final reports were never adopted, however 7 of those reports were not adopted for valid reasons, and the other six exams were terminated so no report was necessary, to wit: • Seven of the exams from July 1995 – CY 1998 were exams of Fackler pools which were not adopted because DOI brought a revocation action against Fackler as a service company. He ceased doing business in Illinois before the reports could be adopted. Since Fackler no longer existed, adoption of the reports was unnecessary and could not be completed in

accordance with statutes.

- One examination referenced was rescheduled to the next year, so the exam begun in CY 1999 was not conducted at all, but was done in the year 2000 and completed later, within statutory limits.

- Five of the exams referenced as begun in 2000 were related to warrants issued on Fackler pools at the time Fackler was ceasing to do business. The warrants were issued just for the purpose of having an examiner on-site to monitor the pools until a decision could be made on their fate. No exams were actually conducted or intended so no reports were ever prepared.

Moreover, the Auditor General's *Financial and Compliance Audit* conducted for the two years ended June 30, 1999 tested specifically, Workers' Occupational Diseases Act 820 ILCS 305/4a(7). The report states the following on page 130:

> "Tests included, but were not limited to:
> 1. Interviews with Department personnel to determine the activities carried out to comply with the mandates;
> 2. Tests to support the existence of activities as described by the Department personnel; and
> 3. Reviews of applicable reports, files, and transactions to support compliance with mandates.
>
> There were no instances of noncompliance noted."

DOI agrees that financial examinations of insurance entities provide several benefits and provide more insight into whether information that the entity has filed with the DOI is accurate.

AUDITOR COMMENT: As a result of issues identified during the audit, DOI recently updated its examination report processing policies and procedures in November 2002. The statutes requiring the exams include specific time frames for filing and adopting examination reports.

Information provided by the Department to the auditors shows that all seven of the examinations referred to in the first bullet were sent to the applicable pools on October 21, 1999 and sent to Springfield for adoption on November 22, 1999. The Department filed an order of revocation against the administrator of the pools on November 4, 1999. However, the administrator did not surrender his license until July 31, 2000, over eight months after the examinations were sent to Springfield for adoption.

	According to exam information provided by the Department as of February 14, 2002, the exam referenced as begun in CY 1999 was started in September 1999. No other dates were provided. Another exam for the same pool is listed. However, there is a different warrant number and no start date. *Information provided by the Department to the auditors shows that all five of the exams referenced as begun in CY 2000 were started in July 2000. It also states that no reports were filed, only internal memos. The administrator of the pools also voluntarily surrendered his license in July 2000. The Department's explanations regarding these examinations were added to the audit report.* *The testing performed as part of the financial and compliance audit was a more limited review than was conducted as part of this management audit.*

Chapter Four

CORRECTIVE ACTIONS

CHAPTER CONCLUSIONS

Corrective orders were issued to three of the four pools currently being liquidated. The corrective orders issued to the pools in liquidation were not effective because:

- The pool administrator did not comply with the orders and questioned DOI's authority to issue corrective orders to pools; and
- DOI's corrective actions were untimely.

We also reviewed corrective orders and assessment orders issued to other pools that are currently solvent and found that DOI conducts limited tracking of whether all required information is received. Based on documentation DOI provided, four of eight pools that were issued an assessment order in 2001 improved their financial conditions between December 31, 2000 and the most recent quarterly statement. Of those four, two pools improved their financial condition based on factors that did not involve assessment collection. In reviewing assessment orders, we also found that membership collection ranged from 24 percent to 135 percent of the total assessment. For the other solvent pools, effectiveness of assessments varied because:

- The financial condition of the pools did not always improve after pools implemented the requirements of the corrective orders and assessment orders, and
- As of June 30, 2002, four of the eight pools issued an assessment order reported a negative surplus.

DOI officials stated that they do not require pools to submit copies of board resolutions, which would document the initial process of assessing members. DOI officials also stated that they did not approve assessment plans related to the orders, believing that they did not have the authority to do so. Approving assessment plans would give DOI more control in helping pools reach financial stability, as well as provide DOI with an overview of how pools are attempting to resolve their financial problems.

TYPES OF CORRECTIVE ORDERS

There are two general categories of corrective actions that can be taken prior to liquidation of a group workers' compensation self-insured pool: 1) Departmental supervised actions (such as corrective orders and assessment orders, which are discussed in this chapter) or 2) Court supervised actions (receivership, which is discussed in Chapter Five).

Departmental Actions

The Department of Insurance (DOI) issues corrective orders, stipulation and consent orders, and assessment orders which recommend steps to be taken by a pool to help keep the pool solvent.

Corrective Order - Corrective orders recommend that pools take certain steps to improve operations, including ordering the pool not to write new business or spend money on advertising. Corrective orders may also require the pool to submit supplemental financial information on a monthly or quarterly basis.

Assessment Order - Assessment orders recommend that the pool levy an assessment against member employers to correct the financial condition of the pool. These orders identify the amount of negative surplus for a pool at a certain point in time and order the pool to correct the deficiency by levying and collecting an amount from each member.

Stipulation and Consent Order - Stipulation and Consent orders recommend actions that the pool has already agreed to implement.

CORRECTIVE ORDERS ISSUED TO POOLS NOW IN LIQUIDATION

We reviewed the corrective orders and assessment orders DOI issued to all pools. In total since July 26, 1999, DOI has issued corrective orders to seven pools and stipulation and consent orders to two pools. Of the four pools currently in liquidation, three were issued a corrective order. However, none of the four pools were issued an assessment order before being placed into receivership. One of the pools now in liquidation did not receive either a corrective order or an assessment order from the Department before receiving an order of conservation through the Illinois courts. The same administrator managed three of the four pools currently in liquidation. Some of the issues that may have contributed to the ineffectiveness of the corrective orders include pool administrator protests to corrective orders asserting that the pool was not an assessable domestic mutual insurance company and not subject to corrective orders and untimely issuance of corrective orders.

Public Act 91-757 (effective January 1, 2001) includes a section that now clarifies pools as assessable domestic mutual insurance companies and contains a section that specifically gives DOI authority to issue corrective orders. These revisions of the law should assist DOI in executing future corrective orders. However, based on rules and statutes, DOI had authority to regulate the pools dating back a number of years prior to the four pools being placed into liquidation, both preventative and curative. Provisions either in statute or rule have, for example, allowed DOI to:

- obtain financial information,
- require loss reserves,
- monitor/audit loss reserves, and

- order assessments on members of all pools.

Further, when asked about its authority to issue a corrective order, DOI officials stated that it was never ruled that DOI did not have the authority to issue a corrective order. Public Act 91-757 gives DOI authority to issue corrective orders by including Article XII ½ - Corrective Orders (215 ILCS 5/186.1). It was this section that the pools were asserting was not applicable to them because they were not assessable domestic insurance companies. Under the old statute, however, DOI concluded that if anything was not directly referenced in the statute, DOI did not have the authority.

Administrator Protest

The pool administrator for three of the four pools currently in liquidation protested DOI's corrective orders issued to these pools. For example, this administrator's attorneys for one of the pools filed a brief supporting a motion for summary judgement, and for the corrective order to be dismissed. Essentially, the motion stated that none of the provisions listed in the order authorized the Department of Insurance to issue a corrective order. As quoted from the motion, "The Department's authority to issue corrective orders is derived from 186.1, which specifically applies to assessable domestic insurance companies. [The pool] is not an assessable domestic insurance company. This is made plain by a review of the relevant provisions of the Insurance Code and Illinois Law."

DOI resolved these written appeals prior to them reaching the formal hearing stage by placing the pools into receivership and OSD assumed the management of the pools, while the administrator surrendered its license and ceased doing business in Illinois. Additionally, Public Act 91-757 (effective January 1, 2001) makes several sections regarding assessable domestic mutual insurance companies applicable to the pools and contains a section that specifically gives DOI authority to issue corrective orders. These revisions of the law should assist DOI in executing future corrective orders.

Timeliness of Actions

The first corrective order issued to a group workers' compensation self-insured pool was on July 26, 1999 to one of the pools currently in liquidation. Less than a month after the order, however, the pool was ordered into conservation. Other pools were allowed to run negative surpluses for some time. For example, one of the pools currently in liquidation ran a negative surplus since its inception in 1995. In August of 1999, a corrective order was issued stating that the pool was in hazardous financial condition, as evidenced by the June 30, 1999 surplus level of negative $206,013. The pool administrator was ordered to, among other things, discontinue advertisement, provide monthly financial statements, and be paid no administrative fees or agents' commissions.

When asked why they did not issue the corrective orders sooner, DOI officials stated that they did not have the authority. DOI officials also stated that in many situations since the self-insured pools came into existence, the pools cooperated with DOI's directions without the need to issue formal actions. However, all of the corrective orders DOI issued were prior to the new legislation becoming effective clarifying DOI's authority on corrective orders. And, as stated

previously, based on rules and statutes, DOI had authority to regulate the pools for a number of years, both preventative and curative.

Content of Corrective Orders

Corrective orders we reviewed varied slightly in language and content. All DOI corrective orders required the following:

- Providing by the 20th of each month a balance sheet, income statement, and cash flow statement.
- Submitting to the Director a plan for improving the financial condition within 10 or 20 days of the order.

Other requirements in some corrective orders issued included:

- Collecting premium adjustments as stated in the board resolutions.
- Considering whether administrative or agent fees are excessive and notifying the Department within 30 days of the pool's actions on this issue.
- Providing the Director with a list of outstanding policy claims within 10 days of the order.
- Discontinuing any advertisement, solicitation, selling, issuance, or renewal of any agreement or contract covering insurance risks in Illinois and other states by and through any entity or pooling arrangement.
- Making no transfer, distribution, encumbrance, pledge, sale, loan, or exchange of a pool's assets without the prior written approval of the Director of Insurance.
- Billing the premium to each pool policyholder based on standard NCCI class rates retroactive to policies effective April 1, 1999.
- Paying no administrative fees or agents' commissions from the date of the Order. The Service Agreement shall be amended to provide for the administrative fee to be based upon actual billed premium, as collected.
- Using all monies collected, including premium payments, audit premiums, etc. only for payments to injured workers and medical providers.
- Limiting any assessment receivable to a maximum of 5 percent of total assets, provided that any admitted portion is not more than 60 days past due.
- Making all claim payments as they become due without delay or exception, and notify the Director immediately should the pool fail to do so, or become aware that such failure is imminent.
- Not entering into any new pooling agreements, thus adding no new pool participants.

DOI officials stated that the financial progress is monitored through individual analyst summaries using the information list above. When asked if there was a reason why orders did not request all the same information, DOI officials stated that different individuals drafted the corrective orders. However, it was decided at one point to make the order requests similar to eliminate the perception that some pools were being unfairly over-burdened.

Status of Corrective Orders

Auditors asked DOI to locate any applicable documentation that may have been used to track the status of the corrective orders. DOI did not have applicable corrective order documents for the three pools in liquidation that were issued corrective orders. DOI officials stated that the administrator for these three pools was not open to the idea of corrective orders. The pool administrator filed a protest with DOI regarding the corrective orders.

In addition, these three pools went into receivership shortly after receiving their corrective orders. DOI officials have stated that once a pool is in receivership, they no longer require the reports, stating that the usefulness of the reports ends once pools enter receivership. The information requested in the corrective orders would no longer have been necessary to help the solvency of the pools.

ASSESSMENT ORDERS

DOI did not issue assessment orders to the pools currently in liquidation prior to them being placed into receivership. Assessment orders are issued to pools with the intent of having pool members contribute additional funds to the pool to correct any deficit. Generally, assessment orders give the deficit amount that is to be corrected, as well as a timeline for other activities. Assessment orders generally give the pool 30 days from the date of the order to develop a plan of assessment that must be approved by the Director; 60 days to levy the assessment to their members; and 90 days to begin billing and collecting the assessment from pool members.

The first assessment orders were issued May 14, 2001. According to information received from DOI, it has issued assessment orders to eight pools. DOI vacated one order after the pool settled one claim for substantially less than anticipated. Another pool resolved its assessment order by filing a surplus debenture, which allowed the pool to receive a loan from an offshore subsidiary. The Director of DOI approved this transaction because the Director has the power to approve interest and premium payments.

During the audit, we gathered information to determine which pools were issued assessment orders, whether the assessments were issued by the pools, whether members paid the assessment, and how effective they were at improving the financial condition of the pool. It is difficult to determine the effectiveness of assessment orders on the financial condition of the pool because there are other factors involved that affect the surplus.

DOI officials explained that each pool has a different amount to pay based on the size of the pool and the number of assessments. We concluded that DOI conducts only limited tracking of pool assessments. When asked how they monitor assessments, DOI analysts provided a narrative, which consisted of a memo on each quarterly and annual financial report. The main objective for these narratives is to determine whether the assessments cover the deficit.

DOI officials stated that they did not approve assessment plans related to the orders, believing that they did not have the authority to do so. However, according to DOI officials, they required modification to several assessment plans because such plans were either ineffective as presented or unfair to pool members in some way. Approving assessment plans would give DOI more control in helping pools reach financial stability, as well as provide DOI with an overview of how pools are attempting to resolve their financial problems. DOI also does not require pools to submit copies of board resolutions, which would document the initial process of assessing members.

Status of Assessment Orders

Exhibit 4-1 shows the assessment orders DOI issued to the pools and the effect that the assessments had on their financial condition. As can be seen, the effect of assessments on surplus varied. As of the most recent available quarterly statements, four of the pools showed a positive surplus. As of October 2002, two of the pools had not submitted their June 30, 2002 quarterly statements. Therefore, we used the March 31, 2002 quarterly statements.

Exhibit 4-1
ASSESSMENT ORDERS AND THEIR EFFECT ON FINANCIAL CONDITION
Calendar Year 2001

Name of Pool	Assessment Order Date	Assessment Amount	Annual Statement Surplus 12/31/00	Annual Statement Surplus 12/31/01	Quarterly Statement Surplus 3/31/02	Quarterly Statement Surplus 6/30/02
Nursing Homes RMA*	5/14/01	$645,554	($645,554)	$42,371	$455,488	$196,060
Peoria Area Chamber of Commerce Trust	5/14/01	$675,000	($489,760)	$85,043	$226,850	Statement not provided as of 10/02
Illinois Green WCA	5/25/01	$1,227,000	($454,360)	($1,121,019)	($604,132)	($511,483)
Illinois Grocers RMA	5/25/01	a)$935,000 b)$600,000	($1,185,265)	($716,379)	($592,088)	($529,355)
Illinois Non Profit RMA	5/25/01	$2,000,000	($2,018,106)	($3,307,392)	($3,239,082)	($3,343,765)
Illinois Agricultural Service WCT	7/3/01	$291,607	$3,784	$28,672	($208,067)	($169,587)
Illinois Cemetery**	5/14/01	$19,874	($19,874)	$213,667	$214,977	$216,721
Illinois Green WCA	8/10/01	$451,414	($454,360)	($1,121,019)	($604,132)	($511,483)
Chicago Midwest Meat Association WCP	10/2/01	$143,170	$74, 185	$63,521	$20,204	Statement not provided as of 10/02
Illinois Non Profit RMA	11/2/01	$3,000,000	($2,018,106)	($3,307,392)	($3,239,082)	($3,343,765)

Notes:
At the exit conference, DOI officials also provided two assessment orders that were issued to pools in June 2002.
* The pool secured funds through a surplus debenture with an offshore subsidiary.
** DOI vacated the assessment after the pool settled one claim for substantially less than anticipated.

Source: OAG analysis of DOI data.

While assessments have resulted in pools obtaining additional funding, it is difficult to measure the degree to which the assessment alone had an effect on improving pools' financial conditions because 1) assessments are not always collected by the due date, and 2) external factors can affect pool surpluses. As can be seen in Exhibit 4-1, from December 31, 2000 to December 31, 2001, three of the eight pools' financial conditions worsened, even though all of the orders were issued in 2001. Since none of the orders, however, were issued until at least May 2001, and the latest order was issued in November 2001, auditors also compared the December 31, 2000 annual statement surplus amount with the March 31, 2002 quarterly statement surplus amount. As Exhibit 4-1 also shows, however, four of the pools' financial conditions worsened between December 31, 2000 and the most recent available quarterly statement despite the assessment orders that were in effect. In addition, pool members in some cases have been put on monthly payment plans for years in order to pay the assessments. Therefore, the effects of collecting the assessment are ongoing.

The percentage of assessment dollars the pools collected provided inconclusive results regarding the effectiveness of assessment orders, as can be seen in Exhibit 4-2. For example, the Illinois Agricultural Service pool collected 96 percent of its assessed amount yet still showed a negative surplus of $169,587 as of June 30, 2002.

Exhibit 4-2
PERCENTAGE OF ASSESSMENTS COLLECTED
As of June 30, 2002

	Assessment Amount	Assessment Collected	Percent Collected	Surplus as of 6/30/02
Peoria Area Chamber of Commerce Trust	$675,000	$160,313	24%	* $226,850
Illinois Green WCA	$1,227,000	$1,653,332	135%	($511,483)
Illinois Grocers RMA	$935,000	$446,293	48%	($529,355)
Illinois Grocers RMA	$600,000	$489,217	82%	($529,355)
Illinois Non Profit RMA	$2,000,000	$1,088,929	54%	($3,343,765)
Illinois Non Profit RMA	$3,000,000	$1,007,824	34%	($3,343,765)
Illinois Agricultural Service WCT	$291,607	$280,849	96%	($169,587)
Chicago Midwest Meat Association WCP	$143,170	$138,438	97%	* $20,204

Notes: Pools for which DOI vacated the assessment order or secured funds through a surplus debenture are not included in this chart.
* The surplus amount as of 3/31/02 was used because, as of October 2002, these two pools had not filed their Quarterly Financial Statements with DOI.

Source: OAG analysis of DOI data.

CORRECTIVE AND ASSESSMENT ORDERS	
RECOMMENDATION 8	***The Illinois Department of Insurance should continue to issue corrective orders and assessment orders to pools in hazardous financial condition. DOI should also monitor the collection of assessments.***
DEPARTMENT OF INSURANCE RESPONSE	The DOI has used and will continue to use all means, including corrective orders and assessment orders, to attempt to alleviate a potentially troubling situation or to address an issue. Moreover, the DOI has records reflecting the subsequent monitoring of assessment and corrective orders. Contrary to the inference of the Audit Report other means available to the DOI are and will continue to be relied upon for compliance and to address hazardous conditions as they arise. These include testing analysis, stipulation and consent orders, meetings with the service companies or Pools to discuss options, information requests, telephone conferences, examinations and correspondence with the service company or Pool addressing issues and suggesting corrective actions. The records of the Department indicate that such efforts were made in the case of at least three Pools and as early as 1993, prior to issuance of Corrective Orders or assessments. Prior to 2001, and in the absence of statutory authority to require compliance with Corrective Orders the DOI attempted to use such orders to achieve obviously needed changes in the hope that the actions ordered would be agreed upon. In the absence of other viable remedies, this was a last resort. In most cases, the corrective orders were in fact uncontested. According to records in the files or our actuarial section, the DOI even considered the levy of fines, at some time prior to 1998, but was unsuccessful for the reasons set forth above under **"Regulation and Authority of the DOI".** Nevertheless, the form of penalties allowed under the law today is more often than not an all or nothing proposition. That is, there is still a lack of flexibility in the enforcement powers allowed to the DOI. Trustees and Administrators realize full well that it is unlikely that a Court will permit us to revoke authority or liquidate these entities on the basis of untimely filings, poor record keeping, or technical violations of previously issued orders. The current situation permits those responsible for the operations of the Pool's and service companies to avoid the threat of civil

	penalties to which those responsible for the operations of standard insurers are subject. The DOI strongly suggests that, at minimum, the legislature should subject both Trustees, Pool administrators and service companies to the civil forfeiture remedy provided for by Section 403A of the Illinois Insurance Code.
	AUDITOR COMMENT: Although the Department "strongly suggests" to the auditors that the legislature should subject pool trustees and administrators to civil forfeiture, the Department did not provide any documentation to show that they have taken any action to make such a suggestion to the General Assembly in the form of legislation.

Chapter Five

LIQUIDATION PROCESS

CHAPTER CONCLUSIONS

The process for liquidating the four group workers' compensation self-insured pools is ongoing and will not be completed until at least some time in 2003. As of July 2002, OSD had not completed the review of proofs of claim for three of the four pools. The last bar date (date to return a proof of claim) passed in March 2002. The last date to file evidence in support of a contingent claim against the four pools is March 2003 (contingent claims due date). At the time the liquidation orders were entered against the four pools, there were a total of 628 claims for $18,128,552 outstanding or an average claim amount of $28,867.

According to OSD, there is an estimated $18 million in claims related to these four pools. In addition, as of June 30, 2002, a total of $3,120,918 in expenses and claims payments had been incurred by OSD in administering the pools while in receivership. OSD has issued $15,923,416 in assessments and collection notices to the four pools in liquidation. However, only $4,547,028 had been collected (29%) as of July 2002. As of June 25, 2002, the combined assets of the four pools, including assessments collected and expenses paid while in receivership, was $4,187,701.

The Group Workers' Compensation Pool Insolvency Fund as of June 30, 2002 had a balance of $152,051 and outstanding claims of $1.1 million. DOI has levied an additional assessment to two of the four pools in liquidation and to the remaining solvent pools; however, most of the pools protested the assessment and litigation is ongoing. We reviewed the semi-annual statutory assessments and recommended that DOI consider whether the statutory percentage of semi-annual assessment paid by the pools should be increased to raise the Fund's balance. We also recommended that DOI ensure that each pool is paying the correct amount of semi-annual assessment and that it is collected in a timely manner.

Although court ordered receivership has resulted in the collection of additional assessments, it has not been successful in making the pools viable again. All four of the pools that entered receivership (conservation or rehabilitation) in 1999 and 2000 are now in the process of liquidation. Two of the four pools did not go through all three steps in the receivership process. The Illinois Electrical Employers Workers' pool was ordered directly into rehabilitation and skipped conservation while the Illinois Environmental Services Workers' Risk Management Association was ordered from conservation directly to liquidation without an attempt at rehabilitation.

COURT ORDERED CORRECTIVE ACTIONS

If DOI finds that the financial condition of a pool is hazardous the Director can, through the Illinois Attorney General's Office, seek a court order of conservation or rehabilitation prior

to a court order for liquidation. These receivership proceedings are handled by the Director, who is assisted by the Office of Special Deputy Receiver (OSD).

Office of Special Deputy Receiver

The Director of the Illinois Department of Insurance is empowered to act as the conservator, rehabilitator, and liquidator of Illinois insurance companies (or group workers' compensation self-insured pools) found to be operating in a manner detrimental to the interest of the policyholders, creditors, or the public. The Office of Special Deputy Receiver (OSD) is an entity that is authorized by statute to assist the Director of Insurance in his capacity as receiver of insurance companies. Under 215 ILCS 5/202, the Director may appoint special deputies to assist in fulfilling his responsibilities when an insurance company (or workers' compensation pool) enters receivership. The Director may also hire accountants, actuaries, attorneys, and others to assist in these responsibilities.

OSD is notified when the Department determines that an insurance company or pool is in need of receivership. The Attorney General petitions the court to appoint the Director of Insurance as the receiver, as specified in statute. Once the court signs the order, the Director may appoint a special deputy and retain OSD to assist him.

OSD plays a role in the three stages of receivership: conservation, rehabilitation, and liquidation. Conservation is usually the first stage in the process. During conservation, the Director tries to save the company or determine if rehabilitation or liquidation is necessary. The company may continue to pay claims and temporary disability to injured workers.

If during the conservation process a determination is made that the company is insolvent, then the rehabilitation process may, if appropriate, be attempted. Under rehabilitation, the Director takes title to and begins running the company. Certain hardship claims and temporary disability may be paid during rehabilitation.

If the rehabilitation steps taken are unsuccessful, the company enters the liquidation stage. Once a company enters liquidation, OSD closes the company and stops paying any claims. The Director assesses the company's outstanding claims and determines what assets are available to pay them. For the workers' compensation pools, the only real assets available are the premiums paid by pool members and the assessments of pool members that are collected under the pooling agreements. Statutes specify an order for which debts have priority and will be paid first. OSD personnel are paid for their time on workers' compensation pools directly from the remaining assets of the pools. OSD officials stated that it is very rare for a company to make it out of receivership as a viable company.

Companies or pools in liquidation generally start out in conservation. Some may proceed to rehabilitation before being placed into liquidation depending on their financial condition. However, it is possible that a company may skip a stage. Two of the four pools currently in liquidation skipped corrective steps in the receivership process. The Illinois Electrical Pool was never issued an order of conservation. The Illinois Environmental Services Pool went from conservation to liquidation without an attempt being made at rehabilitation. OSD officials stated that the Illinois Environmental Services Pool was the last one to go into receivership and by the

time it went into conservation, it was clear that rehabilitation would not be possible given its financial condition, so the Director decided to go right to liquidation. As for Illinois Electrical, officials at OSD stated that by the time the pool entered receivership, it had barely enough assets to pay claims and weekly temporary disability payments. Therefore, the Director determined that it should proceed straight to rehabilitation.

Exhibit 5-1 shows a breakout of the claims for each of the four pools based on the initial claims data obtained by OSD at takeover. The takeover data shows that there were more than 600 claims for a total of over $18 million at that time. According to OSD officials this is the most accurate estimate of the total claims liability of these pools.

Exhibit 5-1
CLAIMS BY POOL
At OSD Takeover

	BYRMA	IL Electrical	IL Environmental	IL Earth Care	Total
Total Number of Claims	203	25	128	272	628
Total Dollar Amount of Claims	$6,556,907	$1,150,862	$3,781,331	$6,639,453	$18,128,552
Average Claim Amount	$32,300	$46,034	$29,542	$24,410	$28,867

Note: Totals do not add due to rounding.

Source: OAG analysis of DOI data.

LIQUIDATION PROCESS

Once a company or pool has been placed in liquidation, there are many steps before the final liquidation and claims are paid. OSD has an established liquidation process, some of which is specified in statutes, for all insurance companies, including the group workers' compensation self-insured pools. Exhibit 5-2 is a flowchart that illustrates the various processes and stages that occur during the liquidation process.

Prior to the four pools being ordered into liquidation, OSD had never used its established liquidation process for liquidating a group workers' compensation self-insured pool. There are several differences between liquidating these pools and regular insurance companies. First, insurance companies are generally required to maintain at least a $1.5 million minimum surplus. According to DOI officials, as of January 1, 2001, the pools are required to have at least a $0 balance. The statutes now require that the assets possessed by the pool cannot be less than the reserves required together with any other unpaid liabilities (215 ILCS 5/107a.14). Before that time, the reserve balance could have been negative. Second, most insurance companies have some significant assets; either real property or investments that can be converted to cash to help in paying existing claims. The pools currently in liquidation had no real property and most have very little cash or investments. Third, insurance companies have guaranty funds from which

claims can be paid if there are insufficient funds to pay all the existing claims. Although there is an insolvency fund for the pools, it is not the same cushion that insurance companies have.

Claimants who are not paid or are only paid a portion of their claims may receive compensation from the Group Workers' Compensation Insolvency Fund, provided there are sufficient funds.

At the time of the liquidation order, the court also sets two important dates: the bar date and the contingent claim cut-off date. The bar date is usually a year from the date of the liquidation order. It is the last date that a proof of claim can be submitted and be considered a timely claim under the statute for eventual payment. The contingent claim cut-off date is usually a year after the bar date. It is the last date that a contingent claim can be liquidated. A contingent claim means that the total liability had not been established at the time the claim was filed against the estate.

After the liquidation order is obtained from the court, the Director takes control of the company and stops paying claims. An attempt is made to identify all potential assets of the company, including hidden assets. According to OSD officials, the pools had few assets other than the premiums collected from members. The Director may also file suit for the recovery of assets. For example, the Director filed suit against the members of a group workers' compensation pool to collect assessments levied to help increase the pools' assets.

The four pools currently in liquidation with OSD have all signed administrative service agreements with the same third party administrator to assist in the liquidation process. These agreements allow the administrator to perform administrative functions, manage the daily business of the pool, administer claims, and keep books and records. These services are being provided at no cost to the pools currently in liquidation or DOI. This administrator is also currently the third party administrator for several of the remaining group workers' compensation self-insured pools which are being assessed by the Insolvency Fund to pay for outstanding claims of the four pools in liquidation. These services are usually performed by OSD. Since these services are being provided for free it should decrease the cost of liquidation for these pools.

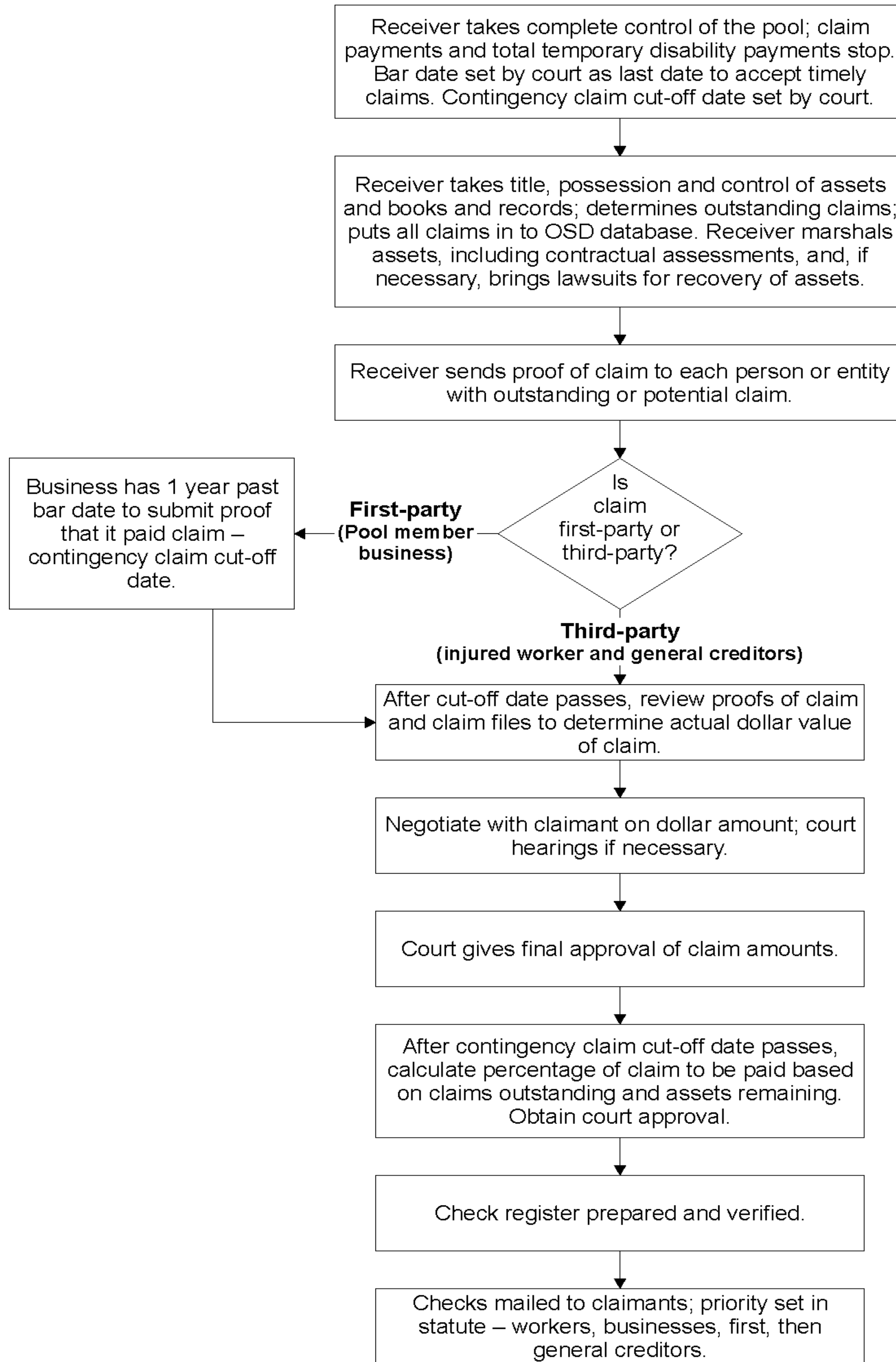
Claim Identification

Once the pool or company enters liquidation, OSD takes possession of all of the company's existing claims. OSD uses both manual and computer processes to determine all potential claims and sends a proof of claim to all those who have claims that have not been paid.

These proofs are mailed to all potential creditors of the estate including first-party loss claimants (insured, which is the employer) and third-party loss claimants (injured worker, defense attorneys, and other general premium creditors).

To establish a claim on the estate's assets, claimants must return properly signed and notarized proofs to OSD before the bar date. However, only the proof of claim has to be filed by the bar date. All the evidence supporting the claim does not have to be submitted at that time. Sometimes the claimant will go ahead and submit it with the proof. The statute does not set a time limit on an injured worker submitting evidence of a claim; it can be submitted up until the date the claim is fixed by the court.

Exhibit 5-2
LIQUIDATION PROCESS FLOWCHART



Source: OAG analysis of OSD process.

Until the bar date passes, OSD does not get into the claims evaluation and adjudication process. The staff will not begin to evaluate the individual claims until they know which claims have a valid proof submitted.

The deadline for filing evidence for a contingent claim is usually two years after the entry of the order of liquidation, which is a year from the bar date. This means that, essentially, employers who have paid medical or other expenses for an injured worker after the pool went into liquidation have another year to submit the proof in order to be reimbursed during liquidation. This deadline can be extended at the discretion of the Director of Insurance by submitting a petition to the supervising court and obtaining an order specifying a new deadline.

Claim Evaluation/Adjudication

Once the bar date has passed, OSD begins to examine the proofs of claim that were submitted by the deadline. The claim examiner inspects the facts of the claim to determine the following damage issues: type of injury; degree of injury; likelihood of recovery; future loss of skill; and medical expenses related to the claim. The examiner makes a recommendation on the claim and OSD may negotiate with a claimant based on the recommendation. When all the negotiation is finished, the claim is submitted for final approval to the court.

OSD began the claim evaluation phase after the bar dates passed for the pools in liquidation. However, as of July 2002, the claims review had only been completed for one of the four pools. As discussed earlier, a pool administrator is providing staff to evaluate the claims at no cost. The pool administrator recommends a dollar amount each claimant should be paid based on the value of the claim. If the claimant disagrees with the recommendation, a court hearing can be scheduled to argue the facts and determine the appropriate amount.

Asset Distribution

After the court has approved the amounts recommended for each claim, OSD determines a final distribution amount. If there are sufficient funds, then each claimant receives the amount approved by the court. If not, then a percentage is determined so that each claimant receives a percentage of his or her claim.

The statutes contain a priority for paying claims during a final distribution. Some claims are considered a higher priority and thus get paid first. Exhibit 5-3 shows the listing of the priority of creditors when liquidating an insurance company or pool. Most workers' compensation claims for the pools are included in the "d" statutory category.

OSD Funding

Statutes specify that the funding for salaries and expenses for the special assistants hired by the Director is to be taken from the assets of the companies in receivership. State funds may be used to pay the expenses, but any amounts paid from State funds are to be reimbursed from a company's assets.

Exhibit 5-3 shows that administration expenses are the highest priority in the statutes. Therefore, costs of administration will be the first priority to be paid out of a pool's remaining funds. If the cost for administering the pools uses up all a pool's funds, there will be no funds to pay claimants. In these cases the claimants would have to go to the Insolvency Fund for payment.

Exhibit 5-3
ESTIMATED COST AND PROOFS OF CLAIM BY CATEGORY
As of July 2002

Statutory Category of Asset Distribution	**Expenses Reported by OSD**	**Total Claim Amount**	**# of Claimants**
(a) The costs and expenses of administration (including OSD reported expenses for salaries, legal fees, loss and loss adjustment expense, rent etc...)	$3,120,918	N/A	N/A
(b) Secured claims, including claims for taxes and debts due the federal or any state or local government.		$0	1
(c) Claims for wages actually owing to employees for services rendered within 3 months prior to the date of the filing of the complaint.		$0	0
(d) Claims by policyholders, beneficiaries, insureds and liability claims against insureds covered under insurance policies and insurance contracts issued by the company.		$13,097,301	751
(e) Claims by policyholders, beneficiaries, and insureds, the allowed values of which were determined by estimation.		$0	0
(f) Any other claims due the federal government.		$0	0
(g) All other claims of general creditors not falling within any other priority (i.e. claims for attorneys' fees, taxes and debt due to State and local government, and claims by doctors and hospitals).		$741,893	482
(h) Claims of guaranty fund certificate holders, guaranty capital shareholders, capital note holders, and surplus note holders.		$0	0
(i) Proprietary claims of shareholders, members, or other owners.		$0	0
Unknown		$784	3
Total Outstanding Costs to Pools in Liquidation as of July 23, 2002	$3,120,918	*$13,839,978	1,237

Note: *As of July 2002, OSD had not yet completed the review of all proofs of claim. Therefore, the data contained numerous claims with a $0 amount because the claim had not yet been settled. According to OSD officials, the total claims for the four pools are estimated to be $18 million.

Source: 215 ILCS 5/205 and OAG analysis of OSD proof of claim data as of July 23, 2002 and court reports as of June 30, 2002.

Liquidation Process

According to OSD, there is an estimated $18 million in claims related to the four pools that are currently in liquidation. As shown in Exhibit 5-3, as of July 2002, adjudicated claims totaled $13.8 million. As of July 2002, the review of proofs of claim had only been completed for one of the four pools. Each pool also has a

contingent claims cut-off date that must pass before liquidation can be completed. The last bar date (date to return a proof of claim) passed in March 2002. The last of the four pools contingent claim cut-off date is in March 2003. As of June 25, 2002 the combined assets for the four pools, including assessments collected and expenses paid while in receivership, was $4,187,701.

OSD has issued $15,923,416 in assessments and collection notices to the four pools in liquidation. However, only $4,547,028 (29%) has been collected as of July 2002. As of June 30, 2002, OSD had disbursed from the four pools' estates a total of $3,120,918 in claim payments and expenses in administering the pools while in liquidation. Exhibit 5-4 shows a detailed breakdown of these costs for each pool. The largest overall costs were for the salaries of OSD employees, loss/loss adjustment expenses, and legal fees and expenses. Loss/loss adjustment expenses represent claim payments as well as expenses associated with the settlement and payment of claims. According to OSD officials, an additional $2,307,829.92 in installment settlements have been negotiated and are being paid over time.

Exhibit 5-4
COSTS CHARGED TO POOLS
As of June 30, 2002

Expense	BYRMA	IL Electrical	IL Environmental	IL Earth Care	Total
Salaries and Compensation	$ 459,499	$ 95,401	$ 167,760	$ 309,593	$ 1,032,253
*Loss/Loss Adjustment Expense	856,498	592	22,153	4,012	883,255
Legal Fees and Expenses	306,315	63,823	10,667	371,145	751,950
Consulting Fees	141,699	1,258	467	1,315	144,739
Rent and Rent Items	55,172	11,066	23,096	36,558	125,892
Other	83,351	9,765	39,981	49,732	182,829
Total	**$1,902,534**	**$181,905**	**$264,124**	**$772,355**	**$3,120,918**

Note: *Loss/loss adjustment expenses represent claim payments as well as expenses associated with the settlement and payment of claims.

Source: OAG analysis of OSD court reports.

INSOLVENCY FUND

The Workers' Compensation Pool Law (215 ILCS 5/107a.13), effective January 1, 2001, established the Group Workers' Compensation Pool Insolvency Fund. Prior to that date, the Group Self-Insurers' Insolvency Fund was effective under the Workers Compensation Act or the

Workers Occupational Disease Act. All funds were transferred from the Group Self-Insurers' Insolvency Fund to the Group Workers' Compensation Pool Insolvency Fund.

The purpose of the fund is to compensate eligible employees when their group workers' compensation self-insured pool is unable to pay compensation and medical service payments due to financial insolvency. As of January 1, 2001, the Department of Insurance (DOI) is responsible for collecting semi-annual assessments for the Insolvency Fund. Prior to that date, the Illinois Industrial Commission had that responsibility.

Statutory Semi-Annual Assessments

The Workers' Compensation Pool Law (215 ILCS 5/107a.13a) requires all qualified group workers' compensation pools to pay a sum equal to .5 percent of all compensation and medical service payments into the Group Workers' Compensation Pool Insolvency Fund. Payments are due on January 1st and July 1st for the preceding six months. The only pools not required to pay this assessment are those in conservation, rehabilitation, liquidation, run-off, or loss portfolio transfer.

DOI sends a letter and transmittal form to each pool. The pools compute the semi-annual assessment amount internally and send their checks to DOI. DOI officials said they do not audit the amount paid by each pool because they cannot compute this amount. DOI officials added that the statutory semi-annual assessment is based on a six-month period and all relevant financial reports are for a one-year period. However, each pool is now required to file monthly or quarterly reports in addition to the annual reports, so DOI should be able to compute the semi-annual assessment amount.

Although the statutes do not specify a specific due date, the semi-annual assessments, in some cases, were not being paid in a timely manner. For example, the semi-annual assessment for the first half of fiscal year 2001 (July 2000 – December 2000) was not paid until at least August 2001 for 20 pools. According to DOI officials, the delay was attributable to the fund transfer and the time required in establishing a new fund. The timeliness of semi-annual assessments for the first half of fiscal year 2002 improved but 61 percent of these assessments were paid 60 days or more after January 1.

The pools paid .5 percent on compensation payments prior to January 1, 2001, but now they pay .5 percent on both medical and workers' compensation payments. Therefore, the pools should be assessed on a greater dollar amount. However, the Insolvency Fund has existed since 1983 and never attained $1,000,000. Exhibit 5-5 shows the Insolvency Fund income and balances for fiscal years 1999 through 2002.

The 1997 Auditor General Financial/Compliance audit of the Illinois Industrial Commission stated that in the event of a significant award, there simply would not be enough money. The Insolvency Fund Balance as of June 30, 2002 was $152,051. The estimated amount of outstanding claims against the fund as of June 30, 2002 was $1.1 million dollars. Some claims have been waiting to be paid since November 2001. As a result, DOI may want to consider requesting legislation increasing the .5 percent statutory semi-annual assessment paid on all compensation and medical payments to a higher percentage.

Exhibit 5-5
INSOLVENCY FUND ANALYSIS
Fiscal Years 1999-2002

Fiscal Year	Beginning Balance	Income Received	Expenditures	Ending Balance
1999	$473,884	$106,031	$0	$579,915
2000	$579,915	$80,790	$0	$660,705
2001 (First Half)	$660,705	$114,998	$0	$775,704
2001 (Second Half)	$775,704	$62,320	$161,890	$676,134
2002	$676,134	$382,472	$906,556	$152,051

Note: The responsibility for collecting the semi-annual assessments was transferred from the Illinois Industrial Commission to the Illinois Department of Insurance effective January 1, 2001. Therefore, the first and second halves of fiscal year 2001 are presented separately. Fund balances may not add due to rounding.

Source: Analysis of OAG financial/compliance audits for the Illinois Industrial Commission and Illinois Department of Insurance and Comptroller data.

INSOLVENCY FUND SPECIAL ASSESSMENTS

The Director of DOI collects and can levy several different types of assessments. As is discussed in Chapter Four, the Director can issue an assessment order to correct the financial condition of a pool. DOI also collects the statutorily required assessment for the Insolvency Fund. The Director can also issue special assessments of pools to pay claims against the Insolvency Fund.

The Workers Compensation Pool Law (215 ILCS 5/107a.14(b)) states that when the Director determines that the compensation and medical services of a pool may be unpaid by reason of the default of an insolvent qualified group workers' compensation self-insured pool, the Director shall declare the qualified group workers' compensation pool to be in default and first levy upon and collect from the individual employer members of the pool in default. As discussed below, this was done for two of the four pools. If the Insolvency Fund has less than a $1 million balance, a pool has been declared in default, and the Insolvency Fund is unable to pay compensation and medical claims, the Director shall levy and collect from all qualified group workers' compensation self-insured pools an assessment to provide the balance necessary to assure payment of claims.

The Director of Insurance ordered several special assessments on December 21, 2001. These special assessments included an assessment of $257,851.27 to members of the Illinois Earth Care pool and an assessment of $82,596.88 to members of the BYRMA pool. Exhibit 5-6 shows that, as of June 30, 2002, DOI had collected $87,843.27, or 34 percent, of Illinois Earth Care's special assessment. DOI also collected $40,318.51, or 49 percent, of BYRMA's special assessment.

Exhibit 5-6
INSOLVENCY FUND SPECIAL ASSESSMENTS AND COLLECTIONS
As of June 30, 2002

Pool	Amount Assessed	Amount Collected	% Collected
Illinois Earth Care	$257,851.27	$87,843.27	34%
BYRMA	$82,596.88	$40,318.51	49%
Remaining Pools	$1,000,000.00	$52,044.00	5%
Total	$1,340,448.15	$180,205.78	13%

Source: OAG analysis of DOI collection information.

In addition, DOI sent a letter to the remaining pools assessing them a total of $1,000,000. As of June 30, 2002, DOI had received $52,044, or 5 percent, of this special assessment. Of the 25 pools, 3 paid their total amounts due, 20 filed for an administrative hearing, and 2 did not pay or request a hearing. At that time, DOI officials said the administrative hearings have not actually begun, but they are in discovery, and their length is indeterminable. DOI officials believe the hearings could take several years to be resolved. In October 2002, the pools obtained a Motion to Stay the administrative proceeding pending before the Illinois Department of Insurance from the Circuit Court because they are challenging the constitutionality of the statute.

INSOLVENCY FUND	
RECOMMENDATION 9	*The Illinois Department of Insurance should:* • *Consider whether the statutory percentage of semi-annual assessment paid by the pools should be increased to raise the fund's balance and seek legislation to assist in preventing future shortfalls; and* • *Ensure that each pool is paying the correct amount of semi-annual assessment and that it is collected in a timely manner.*
DEPARTMENT OF INSURANCE RESPONSE	Prior to 2001 this percentage assessment was applied to indemnity payments, while effective January 1, 2001 this percentage is applied to medical and indemnity payments. Based upon the amount of semi-annual assessments collected to date, this percentage would have needed to be raised from .5% to roughly **8.22%** in order to cover the $18M in insolvencies currently in liquidation. Even guarantee funds put a maximum of **2%** of annual premiums on their assessments. Simply put the Pool's Insolvency Fund cannot be made to function

in a way that protects workers from the current problem while at the same time allowing for continued cheaper coverage. These entities operate under a statutory framework akin to Lloyds of London; one that relies upon the ability to collect various forms of assessments against members and Pools to cover Fund liabilities. But all evidence suggests that, unlike the centuries old Lloyd's market, the ability of the Pools to collect adequate assessments as required is impossible either due to the inability to pay or the reliance upon due process rights to litigation to delay payment indefinitely. Many of the assessment "payers" have gone so far as to file suit to challenge the constitutionality of the very statute that allows them to exist. The DOI has proposed legislation to resolve the immediate funding problems if not future problems. We have discovered no new solutions, but we do not consider it prudent to permit the current Pool's to expand either in number or membership unless and until such solution is found, and would support legislation which so limited new formations and/or sales.

The other Recommendation is that DOI "ensure" that each Pool is paying the correct amount of semi-annual assessment and that it is collected in a timely manner. Fulfillment of this recommendation, assuming it can be done, would require significant DOI personnel time which may be better spent elsewhere. As far as we know, it would require special semiannual audits of claim files by examination staff familiar with workers compensation awards. Based on the amount of business written by the self-insured workers' compensation Pools compared to the rest of the insurance industry the DOI regulates, these entities require an inordinate amount of administrative time already and the DOI simply does not have the staff to accomplish this. We believe that any such recommendation should be accompanied by a fiscal impact statement.

But were the DOI given the authority to impose civil forfeitures, the threat of possible fines and the inclusion of a review of assessment payments in the scope of examinations could prove effective in addressing this problem.

AUDITOR COMMENT: At the exit conference on November 13, 2002, we asked for any documentation showing that the Department had taken steps to introduce additional legislation to correct the perceived "shortcomings" in the law. The Department did not provide any such documentation.

DOI receives regular reports from group workers' compensation self-insured pools that could be used to collect the information

	needed to carry out this recommendation. We do not see requesting and/or reviewing reports that show the amount of claims paid as an overly burdensome or time-consuming process.

APPENDICES

APPENDIX A

LEGISLATIVE AUDIT COMMISSION RESOLUTION NUMBER 121

RESOLUTION NO. 121
Presented by Representative Mautino

WHEREAS, as of December 31, 1999, 26 Group Workers Compensation Self-insured Pools were licensed by the Department of Insurance (the Department);

WHEREAS, Workers Compensation Insurance is required for most employers under the Workers Compensation Act which is administered by the Illinois Industrial Commission (the Commission);

WHEREAS, during the past year, several Group Workers Compensation Self-insured Pools have been placed into liquidation due to insolvency, with deficits of over $15 million;

WHEREAS, for those Self-insured Pools that have been placed into liquidation, payment on compensation claims from injured workers have been delayed; an

WHEREAS, the Director of the Department of Insurance, acting as the Court Appointed Receiver, and by or through one or more special deputy receivers (herein referred to as the Office of the Special Deputy Receiver or OSD), is responsible for overseeing the conservation, rehabilitation and liquidation of insolvent domestic insurance companies; therefor

BE IT RESOLVED, BY THE Legislative Audit Commission that the Auditor General is directed to conduct a management audit of the Department, the OSD, the Commission and any other State agency with regard to their responsibilities pertaining to Group Workers Compensation Self-insured Pools in the State of Illinois; and be it further

RESOLVED that the audit include, but need not be limited to, the following determinations with regard to the Group Workers Compensation Self-insured Pools (Pools) in liquidation:

- What activities are or were undertaken by any State agency to regulated, oversee manage or monitor the Pools;
- What information was available to those agencies concerning the financial condition of the Pools and the frequency, timeliness and comprehensiveness of such information;

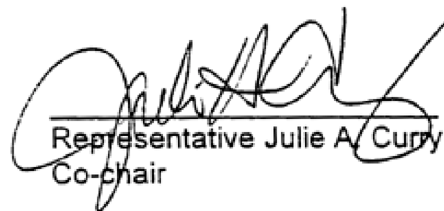
- The process for reviewing financial reports and other information provided by the Pools in the years prior to their default and any actions undertaken by State agencies in response to that information prior to the Pools' insolvencies;
- What methods are available to the State to identify and cure deficiencies in the financial condition of Pools prior to their being placed in liquidation and whether those methods are effective; and
- The process for liquidating insolvent Pools, including asset protection, allocation of losses and payment of claims.

RESOLVED, that the Department, OSD, the Industrial Commission and any other entity that may have relevant information pertaining to this audit cooperate fully and promptly with the Auditor General's Office in the conduct of this audit;

RESOLVED, that the Auditor General commence this audit as soon as possible and report his findings and recommendations upon completion to the Legislative Audit Commission, the Governor and the members of the General Assembly.

Adopted this 26th day of June 2001.

Senator Thomas J. Walsh
Co-chair



Representative Julie A. Curry
Co-chair

APPENDIX B

STATUS OF GROUP WORKERS' COMPENSATION SELF-INSURED POOLS IN ILLINOIS

AS OF JUNE 2002

Appendix B

Status of Group Workers' Compensation Self-Insured Pools in Illinois

As of June 2002

	Pool Name	License Date	Status	Liquidation/out of business date
1	Chicago Midwest Meat Assn. Workers' Comp. Pool	6/26/81	Runoff	
2	Workers' Comp. Trust of Illinois	7/1/81	Active	
3	Consolidated Construction Safety Fund of Illinois	9/22/81	Active	
4	IL Contractors Workers' Comp. Group	12/1/81	Out of business	2/1/85
5	Associated General Contractors of Illinois Selective Self-Insurance Fund	1/1/82	Out of business	12/31/85
6	IL Manufacturers' Assn. of Workers' Comp. Group Self-Insurance Pool	1/1/82	Out of business	12/31/84
7	IL Assn. of School Board Workers' Comp. Pool	2/1/82	Out of business	1/1/84
8	IL Dealers WCT	3/1/82	Out of business	1/1/85
9	Nursing Homes RMA	5/29/87	Active	
10	IL Assn. of Building Maintenance Contractors	2/16/88	Active	
11	IL State Ambulance RMA	10/18/88	Out of business	7/1/97
12	Associated Beer Distributors of Illinois RMA	9/1/89	LPT	
13	IL Movers' and Warehousemen's RMG	12/12/89	Active	
14	McDonald's Operators RMA	1/1/90	Active	
15	IL Press Assn. RMG	12/1/90	Out of business	2/15/97
16	IL Cemetery and Funeral Service WCT	1/22/91	Runoff	
17	IL Aggregate Producers RMA	1/25/91	LPT	
18	Mid-West Truckers RMA	6/14/91	Active	
19	IL State Bowling Proprietors and Recreation WCT	6/28/91	Active	
20	IL Restaurant RMA	8/14/91	Active	
21	IL Environmental Services WCT	12/1/91	Liquidation	3/22/01
22	Associated General Contractors of Illinois RMA	12/12/91	Runoff	
23	Residential Construction Employer's Council RMA	1/1/92	Active	
24	IL Ag. Service WCT	3/6/92	Runoff	
25	Back of the Yards RMA	5/8/92	Liquidation	1/22/01
26	IL Non-Profit RMA	2/24/93	Runoff	
27	IL Earth Care WCT	2/24/93	Liquidation	10/26/00
28	Construction Employers RMA	9/1/93	Runoff	
29	IL Grocers RMA	9/23/93	Runoff	
30	IL Cooperative Workers' Comp. Group	12/17/93	LPT	
31	IL Green Industry WCA	1/3/94	Runoff	
32	Home Builders RMG	1/28/94	Out of business	3/12/96
33	IL Homecare Council WCT	5/25/94	Runoff	
34	IL Electrical Employers WCA	1/25/95	Liquidation	11/3/00
35	Messenger Services of Illinois RMA	8/29/95	Out of business	1/8/96
36	Roofers of Illinois Comp. Trust	9/5/95	Out of business	6/1/98
37	Home Builders Assn. of Illinois WCT	4/1/96	Out of business	3/17/98
38	Peoria Area Chamber of Commerce Trust	12/9/96	Active	
39	IL Lumber and Material Dealers RMA	9/25/98	Out of business	7/1/99

Notes: Runoff includes pools in runoff and those that have ceased writing coverage.
LPT means that the pool has obtained a Loss Portfolio Transfer.

Source: OAG compilation of DOI data.

APPENDIX C

GROUP WORKERS' COMPENSATION SELF-INSURED POOLS PREMIUMS AND SURPLUSES

CALENDAR YEARS 1997 - 2001

APPENDIX C
Group Workers' Compensation Self-Insured Pool Surplus Summary
Calendar Years 1997-2001

POOL NAME	CY 1997	CY 1998	CY 1999	CY 2000	CY 2001
Associated Beer Distributors of Illinois RMA	$1,029,856	$498,180	$298,297	*	$525,659
Associated General Contractors of Illinois RMA	$491,255	($319,040)	Not filed	*	$11,811
Chicago Midwest Meat Assn. Workers' Comp. Pool	$116,439	$141,374	$366,614	$74,185	$63,521
Consolidated Construction Safety Fund of Illinois	$2,554,056	$2,227,412	$1,552,017	$204,173	$15,057
Construction Employers RMA	$129,302	$134,620	$240,697	$254,040	$133,699
IL Ag. Service WCT	$190,419	$156,286	$231,580	$3,784	$28,672
IL Aggregate Producers RMA	$583,288	$752,010	$361,236	$39,880	$0
IL Assn. of Building Maintenance Contractors	$596,995	$682,625	$480,308	$528,957	$621,262
IL Cemetery and Funeral Service WCT	$299,000	$201,293	$220,372	($19,874)	$213,667
IL Cooperative Workers' Comp. Group	($56,511)	$3,389	$83,417	$2,279	$141,711
IL Green Industry WCA	$103,155	($42,262)	$40,425	($454,360)	($1,121,019)
IL Grocers RMA	$51,667	($140,652)	($194,643)	($1,185,265)	($716,379)
IL Homecare Council WCT	$535,492	$593,267	$755,790	$800,872	$766,280
IL Movers' and Warehousemen's RMG	$163,772	$340,979	$347,299	$207,806	$290,854
IL Non-Profit RMA	$30,113	($347,496)	($1,171,056)	($2,018,106)	($3,307,392)
IL Restaurant RMA	$295,908	$355,935	$321,853	$274,158	$205,676
IL State Bowling Proprietors and Recreation WCT	$254,876	$390,115	$465,570	Not filed	$310,585
McDonald's Operators RMA	$146,462	$164,397	$117,319	$149,777	$74,045
Mid-West Truckers RMA	$3,613,730	$3,127,059	$2,145,398	$365,861	$601,783
Nursing Homes RMA	$48,140	$19,999	$81,036	($645,554)	$42,371
Peoria Area Chamber of Commerce Trust	($98,294)	($391,055)	($284,575)	($489,760)	$85,043
Residential Construction Employer's Council RMA	$46,098	$3,282	$277,508	$3,196,008	$5,084,971
Workers' Comp. Trust of Illinois	$330,150	$155,072	$1,129,614	$602,468	$68,738
LIQUIDATED POOLS					
Back of the Yards RMA	($1,179,412)	($2,100,151)	Not required	Not required	Not required
IL Earth Care WCT	$227,069	($1,216,470)	Not required	Not required	Not required
IL Electrical Employers WCA	($69,722)	($128,518)	Not filed	Not required	Not required
IL Environmental Services WCT	$236,137	$170,881	($610,446)	Not required	Not required

Note: * Filed in a different format than what was required.

Source: Annual financial statements submitted to DOI.

APPENDIX D

HISTORICAL SUMMARIES OF POOLS IN LIQUIDATION

Back of Yards Risk Management Association (BYRMA)

Background and Financial History

Back of Yards Risk Management Association (BYRMA) was originally issued a Certificate of Authority by the Illinois Department of Insurance (DOI) on May 8, 1992 to operate a group workers' compensation self-insured pool. BYRMA was derived from Back of the Yards Neighborhood Council, which was founded in 1939. The Council was a not-for-profit organization that worked to improve conditions by establishing crime control programs and enabling Chicago's water to be fluoridated. The fund information included a long list of job classes that could not join, but did not list criteria for acceptable job classes.

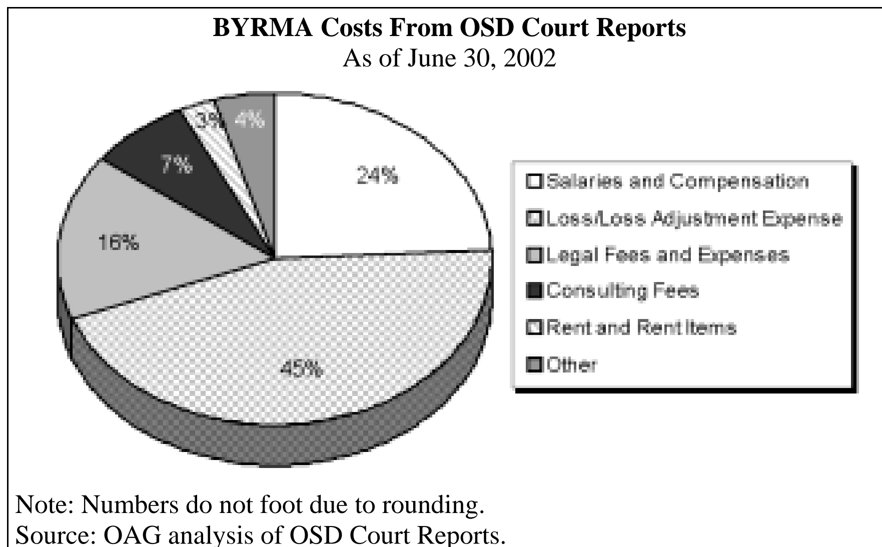
BYRMA Claims at OSD Takeover	
Total Number of Claims	203
Total Dollar Amount of Claims	$6,556,907
Average Claim Amount	$32,300
Source: OAG analysis of OSD data.	

Premiums and Surplus 1995-1999		
CY	Premium Amount	Surplus Amount
1995	$5,111,062	$171
1996	$6,200,880	$30,342
1997	$4,623,803	($1,179,412)
1998	$3,305,044	($2,100,151)
1999	Not filed	Not filed
Source: Annual Financial Statements.		

Chronology	Date
Certificate of Authority	5-8-92
Actuarial Unit Review – The 1995 review discovered that BYRMA had a qualified actuarial opinion due to a low fund balance of $171. This pool also had a negative surplus for the previous two years.	5-23-96
Actuarial Unit Review – The 1997 review found BYRMA had a negative surplus of ($1,179,412) and had not filed an actuarial opinion.	11-30-98
Order of Conservation	4-21-99
Order of Rehabilitation	12-20-99
Order of Liquidation	1-22-01
DOI Financial Examinations	None
Corrective Orders	None
Source: OAG analysis of DOI data.	

The pool included a wide array of members. As of 1995, BYRMA had 150 active companies, ranging from milk distributors to real estate companies. The number of active companies fluctuated greatly during BYRMA's existence. In 1998, there were 306 active employer members in BYRMA with an estimated annual payroll of $139,272,640.

BYRMA Costs From OSD Court Reports
As of June 30, 2002



Note: Numbers do not foot due to rounding.
Source: OAG analysis of OSD Court Reports.

The BYRMA Service Agreement states that BYRMA agreed to pay the pool administrator 17% of its Gross Written Premium. The amount of earned premium increased from CY 1995 to CY 1996, but consistently declined from CY 1996 through CY 1998. The pool had negative surpluses in CY 1997 and CY 1998. BYRMA was ordered into conservation in April 1999 followed by rehabilitation in December 1999. The pool has been in liquidation since January 2001. According to DOI officials, beginning in September 1998, the Department started approving expenses for BYRMA and used a reinsurance risk management service to review the program.

As of June 30, 2002, a total of $1,902,534 had been charged to BYRMA. The largest costs were for Loss/Loss Adjustment Expenses which represents claim payments as well as expenses associated with the settlement and payment of claims. Salaries and compensation accounted for $459,499 and legal fees and expenses accounted for $306,315.

Illinois Earth Care Workers' Compensation Trust (IEC)

Background and Financial History

Earth Care Claims at OSD Takeover	
Total Number of Claims	272
Total Dollar Amount of Claims	$6,639,453
Average Claim Amount	$24,410
Source: OAG analysis of OSD data.	

Premiums and Surplus 1995-1999		
CY	Premium Amount	Surplus Amount
1995	$7,065,542	$267,826
1996	$6,400,014	$289,098
1997	$4,382,376	$227,069
1998	$2,939,168	($1,216,470)
1999	Not filed	Not filed
Source: Annual Financial Statements.		

The Illinois Earth Care Workers' Compensation Trust (IEC) was issued a Certificate of Authority by the Illinois Department of Insurance (DOI) on February 24, 1993 to operate a group workers' compensation self-insured pool. IEC was sponsored by Land Improvement Contractors of America (LICA).

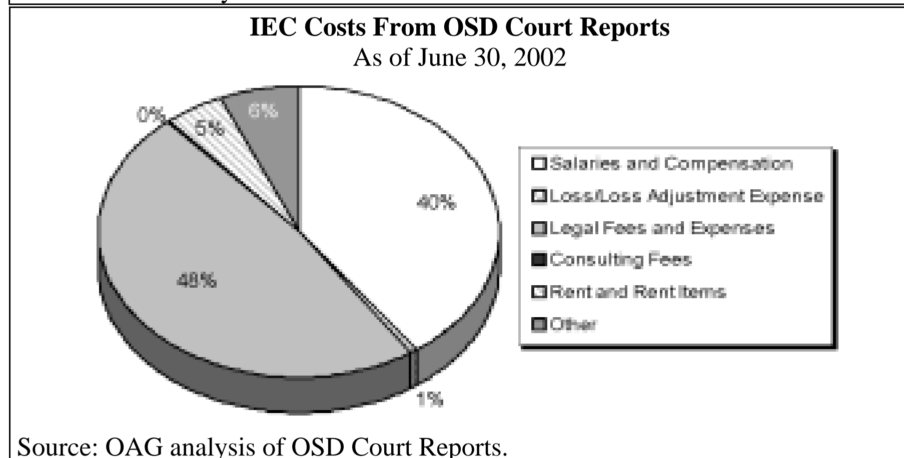
The 30 original LICA classifications included employers in a variety of fields including landscape gardening, concrete work, plumbing, sewer construction, claim adjusters, and clerical office employees. At least one DOI administrator expressed reservations about multiple sponsorship of IEC as far back as 1994. In a response memo addressing these reservations, the pool administrator's attorney stated that "multiple sponsorship is healthy for IEC…In order to ensure the success of the plan, IEC accepted the sponsorship of Earthcare Contractors Coalition (ECC) and Home Builders Association of Illinois." In 1998, IEC reported a total of 163 members and an estimated annual payroll of $55,845,216.

Chronology	
	Date
Certificate of Authority	2-24-93
DOI Financial Exam – The exam for the period December 15, 1992 through December 31, 1993 found IEC's 1993 annual financial statement overstated surplus by $178,004 and raised concerns about the operation of the board of trustees.	6-19-96
RAU Financial Review – The 1997 review noted that IEC auditors reduced the reported surplus by $45,315 to record additional nonadmitted assets.	7-15-98
Actuarial Unit Review – The 1997 review found IEC reserves were deficient by approximately 17%.	12-8-98
DOI Financial Exam – The exam for the period January 1, 1994 through December 31, 1997 found IEC's 1997 annual statement overstated surplus by $1,078,000.	Not filed
Corrective Order	7-26-99
Actuarial Unit Review – The 1998 review found IEC to have inadequate loss reserves. The actuarial unit review commented that the actuary optimistically estimates a redundancy and the pool should assess at least $1.5 million.	8-6-99
Amended Corrective Order	8-12-99
Order of Conservation	8-19-99
Order of Rehabilitation	10-21-99
Order of Liquidation	10-26-00
Source: OAG analysis of DOI data.	

The IEC Service Agreement states that the pool administrator charged 39% of standard premium for administering the pool. The amount of earned premium declined between CY 1995 and CY 1998. The pool had a negative surplus in CY 1998. IEC was ordered into conservation in August 1999 and rehabilitation in October 1999. The pool has been in liquidation since October 2000.

IEC Costs From OSD Court Reports

As of June 30, 2002



Source: OAG analysis of OSD Court Reports.

As of June 30, 2002, a total of $772,355 has been charged to IEC. The largest costs were salaries and compensation and legal fees and expenses, which accounted for $309,593 and $371,145 respectively.

Illinois Electrical Employers Workers' Compensation Association Inc. (IEE)
Background and Financial History

Illinois Electrical Employers Workers' Compensation Association Inc. (IEE) was issued a Certificate of Authority by the Illinois Department of Insurance (DOI) on January 25, 1995 to operate a group workers' compensation self-insured pool. IEE was sponsored by the Professional Electrical Contractors Association of Illinois (PECA).

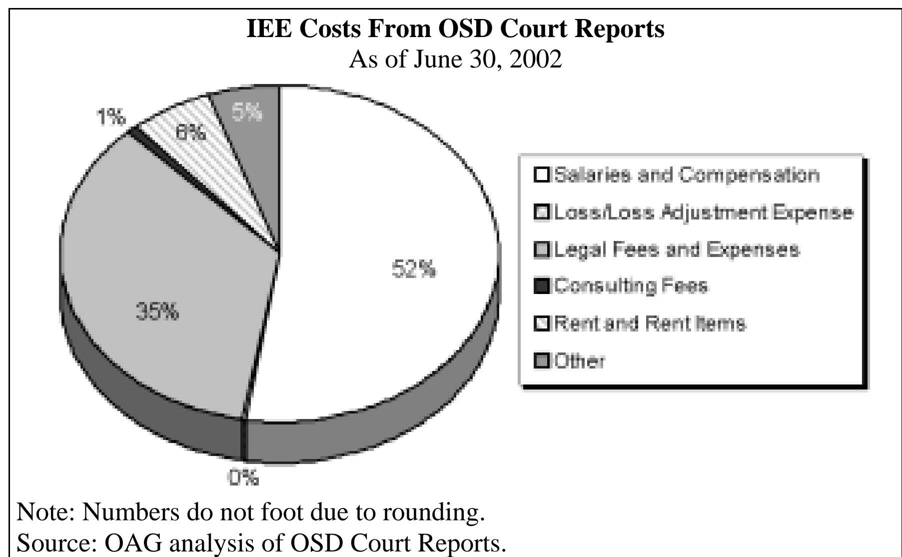
Electrical Claims at OSD Takeover	
Total Number of Claims	25
Total Dollar Amount of Claims	$1,150,862
Average Claim Amount	$46,034
Source: OAG analysis of OSD data.	

Premiums and Surplus 1995-1999		
CY	Premium Amount	Surplus Amount
1995	$174,851	($52,480)
1996	$745,477	($74,837)
1997	$749,053	($69,722)
1998	$432,002	($128,518)
1999	Not filed	Not filed
Source: Annual Financial Statements.		

Chronology	
	Date
Certificate of Authority	1-25-95
Actuarial Unit Review – The 1995 review found IEE had a negative surplus of ($52,480).	5-23-96
Actuarial Unit Review – The 1997 review found IEE had a negative surplus of ($69,722).	11-30-98
DOI Financial Exam – The exam for the period August 1, 1995 through December 31, 1997 discovered IEE's 1997 annual financial statement overstated surplus by $167,946.	Not filed
Actuarial Unit Review – The 1998 review found IEE had a negative surplus of ($128,518). The review also found reserves were inadequate by 20.7%.	8-5-99
Corrective Order	8-26-99
Order of Rehabilitation	12-20-99
Order of Liquidation	11-3-00
Source: OAG analysis of DOI data.	

Correspondence between DOI and the pool administrator illustrates that there was some uncertainty about the initial pool members. Apparently, the first list of members submitted did not meet the minimum $10,000,000 payroll requirement. Consequently, DOI's Corporate Regulation Section sent the pool administrator a letter stating that they would need "evidence that sufficient participants have firmly committed and when they will become pool participants." The pool administrator responded with a list of 13 participants, seven of which were only commitments upon expiration of their existing insurance. The total estimated payroll was $10,373,000. Because these weren't firm commitments, it is difficult to identify IEE's members upon inception and the industries they represented. In 1998, the pool had 18 employer members and a total annual payroll of $14,898,068.

IEE Costs From OSD Court Reports
As of June 30, 2002



Note: Numbers do not foot due to rounding.
Source: OAG analysis of OSD Court Reports.

The IEE Service Agreement states that the service administrator charged 39 percent of standard premium for administering the pool plus a 12 percent charge on paid claims. The amount of earned premium increased from CY 1995 to CY 1996, but declined from CY 1997 to CY 1998. The pool had negative surpluses in CY 1995 through CY 1998. IEE did not go through conservation. The pool was ordered into rehabilitation in December 1999 and has been in liquidation since November 2000.

As of June 30, 2002, a total of $181,905 has been charged to IEE. The largest costs were salaries and compensation and legal fees and expenses, which accounted for $95,401 and $63,823 respectively.

Illinois Environmental Services Workers' Compensation Trust (IES)
Background and Financial History

Illinois Environmental Services Workers' Compensation Trust (IES) was issued a Certificate of Authority by the Illinois Department of Insurance (DOI) on December 1, 1991 to operate a group workers' compensation self-insured pool. IES was sponsored by the Illinois Association of Environmental Service Companies. The pool was composed of employers in the waste management and environmental services industry. Participants were to be members in good standing of the Illinois Solid Waste Association. In 1998, IES reported a total of 88 employer members and a total annual payroll of $38,837,066.

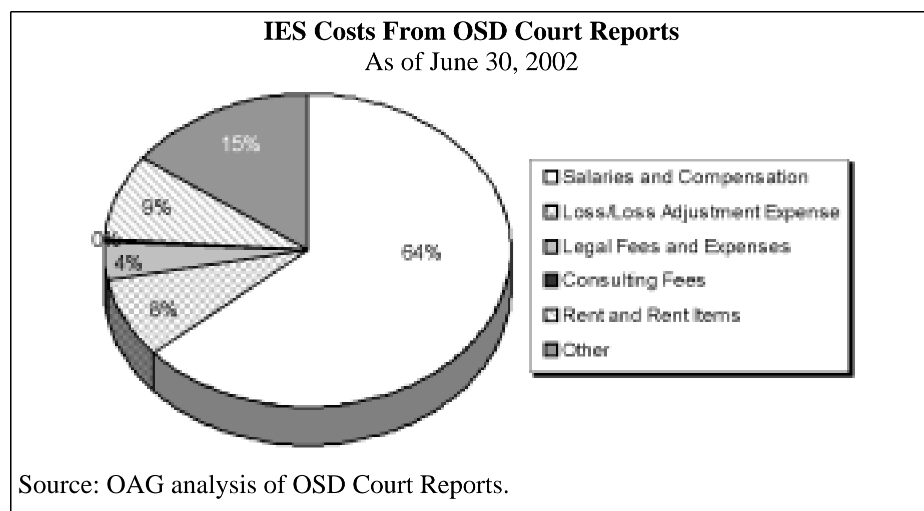
Environmental Claims at OSD Takeover	
Total Number of Claims	128
Total Dollar Amount of Claims	$3,781,331
Average Claim Amount	$29,542
Source: OAG analysis of OSD data.	

Premiums and Surplus 1995-1999		
CY	Premium Amount	Surplus Amount
1995	$4,824,845	($73,859)
1996	$4,362,750	$124,579
1997	$2,005,693	$236,137
1998	$1,626,231	$170,881
1999	$1,400,860	($610,446)
Source: Annual Financial Statements.		

Chronology	Date
Certificate of Authority	12-1-91
Actuarial Unit Review – The 1995 review stated that IES had a negative surplus of ($73,859).	5-23-96
DOI Financial Exam – The exam for the period November 1, 1991 through December 31, 1993 found the surplus to be reasonably stated at $58,377 in IES's 1993 amended annual financial statement.	6-19-96
RAU Financial Review – The 1997 review noted that IES auditors reduced the reported surplus by $44,175 to record additional nonadmitted premium receivable.	7-15-98
DOI Financial Exam – The exam for the period January 1, 1994 through December 31, 1997 found no surplus misstatement at $236,137 in IES's 1997 annual financial statement.	Not filed
Corrective Order	2-23-00
Order of Conservation	7-31-00
Order of Liquidation	3-22-01
Source: OAG analysis of DOI data.	

According to a July 26, 2000 fax, a Senior Claims Adjuster for the pool administrator embezzled $341,340.54. The embezzlement according to DOI officials took place from June 1998 through August 1999. The case was reported to law enforcement officials in June 2000 prior to receivership. According to DOI officials, following receivership the liquidator recovered all but the amount loss, less a deductible amount under a crime or fidelity policy held by the pool administrator.

IES Costs From OSD Court Reports
As of June 30, 2002



Source: OAG analysis of OSD Court Reports.

The IES Service Agreement states that the service administrator charged 39% of standard premium for administering the pool plus a 12% charge on paid claims. The amount of earned premium declined between CY 1995 and CY 1999. The pool had a negative surplus in CY 1995 and CY 1999. IES was ordered into conservation in July 2000 but there was no attempt made at rehabilitation. The pool has been in liquidation since March 2001.

As of June 30, 2002, a total of $264,124 has been charged to IES. The largest cost was salaries and compensation that accounted for $167,760.

APPENDIX E

AGENCY RESPONSES

Note: The Illinois Department of Insurance's responses appear on the left-hand pages. The right-hand pages contain Auditor Comments that respond to issues raised by the Department.

STATE OF ILLINOIS
DEPARTMENT OF INSURANCE
320 WEST WASHINGTON STREET
SPRINGFIELD, ILLINOIS 62767-0001

RECEIVED
AUDITOR GENERAL
SPFLD.

2002 NOV 27 P 3:19

GEORGE H. RYAN
GOVERNOR

NATHANIEL S. SHAPO
DIRECTOR

November 27, 2002

William G. Holland
Illinois Auditor General
740 East Ash Street
Springfield, Illinois 62703-3154

Dear Mr. Holland:

Thank you for your work on the Management Audit of Group Workers Compensation Self-Insurance Pools ("Audit"). We appreciate the significant time and effort your staff has put in as well as their sincere efforts to be fair. Although we have and will continue to object to many of the Audit's conclusions, we see this as a respectful professional disagreement. Nonetheless, we still believe that the final report which we received on the afternoon of November 18th contains erroneous inferences and conclusory statements unsupported in either fact or law.

We had the opportunity to present our concerns to your staff during the exit conference held November 13th and some changes were made in the report as a result; however, the report still makes key conclusions based on erroneous or unfair premises.

We appreciate the extension in our response time. While we still have had difficulty responding due to the length of the report and the complexity of the subject matters, we categorize our primary objections as follows:

- The Audit contains no definition, understanding or appreciation for the legal or practical meaning of the term "regulation." There are many forms of regulation covered by the Illinois Insurance Code. The legislation creating Group Workers Compensation Self-Insurance Pools ("Pools") employed the least oversight possible and yet the Audit expects the Department to have applied a rigorous level of scrutiny commensurate with the statute governing the regulation of admitted insurance carriers.

- The Audit fails to disclose or discuss the significance of the creation of these Pools as "self-insurers," nor does it recognize the status of "self-insurers" as distinct from "insurers."

AUDITOR COMMENTS

Auditor Comment:
Our audit work took place over a period of 16 months during which the auditors met more than 17 times with Department representatives and conducted an extensive review of Department documentation. The result – this audit – does not contain "erroneous inferences." It does, however, contain statements and those statements are adequately supported.

Auditor Comment:
Neither the audit nor the auditors had any expectations of the Department other than those stated in the law and, where applicable, we have cited the law in support of our conclusions.

Auditor Comment:
The audit report discusses the significance of pools being self-insured and recognizes that self-insurers are different from other insurers (pages seven and eight and throughout Chapter Five). Notwithstanding these differences, however, we found that the Department did have certain statutory responsibilities over the group workers' compensation self-insured pools and those responsibilities are the subject of this audit.

- The Audit infers a level of statutory authority to "regulate" these Pools both before and after 2001 which has never existed.

- The Audit fails to consider the absence of resources that would be necessary to "regulate" these Pools as "insurers." These Pools provide coverage for ¼ of 1% of the insurance market in Illinois.

- The Audit infers that Pools can be "regulated" so as to "ensure" solvency.

The statute authorizing these pools, passed during an extraordinary availability/affordability crisis, is specifically intended to allow participating employers to obtain coverage that is cheaper than the regular market because of the minimal regulatory oversight. To analyze the insolvencies of the pools as if they were admitted insurance companies misses the intent of the statute and ignores the public policy tradeoff at the heart of the legislation. It is impossible to have both the benefits of cheaper, more available coverage created by the statute while also maintaining the same level of regulatory protection for employees and workers as exists in the regular market. By holding the Department responsible for what amounts to full regulation of the pools without the necessary tools, this report would leave the shortcomings in the statute unchallenged and prevent the legislature from understanding that these deficiencies have arisen before in other areas of insurance regulation, and they will arise again unless they are understood and acted upon.

Background and Introduction

As in the case of the Illinois Health Maintenance Organization Act and Illinois Insurance Exchange Act, the law authorizing Pool's was adopted at a time when the standard insurance market was constrained by both limited availability and price. Many employers large and small found it difficult to obtain workers' compensation insurance coverage.

As with the problems of availability and price in the health insurance industry and the commercial risk property and casualty market the General Assembly responded to the problems in the workers compensation market in a similar way. That response was to authorize a largely unregulated "form" of insurance in the expectation that by reducing the costs and burden of regulation the constraints of availability and unacceptable costs could be addressed. This was principally accomplished by declaring these Pools to be "self-insurers," whose solvency relied upon the power to assess their members rather than on the maintenance of adequate capital and surplus required of standard insurance companies.

This approach to resolving market problems is not new; but has become disfavored in law and practice such that today, standard "insurers" can no longer be organized on an assessment basis or, in the alternative, also are subject to

AUDITOR COMMENTS

Auditor Comment:

While it is unclear what "public policy tradeoff" the Department is referring to, it is clear that the legislators did not intend that the claims of insured workers would go unpaid. Section 1 of the enabling legislation specifically provided that:

"Whenever the Director of Insurance shall determine that the compensation and medical services provided by this Act may be unpaid by reason of the default of an insolvent group self-insurer then the penal sum of the surety bond and/or the securities provided by the group self-insurer are about to become exhausted, the Director shall levy upon and collect from all group self-insurers an assessment to ***assure*** *prompt payment of such compensation and medical services."* (emphasis added)

Auditor Comment:

Since the original legislation was passed in 1980, there have been major changes made to the pooling law in 1983, 1995, and most recently in January 2001. If the Department's efforts to obtain legislative changes were not successful and there are still perceived "shortcomings" in the statutes, the Department should attempt to introduce new legislation to rectify these problems. At the exit conference on November 13, 2002, we asked for any documentation showing that the Department had taken steps to introduce additional legislation to correct the perceived "shortcomings" in the law. The Department did not provide any such documentation.

maintenance of adequate capital and surplus. The reasons for this are many. Suffice it to say that in an age wherein individuals and firms see themselves as being members of competitive communities, rather than as cooperative units within a common community; rely largely upon litigation first to protect their interests; and assume that government will provide a bail-out when all else fails, assessment based insuring mechanisms are a prescription for trouble should a shortfall occur.

A similar approach produced intractable solvency problems in respect to the health insurance and large property and casualty insurance markets. There the once minimally regulated HMO and Insurance Exchange markets have been brought in line with accepted standards of insurance regulation, in large measure because of failures very similar to those now presented by the present Pools.

The passage of time has proven that simply labeling an "insurance business" as an "HMO," or an "Exchange," or as "Self-Insurance" and granting it license to operate without all the same protections against failure as have been found necessary and reasonable for the operation of normal insurance companies simply leads to more insolvencies rather than fewer. In the time permitted, we will attempt to address the above deficiencies we see in the Audit and Recommendations.

Regulation and Authority of the DOI

The Pools were clearly established to be minimally regulated entities. This is obvious based on any comparison of their enabling legislation to that of the numerous other types of entities subject to the jurisdiction of the DOI. The Illinois insurance laws provide for a broad range of "regulation" by the DOI, **but the legislature has never granted the DOI the authority to employ all, or even the most important, "regulatory" tools with respect to "self-insurers."** Invariably where it has authorized the creation of a special "self-insurance" mechanism, it has limited the normal regulatory authority otherwise applicable to standard insurers.

For example, the Religious and Charitable Risk Pooling Trust Act [215 ILCS 150/1, et seq.] was enacted with minimal regulatory oversight limited to licensing, rulemaking, and examination authority in the DOI [see, P.A. 80-530]; and intergovernmental risk Pools are authorized subject only to rulemaking and audit filing requirements [5 ILCS 220/6]. The Pools authorized under the former 820 ILCS 305/4a were no exception in that the DOI was given limited licensing, rulemaking, and only partial examination authority. [P.A. 81-1482]

By comparison to standard insurers subject to the entirety of the Illinois Insurance Code, even today the DOI has no effective ability to revoke the license, penalize or enforce its will on such entities short of a receivership. In most cases the laws do not even contemplate, or make reference, to a power to

AUDITOR COMMENTS

Auditor Comment:
DOI had authority to regulate the pools dating back to 1980, well before the four pools were placed into liquidation, both preventative and curative. Provisions either in statute or rule have, for example, allowed DOI to:

- obtain financial information,
- require loss reserves,
- monitor/audit loss reserves, and
- order assessments on members of all pools.

In addition, beginning in July 1995, the Department was required to conduct examinations of all group workers' compensation self-insured pools at least every five years.

Auditor Comment:
Effective January 1, 2001, under Article XXIV of the Insurance Code, the Director of Insurance can revoke a pool certificate of authority and levy monetary penalties. If the Department concluded that they have "no effective ability to revoke the license, penalize or enforce its will on such entities short of receivership" then the Department should seek a legislative remedy to rectify this problem.

revoke a license granted. That this minimal regulation of Pools was intended is seen on the face of the original enabling legislation. Any analysis of the "management" efforts of the DOI must start there.

In the first instance, it should be noted that the enacting legislation, P.A. 81-1482, was not included within the Insurance Code. As a result, the DOI's standard mechanisms of enforcement were not available for the Pools. [see, e.g., 215 ILCS 5/35A-1 through 5/35A-70, 5/43, 5/401.1, and 5/403A, among others which were expressly excluded from the re-codification of DOI authority under 5/107a.4, effective Jan. 1, 2001.] Even the authority to examine the entirety of a Pool's business was omitted from the statute until the adoption of P.A. 89-97, effective July 7, 1995. Prior to that time the DOI's authority to force the examination of Pool records was limited to that which was necessary to audit loss reserves.

Nevertheless, DOI did conduct uncontested examinations of Pools. It did so more frequently than was required and covering a broader scope than simply an audit of loss reserves. The Audit Report verifies that such examinations were done, but then infers that such examinations were untimely. Further, it fails to acknowledge that had a Pool presented a formal objection, the DOI lacked the basic authority to enforce its desire for such information. Similarly, the Audit Report gives no recognition to the DOI's inability to impose fines, or to issue orders prohibiting technical violations of the standards, guidelines and requirements adopted by its rules, or to remove trustees for misconduct.

Furthermore, the pre 2001 law was explicit in declaring that Pools were to be permitted as "Self-Insurers." Historically, 'self-insurance' has been presumed to be outside the regulatory jurisdiction of the DOI. [see, e.g., Hill et al., v. Catholic Charities, (1st Dist., 1983) 118 Ill. App. 3d 488; 455 N.E.2d 183; 1983 Ill. App. LEXIS 2356; 74 Ill. Dec. 153] "Self-insurance" *(wherein a person or entity subject to a fortuitous risk of harm retains such risk rather than spreading or sharing it with others by means of purchased contracts)* is an activity in which everyone engages to some extent every day. [see, 820 ILCS 305/4a-1, et seq.] **It is customarily and completely unregulated because it simply does not fit the definition of an insurance "company"** under 215 ILCS 5/2(e), or the definition of "insurance" as set forth by Griffin Systems Inc. v. Washburn, (1st Dist., 1987) 153 Ill. App. 3d 113; 505 N.E.2d 1121; 1987 Ill. App. LEXIS 2140; 106 Ill. Dec. 330, and similar cases. The Insurance Code and its regulatory tools are designed to act upon risk spreading insurance companies. There are no such risk bearing entities in a self-insured situation.

As a statutory agency, DOI must assume that the legislature's declaration that Pools were to be permitted as "self-insurers" was intended to indicate a limitation on the authority delegated under P.A. 81-1482, as subsequently amended. To construe this use of the term otherwise would amount to either reading the term "self-insurers" out of the statute, or reading it as an equivalent to the term "insurance," neither of which DOI is authorized to do.

AUDITOR COMMENTS

Auditor Comment:

Notwithstanding any differences between "insurance and self-insurance", P.A. 81-1482, which established the authority for employers to form group workers' compensation self-insured pools, clearly provided that the "Department of Insurance shall adopt rules" and that such "rules shall (a) establish standards and guidelines to **assure** the adequacy of the financing and administration of group self-insurance plans" and required the Department, in the event of nonpayment of claims to "levy upon and collect from all group self-insurers an assessment to **assure** prompt payment of such compensation and medical services." (emphasis added)

Moreover, this legislative intent to limit the DOI's authority to "manage" the conduct of Pools is confirmed by the plain language of the pre 2001 enabling legislation, which stated in pertinent part:

§ 820 ILCS 305/4a. [Group self-insurance plans]

Sec. 4a. (1) **The Department of Insurance shall adopt rules *permitting*** 2 or more employers with similar risk characteristics or that are members of a bona fide professional, commercial, industrial or trade association **to enter into agreements to Pool their liabilities under this Act and to Pool employers' liability exposures for the purpose of qualifying as group *self-insurers*.** Such agreements may provide that the Pool shall be liable for 80 percent, and the employer member shall be liable for 20 percent, of the medical benefits due any employee under this Act up to the amount of $5,000. One hundred percent of the medical benefits above $5,000 due to an employee for the same claim shall be paid by the Pool. Any such agreement may also provide that each employer shall be responsible for the first $100 of medical benefits due each of its employees for each injury. The claim shall be paid by the Pool, regardless of the size of the claim, and the Pool shall be reimbursed by the employer for any amounts required to be paid by the employer under the agreement.

(2) The rules shall (a) **establish standards and *guidelines*** to assure the adequacy of the financing and administration of group self-insurance plans, including bonding or security provisions consistent with Section 4 [820 ILCS 305/4], except that the bonding or security provisions shall be subject to the approval of the Director of Insurance; (b) **establish standards**, including but not limited to minimum terms of membership in self-insurance plans, as necessary to provide stability for those plans; (c) **establish standards or *guidelines*** governing the formation, operation, administration and dissolution of self-insurance plans; and (d) **establish other reasonable requirements** to further the purposes of this Section.

(3) Administrative or service agencies which engage in the administration of group self-insurance plans must be licensed under Section 464a of the Illinois Insurance Code [215 ILCS 5/464a].

(4) Every group self-insurer shall, at all times, maintain reserves which are actuarially sufficient, **as determined by the Director of Insurance**, to provide for the payment of all losses and claims incurred, whether reported or unreported, which are unpaid and for which such group self-insurer may be liable, and to provide for the expense of adjustment or settlement of such losses and claims. Furthermore, **the Director of Insurance shall audit, as he deems necessary**, the reserves of group self-insurers to ensure their sufficiency. [820 ILCS 305/4a(1)-(4), as amended by P.A. 83-189, eff. Aug. 31, 1983 ***emphasis added***.]

AUDITOR COMMENTS

Auditor Comment:

Section 4.a.(2) of the pooling law, quoted by the Department on the facing page, clearly gives the Department the responsibility to establish **standards** "to assure the adequacy of the financing and administration of group self-insurance plans," as well as pool membership, formation, and operation.

In their comments, the Department omitted paragraph 5 of Section 1 of the enabling legislation, which further defined the Department's responsibility with regard to the group workers' compensation self-insured pools and states that:

"Whenever the Director of Insurance shall determine that the compensation and medical services provided by this Act may be unpaid by reason of the default of an insolvent group self-insurer then the penal sum of the surety bond and/or the securities provided by the group self-insurer are about to become exhausted, the Director shall levy upon and collect from all group self-insurers an assessment to ***assure*** *prompt payment of such compensation and medical services."* (emphasis added)

The foregoing statute was clear and contained no equivocation. The "rules" which the DOI was authorized to adopt were limited to those "permitting" the employers described to "qualify as group self-insurers." The statute further specified the scope of that rulemaking at paragraph (2) wherein it provided authority to adopt rules containing "standards, guidelines, and requirements" of various types to accomplish the purposes of the law.

Conspicuous by their absence in the original legislation was the delegation of any authority to fully examine, much less to impose corrective orders or penalties based on the conduct of Pools with the sole exception of the discretion to permit. As discussed hereafter, the DOI took a variety of actions to obtain compliance with its statutorily authorized regulations. But what it lacked were enforcement tools suitable to the task and the DOI neither has, nor had, authority to unilaterally create such tools.

In the case of The Northern Trust Company, v. Bernardi, Director of Labor, (1987) 115 Ill. 2d 354, at 365-366; 504 N.E.2d 89; 1987 Ill. LEXIS 149; 105 Ill. Dec. 220, the Illinois Supreme Court traced the history of judicial limitations on the use and abuse of administrative authority and held as follows:

> ***"Our courts have long maintained, however, that an ambiguous statute will not be construed to impose a penalty*** (e.g., Goudy v. Mayberry (1916), 272 Ill. 54, 58; Citizens Utilities Co. v. Pollution Control Board (1972), 9 Ill. App. 3d 158, 165; Mallinckrodt Chemical Works v. Belleville Glass Co. (1890), 34 Ill. App. 404, 412); ***a fortiori, the State cannot extract a penalty where the statute contains not even an inkling of authorization.*** As the appellate court noted in this case, authority for the Director's method of enforcing retroactive rate revisions can only be found by appending to section 1503(A) unenacted language which would limit to 30 days the time in which an employer could pay a retroactive increase and retain full 'wages on which' credit for years following the year for which rates were revised. There is simply no legislative indication that the time for paying retroactive rates should be so limited. While it is true that courts defer to the construction of ambiguous statutes by agencies charged with their administration (Illinois Consolidated Telephone Co. v. Illinois Commerce Com. (1983), 95 Ill. 2d 142, 152), it is 'fundamental that an erroneous construction of a statute by an administrative agency is not binding upon the courts' (Winakor v. Annunzio (1951), 409 Ill. 236, 248). ***Our deference to administrative expertise does not license a 'governmental agency to extend the operation of a statute by administrative regulation. If the act is inadequate the remedy lies with the legislature.'*** P. H. Mallen Co. v. Department of Finance (1939), 372 Ill. 598, 601." (***emphasis added***)

AUDITOR COMMENTS

Auditor Comment:

Prior to the four pools being placed into receivership, the Department was required to promulgate administrative rules and was given the statutory authority to "establish other reasonable requirements to further the purposes of this Section," which included assuring the adequacy of the financing and administration of group workers' compensation self-insured pools.

Auditor Comment:

The Department has had the authority to order pools to assess their members since 1983, and was given authority in the statutes to promulgate rules to establish other reasonable requirements. The Department did not issue an assessment order to a pool until 2001.

These principals are equally applicable to monetary as well as non-monetary penalties. Citizens Utilities Company, v. The Pollution Control Board et al., (1972, 2nd Dist.) 9 Ill. App. 3d 158, at 165-166; 289 N.E.2d 642; 1972 Ill. App. LEXIS 1482; 4 ERC (BNA) 1812.

The Audit Report makes note of the DOI's adoption of rules [50 Ill. Adm. Code 2901] setting forth the standards, guidelines, and requirements authorized. However, it fails to recognize or report on the difference between effective "insurance" regulation and the establishment of standards and requirements for "self-insurers" to be allowed to operate.

Effectively, the DOI had two alternative remedies for violations of its rules under the original legislation. It could attempt to persuade, advise, threaten and cajole; and it could seek to revoke the authority of a Pool's administrator and service company to operate. If the DOI chose the latter remedy of administrator revocation, a "successful" enforcement action would have meant that the underlying Pool exhibiting the violations would have been left without administration and forced into liquidation. In addition any other Pool administered by that service company would be forced into the same situation whether it exhibited violations or not.

Based on DOI's experience in contested enforcement actions and liquidations involving self-insurers as well as standard insurers, such contested efforts would have inevitably brought about the very same insolvencies we have today. The DOI experience in this regard has been no different than that of the other states which, at one time, allowed similar group self-insured entities to operate in their jurisdictions.

Despite this legal context, the Audit Report generally concludes and infers in several places that: ***"The laws and administrative rules regulating group worker's compensation self-insurance Pools contained provisions that gave DOI authority to regulate Pool operations prior to the insolvency of the four Pools."*** [see, Audit Report, Ch. Two, Pool Operations Requirements, 1st sentence.]

For an agency engaged in insurance regulation daily - it is surprising to read that the authority to set *'standards, guidelines and license requirements'* amounts to anything more than a limited registration authority. Nor should such erroneous conclusions be viewed as "harmless" commentary.

The DOI, and thus the State, is currently defending a broad Constitutional challenge to the statutory provisions governing the assessment mechanism provided for funding the Group Worker's Compensation Pool Insolvency Fund (Insolvency Fund) under 215 ILCS 5/107a.14. Other suits have been filed, and more are likely to be filed, wherein the DOI's assessment authority is similarly challenged on grounds, inter alia, that the enabling legislation is vague and

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Auditor Comment:
The facts do not support this statement. The Department filed an order of revocation against the pool administrator for three of the four pools currently in liquidation. This administrator also managed several other pools. The other pools that were managed by this administrator did not go into liquidation, but rather are now either administered by another administrator or are self-administered.

Auditor Comment:
DOI had authority to regulate the pools dating back to 1980, well before the four pools were placed into liquidation, both preventative and curative. Provisions either in statute or rule have, for example, allowed DOI to:

- obtain financial information,
- require loss reserves,
- monitor/audit loss reserves, and
- order assessments on members of all pools.

In addition, beginning in 1995 the Department was required to conduct examinations of all group workers' compensation self-insured pools at least every five years.

unclear or that the DOI could or should have undertaken actions beyond it's statutory authority and somehow "ensured" that the four insolvent Pools remained solvent. The inaccuracies of the Audit Report as evidenced by such commentary, will no doubt be suggested by the Plaintiff's in such suits as "determinative" of their assertions that the assessments ordered under Section 107a.14 of the Illinois Insurance code are "unfair" to them.

The DOI will continue to defend these suits, as well as it's interpretation and administration of the law, as the only viable means of accomplishing the legislative purpose set forth by the Group Workers Compensation Self-Insurance Pool legislation. According to the Audit Report there are over $18.1 million dollars in outstanding claims against the four insolvent Pools. If the DOI fails in this effort to defend Section 107a.14 in such suits there is no viable source of funds for paying such claims to injured workers.

Should plaintiff's use this audit in support of their case and should they succeed in defeating the statute, a court will have to determine whether or not the legislature would have intended the Pools themselves to stand, in the absence of such a funding mechanism. If the statute is found unconstitutional the DOI will have no ability to protect injured workers.

Regulatory Resources and "Ensuring" Solvency

The Audit Report is lacking any meaningful discussion of resources required or the process involved in regulating the solvency of insuring entities. This omission compounds, or may be the cause of, the misuse of the term "ensure" to describe government's role in regulating for solvency.

The solvency of an insuring entity - whether it is denominated as an insurer, self-insurer, HMO or Exchange - depends upon several estimated values, including rates and loss reserves. Insurance is priced and sold to consumers before knowing the actual ultimate cost of the product. Insurance rates are estimated by trending estimated ultimate losses, adding in expenses and profit and contingencies. To determine the final premium, workers' compensation rates are further adjusted with experience modification factors and possibly with schedule rating plans (debits and credits) based upon exposures. Loss reserves are estimated by extrapolating historical development patterns of incurred and paid losses to determine an estimated ultimate loss. These estimates must include any trends in inflation and/or any other economic factors that will impact ultimate payout amounts. Estimated future changes in workers' compensation laws must also be contemplated in the calculation of rates and setting of loss reserves.

Prior to the current insolvencies, the general reserve requirement referred to above reads as follows: *"Every group self-insurer shall, at all times, maintain reserves which are actuarially sufficient, as determined by the Director of*

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Insurance, to provide for the payment of all losses and claims incurred, whether reported or unreported, which are unpaid and for which such group self-insurer may be liable, and to provide for the expense of adjustment or settlement of such losses and claims. Furthermore, the Director of Insurance shall audit, as he deems necessary, the reserves of group self-insurers to ensure the sufficiency." [820 ILCS 305/4a(4), as effected by P.A. 83-189.]

Page 15, paragraph three of the Management Audit Report states, *"Although the statutes contained a general reserve requirement prior to the four pools being placed into receivership, the Department of Insurance did not* ***ensure*** *that every pool had sufficient reserves on an actuarial basis to pay losses and claims."*

This statement from the OAG report makes an erroneous inference concerning the DOI's actions regarding loss reserve adequacies of pools for several reasons, which include:

- Reserves are ***estimates*** of future losses, so it is technically impossible to ***ensure*** reserve adequacy. As stated in the Casualty Actuarial Society's *Statement of Principles Regarding Property and Casualty Loss and Loss Adjustment Expense Reserves, "The uncertainty inherent in the estimation of required provisions for unpaid losses or loss adjustment expenses implies that a range of reserves can be actuarially sound. The true value of the liability for losses or loss adjustment expenses at any accounting date can be known only when all attendant claims have been settled."* For this very reason, the opining actuary provides a range of reasonable estimates. The DOI found some pools' reserves deficient of our point estimate, yet that does not necessarily mean that they were outside a range of reasonable estimates.

- The Department has reviewed the adequacy of loss reserves carried by the pools for many years. A significant amount of time and resources have been spent to obtain accurate and adequate reporting of losses and loss development schedules, so that an actuarial analysis could be performed. Even with accurate reporting, a reliable loss reserve analysis is difficult to perform since the pools write only a small amount of workers' compensation coverage **and lack historical data**. Many of the pools commenced operations in the early to mid 1990's. A pool would have needed to be in operation for several years before a credible reserve analysis could be performed. In fact, the only adequate reserve analysis until that time would have required an individual claims review. The DOI neither had nor has the resources or personnel to perform such a detailed and time-consuming analysis.

- At least as far back as 1995, the DOI has requested the actuarial workpapers of the opining actuary from pools with questionable reserves. This review of workpapers allowed the DOI to determine whether

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Auditor Comment:

The audit report does not make an "erroneous inference" when it reports that the Director did not "ensure" the sufficiency of pool reserves. As contained in the Department's quote from the pooling law in the 1st paragraph at the top of the facing page, State law required that the "Director of Insurance **shall** audit, as he deems necessary, the reserves of group self-insurers to **ensure** their sufficiency." (emphasis added) Four pools were placed into receivership in 1999 and 2000. The Actuarial Unit at DOI conducted reviews of the pools' annual financial statements and actuarial opinions prior to the insolvencies and identified several problems, including concerns about surpluses, reserve deficiencies, and qualified actuarial opinions. These deficiencies were identified as early as 1994 and 1995 for some pools, yet no formal actions were taken by the Department against the pools until July 1999.

Auditor Comment:

If the Department had concluded in the 1990's that it lacked any regulatory authority over self-insured pools, one must question why the Department spent a "significant amount of time and resources" to obtain accurate and adequate reporting of losses to conduct an actuarial analysis of these pools if they thought the analysis would be inaccurate and that they would not be able to take actions to correct a deficiency.

appropriate actuarial methods and assumptions were used. In at least one instance, a pool administrator and appointed actuary for several of the pools were notified of our concerns with their assumptions and resulting actuarial estimates. Subsequent to this notification, the actuary no longer issued opinions for any of the group self-insured workers' compensation pools. Forecast models and loss runs have also been reviewed by the DOI. Even with these reviews being performed, the volatility associated with the workers' compensation self-insured pools' loss reserves is so great that reserve inadequacies are often not foreseeable.

- Moreover, the DOI has, both before and after the statutory changes of 2001, taken all available regulatory actions to address reserve inadequacies. This was, and is, done using a standard review comparable to that permitted today by Section 5/378 of the Illinois Insurance Code, which states in part, *"every such company shall, at all times, maintain reserves in an amount* ***estimated*** *in the aggregate to provide for payment of all losses and claims incurred, whether reported or unreported, which are unpaid and for which the company may be liable..."*

The self-insured workers' compensation Pools are not the only entities facing solvency problems, however. Several significant insolvencies have occurred among workers' compensation insurance carriers in the last several years. Regulators of multiple states scrutinized these insurers in several areas consistent with Audit Report's recommendations for increased regulation of the self-insured workers' compensation Pools, yet the insolvencies still occurred. [see, Exhibit A attached]

If DOI had all Audit Report recommendations in place, would we have been able to forestall insolvencies? It is impossible to state with certainty whether the four self-insured workers' compensation Pool insolvencies could have been prevented. However, if standard insurers subject to the full panoply of capital and surplus requirements, risk based capital requirements, corrective orders, civil forfeitures, and all the other regulatory tools can still become insolvent, then certainly it is highly unlikely that group self-insurance Pools with no cushioning capital whatever can be "ensured" against insolvency by any government agency.

It is unlikely that adoption of the stated Recommendations will prevent further Pool insolvencies. They certainly will not and cannot "ensure" future solvency of these Pools. That is particularly true when the statute continues to lack many of the basic tools of solvency oversight. Indeed, a prior Management Audit – *State Regulation of Insurer Solvency*, 1991, at page 42, the Auditor General concluded: "***The best state regulation cannot prevent all insurer failures, and it is not designed to do so.***"

AUDITOR COMMENTS

Auditor Comment:

The Department first identified problems with these pools in 1994 and 1995. While we will not know whether these insolvencies could have been prevented with the implementation of the audit recommendations, considering the amount of time between identification of the problems and liquidation actions, implementing these recommendations may have, at a minimum, limited the amount of losses experienced by these pools.

Omitted by the Department is the sentence immediately following in the 1991 audit which states that, “A sound system of regulation should be able to detect early warning signs of potential insolvency and move quickly to correct the problems or **limit the damages**.” (emphasis added)

To secure the protections that the Audit Report seeks to afford workers, prudence would dictate that establishing appropriate capital and surplus requirements and risk based capital standards would be the best course to decreasing the potential insolvencies among the Pools. But doing so would require graduated increases in capital over time and would, contrary to the enabling legislation, have the effect of making the pools subject to regulation as standard insurers.

It's the intractable nature of insurer insolvencies in a "free market" which gave rise to the demand for effective guaranty funds. Unfortunately, the Insolvency Fund provided for Pool's was not, and is not, effective to cover the result of past or future insolvencies that are likely to arise. It's reliance on post insolvency assessments, against employers and Pools which operate without capital and surplus sufficient to cover such contingencies is unrealistic and misplaced. Simply put, the Insolvency Fund has neither an **effective funding source**, nor an **effective payment mechanism.**

This "safety net" is also legally inconsistent with the statutes governing insurer liquidations and receiverships in several crucial respects. These inconsistencies preclude the possibility of "early access" to estate funds for use in making payments from the statutory Insolvency Fund. Moreover, there are inconsistencies between the Director's statutory duties and procedures established to resolve claims against the insolvent Pools in liquidation, and the DOI's role as administrator of the Insolvency Fund.

Furthermore, even if all such conflicts, inconsistencies, funding deficiencies and surplus inadequacies could be eliminated overnight, the administration of the Insolvency Fund would still be impossible without the funds and specialized staffing required to adjust the many unpaid worker's compensation claims presented. The enabling legislation has never taken such necessary expenditures into account.

This lack of resources compounds the disproportionate level of staff time required by these Pools, both solvent and insolvent. [see, Exhibit B attached] Unless the Insolvency Fund deficiencies are corrected, it should be understood that allowing the continued formation and operation of such Pools will likely result in a repeat of the current problems.

DOI RESPONSES TO RECOMMENDATIONS

The following are offered as general responses to the Recommendations of the Office of the Auditor General's Management Audit Report. In further response to the specific discussion and details set forth in the body of the Report, the DOI offers the attached **EXHIBIT C – Modifications to October 30, 2002 (first draft) and EXHIBIT D – Modifications to November 18, 2002 (second draft).**

AUDITOR COMMENTS

Auditor Comment:
If there are "conflicts" or "inconsistencies" in the Director of the Department of Insurance's statutory duties as the receiver of insolvent pools that undermine his responsibilities as the administrator of the Insolvency Fund, the Department should seek a legislative remedy as soon as possible.

Auditor Comment:
Exhibit C and Exhibit D are audit report drafts containing the Department's edits and comments. These exhibits, which were the Department's rewrites of the audit report, in some cases, line by line, were not included in the final printed report. These exhibits are available for public inspection at the Chicago and Springfield Offices of the Auditor General.

Recommendation 1:
The Illinois Department of Insurance should ensure that each Pool maintains a board of trustees in accordance with each Pool's trust agreement and should consider promulgating rules that require these boards to file meeting minutes and board resolutions with the Department so that their activities can be better monitored.

DOI Response 1:
The DOI agrees that Pool's should be monitored to determine whether they maintain an active board of trustees consistent with their Pool trust agreements. The DOI currently does this as part of its current examination scopes. Illinois does not require standard insurance companies to file meeting minutes. Therefore, this requirement would be regulating less than **1/4th of 1%** of the insurance market beyond our current authority with respect to standard insurance companies.

Recommendation 2:
The Illinois Department of Insurance should monitor and review the rate setting practices of group workers' compensation self-insurance Pools.

DOI Response 2:
The Department agrees that rates of Pools should be monitored. The DOI currently monitors them internally as part of the financial analysis of Pools as well as in the examination process under the standards of Section 5/456 of the Illinois Insurance Code. Even before 2001, when the DOI was given expanded authority regarding solvency regulation, rates were often taken into consideration.

Although Illinois is a so-called use and file state, i.e., requires no prior approval of such rates, when the actuarial unit became aware of a proposed rate decrease in 1996 by Back of the Yards Risk Management Association, a letter was sent to the Pool stating that their proposed rate decrease was unacceptable to the DOI. DOI also has identified records showing that rates were reviewed for Illinois Electrical Employers' Workers' Compensation Association in 1995, for Illinois Cooperative Workers' Compensation Group in 1993, and for Homebuilders of IL in 1996.

Property and casualty insurance companies across the nation are subject to extensive review and monitoring of rates. Even with this regular and stringent rate regulation, companies become insolvent. For instance, in Pennsylvania, a state which requires prior approval of loss costs, an estimated $1.05 billion insolvency occurred when Reliance Insurance Company was determined financially impaired.

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Recommendation 3:
The Illinois Department of Insurance should review administrative service agreements between the Pools and their prospective administrators for reasonableness of administrative fees.

DOI Response 3:
The DOI agrees that under the current law, such fees can and should be reviewed for approval or disapproval under Sections 141.1 and 141.2 of the Illinois Insurance Code. This review is currently done by internal analysis of filings and as part of the ongoing examination process.

Prior to the existence of authority to disapprove such fees in 2001, at least one such agreement for a Pool administered by E.C. Fackler was reviewed by the actuarial section prior to 1998, as documented by a note from a member of the actuarial section. The current Illinois law requires that these contracts for insurance companies be filed with the DOI, unless they are with "affiliated companies on a "Pooled" funds basis or service company management basis, where costs to the individual member companies are charged on an actually incurred or closely estimated basis."

Recommendation 4:
The Illinois Department of Insurance should promulgate rules that define the term "homogeneous" for Pool membership before issuing any new certificates of authority. DOI should also monitor Pools for members that do not have homogeneous risks.

DOI Response 4:
The DOI is in general agreement with this recommendation and has provided information regarding post 2001 efforts to resolve an issue regarding non homogeneous risks presented by a currently solvent Pool. The circumstance presents the difficulty associated with enforcement. Assuming the Pool does not become insolvent the remedy available is provided by Section 107a.15 of the Illinois Insurance Code which allows the DOI to issue a compliance order. If the order is violated, the Pool would then be considered "hazardous" and ultimately subject to liquidation.

This is a one size fits all penalty, which our experience in receiverships indicates will be very difficult if not impossible to enforce in the absence of an insolvency.

AUDITOR COMMENTS

Auditor Comment:

If, in the Department's experience, it would be impossible to enforce these provisions, we are unaware of any alternative legislative proposals put forth by the Department to rectify this situation.

Recommendation 5:
The Illinois Department of Insurance should ensure that Pools maintain $10,000,000 of gross annual payroll and should promulgate rules that set forth a process to follow in the event that a Pool has less than the required payroll.

DOI Response 5:
The DOI agrees that payroll status must be monitored and does so by written interrogatories to the Pools which showed that the eleven active pools met this requirement. We believe there is little utility in rulemaking to establish a remedy here in that the statutory remedy of Section 107a.15 would already be applicable. [see, also, **DOI Response 4**, above] The DOI suggests that a more flexible statutory authority, including the ability to impose civil forfeitures would be more appropriate.

Recommendation 6:
The Illinois Department of Insurance should take available regulatory actions to ensure that each group workers' compensation self-insured Pool maintains adequate reserves.

DOI Response 6:
Although this recommendation is obviously well intentioned, it is technically impossible to "*ensure*" reserve adequacy. Nor can static dollar values or ranges be assigned as standards. As stated under "**Regulatory Resources and 'Ensuring' Solvency,**" above, reserves are estimates of future losses. As the workers' compensation market changes and as litigation changes, the reserves will also change. Because the workers' compensation Pools are relatively small, have no other lines to counteract bad loss years in the workers' compensation line, and have no positive surplus requirement, one large claim could literally cause an insolvency. Such an instant is impossible to "ensure" against.

Moreover the DOI has, both before and after, the statutory changes of 2001, taken all available regulatory actions to address reserve inadequacies. This was, and is, done using a standard of review comparable to that permitted today by Section 5/378 of the Illinois Insurance Code, which states in part, *"every such company shall, at all times, maintain reserves in an amount* ***estimated*** *in the aggregate to provide for the payment of all losses and claims incurred, whether reported or unreported, which are unpaid and for which such company may be liable..."*

The remedies of revocation of authority and liquidation existed prior to 2001. But in contested circumstances they required a very high burden of proof, and challenges to DOI's legal authority may have been made. Today remedies have been expanded by authority to enter corrective orders and limitations on continued operations – with or without the consent of the deficient Pool. This is significant in view of the DOI's need to rely on Pool records and the difficulties of

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Auditor Comment:
Twelve of the remaining 23 pools that continue to hold a certificate of authority either had less than the $10 million payroll or did not disclose the amount of payroll in their annual statements for the year ended December 31, 2001. Given that these pools still hold a certificate of authority, but have less than the statutorily required $10 million in payroll, administrative rules may be desirable to address this situation. If the Department is suggesting that they need more flexible statutory authority, the Department provided no documentation of legislation proposed to rectify this problem.

Auditor Comment:
The auditor's recommendation merely reiterates the mandate given to the Department directly by the Legislature in 1980. Prior to January 1, 2001, the pooling law required that every group self-insurer maintain at all times reserves which are actuarially sufficient, as determined by the Director of Insurance, to provide for the payment of all losses and claims incurred. It also stated that the Director of Insurance shall audit, as he deems necessary, the reserves of group self-insurers to **"ensure"** their sufficiency.

proof regarding the adequacy of reserves when a Pool's management and independent actuary are prepared to assert that their reserves are adequate.

At least as far back as 1995, the DOI has requested the actuarial workpapers of the opining actuary from Pools with questionable reserves. Forecast models and loss runs have also been reviewed by the DOI. Even with these reviews being performed, the volatility associated with Pool loss reserves is so great that reserve inadequacies are impossible to "ensure" against.

Recommendation 7:
The Illinois Department of Insurance should conduct all required financial examinations and adopt them in a timely manner to comply with statutory requirements.

DOI Response 7:
Records of the DOI indicate that its examinations have exceeded the statutory requirements with respect to their timing in that this regulatory tool was applied prior to the receipt of statutory authority to require full financial examinations by the adoption of P.A. 89-97 which became effective July 7, 1995. Moreover, the only examination reports which were not filed within the 60 day time frame established by P.A. 89-97 were reports on Pools which the DOI believed to be in financial difficulty, and demonstrated anomalous financial information for which adoption was not appropriate.

Also, DOI resources for supervisory review of the reports were also quite limited as has been mentioned previously in this document. Regardless of the reasons for such delays, the pools were made aware of appropriate findings, both major and minor, so corrective action could be taken. It is DOI's view that it is better to take greater time in adopting the exam reports, resulting in a better work product, than to shortcut the process and adopt an inferior or inadequately reviewed report.

In particular the inferences and findings of Exhibit 3-7, at page 41, of the Audit Report are simply incorrect and misleading. The exhibit also shows that 13 final reports were never adopted, however 7 of those reports were not adopted for valid reasons, and the other six exams were terminated so no report was necessary, to wit:

- Seven of the exams from July 1995 – CY 1998 were exams of Fackler pools which were not adopted because DOI brought a revocation action against Fackler as a service company. He ceased doing business in Illinois before the reports could be adopted. Since Fackler no longer existed, adoption of the reports was unnecessary and could not be completed in accordance with statutes.

Auditor Comment:

As a result of issues identified during the audit, DOI recently updated its examination report processing policies and procedures in November 2002. The statutes requiring the exams include specific time frames for filing and adopting examination reports. The statute is reprinted below:

(215 ILCS 5/132.5)
(b) Filing of examination report. No later than 60 days following completion of the examination, the examiner in charge shall file with the Department a verified written report of examination under oath. Upon receipt of the verified report, the Department shall transmit the report to the company examined, together with a notice that affords the company examined a reasonable opportunity of not more than 30 days to make a written submission or rebuttal with respect to any matters contained in the examination report.

(c) Adoption of the report on examination. Within 30 days of the end of the period allowed for the receipt of written submissions or rebuttals, the Director shall fully consider and review the report, together with any written submissions or rebuttals and any relevant portions of the examiners work papers and enter an order:

(1) Adopting the examination report as filed or with modification or corrections. If the examination report reveals that the company is operating in violation of any law, regulation, or prior order of the Director, the Director may order the company to take any action the Director considers necessary and appropriate to cure the violation.
(2) Rejecting the examination report with directions to the examiners to reopen the examination for purposes of obtaining additional data, documentation, or information and refilling under subsection (b).
(3) Calling for an investigatory hearing with no less than 20 days notice to the company for purposes of obtaining additional documentation, data, information and testimony.

Auditor Comment:

Information provided by the Department to the auditors shows that all seven of the examinations were sent to the applicable pools on October 21, 1999 and sent to Springfield for adoption on November 22, 1999. The Department filed an order of revocation against the administrator of the pools on November 4, 1999. However, the administrator did not surrender his license until July 31, 2000, over eight months after the examinations were sent to Springfield for adoption.

- One examination referenced was rescheduled to the next year, so the exam begun in CY 1999 was not conducted at all, but was done in the year 2000 and completed later, within statutory limits.

- Five of the exams referenced as begun in 2000 were related to warrants issued on Fackler pools at the time Fackler was ceasing to do business. The warrants were issued just for the purpose of having an examiner on-site to monitor the pools until a decision could be made on their fate. No exams were actually conducted or intended so no reports were ever prepared.

Moreover, the Auditor General's *Financial and Compliance Audit* conducted for the two years ended June 30, 1999 tested specifically, Workers' Occupational Diseases Act 820 ILCS 305/4a(7). The report states the following on page 130:

> "Tests included, but were not limited to:
> 1. Interviews with Department personnel to determine the activities carried out to comply with the mandates;
> 2. Tests to support the existence of activities as described by the Department personnel; and
> 3. Reviews of applicable reports, files, and transactions to support compliance with mandates.
>
> There were no instances of noncompliance noted."

DOI agrees that financial examinations of insurance entities provide several benefits and provide more insight into whether information that the entity has filed with the DOI is accurate.

Recommendation 8:
DOI should continue to issue corrective orders and assessment orders to Pools in hazardous financial condition. DOI should also monitor the collection of assessments.

DOI Response 8:
The DOI has used and will continue to use all means, including corrective orders and assessment orders, to attempt to alleviate a potentially troubling situation or to address an issue. Moreover, the DOI has records reflecting the subsequent monitoring of assessment and corrective orders.

Contrary to the inference of the Audit Report other means available to the DOI are and will continue to be relied upon for compliance and to address hazardous conditions as they arise. These include testing analysis, stipulation and consent orders, meetings with the service companies or Pools to discuss options, information requests, telephone conferences, examinations and correspondence with the service company or Pool addressing issues and suggesting corrective actions. The records of the Department indicate that such efforts were made in

AUDITOR COMMENTS

Auditor Comment:

According to exam information provided by the Department as of February 14, 2002, this exam was started in September 1999. No other dates were provided. Another exam for the same pool is listed. However, there is a different warrant number and no start date.

Auditor Comment:

Information provided by the Department to the auditors shows that all five of these exams were started in July 2000. It also states that no reports were filed, only internal memos. The administrator of the pools also voluntarily surrendered his license in July 2000. The Department's explanations regarding these examinations were added to the audit report.

Auditor Comment:

The testing performed as part of the financial and compliance audit was a more limited review than was conducted as part of this management audit.

the case of at least three Pools and as early as 1993, prior to issuance of Corrective Orders or assessments.

Prior to 2001, and in the absence of statutory authority to require compliance with Corrective Orders the DOI attempted to use such orders to achieve obviously needed changes in the hope that the actions ordered would be agreed upon. In the absence of other viable remedies, this was a last resort. In most cases, the corrective orders were in fact uncontested. According to records in the files of our actuarial section, the DOI even considered the levy of fines, at some time prior to 1998, but was unsuccessful for the reasons set forth above under "**Regulation and Authority of the DOI**".

Nevertheless, the form of penalties allowed under the law today is more often than not an all or nothing proposition. That is, there is still a lack of flexibility in the enforcement powers allowed to the DOI. Trustees and Administrators realize full well that it is unlikely that a Court will permit us to revoke authority or liquidate these entities on the basis of untimely filings, poor record keeping, or technical violations of previously issued orders.

The current situation permits those responsible for the operations of the Pool's and service companies to avoid the threat of civil penalties to which those responsible for the operations of standard insurers are subject. The DOI strongly suggests that, at minimum, the legislature should subject both Trustees, Pool administrators and service companies to the civil forfeiture remedy provided for by Section 403A of the Illinois Insurance Code.

Recommendation 9:
The Illinois Department of Insurance should (a) consider whether the statutory percentage of semi-annual assessment paid by the Pools should be increased to raise the Insolvency Fund balance and seek legislation to assist in preventing future shortfalls; and (b) ensure that each Pool is paying the correct amount of semi-annual assessment and that it is collected in a timely manner.

DOI Response 9:
Prior to 2001 this percentage assessment was applied to indemnity payments, while effective January 1, 2001 this percentage is applied to medical and indemnity payments. Based upon the amount of semi-annual assessments collected to date, this percentage would have needed to be raised from .5% to roughly **8.22%** in order to cover the $18M in insolvencies currently in liquidation. Even guarantee funds put a maximum of **2%** of annual premiums on their assessments.

Simply put the Pool's Insolvency Fund cannot be made to function in a way that protects workers from the current problem while at the same time allowing for continued cheaper coverage. These entities operate under a statutory framework akin to Lloyds of London; one that relies upon the ability to collect

AUDITOR COMMENTS

Auditor Comment:

Although the Department "strongly suggests" to the auditors that the legislature should subject pool trustees and administrators to civil forfeiture, the Department did not provide any documentation to show that they have taken any action to make such a suggestion to the General Assembly in the form of legislation.

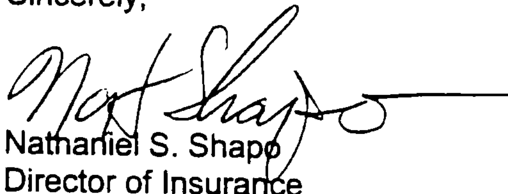
various forms of assessments against members and Pools to cover Fund liabilities. But all evidence suggests that, unlike the centuries old Lloyd's market, the ability of the Pools to collect adequate assessments as required is impossible either due to the inability to pay or the reliance upon due process rights to litigation to delay payment indefinitely. Many of the assessment "payers" have gone so far as to file suit to challenge the constitutionality of the very statute that allows them to exist. The DOI has proposed legislation to resolve the immediate funding problems if not future problems. We have discovered no new solutions, but we do not consider it prudent to permit the current Pool's to expand either in number or membership unless and until such solution is found, and would support legislation which so limited new formations and/or sales.

The other Recommendation is that DOI "ensure" that each Pool is paying the correct amount of semi-annual assessment and that it is collected in a timely manner. Fulfillment of this recommendation, assuming it can be done, would require significant DOI personnel time which may be better spent elsewhere. As far as we know, it would require special semiannual audits of claim files by examination staff familiar with workers compensation awards. Based on the amount of business written by the self-insured workers' compensation Pools compared to the rest of the insurance industry the DOI regulates, these entities require an inordinate amount of administrative time already and the DOI simply does not have the staff to accomplish this. We believe that any such recommendation should be accompanied by a fiscal impact statement.

But were the DOI given the authority to impose civil forfeitures, the threat of possible fines and the inclusion of a review of assessment payments in the scope of examinations could prove effective in addressing this problem.

The Department of Insurance appreciates the effort expended to produce this report of The Management Audit of Group Workers Compensation Self-Insurance Pools prepared by your staff. While we disagree with several of its conclusions and Recommendations, under the circumstances, including the complexities of terminology, accounting, law and voluminous records, the result raises important issues for the consideration of the General Assembly.

Sincerely,



Nathaniel S. Shapo
Director of Insurance

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Auditor Comment:
At the exit conference on November 13, 2002, we asked for any documentation showing that the Department had taken steps to introduce additional legislation to correct the perceived "shortcomings" in the law. The Department did not provide any such documentation.

Auditor Comment:
DOI receives regular reports from group workers' compensation self-insured pools that could be used to collect this information. We do not see requesting and/or reviewing reports that show the amount of claims paid as an overly burdensome or time-consuming process.

EXHIBIT A - Property Casualty Insurance Company Insolvencies/Rehabilitations

- Superior National Insurance –
  - Declared insolvent in 2000.
  - Holding company of 4 failed workers' compensation carriers.
  - Guarantee fund responsible for paying for $1.4B in claims, assuming no reinsurers pick up a portion. It is anticipated that reinsurers will/already are paying (as of 9.24.2001).
- Reliance Insurance Companies –
  - Declared insolvent in 2001.
  - A group of several insurance companies.
  - Multi-state, multi-line group that sold workers' compensation, commercial auto, commercial liability and personal auto coverages.
  - Current estimate of magnitude of insolvency equals $1.05B.
- Legion Insurance Companies –
  - Put into rehabilitation in 2002.
  - Multi-state, multi-line carrier writing workers' compensation, medical malpractice, general liability, group accident and health and property coverages in all 50 states.
- Fremont Insurance Companies –
  - Taken under supervision in 2000.
  - Magnitude of impairment equals $13M.
  - Multi-state carrier of primarily workers' compensation coverage.

Even though the self-insured workers' compensation Pool system is flawed, 11 Pools are still solvent and continue to write business, 9 Pools are voluntarily running off their business, and 3 have made Loss Portfolio Transfers.

AUDITOR COMMENTS

EXHIBIT B - Market Share Chart

	Total IL Premium*	IL WC Premium*	Self Insured WC Pool Premium **	Pool Prem as % of Total IL Prem	Pool Prem as % of IL WC Prem
1990 Earned:	$10,494,564,717	$2,075,666,682	$12,221,000	0.12%	0.59%
Written:	$10,630,161,232	$2,107,305,837			
1991 Earned:	$10,675,311,926	$2,045,079,293	$17,623,000	0.16%	0.85%
Written:	$10,742,125,292	$2,023,114,819			
1992 Earned:	$10,956,481,745	$2,080,667,109	$34,517,000	0.31%	1.63%
Written:	$11,023,991,010	$2,065,110,372			
1993 Earned:	$11,026,221,550	$2,038,788,401	$46,699,000	0.42%	2.24%
Written:	$11,272,027,368	$2,089,628,522			
1994 Earned:	$11,387,503,656	$1,981,427,871	$66,412,189	0.58%	3.24%
Written:	$11,720,749,819	$2,051,117,902			
1995 Earned:	$11,940,449,243	$2,010,123,430	$76,715,019	0.64%	3.68%
Written:	$12,171,125,341	$1,991,476,756			
1996 Earned:	$12,268,532,404	$1,738,216,187	$73,415,270	0.59%	4.05%
Written:	$12,582,342,876	$1,678,080,085			
1997 Earned:	$12,562,975,012	$1,542,908,087	$53,890,702	0.43%	3.37%
Written:	$12,968,809,512	$1,510,290,824			
1998 Earned:	$12,907,527,984	$1,457,614,292	$43,604,503	0.34%	2.90%
Written:	$13,169,170,203	$1,486,074,917			
1999 Earned:	$13,217,697,404	$1,557,471,418	$40,556,870	0.31%	2.54%
Written:	$13,748,262,593	$1,605,054,412			
2000 Earned:	$13,917,744,554	$1,546,650,338	$34,523,485	0.25%	2.18%
Written:	$14,425,030,628	$1,654,266,263			
2001 Earned:	$15,078,066,332	$1,748,291,576	$34,107,688	0.23%	1.91%
Written:	$15,721,370,945	$1,867,535,339			

* The Total IL Premium and the IL WC Premium columns are amounts reported to NAIC from standard insurance companies and do not include Self-insured WC Pool Premium amounts. The amounts shown include property and casualty Illinois premium only.

** The workers' compensation Pool premium for years 1995 and prior are estimates based upon readily available data. Actual premium may or may not vary substantially from this amount. Any difference in the workers' compensation premium, however, will most likely not have a significant impact on the percentage of total Illinois premium it comprises.

AUDITOR COMMENTS

EXHIBIT C – MODIFICATIONS TO OCTOBER 18, 2002 (FIRST DRAFT)

Exhibit C is a copy of the document that was provided by the Department of Insurance (DOI) to the Office of the Auditor General at the Exit Conference held on November 13, 2002 for the Management Audit of Group Workers Compensation Self-Insured Pools.

We have included the attached document for documentation of DOI's review of the October 30, 2002, management audit draft report and significant errors in the basis used throughout the Audit Report and specifically Chapters 3 and 4 in determination DOI authority for examinations and corrective orders.

AUDITOR COMMENTS

Auditor Comment:

Exhibit C and Exhibit D are audit report drafts containing the Department's edits and comments. These exhibits, which were the Department's rewrites of the audit report, in some cases, line by line, were not included in the final printed report. These exhibits are available for public inspection at the Chicago and Springfield Offices of the Auditor General.

EXHIBIT D – MODIFICATIONS TO NOVEMBER 18, 2002 (SECOND DRAFT)

Exhibit D is a copy of the document that is provided by the Department of Insurance (DOI) to the Office of the Auditor General as documentation of DOI's comments on the November 18, 2002, management audit draft report.

AUDITOR COMMENTS

Auditor Comment:

Exhibit C and Exhibit D are audit report drafts containing the Department's edits and comments. These exhibits, which were the Department's rewrites of the audit report, in some cases, line by line, were not included in the final printed report. These exhibits are available for public inspection at the Chicago and Springfield Offices of the Auditor General.