

REPORT

TO

STANFORD I. "BUD" LEHR, CHAIRMAN
SUBCOMMITTEE ON INSURANCE
CONSUMER PROTECTION COMMITTEE

ON

DEPARTMENT OF PROPERTY & SUPPLIES
BUREAU OF INSURANCE

FRANK C. HILTON, SECRETARY
ANTHONY TRUCCO, DIRECTOR

by
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Consumer Protection Committee

April 1974

Purpose of Study

Pursuant to instructions of the Chairman, the Staff has commenced a review of the purchase of insurance coverages for the Commonwealth of Pennsylvania, its Agencies, Boards, Commissions and Authorities together with observations as to the adequacy or inadequacies of those insurance coverages as they relate to known risks of loss or hazards to which the Commonwealth and its Agencies, etc., are exposed by reason of their Governmental or proprietary functions.

The Staff met initially to establish guidelines and objectives regarding the request of the Chairman during the weeks of February 11 and February 18, 1974.

It was concluded that the Commonwealth of Pennsylvania and its Agencies, Boards, Commissions and Authorities should be separated into three broad risk categories, (1) loss of property, (2) loss of assets or revenues arising out of the ownership, maintenance or use of property by reason of liability imposed by law, and (3) liability imposed by law arising out of governmental and non-governmental (proprietary) operations not necessarily related to the ownership, maintenance or use of property.

It was also concluded that a meeting should be held with the Bureau of Insurance, Department of Property and Supplies to obtain information relative to their understanding of their responsibilities and duties and to make arrangements for a systematic and orderly review of all insurance coverages purchased.

On February 25, 1974, members of the Staff met with Mr. Anthony Trucco, Director of the Bureau of Insurance, Department of Property and Supplies and members of his staff to make inquiry of Mr. Trucco of the responsibilities, duties and procedures of the Bureau.

Mr. Trucco stated that his Bureau was responsible for the placement of all insurance except Blue Cross, Blue Shield and other employee benefits except group life. These are handled by the Office of Administration. The group life insurance is serviced pursuant to Public Law 229, the Act of July 31, 1968.

The Bureau is subject to the authority, direction and Supervision of the Secretary of Property and Supplies.

The Commonwealth's liability for Workmen's Compensation Benefits is handled through the State Workmen's Compensation Fund. In response to questions, Mr. Trucco admitted that the Bureau made no effort to negotiate the cost of Workmen's Compensation coverages based on experience or size of risk. He also admitted that based on his experience the Commonwealth could obtain the needed protection at less cost from private insurance carriers. He stated that at no time did the bureau get involved in the placement of compensation benefits coverage, that they never reviewed the policy and do not know the cost.

Under further questioning concerning the determination of need for insurance coverages, Mr. Trucco stated that they get involved in the placement of insurance only when directed by the Agency or Department purchasing the insurance requests coverage. He stated that the Bureau makes no provision for evaluating the need for the insurance or analysis of the risks of loss to which the Agency or Department may be exposed. Certain Agencies or Departments such as the Pennsylvania Turnpike Commission and General State Authority employ full-time personnel as insurance managers who are supposed to determine those Agencies Insurance needs, but that except for readily apparent errors, no attempt is made to review the judgements or requests for insurance by Agencies or Departments.

During the tenure of the previous Administration, insurance was handled by Frank J. Barbera, Director of the Bureau of Real Estate and Insurance. This Bureau was charged with the responsibility of placing the insurance on state properties, agencies, boards and commissions, in addition to negotiating all leases for or on behalf of the Commonwealth.

Following the enactment of Act 577, creating the Secretary of Property and Supplies as Broker of Record, Mr. Barbera, under the direction of the Secretary of Property and Supplies, announced that the Commonwealth would accept bids on all renewals of Insurance policies and created a bid list of persons interested

in bidding on the Commonwealth's insurance. It was also specified that all bids would indicate that a 10% commission was payable to the Secretary of Property and Supplies.

Prior to the expiration date of any insurance policy, the Bureau, under the Direction of Mr. Barbera, prepared policy specifications and underwriting information that was furnished to all prospective bidders.

Mr. Trucco stated that, under the Direction of Mr. Hilton, this bidding procedure has been discontinued on the basis that they felt it would be more advantageous to negotiate insurance through a limited number of insurance brokers on the theory that those brokers would be knowledgeable of insurance markets and their relative costs and advantages. Also, under Direction of Mr. Hilton, Commissions payable to the Secretary of Property and Supplies were reduced to 7% from 10% beginning in May of 1971. The Commission payable to the Secretary was restored in October of 1972 to 10% following a recommendation from the Governor's Management Study Team.

Mr. Trucco stated that he believed the reduction in commissions payable to the Secretary was due to the Secretary's understanding that average commissions to agents and brokers had been reduced.

Further, with regard to the discontinuance of the bidding process, Mr. Trucco defended the new policy on the grounds that there are 30,000 licensed brokers in Pennsylvania, more than 1,100 fire and casualty companies and that the cost of advertising to invite bidders would be prohibitive when one considers that only 50 insurance policies, on the average, are placed by the Bureau each year.

Mr. Trucco said he did not know how the previous Director, Mr. Barbera, prepared the bid list, but that it was not a good representative list of Pennsylvania Insurance Markets.

The Bureau of Insurance, in addition to placing insurance policies as requested, also acts as custodian of funds for the PHEAA and remits commissions twice annually. The funds are deposited with the National Central Bank in a

savings account. Commissions are not paid to PHEAA until they have been fully earned. In 1972, Commissions turned over to PHEAA amounted to \$308,086 and in 1973 they amounted to \$221,604. The figure for 1972 is high due to the retention of funds in the depository for the year 1971. Funds were not fully transferred to PHEAA, because of the changeover of Department Secretaries in 1971.

The figures for 1973 more accurately reflect the current annual commission income. However, an undetermined portion of those commissions reflect the lower 7% commission rate on policies issued through October 1972.

The 1973 commission on deposit figures represents more than a 100% increase in the cost of insurance to the Commonwealth over 1969 where the amount of commission income at a 10% figure was reported at \$111,811.53. The 1973 figures are 32% higher than 1970. The 1972 figure was also based on a 10% commission payable to the Secretary of Property and Supplies.

The Bureau of Insurance assumes no responsibility for the supervision of payment or collections of premiums for insurance policies. Premiums are billed by the Agent or Company involved directly to the Department or entity insured. Commission checks are then remitted to the Secretary of Property and Supplies. In short, the Secretary does not fully function as a broker in all respects.

The Bureau also handles claims and notices of loss to the extent that they are a reporting agency only. They make no investigation of claims or losses unless they come under the State Insurance Fund. No one in the Bureau has any expertise in claims investigation or loss adjustment.

The Bureau has called to the attention of the Governor's Office and the Office of Administration of several instances where the Administration, in collective bargaining procedures has obligated the Commonwealth to insurable liability risks but failed to follow through to protect the Commonwealth from such liability. One such instance involved a contract with the Association of Pennsylvania State Colleges and University faculties and the Pennsylvania Association for Higher Education. In this particular contract the Commonwealth agreed to hold the

members of the Association harmless from any liability in connection with their occupation but failed to take proper steps to provide the necessary protection to the Commonwealth through insurance or other transfer of risk.

Mr. Trucco stated that there may be other instances of liabilities assumed by the Commonwealth in collective bargaining agreements and other contracts but there is no established procedure for the review of such contracts to determine the nature and extent of insurable contractual liabilities or how to deal with them.

Authority for the purchase of insurance is found under 71 P. S. Section 634 (Adm. Code Section 2404), 71 P. S. Section 634.1 (Adm. Code Section 2404.1) 71. P. S. Section 780.1 to Section 780.7, 71 P. S. Section 249 (1), 40 P. S. Section 535, 40 P. S. Section 539, 72 P. S. Section 3731 to Section 3738.

71 P. S. Section 634 authorizes the Department of Property and Supplies to procure sureties as approved by the Attorney General, and to procure automobile liability insurance, public liability insurance on the State Police, excess fire insurance on state buildings and any other kind of insurance which it may be lawful to carry and for which an appropriation has been made.

The Act requires the procurement of sureties from "a corporation or corporations authorized by law to act as sureties in the Commonwealth." No such similar provision applies with respect to other kinds of insurance authorized.

71 P. S. Section 634 designates the Secretary of Property and Supplies as a Licensed Insurance Broker for the purpose of contracting all insurance and surety bonds for the Commonwealth, its agencies, boards, commissions and authorities. It is the intent of the Legislature that this authority is exclusive and not subject to assignment to any other broker. (See Legislative Journal-Senate, page 870, July 28, 1965 - House, page 2786, December 15, 1965). This Act also provides that all commissions collected by the Secretary be paid into the Pennsylvania Higher Educational Assistance Agency.

71 P. S. Section 780 authorizes the Department of Property and Supplies with

the approval of the Governor and the advice of the Auditor General, Attorney General and Insurance Commissioner to procure life insurance for Commonwealth employees.

71 P. S. Section 249 (i) authorizes the procurement of liability insurance covering claims for damages against the Commonwealth, and state officers and employees arising out of the operation of state automobiles or the performance of any other assigned duties and responsibilities by such officers and employees subject to the approval of the Executive Board.

40 P. S. Section 535 authorizes the purchase of group insurance and pensions for state and municipal employees.

40 P. S. Section 539 authorizes the payroll deduction of premiums for group insurance.

72 P. S. Section 3731 created the State Insurance Fund subject to a limit of \$1,000,000 for the purpose of rebuilding, restoring and replacing buildings, structures, equipment and other property destroyed by fire and other casualty and regulating the placing of insurance thereon. The Act, as amended, provides for certain exceptions.

An examination was made on all policies of insurance in the possession of the Bureau of Insurance by agreement with Secretary Hilton and Bureau Director Trucco.

This examination disclosed that there appeared to be no conscious program or effort to identify or evaluate the overall insurance needs of the Commonwealth.

It would appear that each Department, board, agency, commission and authority of the Commonwealth is considered and treated as a separate and distinct insurable entity rather than as a subsidiary or affiliate of the Commonwealth.

The failure of the Bureau to consider the various Departments, boards, agencies, commissions and authorities as subsidiary or affiliates of the Parent Entity, the Commonwealth has resulted in the proliferation of numerous limited liability insurance contracts that inadequately protect the interest of the Commonwealth and result in excessive premium costs.

In one instance, a comprehensive general liability insurance policy was procured in the name of the employees of the Commonwealth of Pennsylvania for a three year

premium of \$603,000, the waiver of Immunity Endorsement was deleted from the policy. The waiver of Immunity Endorsement would prohibit the Insurance carrier from invoking the defense of sovereign immunity against claimants without the written consent of the Commonwealth. The deletion of this waiver means that every claimant could be denied liability in a claim against an employee of the Commonwealth on the grounds of the defense of Sovereign Immunity.

This particular policy was apparently purchased under the authority of 71 P. S. Section 249 (i). However, since the employees of the Commonwealth of Pennsylvania are not a legal entity it would appear that the policy is improperly issued and should have been written in the name of the Commonwealth of Pennsylvania.

The policy, as written, would appear to be a bonanza to the Insurance Company and the broker through whom it was placed.

In other instances the Commonwealth has purchased limited liability insurance on state-owned watercraft, some of substantial size, operating in navigable waterways instead of marine protection and indemnity coverage, a special marine liability contract.

This is important, because the limited liability coverages purchased by the Commonwealth do not provide the Commonwealth necessary protection against liabilities that may be incurred under Admiralty law such as claims in Rem, removal of wreck as a hazard or obstruction to navigation and the liability and maintenance and cure of the master and crew under the Federal Jones Act and the Harbormasters and Longshoremans Act.

Limits of liability under the many liability policies are not uniform and in most cases are inadequate. In some instances, excess liability or umbrella liability contracts have been purchased to provide reasonably adequate liability protection. However, comparison of the premium costs of these excess liability policies with the primary insurers premium costs would seem to indicate that the cost of these excess liability policies are grossly excessive.

The Act of 1915, P. L. 524 (72 P. S. 3731) approved May 14, 1915 created a State Insurance Fund for the purpose of replacing state-owned real and personal property. The act specifically prohibits the purchase of insurance on all such property, with specific exceptions, against loss by fire or other casualty. The fund is statutorily limited to \$1,000,000 and is "self-sustaining."

By interpretation of the Attorney General, (informal opinion #675, February 28, 1936) State Agencies that operate as proprietary enterprises are not subject to the provisions of the State Insurance Fund Act of 1915 are therefore not eligible for reimbursement for loss of real and personal property from the fund and would be required to purchase their own insurance on their property and their operations.

As a result the following agencies would appear to be exempt from the provisions of this Act:

1. Liquor Control Board
2. Turnpike Commission
3. General State Authority
4. State Highway and Bridge Authority
5. State Public School Building Authority
6. Pennsylvania Industries for the Blind
7. Regional Planning Commissions
8. Port Authorities
9. Museum Commission

The list is intended to be illustrative, and not all inclusive.

As a result of this law creating the State Insurance Fund and the failure of the Secretary to employ a Qualified Risk Manager to identify and evaluate the exposures to loss faced by the Commonwealth, its agencies, boards, departments, commissions and authorities, there exists considerable confusion with regard to the treatment of risks of loss of real and personal property.

There is no Commonwealth policy with respect to the insuring of Commonwealth property. Consequently there is a proliferation of insurance policies covering sundry property. These policies range from limited named peril contracts to broad all risk contracts.

For example, automobile physical damage policies are carried by some entities of State Government providing coverage against loss by fire and theft or comprehensive and collision subject to a \$50 deductible in some cases, and \$100 deductible in others.

No effort has been made by the staff to test available insurance markets to determine whether or not costs and coverages have been provided upon the best terms available to the Commonwealth or placed with the most financially secure companies. Such an effort might be considered to be in violation of the insurance laws of the Commonwealth and certainly staff has no authority nor is it equipped with sufficient underwriting data to enter such markets for the purpose of such testing.

Summary

The Staff of the Subcommittee on Insurance of the House Consumer Protection Committee is unfavorably impressed with the lack of expertise and professionalism in the handling of the Commonwealth's insurance.

The Bureau of Insurance, Department of Property and Supplies, has discontinued the practice of obtaining bids for the placement of insurance policies. Instead, the Bureau, under the direction of the Secretary, has adopted the practice of dealing with selected brokers. Mr. Trucco, Director of the Bureau, contends that the brokers, through their expertise and knowledge of competitive insurance markets, assure that the Commonwealth's insurance is placed in the best companies at competitive terms and conditions. No reports or experience were available to substantiate Mr. Trucco's contention and a review of policies issued and made available for inspection would not tend to support that contention.

A broker, by statutory definition, is the representative of the insured for the purpose of advising on the placement of insurance or in the procurement of insurance.

In 1966 the Legislature passed Act 577. One of the objectives of Act 577 and the legislative intent was to eliminate the awarding of insurance on the basis of political favoritism.

The discontinuance of the bid process in the placement of insurance by the present Administration would appear to be in contravention to the purpose and intent of the Legislature in enacting Act 577.

In Act 577, the Legislature also intended that all commissions payable would be received by the Secretary of Property & Supplies to be paid into the Pennsylvania

Higher Educational Assistance Agency Fund.

The practice of placing insurance through designated agents and brokers and the designation of a commission payable to the Commonwealth that is substantially less than the normal rate of commission paid by insurers to brokers, indicates that the legislative intent with respect to commissions payable on insurance policies written on behalf of the Commonwealth has also been circumvented and that funds intended to be directed to the Pennsylvania Higher Educational Assistance Agency have been diverted.

A review of the language of Act 577 indicates that an amendment will be necessary if the original legislative intent is to be realized. At this time there is every reason to believe that the once infamous insurance "gravy train" has not been derailed as the Legislature believed and intended, but has been put quietly back on the track and is running at full throttle.

The Secretary of Property and Supplies and his subordinate, the Director of the Bureau of Insurance have completely neglected the function of risk management, one of the major responsibilities of the Secretary and the Department.

In addition, the Secretary and the Bureau Director have failed to establish or create any administrative policy or procedure to provide employees of the Bureau any guidelines or policies to determine how the Commonwealth can best handle those risks with which it is faced. In short, the Secretary and Bureau Director have completely failed in their responsibility and obligations to the people of the Commonwealth to provide and apply modern and professional concepts of risk management techniques in dealing with the Commonwealth's treatment of insurable and uninsurable risks of loss.

As a consequence of this neglect, the Commonwealth's insurance program lacks any sense of direction, is lacking in controls and has resulted in overinsurance, in some instances, underinsurance in others, overlapping and duplication in others, omissions and gaps in coverage and excessive premium costs.

In failing to recognize the basic need for an effective risk management and objective insurance program, the Secretary and the Bureau Director has treated the

Insurance function as a minor or insignificant operations chore unworthy of consideration as a vital staff function worthy of top management guidance.

Recommendations

It is imperative, for the welfare of the Commonwealth and its taxpayers, that the Secretary of Property and Supplies recognize the full nature and ramifications of his responsibilities to the people to achieve the objective of providing economical protection of the Commonwealth's assets and revenues from serious impairment.

1. The Secretary should immediately undertake to reorganize the Bureau of Insurance to function as an effective management tool. Its duties and functions should be carefully identified and defined to provide for an orderly and systematic management of risks to which the Commonwealth is exposed. The successful management of the Commonwealth's operations requires an intimate comprehension of all types of exposure to loss and of all types of risk.

2. The Secretary or his designate must have a constant awareness of all kinds of risk and must be skilled in the methods and technology of identifying, evaluating, avoiding, reducing, controlling, assuming and transferring such risks.

It is obvious that the Bureau of Insurance presently lacks the skills and expertise necessary to competently and effectively deal with these problems. In fact, the failure of the Administration to plan for and budget for such activity is evidence of the low priority which the Administration attaches to this important function of management.

Most business corporations have recognized the importance of risk management. In the larger corporations, the risk manager is generally located in the financial section of the Corporation, reporting to the Chief Financial Officer. Some corporations, in recognition of the importance of the function, require the risk manager to report directly to the President.

3. The Administration should reorganize the Bureau of Insurance into a Bureau of Risk Management. Consideration should be given to placing this responsibility to either the State Treasurer or Auditor General.

4. The Qualifications of the Director of Risk Management should be carefully

prescribed. The position should be a full-time career opportunity and not subject to political patronage considerations. The Director should have the authority and responsibility of setting qualifications for key bureau personnel or staff to assist him in his duties.

5. The Director of Risk Management should have free and complete access to all Departments, Bureaus, Boards, Agencies, Commissions and Authorities of the Commonwealth at all times for the purpose of identifying and evaluating the many risks with which the Commonwealth is faced.

6. Existing laws relating to insurance and risk management should be reviewed and amended where necessary and appropriate to allow for the proper management of risks consistent with sound principles of risk management and sound insurance principles and practices.

7. The Administration should provide the Bureau of Risk Management a comprehensive, but flexible, written policy of duties and responsibilities of the Bureau and its Director based upon recognized sound principles of risk management.

8. The Director of Risk Management should be held solely responsible for risk analysis, record keeping, loss prevention, treatment of risk, including purchase of insurance and loss and claims handling whether or not he delegates some or all of these responsibilities to his staff.

9. Since the Secretary of Property and Supplies, by statute, is designated as the licensed Insurance Broker for the purpose of contracting all insurance and surety bonds for the needs of the Commonwealth, the present, and probably illegal, practice of awarding or sub-contracting the placement of insurance to other brokers or agents and the splitting of commissions thereon should be discontinued at once. All insurance should be contracted for directly with insurance carriers net of commissions normally paid.

10. The Insurance Department should be consulted with respect to the relative financial integrity, security and management of all insurers being considered as carriers for insurance procured by the Commonwealth.

11. The present practice of treating the various Departments, Bureaus, Boards, Agencies, Commissions and Authorities as separate and distinct insurable interests

should be discontinued. The insurance or risk management function of the Commonwealth should be considered in the same context as any decentralized corporate body that operates on a national or even an international scale. Insurance, when procured should be arranged whenever possible to provide automatically for changes in risks as they occur, even in advance to such changes being made known to the Director of the Bureau or the insurance carrier involved.

12. A Communications system or policy must be developed with respect to the reporting of all activities or changes of activities, in order to minimize the possibility of errors or omissions in the risk management process.

13. Where practical and feasible, all insurance should be procured on the basis of competitive bidding consistent with sound insurance principles and practices.

14. The present practice of allowing the various Departments, Boards, Agencies, Commissions and Authorities the freedom to determine and evaluate their own insurance needs should be discontinued and that responsibility re-delegated to the Bureau Director.

15. A policy of cost allocation should be promulgated to allow for the equitable allocation of risk management costs among the various Departments, Agencies, Boards, Commissions and Authorities. If possible, this should be on some uniform basis such as payroll, manpower, values or area of occupancy. The Bureau would have the responsibility of advising the various entities or divisions of government as to the amount to be allocated.

16. At least initially, a review or coordinating committee should be created for the purpose of making the initial risk analysis, establishing standards and guidelines for effective risk management, auditing and reviewing existing insurance and establishing qualifications of the Director and staff. The Committee might be composed of professional, experienced corporate risk managers, agents or brokers, Insurance Company personnel, top management personnel of the Administration or from the membership of the Societies of Chartered Property and Casualty Underwriters and Chartered Life Underwriters. Consideration should be given to the maintenance of a permanent on-going review committee that would periodically review the Bureau and

evaluate its performance. The Committee members should be reasonably compensated and reimbursed for any expenses.

17. Consideration should be given to the establishment within the Bureau of a division to communicate effectively on employee benefits to all state employees including personal insurance counseling.

18. Serious consideration should be given to the procurement of workmen's compensation insurance from commercial insurance carriers. In addition to the likelihood of substantial premium savings employer's liability coverage would be included at no additional cost.

It is conservatively estimated that these recommendations could result in savings in excess of \$1,500,000 annually to the Commonwealth in reduced insurance costs and the reduction of uninsured losses by the employment of sound risk management techniques.

Respectfully submitted,

Otis W. Littleton