COST EFFECTIVENESS OF THE NATIONAL INSURANCE PROGRAM

Audit Report No. D99-039
September 20, 1999

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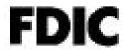

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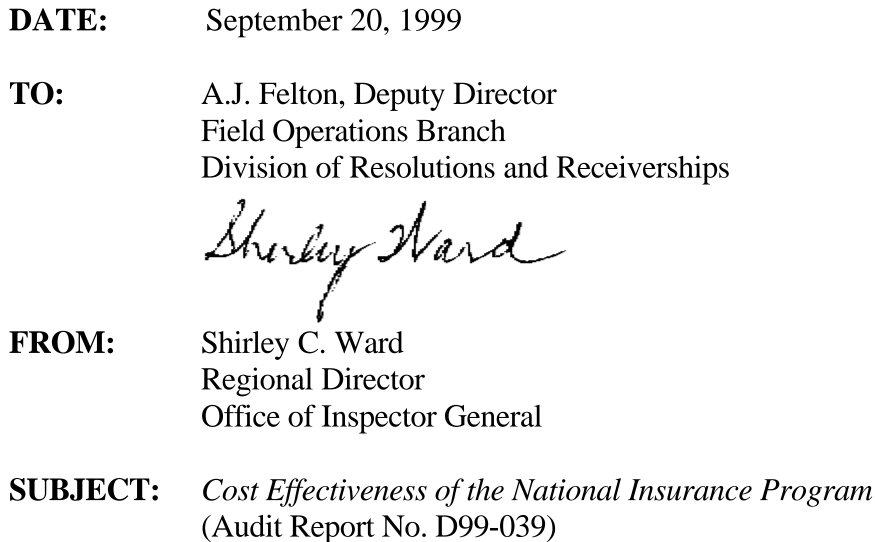

DATE: September 20, 1999

TO: A.J. Felton, Deputy Director
Field Operations Branch
Division of Resolutions and Receiverships

FROM: Shirley C. Ward
Regional Director
Office of Inspector General

SUBJECT: *Cost Effectiveness of the National Insurance Program*
(Audit Report No. D99-039)

This report presents the results of the Federal Deposit Insurance Corporation (FDIC) Office of Inspector General's (OIG) audit of the cost effectiveness of the National Insurance Program. Generally, we found that the program was well structured and protected the FDIC from extraordinary loss. However, we believe there are opportunities for cost savings in the areas of insurance premiums and broker fees, and for improvements in program management.

BACKGROUND

In August 1992, as part of the National Insurance Program, FDIC managers procured commercial insurance coverage for approximately $4.5 billion in owned real estate (ORE) and certain credit assets. The total value of assets insured by the program dropped to about $100 million as of September 30, 1998, and continues to decline in value. The FDIC's Division of Resolutions and Receiverships (DRR) is responsible for managing the program in a timely and efficient manner. The program promulgates policies and procedures for the placement of insurance on receivership assets and corporate-purchased program assets resulting from financial institution closings.

The program, according to the FDIC's *Strategic Plan 1998-99 and Beyond*, is managed by the National Insurance Center (Center), which ". . . is responsible for obtaining insurance coverage to limit the financial loss to Receiverships and the Corporation as a result of physical damage and liability claims occurring on Receivership assets." The Center is also responsible for managing the Corporation's risk of potential financial loss related to these assets. Since 1994, DRR's management control plan has identified the activities of the Center as being predominantly a high-risk area. The plan also indicates that one of the

control objectives for the Center is to track insured losses and asset information to evaluate the cost effectiveness of the FDIC coverage.

DRR's Washington office established the National Insurance Center in Dallas, Texas, in August 1992. As stated in DRR's Directive 7500.34 dated October 31, 1994, *National Insurance Program*, Center personnel are responsible for obtaining liability and property insurance, processing claims, tracking losses to evaluate the cost/benefit of the policy, and paying contractually deductible amounts on liability claims to the insurance carrier. Center personnel are responsible for providing to Northeast Service Center (NESC) and Field Operations Branch (FOB) account officers guidance and training on various insurance-related matters. The account officers are responsible for managing and liquidating receivership assets. Additionally, the Center maintains the FDIC insurance system of record, the National Insurance System (NIS), and Center manuals. Program objectives, as listed in the Center's *National Insurance Manual*, are to purchase insurance coverage in the most cost-effective manner and to track insured losses in order to evaluate the cost/benefit of the policy.

Each account officer has responsibility for ensuring that liquidation assets are properly protected and covered. The account officers are responsible for providing all necessary asset information to the site coordinator whenever there is a change in asset status, including actions for the addition or deletion of an asset. Account officers are also responsible for determining the insurable value of each asset in which the FDIC has an insurable interest and identifying loss situations for FDIC receivership and corporate-purchased assets.

To fulfill its objective of obtaining insurance coverage in the most cost-effective manner, the FDIC entered into a contract with its current insurance broker, Henley, Williams and Associates (Henley-Williams), in August 1992. FDIC entered into a new contract with Henley-Williams in September 1995. The new contract was for 1 year and allowed for two contract extensions for up to 2 years each. The insurance broker's main duties under the contracts were to obtain the most cost-effective insurance and provide claim management services. The broker is responsible for obtaining insurance coverage including liability, property, difference in conditions, boiler and machinery, and other miscellaneous coverage.[1] In the 1995 contract, the broker was engaged at a flat fee of $240,000 per year[2] to complete these fundamental program tasks.

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[1] Liability insurance pays proceeds that the FDIC becomes legally obligated to pay as the result of injury to another or damage to property of another. Umbrella insurance provides additional limits of coverage over the primary liability policy. Hazard (Property) insurance protects the financial interest of the FDIC in the event the property is damaged by fire, rain, wind, vandalism, or flood. Difference in Conditions insurance provides additional limits of coverage on properties damaged by flood or earthquake. Boiler and Machinery insurance protects the financial interest of the FDIC in the event of equipment failures that result in damage to FDIC property or the property of others. Most assets were insured subject to a $10,000 minimum insured value.

[2] In the original contract, the broker's compensation was bundled with the premium payments and was not paid separately.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of our audit was to evaluate the cost effectiveness of the FDIC's insurance program for protecting receiverships and the Corporation from potential financial loss as a result of either physical damage to assets or third-party liability claims. Our audit scope included the inception of the program in 1992 through the most recently completed program year of October 1, 1997 through September 30, 1998.

We interviewed Center personnel and site coordinators at the NESC in Hartford, Connecticut, and FOB in Dallas, Texas, to understand the operation of the insurance program. We reviewed the *Asset Disposition Manual* and *National Insurance Manual* to understand DRR guidance for asset insurance. In addition, we reviewed program goals in the Strategic Plan, risks in the management control plan, and testing of accountability units under the Chief Financial Officers Act.

We reviewed contracts with the insurance broker, the insurance consultant (Aon Specialty Group), and the Resolution Trust Corporation (RTC) claims adjuster for its self-insured program to obtain information on compensation and services being rendered by contractors. We analyzed contractor summary reports to understand tasks performed and review suggestions offered to assist program managers.

We reviewed program details for 3 years, from October 1, 1995 through September 30, 1998. Specifically, we evaluated asset values, premiums, deductibles,[3] carrier losses, and broker fees to determine the total program expenditures and carrier covered losses by each category of insurance.

Further, we randomly sampled 30 assets with a total insured value of $2.7 million from the November 18, 1998 NIS database of 805 assets with a total insured value of $50.1 million. We assessed the adequacy and accuracy of coverage as of January 29, 1999 for the 30 assets in our sample. The NESC managed 21 of the 30 assets and the FOB managed the other 9 assets. We also reviewed condominium and cooperative unit assets and discovered assets[4] in the NIS database of insured assets at November 18, 1998 and March 3, 1999 to determine the significance of reporting errors to the population of assets.

We conducted the audit from November 9, 1998 to April 14, 1999 in accordance with generally accepted government auditing standards. We did not perform a comprehensive review of internal controls relating to the program because we concluded that the audit

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[3] A deductible is the amount of the loss for which the insured is responsible. A deductible is usually expressed as a percentage of the asset's value or a fixed amount. The FDIC's deductible is a fixed amount per policy but varies in amount by the type of coverage.

[4] A discovered asset is an asset for which the FDIC did not previously assume that it held title or responsibility. A discovered asset differs from other liquidation assets in that until some notification is received of receivership ownership, the FDIC does not have a record of the asset.

objectives could be met more effectively by conducting substantive testing rather than by placing reliance on internal controls.

RESULTS OF AUDIT

The Center has effectively provided support to DRR in placing insurance coverage and assisted DRR in processing allowable claims. Generally, the program was well structured and protected the FDIC from extraordinary loss. However, this protection has been at a substantial cost. By maintaining the originally chosen course of action and not revisiting its earlier insurance decisions, we believe Center management lost opportunities for reevaluating insurance options and contract costs. Specifically, over the past 3 years, the FDIC has paid $5,495,000 for premiums, deductibles, and broker fees, but had only $70,000 in losses covered by the insurance carrier. Additionally, Center management did not initiate efforts to renegotiate the broker fee in a timely manner and may have forfeited cost savings opportunities of approximately $100,000. Finally, we found that the inaccurate and inconsistent recording of assets on the NIS caused an overpayment of premiums, resulted in forfeited loss recovery opportunities, and negatively affected projected program performance.

The overall success of the insurance program depends upon the combined sustained efforts of many individuals in DRR operations and real estate management. We believe the program could be more cost-effective with improved program management and data reliability. We believe improvements can be made in three areas: acquiring insurance in a cost-effective manner, tracking and analyzing insured losses in order to evaluate the cost/benefit of the policy, and verifying data accuracy.

Since its inception in August 1992, the program had operated predominately as a commercial insurance program with moderate elements of non-insurance in the form of policy deductibles. This program choice continued through the conclusion of our audit in April 1999 in spite of significant economic changes that occurred from 1995 to 1998 when the FDIC experienced a dramatic 85 percent decrease in the book value of its owned real estate assets. The decline in assets greatly limited the potential for losses because there were no longer great concentrations of risk in any single area. As such, the risk to the Corporation changed substantially, and corresponding opportunities existed for insurance-related cost savings. Nevertheless, Center managers, who thoroughly analyzed insurance data only once since the inception of the program in 1992, did not take advantage of this changing situation and did not act on existing options to reevaluate the program. Additionally, Center managers did not follow advice from the insurance consultant Aon and its own FDIC contracting staff to promptly and appropriately renegotiate brokers fees commensurate with the level of services needed for such a reduced asset base.

Also, the Center is responsible for ensuring that the program operates responsibly and efficiently. Tracking liability claim losses is important in order to evaluate the cost/benefit of the policy. Although the insurance broker maintained loss data, Center management did not have current loss data on file. Moreover, because every asset in which the FDIC has an insurable interest is part of the program, data accuracy for every asset is critical. We found a

23 percent error rate in our sample of 30 assets and systemic insurance valuation problems for condominium units, cooperative units, and discovered assets. We believe that if FDIC management were to improve data accuracy, the use of reliable information would foster additional cost savings.

OPPORTUNITIES EXIST FOR IMPROVED PROGRAM MANAGEMENT

We believe that opportunities exist for improved program management. Specifically, management could improve the program by fully pursuing insurance alternatives, tracking and analyzing insurance data, and renegotiating existing broker fees. There have been changes in the FDIC asset base, total insurance values, claim losses, and insurance costs. Losses have been slightly over 1 percent of the total outlay for insurance coverage for the period of October 1, 1995 through September 30, 1998 (the last period for which final cost data were available). During the same period, the insured value of assets protected under the program and premiums declined 86 percent and 84 percent, respectively. Additionally, broker fees for the 1998/1999 program year are excessive at over 60 percent of estimated total premiums rather than the industry average of 10 percent to 20 percent.

Insurance Program Alternatives Were Not Fully Pursued

Integral elements of an insurance program are insured losses, support services, premium costs, deductibles, and an entity's culture for risk management. When the program was established in August 1992, the FDIC chose to establish a commercial insurance program, rather than a self-insured or pay-losses-as-incurred program.[5] The FDIC emphasized protecting the receiverships and Corporation from extraordinary and catastrophic losses, but what constitutes a catastrophic loss had not been defined by management. As a result, instead of just protecting the FDIC from extraordinary financial losses, the Center attempted to protect the FDIC from all losses.

Over the past 3 years, the FDIC has paid $5,495,000 for loss protection and broker fees while the insurance carrier paid $70,000 in covered losses. As such, the Center has protected the FDIC from financial losses but at a substantial cost. Although we do not believe Center management reacted timely to changing program data trends, thereby missing certain opportunities for cost savings, the Center, through its Aon contract, did start a study to address program changes in February 1999. As part of this study, Aon is evaluating whether the FDIC should partially or fully self-insure the property and liability loss risks of FDIC assets.

Over 4 years have passed since the Center last conducted a comprehensive study of the program. As part of a January 1995 RTC/FDIC Best Practices review, the FDIC contracted with Aon to provide the FDIC with assistance in choosing the most cost-

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[5] Self-insurance incorporates a conscious decision to accept a given type and amount of risk and includes a method for actually financing that risk through other than commercial insurance. Self-insured exposures may be funded either from operations or from special reserves. Paying losses as incurred or being non-insured is the conscious acceptance of loss exposure through deductibles, co-insurance alternatives or simply not purchasing commercial insurance at all.

effective, practical mix of insurance and self-insurance alternatives. The study examined the program's performance and addressed two possible risk-funding alternatives: continuing a commercial insurance program with higher deductibles[6] and developing a self-insurance program. As seen in table 1, Aon determined which insurance coverages should be considered for higher deductibles or self-insurance:

Table 1: Aon Insurance Study Considerations

Coverage	Higher Deductible	Self-Insurance
ORE Property	Yes	Yes
Forced Place Property	Yes	Yes
ORE Liability	Yes	Yes
Difference In Conditions	Yes	No
Boiler and Machinery	No	No
Umbrella Liability	N/A	No

Source: January 4, 1995 Aon Specialty Group report entitled *Study of Current Operation and Cost/Benefit Analysis, National Insurance Program, FDIC.*

Aon considered the costs of commercially purchased insurance including premiums, deductible payments, and staff costs. Loss history and forecasts were developed using asset and insured value data, geographical distribution of properties, and length of time for which loss information was captured. The report concluded that a self-insurance program would be more cost-effective but had greater elements of risk than the FDIC was willing to accept at that time. Therefore, the FDIC continued to obtain commercial insurance in 1995.

Aon's report was evaluated in the March 1995 Best Practices Review of Risk Management. The Best Practices Review of Risk Management, prepared by the Director of DRR and other DRR managers, suggested that annual reviews of the insurance program be conducted to evaluate alternative risk funding and management techniques. A mechanism was established in the July 1996 contract with Aon to perform these program reviews semiannually. According to the contract, the FDIC could request four services requiring Aon to make program recommendations:

(1) annually match technical requirements for solicited brokerage and insurance coverage to DRR's needs for a cost-effective risk management program,
(2) semiannually make suggestions regarding self-insured and purchased insurance risk management program options,
(3) semiannually collect premium and loss statistical data for analyzing the cost/benefit of the program, and
(4) develop insurance training and manuals used for the program.

We found that the only services the Center requested from Aon from July 1996 through February 1999 were for annual insurance coverage-related recommendations (contract service number 1 above). Center management declined to exercise the other three contract services. We believe that if Center management had exercised contract service

[6] Policy deductibles are elements of non-insured risk funding: lower deductibles yield less non-insured risk but often result in higher premiums, while higher deductibles usually result in a greater degree of non-insured risk that can be offset by lower premiums.

number 2 and used it to support the program's annual expenditure case, senior management would have had sufficient information to make critical decisions regarding alternative program options. Instead, annual insurance expenditure cases for program funding since October 1995 have listed three program alternatives--use outside carriers, self-insurance, and paying losses as incurred--without the benefit of a study to support the case recommendation to use an outside carrier. No discussion of the advantages or disadvantages of the three program alternatives were included in the cases, only the justification for choosing one carrier over another. Also, disclosure of loss history information in the expenditure cases was not detailed. Without the benefit of an evaluation of different program alternatives or relevant information on loss history, sufficient information was not available for FDIC senior managers to measure program performance or concur with case recommendations to obtain commercial insurance coverage.

We analyzed all reports provided by the Center that contained any analysis of insurable assets affecting program years October 1995 through September 1998 to understand the scope of the reports and determine whether they addressed program alternatives. We found reports related to the annual recommendation for selecting a carrier, but alternatives for self-insurance, such as paying losses as incurred, were not discussed.[7] Based on the insurance consultant and broker advice, the FDIC chose the carrier with the most competitive rates, eliminated one type of coverage to achieve cost savings, and lowered the deductible levels. While these insurance changes facilitated cost savings in the commercial insurance program, we could not find evidence that similar considerations were given to all program alternatives.

Insurance Data Were Not Effectively Tracked and Analyzed

The effective tracking and analysis of insurance data enables management to make the most prudent business decisions for the insurance program. Important information affecting the program can be obtained from monitoring and evaluating changes to asset values, insured values, premiums, deductibles, and carrier losses. Center managers recognized the importance of analyzing this insurance data when they engaged Aon to conduct the program evaluation as part of the FDIC/RTC best practices initiative in January 1995.

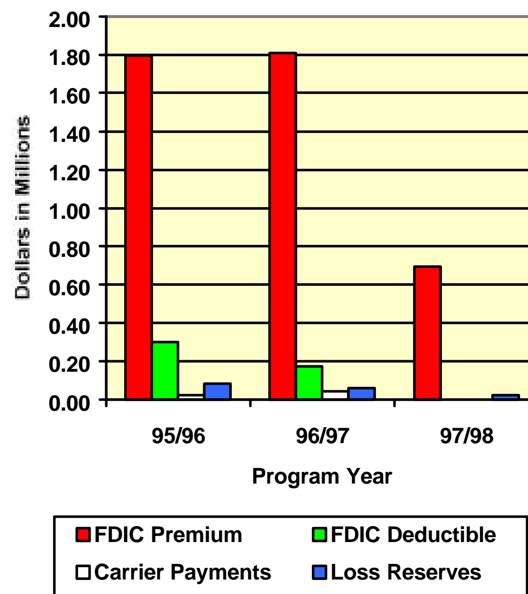
Because we did not find evidence of a similar analysis of program data since the January 1995 effort, we decided to perform our own analysis. We evaluated asset values, total insured values, premiums, deductibles, carrier losses, and broker fees to determine the total program expenditures and carrier covered losses by each category of insurance for the program years following the report. We found a strong correlation between asset values[8] and

[7] We also found a May 1996 report study that focused on whether to commercially insure or self-insure RTC assets and assessed deductible levels. But the study did not include an updated evaluation of the FDIC assets. Instead, only RTC assets were addressed. The study concluded that RTC assets should be incorporated into the FDIC's carrier-based insurance program.

[8] ORE assets were used to gauge the decline in the asset base, rather than all asset types, because assets insured by the program are predominately ORE.

insured values. For the period of October 1, 1995 through September 30, 1998, the total ORE assets in liquidation declined from $742 million to $114 million while the total insured value of assets protected under the program declined from $350 million to $50 million. We also found that the sharp decline in assets from 1995 through 1998 caused a corresponding decline in premiums and claims over the same period. Figure 1 presents the results of our analysis of premiums, loss claims, deductibles, and carrier paid losses for the period of October 1, 1995 through September 30, 1998. Total carrier-paid losses were less than 2 percent of the FDIC's total paid premiums, and 87 percent of total claim payments fell within the FDIC's deductible limit. Even though there was a decline in premiums from 1995 through 1998, FDIC paid a total of $4,300,000 in premiums and $474,000 in claims over the period. The carrier paid losses of $70,000[9] and had established a $171,000 loss reserve for future claim settlements.

Figure 1: FDIC Premium and Deductible Payments Compared to Minimal Carrier Payments (October 1, 1995 to September 30, 1998)



Sources: FDIC Division of Finance disbursement reports, *FDIC Loss Experience History* reports from the broker, Center claim files, DRR reports, and NIS data.

Although Center managers did not act on these indicators of a changing program with poor cost/benefit ratios from 1995 through 1998, they started a study in February 1999

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[9] As noted by Center personnel, the insurance carrier also absorbed legal and claim adjustment expenses as part of claims settlement. Center personnel were not able to quantify these expenses because the carrier does not release this information. As noted in the Aon reports, carriers anticipate that approximately 30 percent of premiums will go to administrative overhead expenses such as legal costs and claims administration, so absorbing these costs is normal.

when they asked Aon to conduct a study of program changes and risk-funding alternatives.

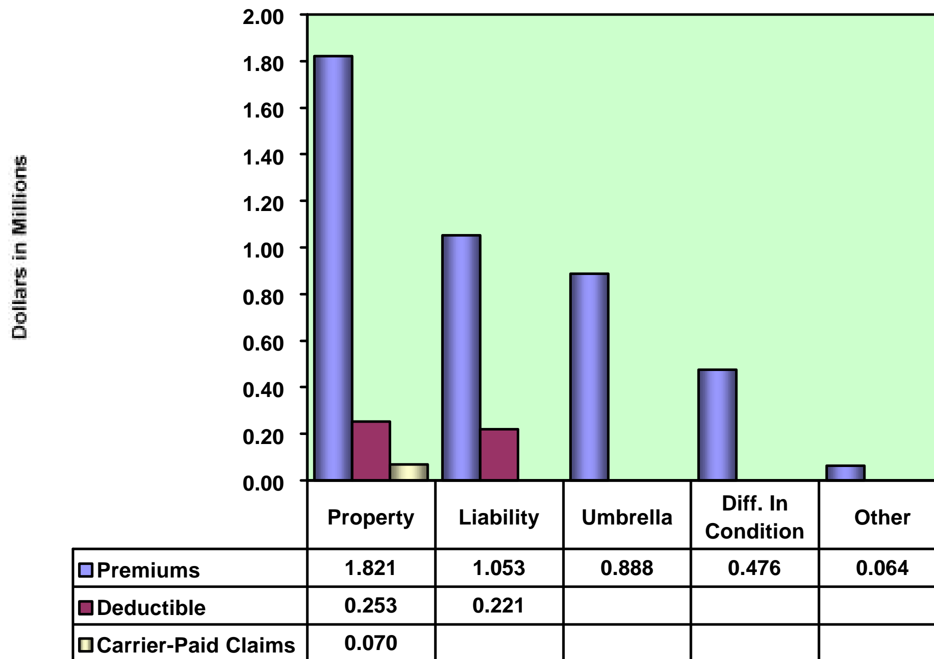
The 85 percent decrease in the book value of FDIC assets from 1995 to 1998 and a further drop of almost 20 percent during the 3-month period ending March 3, 1999 have reduced the potential for catastrophic property and liability losses. In addition, over 76 percent of the assets insured by the Center had insured values of less than $50,000 at November 18, 1998. These factors indicate that the FDIC has a limited loss exposure and that most of the losses will be small (probably within the FDIC's deductible level effective at the time of our review, which was $25,000 for property and $100,000 for liability).[10] During the 3 years under review, property losses dropped to zero by September 30, 1997, and liability losses have declined steadily.

As illustrated in figure 2, we found that premiums significantly exceeded loss claims[11] for liability and property coverage, and most losses were within the deductible limits. All liability losses were within the deductible limit and 78 percent of property losses fell within the deductible limit. Also, carrier-paid claims were less than 2 percent of premiums as well as less than 13 percent of all loss claims. The FDIC had not experienced loss claims for difference in conditions, umbrella, or "other" coverage during our review period.

[10] For the 1998/1999 program year the deductible levels were changed to $10,000 for property and $50,000 for liability.

[11] Loss claim amounts include a 12.5 percent handling fee charged by the carrier.

Figure 2: Total Premiums Paid, FDIC-Paid Loss Claim Deductibles, and Carrier-Paid Claims for Each Type of Insurance Coverage (October 1, 1995 to September 30, 1998)



	Property	Liability	Umbrella	Diff. In Condition	Other
Premiums	1.821	1.053	0.888	0.476	0.064
Deductible	0.253	0.221			
Carrier-Paid Claims	0.070				

Sources: FDIC Division of Finance disbursement reports, *FDIC Loss Experience History* reports from the broker, Center claim files, DRR reports, and NIS data.

Despite all the declines and the low loss-to-premium ratio, the Center did not conduct periodic studies to assess whether the program in place at the time continued to meet the FDIC's needs for risk management. Center officials were knowledgeable about the FDIC's declining asset base, but we did not identify any effort by them to document and evaluate asset trends or program changes. The Center's department head informed us that he had decided the program should only be reevaluated every 3 years. He believed that data trends must be assessed over the long term, not the short term. Center personnel stated that large property losses from natural disasters occur infrequently, so loss amounts can fluctuate dramatically from year to year. They also stated that a business decision was made to insure assets based on high risk, high volume, and an initial concentration of assets in traditional disaster areas such as Florida, California, and Texas. Nevertheless,

loss history information from the broker shows a consistent decline in losses since the 1992/1993 program year.[12]

Although the Center had raw program data on file or in its database, we did not find any evidence of internal efforts to analyze trends and forecast future program needs. During the audit, OIG staff created a database from a variety of sources and completed its own analysis. For example, the OIG calculated deductibles and the 12.5 percent claim handling fees and contacted the broker to obtain some current carrier loss data. These data were not immediately available to us.

The Center had not tracked insured losses by policy to determine the cost effectiveness of that type of policy. The FDIC's contract with Aon included an option for the insurance consultant to track premium and loss data, but the option was not exercised. However, tracking losses is critical to evaluating the cost/benefit of the policy and program. Then, in February 1999, the FDIC instructed Aon to formally review program options and make a recommendation for the most cost-effective alternative. The study was required as part of DRR's 1999 DRR Strategic Plan. Aon estimates the study to cost between $13,000 and $17,000.

OIG has provided its schedules and charts of premiums, losses, and deductibles for the various types of insurance and its analysis of this information to Aon and Center management to assist in the study efforts. Aon completed its preliminary study on June 17, 1999, but the final report will not be available until September 1999.

In the preliminary report, Aon stated that the National Insurance Program has changed so significantly that carriers may take a completely different view of the program than they have in the past. Aon suggested that various deductibles, per occurrence limits, and insurance alternatives be submitted to insurance carriers for premium quotes. Only after quotations have been received from insurance carriers and all options have been evaluated can FDIC make an informed decision. However, using current premium rates and deductible levels, Aon estimated that savings from a form of self-insurance could range from $200,000 to $800,000 over 5 years, depending on the extent of the self insurance program. Additionally, Aon noted that the current broker fee is excessive in light of the size of the FDIC asset portfolio.

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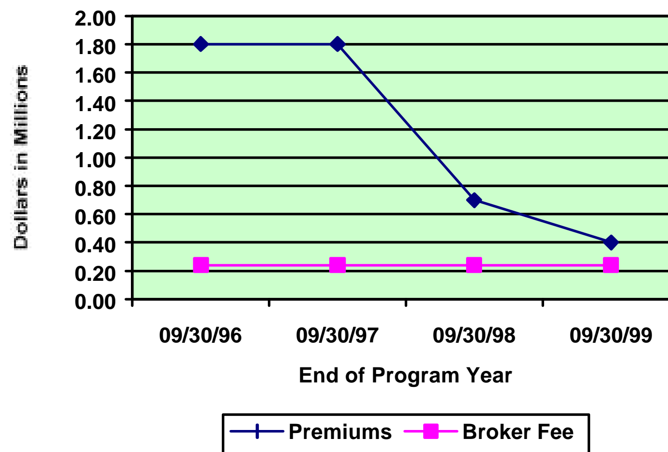
[12] The sharpest decrease in insured losses coincided with a change in insurance carriers from St. Paul to Aetna/Travelers. We were informed by Center personnel that St. Paul did not charge the FDIC a deductible and was not very aggressive at claim resolution, which led to a favorable loss history experience in the early years of the program. Center personnel's perception was that St. Paul readily paid for claims and did not strongly defend against claimants. Aon noted in its analysis of the FDIC's loss history experience with St. Paul that most carriers would not enter into a contract where the contract terms contained such a high probability for financial loss. Therefore, the FDIC should not expect to enter a similarly favorable contract with other carriers.

Broker Fees Were Excessive

Broker fees have remained a constant $240,000 per year despite a steady decline in total premiums paid on insured values from the 1995/1996 program year to the 1997/1998 program year. The $240,000 broker fee for the 1998/1999 program year is over 60 percent of estimated total premiums paid by the FDIC to cover assets in which the FDIC has an insurable interest. Figure 3 depicts the program's premium-to-broker-fee relationships for the 3 program years of 1996 through 1999.

Figure 3: Relationship of Premiums and Broker Fees



Source: FDIC Division of Administration contracts, FDIC Division of Finance disbursement reports, and NIS data.

The FDIC had an opportunity to renegotiate the broker fee for the 1998/1999 program year but forfeited the opportunity, despite the advice of the insurance consultant and FDIC contracting staff, by not starting the process early enough to comply with contract requirements. The FDIC's contract with the broker allowed that at the written request of either party, the broker fees could be renegotiated to reflect changes in the portfolio or services. Such fee re-negotiations were to commence no less than 30 days prior to the expiration of the current contract term, which was September 30, 1998. The Division of Administration contracting officer notified Center personnel 60 days prior to the expiration of the contract that it seemed appropriate to renegotiate the brokerage fees. Also, in the analysis of the 1997/1998 insurance program dated September 17, 1997, Aon recommended that broker fees be reexamined due to the decrease in program size. In the analysis of the 1998/1999 insurance program dated September 4, 1998, Aon recommended a broker-fee-to-premium ratio of 10 percent to 20 percent.

Center personnel met with the broker 7 days prior to the expiration of the contract to renegotiate the fee. The Center's efforts to renegotiate the fee were not successful because they were not initiated within the time periods allowed for in the contract. Because estimated

premiums for 1997/1998 were $700,000, the broker fee for the program year would have been $140,000 or less using Aon's suggested ratio of 10 percent to 20 percent of premiums. The FDIC did not attempt to renegotiate the broker fee within the contract-defined timeframes, thus a cost savings opportunity was missed that may have resulted in broker fees being reduced by $100,000 in the 1998/1999 program year using the Aon-suggested 20 percent broker fee ratio.

When asked about this situation, Center personnel acknowledged that they did not initiate the broker re-negotiation efforts timely and could not quantify what an acceptable broker fee would have been had the re-negotiations been successful. Center personnel expressed concern that the broker would not accept a lower brokerage fee and would withdraw from the contract, thereby causing FDIC to lose the good rates and services it was receiving. Additionally, Center personnel thought there would be an extensive learning curve with a new broker and the possibility of higher rates and unacceptable service. Center personnel also stated that the broker should not be penalized for negotiating beneficial premium rates. Because broker compensation would be tied to total premiums, the more successful the broker is in negotiating lower premiums, the lower the compensation would be. (Although we understand the Center's position, the drop in total premiums was primarily due to a decrease in the insured asset base rather than significant changes in premium rates.) Center personnel notified us that rather than try to renegotiate the broker fee, they plan to re-bid the broker contract after the self-insurance study from Aon is completed.

Recommendations

Based on the significant changes impacting the FDIC's insurance program over the past 3 years, including declines in assets, insured values, premiums, and low loss ratios, we support an all-inclusive cost/benefit study that addresses various risk management options. The study should consider such factors as loss experience history, effect on premium rates if certain coverages dropped, location and insured value of remaining assets, deductible levels on purchased coverages, minimum insured values, and projected asset levels. As such, we support the Center's decision to study the program's cost effectiveness, and we have provided information to Aon, that we believe would be helpful for this effort.

We recommend that the Deputy Director of the Field Operations Branch ensure that the Center:

(1) Conduct a cost/benefit analysis of risk management to study the cost effectiveness of various insurance options, including: purchasing insurance or establishing forms of self-insurance or non-insurance. Risk management assessments should address factors such as loss experience, location and insured value of program assets, and premium rates available from the carrier marketplace.

(2) Improve tracking and verification of asset forecasts, premiums, losses, and deductible payments in relation to other insurance expenses. Analysis of such in-house data

would help Center officials react quickly to changing factors that affect the FDIC's insurance program.

(3) Attempt to renegotiate a broker fee that is commensurate with industry standards (funds put to better use of $115,000, which represents DRR's projected savings for the 1999/2000 program year).

OPPORTUNITIES EXIST FOR IMPROVED NIS DATA RELIABILITY

We believe that opportunities exist for improved data reliability. Specifically, our audit sample disclosed errors in NIS data and inconsistencies in recording certain asset types. FDIC personnel rely on NIS data to make insurance program decisions, settle loss claims, and pay insurance premiums. We found a 23 percent error rate in NIS data from our random sample of 30 assets. We also found systemic problems in the way two categories of assets are recorded on NIS. The inaccurate and inconsistent recording of assets on NIS has caused an overpayment of premiums, resulted in forfeited loss recovery opportunities, and negatively affected the ability of managers to project program performance.

High Error Rate in NIS Data Sample

We reviewed 30 randomly sampled assets from a November 18, 1998 database of 805 assets and found that 7 (23 percent) of the sample assets were incorrectly recorded on NIS as of January 18, 1999. Specifically, 5 of the 30 assets reviewed were not accurately valued on NIS. The 5 assets, which had a total insured value of $1,223,000, were overstated by $603,430, or 49 percent. Two other sample assets had been sold on September 16, 1998 but were still listed as actively insured on NIS for $10,000 each as of late January 1999. These errors caused the FDIC to overpay $4,680 in premiums out of a total $20,402 for the 30 assets in the OIG's sample.

Both the *National Insurance Manual* and *Asset Disposition Manual* provide guidance on how insured value is to be derived for assets in which the FDIC has an insurable interest. Total insured value is generally derived by subtracting the appraised value of land from total appraised value of the asset. According to the *National Insurance Manual,* account officers are responsible for ensuring the liquidation assets are properly protected and covered in the event property value changes. If a new appraisal is received on an asset, it is the account officer's responsibility to ensure the updated value is entered into the NIS. In addition, the account officer is responsible for initiating, through the site coordinator, a cancellation of insurance coverage within 30 days of the date that the FDIC no longer has an insurable interest in the asset.

FDIC's site coordinators and account officer supervisors performed reconciliations between NIS data and the ORE system, but the reconciliations only identified when an asset was on one system but not on the other. The reconciliations did not consider whether an asset was properly valued. Further, account officers were not routinely verifying the total insured value of the assets, nor were their supervisors performing

routine data integrity checks of an asset's insured value. The problems with the NIS data related to total insured value could leave the FDIC uninsured or underinsured in the event of a loss or overinsured and paying too much in premiums. The Center, Aon, the insurance broker, and the carriers rely on the accuracy of the NIS data to determine premiums, settle losses, and make projections regarding the most prudent insurance program.

Account officer supervisors have agreed to correct the data errors identified for the assets in the OIG sample and commence running a report to assist in identifying data integrity problems.

Condominium and Cooperative Units Were Inconsistently Recorded on NIS

Eleven of the assets in our initial sample of 30 were condominium and cooperative units valued on NIS by the NESC site coordinators and account officers at a flat rate of $10,000 each. Two of the assets had appraised values of less than $10,000 and were valued at the minimum insured value set by the insurer of $10,000. Although the other nine assets had appraisals that indicated their value exceeded $10,000, they were recorded in NIS at the flat $10,000 minimum coverage rate in accordance with NESC policy. We compared the NESC policy for valuing condominium and cooperative units to the FOB policy and found inconsistencies. While the NESC used the flat $10,000 minimum coverage for condominium and cooperative unit assets, FOB personnel used appraised value. Based on these discrepancies, we analyzed the entire population of condominium and cooperative units as of November 18, 1998 and March 3, 1999. Table 2 provides details on the number of condominium and cooperative units in the insured asset population.

Table 2: Number of Condominium and Cooperative Units in NIS

	11/18/98	03/03/99
Total Number of Active Assets in NIS	**805**	**658**
Number of Condominium and Cooperative Units in NIS	**257**	**233**
Percentage of Condominium and Cooperative Units in NIS	**32%**	**35%**

Sources: OIG analysis of NIS active asset database.

The *National Insurance Manual* did not address how to value cooperative units. The *National Insurance Manual* (pages 2B-6 through 8) provided guidance on how to value condominium units under ideal circumstances but did not suggest the proper means of valuing the units if key documentation could not be gathered. Although Center managers had a goal in the 1998 Performance Measures to update the *National Insurance Manual,* cooperative units were not addressed in the manual. Additionally, the rewritten manual did not provide sufficient guidance to eliminate possible inconsistent valuation of condominium units. Because condominium and cooperative units constitute a large portion of the population of insured assets (35 percent as of March 3, 1999), the inconsistent treatment of condominium and cooperative units could result in uninsured losses and incorrect payment of premiums.

Center management has agreed to add guidance on cooperative units in the *National Insurance Manual.* Center management also agreed to update guidance for condominium units so that account officers have better information to assist them in placing insurance coverage.

Recent Procedures For Insuring Discovered Assets Were Not Always Followed

While performing our tests on the sample of assets, we determined that *National Insurance Manual* procedures for discovered assets[13] were not always being followed at the FOB. Specifically, FOB account officers were not always ensuring that discovered assets were properly covered by insurance. As a result, the absence of insurance coverage on these discovered assets left the FDIC vulnerable to financial loss.

According to the October 1998 revision of the *National Insurance Manual*, "Discovered Assets are to be added to the NIS within 60 days of discovery. The discovery is to extend back to either the date of acquisition or the date that Travelers/Aetna first provided coverage (08/01/94)." Before issuing the revised *National Insurance Manual*, the FDIC did not have any guidance on how to insure discovered assets.

The FOB identified a total of 107 discovered assets in 1998 and the first 2 months of 1999. However, of the 107 assets that FOB discovered in the 14 months ended February 28, 1999, only 15 assets were back dated, as is now required by the manual. Of the remaining 92 assets discovered during this period, 15 were not listed on NIS as having any type of insurance coverage and 77 assets had insurance coverage that was effective for periods after the date acquired.

FOB identified 38 of the 107 discovered assets after the manual was revised in October 1998. Of these 38 assets, only 5 were properly back dated. Of the remaining discovered assets, 7 were not listed on NIS as having any type of insurance coverage and 26 assets had insurance that was effective for periods after the date acquired.

The insurance carrier has agreed to permit back dating insurance coverage to prior policy periods if FDIC's request for back dating is made within 60 days of asset discovery and premiums are paid for the prior periods. The back dating of coverage could be beneficial to the FDIC because an asset could suffer an uninsured loss during the prior period. Therefore, FOB's failure to back date insurance coverage left the FDIC vulnerable to claim losses for the periods prior to the effective date of insurance coverage for 92 assets.

Although the manual revision has been effective since October 1998, when we discussed the issue of insuring discovered assets with FOB and Center officials during our exit conference, there appeared to be some confusion on the part of the FOB official as to the proper application of the manual's guidance. Specifically, FOB's account officer supervisor expressed confusion over how the insurance policy back dating function worked within NIS. The account officer supervisor further informed us that efforts to

[13] A discovered asset is an asset for which the FDIC did not previously assume that it held title or responsibility.

insure a discovered asset are sometimes hampered by delays of up to several months in obtaining a title opinion and appraisal on which to base insurable interest and value. Nevertheless, on March 19, 1999, the account officer supervisor sent an electronic message to FDIC account officers reminding them of provisions in the *National Insurance Manual* regarding discovered assets.

Recommendations

We recommend that the Deputy Director of the Field Operations Branch and the Regional Director of the NESC:

(4) Initiate periodic random sampling of the NIS data to verify the data accuracy and identify if further action needs to be taken to ensure data accuracy.

We recommend that the Deputy Director of the Field Operations Branch ensure that Center and account officer supervisors work closely to:

(5) Modify the *National Insurance Manual* in collaboration with the broker and carrier to assist account officers with asset evaluations for condominium and cooperative units.

(6) Ensure that discovered assets are properly insured in accordance with the revised *National Insurance Manual*.

CORPORATION COMMENTS AND OIG EVALUATION

On August 27, 1999, the DRR Deputy Director, Dallas Field Operations Branch, provided a written response to a draft of this report. The response is presented in appendix I of this report. The DRR Deputy Director, Dallas Field Operations Branch, stated that he agreed with the OIG's recommendations and had implemented corrective action for four of the six recommendations. The corrective action related to our recommendation regarding *National Insurance Manual* modifications is scheduled to be completed by December 31, 1999. Corrective action related to our recommendation to renegotiate the broker fee commensurate with industry standards is scheduled to be completed by September 30, 1999. DRR's recent re-negotiation of the broker fee is anticipated to result in a fee reduction of $115,000 for the 1999/2000 program year.

The Corporation's response to the draft report provided the elements necessary for management decisions on the report's recommendations. Therefore, no further response to this report is necessary. Nevertheless, we would like to clarify the information provided in the Corporation's response to our recommendation to conduct a cost/benefit analysis of risk management. While the Aon study was part of the DRR Strategic Plan as pointed out in our report, we did not find any evidence that the study had commenced prior to the initiation of our audit in November 1998. Aon was not tasked to start the study until February 1999. The OIG provided Aon our analysis of National Insurance Program data to assist in their evaluation of the program. Center personnel provided the OIG with a draft copy of the preliminary study on July 20, 1999. The draft clearly states that additional analysis must be

performed before the study is completed. According to Center personnel, the study, when completed, will be provided to the OIG.

Based on the audit work, the OIG will report funds put to better use of $115,000 in its *Semiannual Report to the Congress.*

Appendix I

CORPORATION COMMENTS

FDIC
DRR, Resolutions and Receiverships
1910 Pacific Avenue, 17th Floor
Dallas, TX 75201
214/754-0098

M E M O R A N D U M

TO: Shirley Ward
Regional Director
Office of the Inspector General

FROM: A.J. Felton
Deputy Director
Dallas Field Operations Branch

DATE: August 26, 1999

SUBJECT: National Insurance Center OIG Audit

Please find below recommendations and responses to the subject OIG audit.

RECOMMENDATION: Conduct a cost/benefit analysis of risk management to study the cost effectiveness of purchasing insurance, establishing a form of self-insurance or non-insurance. Risk management assessments should address factors such as loss experience, location and insured value of program assets, and premium rates available from the carrier marketplace.

RESPONSE: Agreed and corrective action is complete. The DRR Operations Branch Strategic Plan for 1999 and this OIG recommendation both called for a cost/benefit analysis contrasting the alternatives of purchased insurance, self-insurance, and non-insurance. The National Insurance Center commissioned this analysis in 1998 prior to the OIG audit. The study was completed in June 1999 by AON Services Group, a nationally recognized risk management firm. A copy of the AON study was provided in July 1999 by the National Insurance Center to the OIG as a matter of information and to satisfy this OIG recommendation. (Steve Stockton, 972/761-3204)

RECOMMENDATION: Improve tracking and verification of asset forecasts, premiums, losses, and deductible payment in relation to other insurance expenses. Analysis of such in-house data would help Center officials react quickly to changing factors that affect the FDIC's insurance program.

RESPONSE: Agreed and corrective action is complete. Regular annual actuarial studies to track and compare trends of asset inventories, premium costs, loss experience, and deductible payments should be performed as an enabling measure to aid Field Operations Branch in deciding insurance expenses. This OIG recommendation was incorporated into the AON study which was completed in July 1999. Similar actuarial studies will continue to be completed each year. (Steve Stockton, 972/761-3204)

RECOMMENDATION: Attempt to renegotiate a broker fee that is commensurate with industry standards.

RESPONSE: Agreed. The Division of Administration, Acquisition Services Branch, at the request of the National Insurance Center in May 1999, issued a request for proposals, inviting bids for brokerage services and insurance coverage for the insurance program year October 1999 through September 2000. The results obtained from this solicitation are currently being evaluated with a decision expected in September 1999. (Steve Stockton, 972/761-3204)

RECOMMENDATION: Initiate periodic random sampling of the NIS data to verify the data accuracy and identify if further action needs to be taken to ensure data accuracy.

RESPONSE: Agreed and corrective action is complete. Account officers and supervisors were provided a list of assets that needed corrective action. Those corrective actions were taken and verified. On an ongoing basis, each account officer is provided a quarterly report to determine if the insured values are accurate and up to date. (Harry Chance, 972/761-8305)

RECOMMENDATION: Modify the National Insurance Manual in collaboration with the broker and carrier to assist account officers with asset valuations for condominiums and cooperative units.

RESPONSE: Agreed. The National Insurance Manual contains detailed instructions on valuing condominiums. This section will be re-addressed and any necessary changes will be included in the annual revision in the fourth quarter of 1999.

A co-operatives section will be added to the National Insurance Manual. Both subjects will be addressed in the NIC-hosted training for ORE account officers and managers in the fourth quarter of 1999. (Steve Stockton, 972/761-3204)

RECOMMENDATION: Ensure that discovered assets are properly insured in accordance with the revised National Insurance Manual.

RESPONSE: Agreed. Account officers have been advised to add insurance coverage for discovered assets effective the later of October 1994 or actual date of acquisition. On a quarterly basis, the Site Insurance Coordinator performs a reconciliation of owned real estate assets to a schedule of assets actually insured to identify any omissions or needed corrections. (Harry Chance, 972/761-8305)

cc: J. Forrestal
T. O'Keefe
B. Ostermiller
R. Hoffman
A. Rouse
S. Stockton

APPENDIX II

MANAGEMENT RESPONSES TO RECOMMENDATIONS

The Inspector General Act of 1978, as amended, requires the OIG to report the status of management decisions on its recommendations in its semiannual reports to the Congress. To consider FDIC's responses as management decisions in accordance with the act and related guidance, several conditions are necessary. First, the response must describe for each recommendation

- the specific corrective actions already taken, if applicable;
- corrective actions to be taken together with the expected completion dates for their implementation; and
- documentation that will confirm completion of corrective actions.

If any recommendation identifies specific monetary benefits, FDIC management must state the amount agreed or disagreed with and the reasons for any disagreement. In the case of questioned costs, the amount FDIC plans to disallow must be included in management's response.

If management does not agree that a recommendation should be implemented, it must describe why the recommendation is not considered valid. Second, the OIG must determine that management's descriptions of (1) the course of action already taken or proposed and (2) the documentation confirming completion of corrective actions are responsive to its recommendations.

This table presents the management responses that have been made on recommendations in our report and the status of management decisions. The information for management decisions is based on management's written response to our report and subsequent discussions with management representatives.

Rec. Number	Corrective Action: Taken or Planned/Status	Expected Completion Date	Documentation That Will Confirm Final Action	Monetary Benefits	Management Decision: Yes or No
1	A draft of the study was completed in June 1999.	9/30/99	Copy of the final analysis	Not quantifiable	Yes
2	Actuarial studies will be completed each year.	9/30/99	Copy of the final analysis	Not quantifiable	Yes

Rec. Number	Corrective Action: Taken or Planned/Status	Expected Completion Date	Documentation That Will Confirm Final Action	Monetary Benefits	Management Decision: Yes or No
3	Brokerage services and insurance coverage are being re-bid in accordance with FDIC policies.	9/30/99	Copy of the new contract	$115,000 in funds that could be put to better use	Yes
4	A quarterly review of NIS data will be conducted.	Completed	Copy of a recently reviewed quarterly report	Not quantifiable	Yes
5	The National Insurance Manual sections for condominium and cooperative units will be revised.	12/31/99	Copy of the revised manual sections	Not quantifiable	Yes
6	Account officers have been advised to properly add insurance coverage for discovered assets.	Completed	Copy of instruction to account officers has been provided.	Not quantifiable	Yes