Senate Committee on State Affairs
Report to the 77th Legislature

Charge 7

Purchase of Insurance and Surety Bonds by State Agencies and Institutions

ACKNOWLEDGMENTS

The Senate Committee on State Affairs would like to thank the following for their contribution to this interim report:

Office of the State Auditor
The State Office of Risk Management
Texas Legislative Council
The University of Texas System
The Texas A&M University System
Texas Tech University and Texas Tech University Health Science Center
Texas Department of Transportation

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Executive Summary

The Charge:

Evaluate the cost-effectiveness of the purchase of insurance and surety bonds by state agencies and institutions, including an evaluation of premiums paid and claims recovered.

Findings:

(1) While the state can accurately assess the amount of money spent on insurance premiums, due to the fact that the state lacks reliable and comprehensive information on the amount of claims recovered, the state cannot adequately determine the most cost-effective means by which state entities should insure themselves against risks due to loss.

(2) The Texas State Auditor's Office reported that there were significant opportunities for recurring cost savings if the State were either to eliminate or consolidate surety bond coverage for state employees. In the absence of claims data suggesting otherwise, there is little economic justification for maintaining surety bond coverage for state officers and employees, especially with respect to coverage that is capped at $10,000. Any state agency should be able to absorb the risk associated with such a loss.

Recommendations:

(1) The legislature should enhance and simplify the reporting process by requiring insurers writing policies for state agencies and institutions to file a certificate of insurance with SORM at the time that a binder on a policy is issued, and granting to SORM the authority to request from the insurer a loss run on any policy issued to a state agency or institution.

(2) The legislature should designate an appropriate agency to approve surety bond coverage for state employees when warranted by special circumstances. The designated agency should also be charged to make recommendations to the legislature regarding potential amendments to Section 653.002, et. al., of the Government Code and the potential elimination of general surety bond requirements.

Senate Committee on State Affairs

Lieutenant Governor Rick Perry charged the Senate Committee on State Affairs with "evaluating the cost-effectiveness of the purchase of insurance and surety bonds by state agencies and institutions, including an evaluation of premiums paid and claims recovered."[1] In fulfilling the directive, the Committee held a public hearing in Austin on October 28, 1999, to take testimony from interested parties, including the State Office of Risk Management and the Office of the State Auditor. This report summarizes the testimony and contains the findings of the Committee.

BACKGROUND

In order to determine the most cost-effective means by which a state insures itself, the following questions must be asked:

> Is it necessary for Texas state agencies purchase commercial insurance coverage?
>
> Is the state getting its money's worth from the coverage it pays for?
>
> > Do loss histories justify current expenditures?
> >
> > Are there overlaps in coverage across different types of insurance and surety bonds?
>
> Is the state purchasing the right kinds of insurance and in the right amounts?
>
> > Should the state purchase additional insurance for high-risk activities?

[1] Letter from Lieutenant Governor Rick Perry to the Senate Committee on State Affairs, September 7, 1999.

Can the state reduce costs by self-insuring or pooling agency insurance purchases?

There are generally two types of coverages in which a state ordinarily is interested:

1. insurance: coverage that will protect the state from loss to state-owned property or loss due to failure or breakdown of state-owned property, and

2. surety bonds: coverage that will protect the public from wrongful actions of state officials and employees.

For the purpose of this report, the committee used the following definitions of insurance and surety bonds:

Insurance: The purpose of insurance is to shift the burden of risk from the one upon whom it originally falls to another who is more willing and better able to bear it. The final result of such a shifting of the burden of risk is to substitute certainty for uncertainty on the part of the original risk bearer and to prevent the burden of loss from falling upon those not adequately prepared for it.

Surety Bond: The State Employee Bonding Act defines "bond" as "an agreement obligating an insurance company, as a surety, to pay within certain limits a loss caused by a dishonest act of an officer or employee of a state agency, or failure of an officer or employee of a state agency to faithfully perform a duty of the officer's or employee's office or position."[2] The State Employee Bonding Act lists three such bonds: faithful performance blanket position bonds, honesty blanket position bonds and position schedule honesty bonds.

[2] Chapter 653, Government Code.

The Senate Committee on State Affairs reviewed the state's practice of purchasing insurance and surety bonds in order to determine the most economically sound means for government to insure its property and bond its employees. It is widely held that the state could realize true cost savings by either self insuring or pooling many agencies into a single policy. The principal question that arises is whether or not a state should purchase commercial insurance and surety bonds in the first place. In order to answer that question, the following queries must be resolved:

1. Is the state able to absorb all losses without impairing its financial condition, and if not, to what extent is it able to absorb such losses.

2. To what extent, if any, does the state wish to protect the public in view of the fact that it cannot be sued unless its immunity from suit has been expressly waived?

It is axiomatic that insurance and surety bonds should not be purchased simply for the sake of purchasing them, instead, said purchases are justifiable only if the purchaser is in a position to incur a loss which they cannot afford. For these same reasons a number of states with large financial resources do not purchase insurance but instead rely upon current funds and legislative appropriations to meet any unexpected losses.[3] (See Appendix I of this report for a comparison of the 10 most populous states' insurance and employee bond practices.)

The state has four options for insuring state-owned property and bonding its agencies' officers and employees. These four approaches include:

1. purchasing commercial insurance and surety bonds,

2. maintaining no coverage, relying on the fact that the state will be in a position to sustain any potential loss,

3. self-insuring, or

[3] Testimony of the State Office of Risk Management, presented to the Senate Committee on State Affairs, October 28, 1999.

4. a combination of the first three methods.

It should be noted that Texas' workers' compensation insurance is not included in this report because it is considered a self-insurance program[4] and is not purchased as is typically done with insurance. In such a program, losses/claims are covered through an agency's current appropriations. Essentially, no coverage is purchased, whereas the self-insurance option indicated previously usually involves an agency or statewide self-insurance account, where funds are deposited for the sole purpose of covering potential claims.[5]

METHODOLOGY

The committee held a public hearing to discuss the state's current methods of purchasing coverage and whether these practices represent the most cost effective means available. The Committee requested testimony from the State Office of Risk Management (SORM) and the Office of the State Auditor (SAO).

The committee determined it could best evaluate the state's current practice through receipt of information regarding the types of policies being purchased, which agencies and institutions make said purchases, and the monetary values for the premiums paid (from all revenue sources) and claims recovered. This evaluation would then lead to the following questions, which must be answered in order to determine the most cost-effective means by which a state insures its property and bonds its employees:[6]

Is the state getting its money's worth from the coverage it pays for?

Do loss histories justify current expenditures?

Are there overlaps in coverage across different types of insurance and

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[4] Section 501.023, Labor Code.

[5] Section 2259.002, Government Code.

[6] Testimony of the Office of the State Auditor, presented to the Senate Committee on State Affairs, October 28, 1999.

surety bonds?

Is the state purchasing the right kinds of insurance and in the right amounts?

Should the state purchase additional insurance for high-risk activities?

Can the state reduce costs by self-insuring or pooling agency insurance purchases?

If it is determined that an agency's insurance or bond coverage has very little loss history, or that an agency has been purchasing excessive or multiple policies to cover a single asset, the state must decide if it would be a better practice to minimize current insurance purchases, or more simply, pool similar agencies in one policy.

STATE'S PURCHASE OF INSURANCE

Numerous rules and regulations concerning insurance purchases by state agencies and institutions are found throughout various statutory codes. For this reason, it is difficult for many, including agency directors and state risk managers, to grasp all of the options available. Specific regulations can be found in each agency's statutory framework as well as the following codes:

Section 58.002, Agriculture Code,

Sections 54.618, 59.04, and 59.24, Education Code,

Sections 412, and 501 through 505, Labor Code,

Section 201.106, Transportation Code, and

Several sections throughout the Government Code.

Several statutes must be examined together in order to provide an accurate assessment of the cost effectiveness of the current practices of state agencies and institutions in the purchase of insurance. They include the following:

> The General Appropriations Act, which prohibits the use of appropriated funds for the purpose of purchasing insurance to cover potential tort claims, except for the purchase of policies for "directors' or officers' liability;"[7]

> Section 101.027 of the Texas Civil Practice and Remedies Code, which authorizes a governmental unit to purchase liability insurance policies to protect the unit and its employees against tort claims;

> Chapter 2259 of the Government Code, which authorizes a governmental unit of this state to establish and maintain "a self-insurance fund to protect the governmental unit and its officers, employees, and agents from any insurable risk or hazard;"[8]

> Chapter 501, et. seq., of the Labor Code, which authorizes and details the workers' compensation insurance coverage program for state employees; referred to as a self-insured program for employees of all governmental entities, however, as discussed on page 4 of this report, this program could be considered a non-coverage program as no funds are dedicated for potential losses. When losses or claims do occur, an agency pays for them out of current appropriations.

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[7] **General Appropriations Act** **General Limitations on Expenditures Sec. 9-6.35 Purchase of Insurance.** None of the funds appropriated by this Act may be expended for purchasing insurance to cover claims arising under the Chapter 101, Civil Practice and Remedies Code, (Texas Tort Claims Act). Notwithstanding the forgoing, a state agency may purchase director's or officer's liability insurance to cover claims arising under the Chapter 101, Civil Practice and Remedies Code, (Texas Tort Claims Act) with appropriated funds for the agency's appointed commission or board members and executive management staff.

[8] Section 259.002, Government Code, as added by Acts 1999, 76th Leg., ch. 227, Section 5, eff. Sept. 1, 1999.

Section 612.001 of the Government Code, which mandates that the state shall provide coverage for motor vehicle liability insurance for peace officers and fire fighters;

Section 612.002 of the Government Code, which authorizes an agency to purchase liability coverage for its employees to protect the employees and the agency from liability arising out of the operation, maintenance, or use of a motor vehicle, item of power equipment, aircraft, or motorboat or other watercraft owned by that agency;

Section 612.003 of the Government Code, which authorizes liability insurance for agencies that participate in certain state programs, such as a state agency that receives federal grant funds for a foster grandparent program, an agency that operates an integrated day-care program, or an agency that operates a habilitative or rehabilitative work program.

STATE OFFICE OF RISK MANAGEMENT

The 75th Legislature merged the workers' compensation and risk management strategies from two separate state agencies, the Texas Workers' Compensation Commission and the Office of the Attorney General, creating the State Office of Risk Management (SORM). Chapter 412 of the Labor Code establishes that SORM is required to "administer the government employee's workers' compensation insurance and the state risk management programs."[9] Regarding insurance and surety bond purchases, responsibilities of SORM include:

(1) administering guidelines adopted by the board for a comprehensive risk management program applicable to all state agencies to reduce property and liability losses, including workers' compensation losses;

[9] Section 412.011, Labor Code.

(2) reviewing, verifying, monitoring, and approving risk management programs adopted by state agencies; and

(3) assisting state agencies with implementing effective and comprehensive programs that meet the guidelines established by the board.

SORM is also required to submit a report to the legislature regarding:

(1) the methods used to reduce the exposure of state agencies to the risks of property and liability losses, including workers' compensation losses;

(2) the operation, financing, and management of those risks; and

(3) the handling of claims brought against the state.[10]

The report must include:

(1) the frequency, severity, and aggregate amount of open and closed claims in the preceding biennium by category of risk, including final judgments;

(2) the identification of each state agency that has not complied with the risk management guidelines and reporting requirements; and

(3) recommendations for the coordination and administration of a comprehensive risk management program to serve all state agencies, including recommendations for any necessary statutory changes.[11]

Texas state agencies and institutions of higher learning are required to develop, implement and maintain programs designed to assist employees who sustain

[10] Section 412.032, Labor Code.

[11] Section 412.032, Labor Code.

compensable injuries return to work.[12] Agencies are also required to report to SORM, for each fiscal year, information including, but not limited to, "the location, timing, frequency, severity, and aggregate amounts of losses by category of risk, including open and closed claims and final judgments."[13]

Currently, several state entities are exempt from reporting to SORM information regarding their risk management programs and insurance policies based on the fact that they had malpractice insurance, workers' compensation, or other self-insured insurance coverages prior to January 1, 1989.[14] The Texas Department of Transportation, the University of Texas System, the Texas A&M University System and the Texas Tech University System all have internal risk management or insurance divisions that are charged with managing the risks of that entity. (See appendices II through V for insurance policies purchased and claims recovered by these entities.)

All state agencies and institutions currently may purchase commercial insurance. In order to determine exactly how much is spent on these purchases and the claims recovered from those policies, the committee, with assistance from the State Auditor's Office and the State Office of Risk Management, requested data from the different entities responsible for tracking such information.

The committee was able to ascertain that since fiscal year 1994, state entities spent approximately $29 million in general revenue funds on purchases of insurance.[15] This amount does not include premiums paid from local funds, such as those administered by universities. (Please see Chart #2.) It also does not include premiums related to employee benefits, such as health, unemployment, or workers' compensation insurance.

[12] Section 412.051, Labor Code.

[13] Section 412.053, Labor Code.

[14] Section 412.052, Labor Code.

[15] Testimony of the Office of the State Auditor, presented to the Senate Committee on State Affairs, October 28, 1999.

The following charts provide a breakdown of the various categories of insurance policies purchased by Texas state agencies and universities in fiscal year 1999.[16] It is important to note that these charts only express premiums as reported by agencies to SORM in that office's annual survey.

Insurance Purchases: State Agencies and Universities

Category	Premium	% of Total
Liability (Professional)	$1,089,498.00	20 %
Property	$ 938,641.00	17%
Property (General)	$793,662.00	14%
Directors and Officers	$578,695.00	10%
Liability (Auto)	$544,981.00	10%
Liability (Athletics)	$406,239.00	7%
Surety	$350,226.00	6%
Liability (General)	$293,408.00	5%
Other	$98,771.00	2%
Property (Crime)	$94,188.00	2%
Liability (Peace Officers Bond)	$89,462.00	2%
Bond (Miscellaneous)	$81,868.00	1%
Property (Ocean & Inland Marine)	$62,883.00	1%
Notary	$28,339.00	1%
Liability	$20,805.00	1%
Liability (Medical)	$16,912.00	1%
Liability (Special Event)	$6,980.00	0%
Liability (Volunteer)	$3,150.00	0%
Customs Bond	$313.00	0%
Total	$5,499,021.00	100%

[16] Testimony of the State Office of Risk Management, presented to the Senate Committee on State Affairs, October 28, 1999.

Insurance Purchases: State Agencies

Category	Premium	% of Total
Property	$298,180.00	23%
Directors and Officers	$255,608.00	20%
Liability (Professional)	$175,780.00	14%
Property (General)	$154,379.00	12%
Surety	$91,306.00	7%
Bond (Miscellaneous)	$81,172.00	6%
Liability (Auto)	$60,733.00	5%
Property (Ocean & Inland Marine)	$36,154.00	3%
Liability (General)	$35,547.00	3%
Other	$31,942.00	3%
Notary	$28,268.00	2%
Liability	$20,805.00	2%
Liability (Volunteer)	$3,150.00	0%
Property (Crime)	$1,773.00	0%
Liability (Peace Officers Bond)	$546.00	0%
Total	$1,275,343.00	100%

Insurance Purchases: Universities

Category	Premium	% of Total
Liability (Professional)	$913,718.00	22%
Property	$640,461.00	15%
Property (General)	$639,283.00	15%
Liability (Auto)	$484,248.00	11%
Liability (Athletics)	$406,239.00	10%
Directors and Officers	$323,087.00	8%
Surety	$258,920.00	6%
Liability (General)	$257,861.00	6%
Property (Crime)	$92,415.00	2%
Liability (Peace Officers Bond)	$88,916.00	2%
Other	$66,829.00	2%
Property (Ocean & Inland Marine)	$26,729.00	1%
Liability (Medical)	$16,912.00	0%
Liability (Special Event)	$6,980.00	0%
Bond (Miscellaneous)	$696.00	0%
Customs Bond	$313.00	0%
Notary	$71.00	0%
Total	$4,223,678.00	100%

Information on the cost of insurance and surety bonds (premiums) is available from several sources, including the Uniform Statewide Accounting System (USAS), agency and university Annual Financial Reports (AFR), and an annual survey conducted by the State Office of Risk Management. Each of these sources captures a specific expenditure, yet when taken as a whole, these sources do not provide a complete picture. For example:

> The Uniform Statewide Accounting System captures expenditures from state general revenue funds, but it does not capture expenditures from local funds, nor does it contain consistent data on claims paid by insurers. The revenues are being captured, but without corresponding information regarding where or how.
>
> The only information available on claims paid by insurers on behalf of state agencies and universities is self-reported by those agencies and universities on State Office of Risk Management surveys. While this is the best information currently available, it appears that agencies and universities do not always complete the surveys accurately or completely. The Committee has been advised that information on claims recovered is often difficult to obtain as commercial insurance carriers often report that information differently.[17]
>
> Section 2101.011 of the Government Code requires that each agency include in its Annual Financial Report a list of all bonded employees, including the name of the surety company, the name and title of the employee and the amount of the surety. While the state's purchases of surety bonds will be covered in the next section of this report, it is important to note that many agencies include employee liability coverage in their AFRs.[18]

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[17] Testimony of the State Office of Risk Management, presented to the Senate Committee on State Affairs, October 28, 1999.

[18] Testimony of the State Office of Risk Management, presented to the Senate Committee on State Affairs, October 28, 1999.

During the course of the committee's public hearing, committee members questioned why claims data is not available. The State Office of Risk Management responded that their surveys may not be specific enough, or that an agency is unable to receive those figures from the insurance carrier, as each insurer may report that information in different manners.[19]

The overall picture gained from comparing these data sources is that the state lacks a coordinated system for identifying and meeting insurance needs. At present, the decision to purchase insurance is delegated to individual state entities. In fiscal year 1999 alone, at least 146 entities purchased diverse types of insurance from at least 616 vendors.[20]

The Office of the State Auditor recommended that "there could be significant cost savings if agencies and universities were to coordinate purchases of insurance through a single designated agency, such as the State Office of Risk Management. The initial advantage of such a coordinated approach would be that, for the first time, the state would have a clearinghouse through which to obtain reliable data on the types of insurance being purchased and the claims paid under these policies."[21] The State Office of Risk Management concurred with this recommendation.[22] Without knowing the precise ratio of premiums paid to claims recovered, dramatically altering the current system is unwarranted at this time.

[19] Testimony of the State Office of Risk Management, presented to the Senate Committee on State Affairs, October 28, 1999.

[20] Testimony of the Office of the State Auditor, presented to the Senate Committee on State Affairs, October 28, 1999.

[21] Testimony of the Office of the State Auditor presented to the Senate Committee on State Affairs, October 28, 1999.

[22] Testimony of the State Office of Risk Management, presented to the Senate Committee on State Affairs, October 28, 1999.

Findings:

While the state can accurately assess the amount of money spent on insurance premiums, due to the fact that the state lacks reliable and comprehensive information on the amount of claims recovered, the state cannot adequately determine the most cost-effective means by which state entities should insure themselves against risks due to loss.

SORM has revised its process for reporting state insurance purchases and losses to simplify and standardize data collection and reporting. SORM will no longer require state agencies to include insurance information it its annual survey, the SORM 200. Instead, SORM will require state agencies to submit a 'certificate of insurance' prepared by their insurer for each policy that was active at any time during the previous fiscal year. Thereafter, state agencies will provide SORM with a certificate of insurance for each new insurance policy that was purchased or renewed during the next reporting period. In addition, at the end of each fiscal year, state agencies will send a copy of their loss run to SORM.

Recommendation:

The legislature should enhance and simplify the reporting process by requiring insurers writing policies for state agencies and institutions to file a certificate of insurance with SORM at the time that a binder on a policy is issued, and granting to SORM the authority to request from the insurer a loss run on any policy issued to a state agency or institution.

STATE'S PURCHASES OF SURETY BONDS

The State Employee Bonding Act, Chapter 653, Government Code, authorizes the head of a state agency to contract for the purchase of bonds to cover employees of that agency. The Act was passed in 1959 and was intended to provide uniform standards for bonding state officers and employees;[23] the Act has not been substantively amended since it was first enacted.

In 1987, the State Auditors Office reported that there were significant opportunities for recurring cost savings if the state were to self-insure or consolidate its purchase to a specific type of surety bond, blanket honest bonds.[24] The SAO testified at the committee hearing that they believe the findings of the 1987 report, while dated, still hold true.

The Office of the State Auditor testified that since fiscal year 1994, Texas state entities have paid at least $1.5 million out of general revenue for employee bonds. In fiscal year 1999 alone, these entities spent at least $280,000 out of general revenue on purchases of surety bonds.[25] According to a survey administered by the State Office of Risk Management, state entities were reimbursed at most $27,000 against those bonds, for a loss/premium ratio of less than 10 percent.[26] In the absence of claims data suggesting otherwise, there is little economic justification for maintaining surety bond coverage for state officers and employees, especially with respect to coverage that is capped at $10,000. "Any

[23] Testimony of the Office of the State Auditor, presented to the Senate Committee on State Affairs, October 28, 1999.

[24] Office of the State Auditor's report, "*A Study of the Alternative Methods for Managing The State's Risk of Loss Due to Employee Dishonesty*," January, 1987.

[25] "The actual amounts spent could be higher, since USAS does not capture expenditures from non-Treasury funds such as local funds administered by Universities." Testimony of the Office of the State Auditor, presented to the Senate Committee on State Affairs.

[26] These self-reported loss figures are questionable, since the SORM 200 survey does not always make clear whether these losses were for surety bond coverage or some other types of coverage, such as professional liability or commercial crime. Additionally, the Attorney General's Office, which is authorized to seek recovery of surety losses, reports no recent activity in that regard. Testimony of the Office of the State Auditor, presented to the Senate Committee on State Affairs, October 28, 1999.

state agency should be able to absorb the risk associated with such a loss."[27]

The SAO testified though, that the state should not prohibit the purchase of surety bonds altogether, stating that unique circumstances may exist where surety bonds are advisable for state officers or employees.[28] Under such circumstances, a designated agency such as the State Office of Risk Management could be statutorily authorized to approve the purchase of surety bonds after determining that special risks require such coverage. Such circumstances include an employee who handles petty cash,[29] and financial instruments, such as bond covenants. A list of Texas statutes authorizing the bonding of employees can be found in Appendix 6.

Findings:

In the absence of claims data suggesting otherwise, there is little economic justification for maintaining surety bond coverage for state officers and employees, especially with respect to coverage that is capped at $10,000. Any state agency should be able to absorb the risk associated with such a loss.

Recommendation:

The legislature should designate an appropriate agency to approve surety bond coverage for state employees when warranted by special circumstances. The designated agency should also be charged to make recommendations to the legislature regarding potential amendments to Section 653.002, et. al., of the Government Code, relating to bonds covering certain state officers and employees, and the potential elimination of general surety bond requirements.

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[27] Testimony of the Office of the State Auditor, presented to the Senate Committee on State Affairs, October 28, 1999.

[28] Testimony of the Office of the State Auditor, presented to the Senate Committee on State Affairs, October 18, 1999.

[29] Section 403.247(f), Government Code.

Appendix I

Insurance and Surety Bond practices in the top ten most populous states

Appendix II

The University of Texas System

Appendix III

Texas A & M University System

Appendix IV

Texas Tech University and Texas Tech Health Science Center

Appendix V

Texas Department of Transportation

Appendix VI

Employee Bond Statutes