

GAO

United States General Accounting Office

Report to the Chairman, Committee on
Veterans' Affairs, U.S. Senate

March 1992

VA LIFE INSURANCE

Administrative Costs for Three Programs Should Be Paid From Excess Funds





Human Resources Division

B-243900

March 10, 1992

The Honorable Alan Cranston
Chairman, Committee on Veterans' Affairs
United States Senate

Dear Mr. Chairman:

The Congress currently appropriates over \$30 million annually to pay the administrative costs of six Department of Veterans Affairs (VA) administered life insurance programs. At your request, we have examined the issue of using a portion of dividends paid to policyholders by three of these programs, instead of appropriated monies, to pay their administrative costs.

Background

VA is responsible for administering six veterans' life insurance programs and for supervising two others that are administered by the Prudential Insurance Company of America. By law, VA pays the administrative costs for five of the six VA-administered programs out of separate appropriated funds. Three of these programs pay substantial dividends to policyholders. The two remaining VA-administered programs are not self-supporting, require annual appropriations from the Congress to meet program expenses, and do not pay dividends. Table 1 shows which programs pay their own administrative costs and which pay dividends. A brief description of all eight VA life insurance programs is presented in appendix I.

Table 1: Programs Paying Administrative Costs and Dividends

| Program | Pays administrative costs | Pays dividends |
|---------------------------|---------------------------|----------------|
| VA administered | | |
| U.S. Government Life | | X |
| National Service Life | | X |
| Veterans Special Life | | X |
| Veterans Reopened | X | X |
| Service-Disabled Veterans | | |
| Veterans Mortgage Life | | |
| VA supervised | | |
| Servicemen's Group Life | X | |
| Veterans Group Life | X | |

Each year, VA actuarially determines the appropriate level of reserves needed for each program. This determination takes into account current policy reserve levels, mortality rates, interest rates on current investments, the cash values of current policies, and expected premiums it will collect throughout the year. Excess annual earnings, which represent the balance of funds after claims are paid and reserves are funded, where appropriate, are returned to policyholders in the form of dividends.

Results in Brief

Three VA-administered life insurance programs—United States Government Life Insurance, National Service Life Insurance, and Veterans Special Life Insurance—which insure World War I, World War II, and Korean War veterans, respectively, now have and for the foreseeable future will continue to have sufficient excess funds to pay their own administrative costs. This would save an estimated \$27 million annually in appropriated monies. In order to pay for this, veterans' annual dividends (which currently range from \$274 to \$373) would be reduced by about \$10. Insured veterans have no statutory or contractual right to excess funds. However, because the law now requires the government to pay the administrative costs, a legislative change would be required to allow these programs to pay their own administrative costs.

Scope and Methodology

To examine the issue of paying administrative costs from program dividends, we reviewed the laws and insurance policies for the three programs being studied. We also discussed the issues with VA officials and obtained detailed VA data on administrative costs and dividends paid to policyholders for the past 10 years. These data, along with VA's excess earnings data, actuarial reports, and investment portfolio, were used to estimate dividends and administrative costs through 1996. We also collected general information on other VA insurance programs.

We conducted our review at the VA Insurance Center in Philadelphia between April and September 1991. The review was conducted in accordance with generally accepted government auditing standards.

Funds Are Available to Pay Administrative Costs

VA data show that over the last 10 years, it has purchased various 15-year securities with guaranteed interest rates as high as 13.38 percent to support the three programs. VA investments will average about 9 percent interest annually for the next 7 to 8 years. These earnings and a lower-than-expected mortality rate for many of the insured have caused yearly income to accumulate above the solvency levels actuarially determined necessary by VA for these three programs. VA expects investment earnings to remain above the expected return on investment rates that were used in setting the original premiums for these programs.¹ Thus, substantial excess income is expected to accrue for the foreseeable future.

VA's practice has been to reduce the annual excess reserves by paying dividends to policyholders because program reserves have been sufficient to ensure program solvency. Total dividends increased an average of 7.5 percent per year between 1980 and 1989. In 1980, VA distributed over \$600 million in total dividends for these three programs; by 1990, total annual dividends had increased to over \$1.0 billion—an increase of 67 percent.

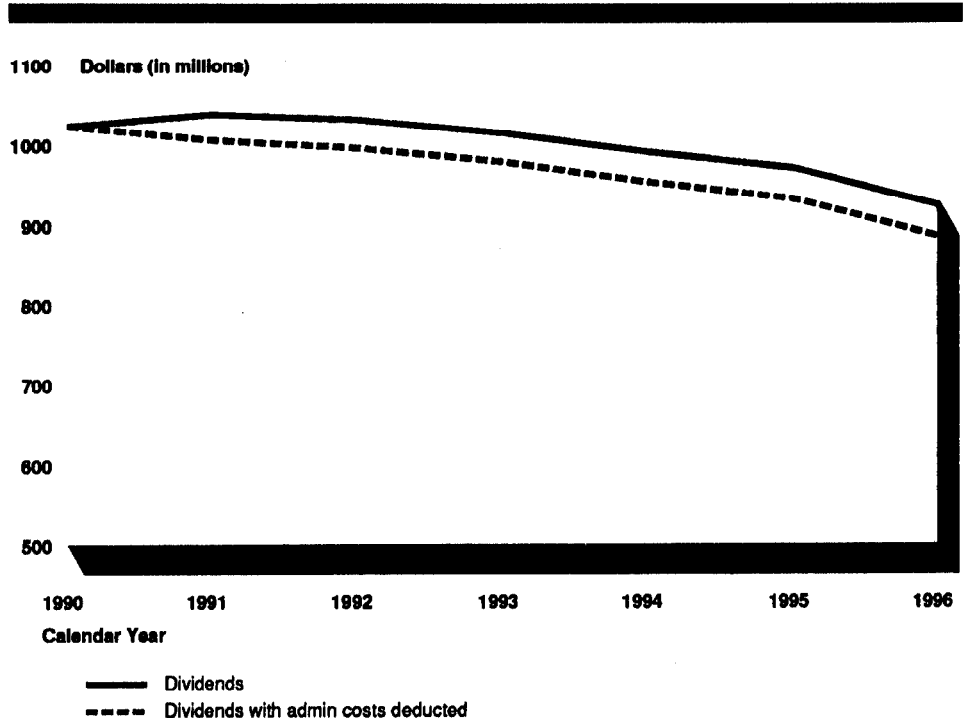
Administrative costs for all six VA-administered life insurance programs are far less than the excess funds available to pay dividends. These costs have increased from \$19.8 million in 1980 to \$31.3 million in 1990 and are expected to average about \$28 million a year through 1994. About \$27 million of these costs are associated with the three programs covered in our review.

Impact on Veterans

VA data show that, if excess income from the three programs was used to fund their administrative costs in 1990, dividends of \$1 billion instead of \$1.03 billion would have been returned to policyholders. The return to each policyholder would have decreased by about \$10 a year. The average return to policyholders would have been between \$263 and \$363, rather than the \$274 to \$373 they actually received. Figure 1 shows our estimate of the overall reduction in total dividends if administrative costs were paid.

¹When the three programs were originally established in 1917, 1940, and 1951, whole life premiums were set based on expected return on investment rates that ranged from 2.25 to 3.5 percent.

Figure 1: Estimated Effect If Administrative Costs Were Paid From Dividends



As shown in figure 1, VA's actuarial projections show that dividends will begin to decrease after 1991, after increases in the 1980s due in part to high yields on investments. The decrease in total dividend payouts corresponds to a continuing reduction in the number of policies outstanding. The actual per policy dividend payment will remain relatively constant throughout the period. The number of policies is decreasing because these programs are closed to new entrants and the normal morality of the insureds. Administrative costs should also begin to decrease.

A 1984 VA study projected that the government could save \$85 million over 3 years by paying administrative costs from excess program funds. Insurance Center officials at that time and currently believe that paying administrative costs is feasible and would cause only a slight reduction in policyholder dividends. VA, however, took no action on its findings.

Veterans' groups opposed paying administrative costs from program funds because they believed the government had agreed to pay the administrative costs for pre-1965 veterans' life insurance programs and that veterans

have a vested right to (1) government payment of administrative costs and (2) excess income from the programs.

We do not believe these benefits are expressly guaranteed by the insurance contracts, VA regulations, or the relevant statutes. Dividends have always been paid at the discretion of the Secretary.² Moreover, each insurance policy states that the applicable statutes are subject to amendment; thus, the law can be amended to allow excess program funds to be used to pay administrative costs without violating the terms of the policies.

Conclusions

The federal government will spend \$27 million per year to administer three long-standing insurance programs for veterans that experience shows could pay their own administrative costs without risk of insolvency or increased premiums and with little impact on policyholder dividends. In our view, because policyholders are not entitled to dividends by law or contract, and the only impact on them would be to reduce dividends slightly, it would be neither illegal nor unfair to them to have administrative costs paid out of excess program income. Given these circumstances, we believe legislative changes transferring responsibility for program administration costs from the federal government to the programs should be made.

Recommendation to the Congress

GAO recommends that the Congress amend 38 U.S.C. 1982 to require that the three VA insurance programs pay administrative costs from excess interest income.

To accomplish this change, we suggest that 38 U.S.C. 1982 be amended by changing the period following "Secretary" to a semicolon and adding the following:

"Provided, however, that to the extent excess revenues (the balance of funds remaining at the end of each fiscal year, beginning with the fiscal year ending before the date of enactment of this proviso, after claims have been paid and reserves have been appropriately funded) for the programs authorized under sections 1901, 1923, and 1940 are available, the cost of administration shall be paid from such excess"

²In the case of the Veterans Special Life Insurance Program, which was established in 1951, regular dividends were not authorized by law until 1974. Further, as experience in this program has shown, the idea of paying administrative costs out of program excesses is not a new one. In 1961, the Congress authorized a one-time special dividend to insureds in which administrative costs were paid out of monies available for dividends.

Agency Comments and Our Evaluation

In a letter dated January 10, 1992 (see app. II), the Secretary of Veterans Affairs commented that from a cost standpoint, our recommendation to pay administrative costs for three insurance programs from excess funds is attractive because the programs could easily absorb the costs without having a major impact on any individual policyholder. He further commented, however, that VA has historically opposed this idea and that the recommendation poses questions of equity and raises some difficult constitutional issues. Central to this issue is the question of the vested rights of the insured. The Secretary commented that the Veterans Benefits Administration has asked the VA Office of General Counsel for a legal opinion on this issue, but that opinion had not been completed as of the date of his comments.

The Secretary also commented that our reference to the Veterans Special Life Insurance Program adds no support for our position. Our reference to Veterans Special Life Insurance, although not a totally analogous example, nor the sole basis for our position, was used simply to show that precedent exists for paying administrative expenses out of excess program funds. Moreover, Veterans Special Life Insurance now pays dividends that were not even authorized until after the program was closed to new issues. Thus, it appears that there was no guarantee that dividends would ever be paid when these policies were issued, and to now argue that dividends are the vested right of the insured, at least for this program, seems inconsistent.

We believe that our recommendation is both equitable and, under current Supreme Court precedents, constitutional. As discussed above, our recommendation would have only a minimal impact on dividends. Further, policyholders would be in no danger of a resulting increase in premiums because government payment of administrative expenses would resume if no excess revenues were earned. Policyholders would not be deprived of anything to which they have become permanently entitled.

VA's doubts about the constitutionality of our recommendation stem primarily from its reading of Lynch v. U.S., 292 U.S. 571 (1934). The Supreme Court in Lynch struck down a law, passed after the deaths of the insured veterans, that would have prevented payment to beneficiaries of VA life insurance policies. The Court said that the policies, "being contracts, are property and create vested rights" protected by the Fifth Amendment (which prohibits the taking of private property for public use without just compensation). 292 U.S. at 577.

Under our recommendation, unlike the statute involved in Lynch, all terms of the veterans' policies would still be honored. It is true that dividends to policyholders might be lower in the future. However, neither the insurance policy nor the applicable statute promises dividends at any level. The dividends are paid only at the discretion of the Secretary of Veterans Affairs, and are therefore not the subject of a vested contractual right like the matured death benefits that the law would have taken away in Lynch. Similarly, government payment of administrative costs is not a vested right because, although it is currently required by statute, individual policies state that they are subject to amendment of the applicable statutes.

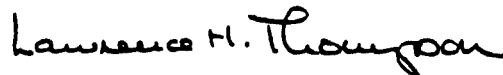
The Court said in Lynch that the government could lawfully change the terms of the policy, or withdraw privileges that it had granted voluntarily, as long as it did not disturb vested rights. Because we believe dividends and government payment of administrative costs are not vested, we also believe that our recommendation falls within this category of permissible actions.

In addition to his comments on our recommendation, the Secretary suggested certain technical changes to the draft report. Changes were made to the draft where appropriate.

We are sending copies of this report to the appropriate congressional committees; the Secretary of Veterans Affairs; the Director, Office of Management and Budget; and other interested parties.

This report was prepared under the direction of Joseph F. Delfico, Director, Income Security Issues. If you have any questions about this report, please feel free to contact him on (202) 512-7215. Other major contributors are listed in appendix III.

Sincerely yours,



Lawrence H. Thompson
Assistant Comptroller General

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Abbreviations

VA Department of Veterans Affairs

VA Life Insurance Programs

The Department of Veterans Affairs, through its Insurance Center, manages life insurance programs for service members and veterans.

Administered Programs

VA directly administers the six programs described below. As of December 31, 1990, these programs had about \$27 billion in life insurance in force and about \$14 billion in reserves for about 3.3 million policyholders.

United States Government Life Insurance

Established in 1917 to provide life insurance for service members and veterans of World War I, this program was closed to new issues in 1951.

National Service Life Insurance

Established in 1940 in anticipation of large-scale military inductions before World War II, this program was closed to new issues in 1951.

Veterans Special Life Insurance

Established in 1951 for those serving in the Korean War, this program was closed to new issues in 1956.

Veterans Reopened Insurance

Established in 1965 to provide coverage for disabled veterans eligible for National Service Life Insurance between 1940 and 1957. This program was open for 1 year.

Service-Disabled Veterans Insurance

Established in 1951 to provide life insurance coverage to disabled veterans at the same premium rates charged nondisabled individuals. The program is not self-supporting and requires periodic appropriations from the Congress to cover losses. The program does not pay dividends.

Veterans Mortgage Life Insurance

Established in 1971 to provide mortgage insurance to severely disabled veterans who received VA grants for specially adapted housing. The program is not self-supporting and requires appropriated funds to pay claims and other expenses that exceed premium receipts. The program does not pay dividends.

Supervised Programs

VA contracted with Prudential Insurance Company of America to administer both the Servicemen's Group Life Insurance and Veterans Group Life Insurance programs. Prudential set up the Office of Servicemen's Group Life Insurance to administer these two government insurance programs.

Servicemen's Group Life Insurance

Established in 1965 to provide 1-year, term-life insurance for service members, especially those serving in Vietnam at that time. As of March 1991, this program provided up to \$100,000 in life insurance coverage to about 3.5 million active members of the military services and reserves. This program provides 120 days of free post-discharge coverage.

Veterans Group Life Insurance

Established in 1974 as a subsidiary program to Servicemen's Group Life Insurance. As of March 1991, Veterans Group Life Insurance provided up to \$100,000 coverage in a 5-year nonrenewable life insurance policy for veterans making the transition from military to civilian life. This program had over 300,000 insured members.

Comments From the Department of Veterans Affairs



THE SECRETARY OF VETERANS AFFAIRS
WASHINGTON

JAN 10 1992

Mr. Joseph F. Delfico
Director, Income Security Issues
Human Resources Division
U. S. General Accounting Office
441 G Street, NW
Washington, DC 20548

Dear Mr. Delfico:

We have completed our review of your draft report, VA LIFE INSURANCE: Administrative Costs For Three Programs Should Be Paid From Excess Funds (GAO/HRD-92-42). This idea has been raised before, most notably by the Hoover Commission in 1957, the Congress in proposed legislation in 1961, and the Grace Commission in the early 1980's.

From a cost standpoint, the idea is attractive because the three insurance programs could absorb the \$27 million in VA administrative expenses without having a major financial impact on any individual policyholder. Also, there would be no significant offsetting costs to the Department in implementing the proposal.

From a legal standpoint, the idea raises several difficult issues that to date have discouraged implementation of this proposal. In December 1991, the Veterans Benefits Administration requested a General Counsel opinion on the issue of whether legislation to require that the administrative expenses of these three government life insurance programs be paid from excess program revenues would be legal.

The Office of General Counsel has not yet completed its work on the opinion. However, the General Counsel has informed me that this proposal poses a difficult constitutional question that will involve consideration of many complex issues. These include the historical development of insurance programs through successive legislative amendments; the question of whether broad statutory provisions providing governmental subsidies of various kinds are to be construed as part of the individual's insurance contract, particularly since the insurance policies indicate that they are subject to governing laws and amendments; and the question of whether participating policyholders have a vested right to dividends and the effect which the charging of administrative costs would have on different groups of policyholders. Moreover, the General Counsel believes it is likely that this proposal presents a question that may not be definitively resolved until it is ruled on by the courts.

**Appendix II
Comments From the Department of Veterans
Affairs**

2.

Historically, VA has opposed this idea for reasons related to both the equity and legality of the proposal. GAO attempts to support the equity of its proposal by referring to another VA life insurance program in which administrative costs were paid out of monies available for dividends. This example, however, provides no support for GAO's proposal. There is no similarity between paying administrative costs of a special dividend paid in a non-participating insurance program (GAO's example) and unilaterally requiring insureds in the three participating insurance programs to begin paying the administrative costs long after the policies were issued. Furthermore, on the legal issue, the GAO report does not contain any analysis of the constitutionality of this proposal; therefore, it cannot be determined whether GAO considered this important issue, and if it did, the rationale for its conclusion.

The enclosure provides additional information regarding VA's past opposition to this proposal and also cites several minor errors in the report that should be corrected. Thank you for the opportunity to comment on this report.

Sincerely yours,



Edward J. Derwinski

Enclosure
EJD/vz

Enclosure

DEPARTMENTAL COMMENTS TO GAO DRAFT REPORT
VA LIFE INSURANCE: Administrative Costs for Three
Programs Should Be Paid From Excess Funds
(GAO/HRD-92-42)

In 1961, Congress introduced legislation (H.R. 6148, 87th Cong.) to require that the administrative costs for the participating NSLI and USGLI programs be paid from the surplus funds remaining after claims were paid and reserves were funded. VA strongly opposed enactment of that legislation for several reasons.

First, VA was concerned that if it would be necessary to suspend dividend payments in the future on any class of policies, the bill could be construed as requiring participating policies earning dividends to bear not only the administrative cost of their own policies but also the administrative cost of other classes of policies on which no dividends would be payable. This would constitute a double burden not contemplated when the contracts were entered into with policyholders.

VA also concluded that because the original insurance laws provided that the government would bear the cost of administrative expenses, the premiums on such insurance were not set so as to cover this cost. Legislation shifting the payment of administrative costs to the participating programs would, in effect, be a unilateral increase in the premiums charged the insureds after the contracts of insurance had been entered into. VA concluded that this would constitute an appropriation by the government of trust funds, belonging to the policyholders, in violation of the existing trust relationship. VA further concluded that such an abridgment of vested contractual or property rights would be of doubtful constitutionality.

In reaching its conclusion that the shift in the payment of administrative costs would constitute an abridgment of vested property rights, VA relied upon Lynch v. United States, 292 U.S. 571 (1934). In Lynch, the United States Supreme Court held that the Economy Act of 1933, ch. 3, 48 Stat. 9, unconstitutionally abrogated contract rights by attempting to repeal all laws granting or pertaining to yearly renewable term insurance. The Court stated:

War Risk policies, being contracts, are property and create vested rights. The terms of these contracts are to be found in part in the policy, in part in the statutes under which they are issued and the regulations promulgated thereunder.

**Appendix II
Comments From the Department of Veterans
Affairs**

In analyzing H.R. 6148, VA reasoned that because the statute provides that the United States will bear the cost of administration in connection with these policies, the government's contractual obligation to pay the expenses is a benefit to the insured. Accordingly, pursuant to Lynch, the use of surpluses available for dividends to pay the administrative expenses would be a curtailment of benefits which was not reserved to the Congress.

The GAO report explains that the shift in administrative costs would result in a minimal reduction in dividends. It estimates that in 1990, each policyholder would only have had a \$10 - \$11 reduction in dividends. However, the overall effect of this proposal in 1990 would have been to reduce dividends on such insurance by approximately \$27 million. Thus, in effect, this proposed legislation would result in a \$27 million increase in premiums charged the insureds long after they entered into their insurance contracts.

The following factual corrections should be made to the subject GAO draft report:

Now on p. 4.

o On page 6 of the draft report, GAO implies that the insurance center conducted a study on the issue of paying administrative costs for the three programs from excess funds. Further, the report implies that this study indicated that savings could be achieved "by paying the administrative costs from excess program funds," but VA subsequently took no action because of opposition from veterans groups.

Actually, VA's Program Evaluation Service of the Office of Program Evaluation Planning and Evaluation conducted the study. In their 1984 report, the authors merely noted that this issue had been raised before. Although they made no recommendations, they cited the opinions of VA's Solicitor (1953) and the Department of Justice (circa 1958) that there was substantial doubt regarding the legality of paying administrative expenses from the trust funds.

Now on p. 5.

o Pub. L. No. 102-83, Section 5(a) Stat. 378, 406 renumbered selected 38 U.S.C. sections. On pages 7 and 8 of the draft report, statute citations should be changed as follows: replace 1982 for section 782, replace 1901 for section 701, replace 1923 for section 723, and replace 1940 for section 740.

Now on p. 10.

o On page 11, Appendix I, Administered Programs -- The \$21 billion in force should be \$27 billion; this would include Paid-Up Additions. The reserves in that same program should be \$14 billion.

**Appendix II
Comments From the Department of Veterans
Affairs**

Not included in this report.

o On page 12, the first sentence states that, "All four of these programs offered renewable term and permanent plan life insurance that could be retained after leaving the Armed Forces." Term policies were not available under the Veterans Reopened Insurance program, and only term insurance coverage was originally available under the Veterans Special Life Insurance (VSLI) program. During the Korean War, gratuitous insurance (no premiums were paid) was provided to members of the service under the Servicemen's Indemnity and Insurance Act. VSLI coverage was available only to separating veterans. Permanent plans of insurance were not made available to VSLI policyholders until 1959.

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