BWC Board of Directors

AUDIT COMMITTEE

Thursday and Friday, March 25-26, 2010, 8:00 a.m.
William Green Building
30 West Spring Street, 2nd Floor (Mezzanine)
Columbus, Ohio 43215

Members Present: Kenneth Haffey, Chair
Robert Smith, Vice Chair
William Lhota
James Harris
James Matesich

Members Absent: None

Other Directors Present: James Hummel, Thomas Pitts, Alison Falls, Larry Price, David Caldwell, Charles Bryan

Counsel Present: John Williams, Assistant Attorney General

CALL TO ORDER – MARCH 25, 2010

Mr. Haffey called the meeting to order at 8:00 AM and the roll call was taken.

MINUTES OF FEBRUARY 25, 2010

The minutes were approved without changes by unanimous roll call vote on a motion by Mr. Smith, seconded by Mr. Lhota.

REVIEW/APPROVE AGENDA

Mr. Haffey noted a change to the Agenda in that the Committee will recess after the Executive Session for Litigation Update, and reconvene after the Board of Directors Meeting on Friday, March 26, 2010. The agenda as amended was approved by unanimous roll call vote on a motion by Mr. Smith, seconded by Mr. Lhota.

NEW BUSINESS / ACTION ITEMS

1. FY 2nd Quarter Executive Summary

Caren Murdock, Chief of Internal Audit, began her review of the 2nd Quarter Executive Summary. The report focused on work completed between October and December 2009. Ms. Murdock began by discussing two new consulting engagements. The first concerned the Drug Utilization Review (DUR) process, specifically the necessity and appropriateness of the process with respect to the program's current goals and purposes. Ten recommendations were made to improve program governance, strengthen internal controls and improve program efficiency and effectiveness.

Internal Audit also performed a consulting review of the Self-Insured Audit process. This process involves auditing self-insured employers at least once every four years to evaluate oversight of claims administration and paid compensation. Fourteen recommendations were made, including revising the SI-40 form to include a chart of individual claims.

Ms. Murdock then reviewed audit comments issued in the second quarter of FY 2010. Management requested an audit of the Workers' Compensation Insurance System (WCIS) credit transactions. Per a question from Mr. Bryan, an example of a credit transaction may be posting a claim to an incorrect employer policy, which results in a premium credit when the claim is transferred to the correct policy. Internal controls were found to be deficient, including a material weakness that the transfers were not required to be documented in writing, or approved by a supervisor. Mr. Harris asked why it was projected that the recommendation to develop appropriate controls would not be implemented until December 2010. Ms. Murdock stated that some initial action has been taken, but the projected date is based upon available resources and complexity of the corrective action.

The second review involved an Investment Accounting Audit. Ms. Murdock noted four minor suggestions were made, but internal controls were effective and operating as expected.

The final new audit comment involved a Fixed Asset Audit. Per a question from Mr. Haffey, this includes such items as furniture and computers. Ms. Murdock reviewed several significant weakness comments, including inadequate procedures, lack of reporting, inadequate controls on asset transfers, and failure to restrict access. Ms. Falls asked if assets have disappeared. Ms. Murdock noted there is a list of missing items being investigated, but the explanation may be a lack of appropriate documentation. Administrator Ryan added that any allegations of theft will be aggressively investigated. BWC is striving for best practices in the protection of fixed assets.

For the audits completed during the report period, there were 20 new comments and 18 resolved comments, for a total of 66 outstanding comments. Management is doing a good job overall of responding to new comments without losing sight of past issues. Some comments, like those with respect to IT, involve long-term solutions. Corrective action for 77% of outstanding comments should be implemented within the next six months. Ms. Murdock specifically reviewed outstanding comments regarding medical billing. A request for proposal to improve billing and retire the MIIS system will be released in May 2010.

Ms. Murdock then highlighted two outstanding comments where management has accepted the risk rather than implement recommendations. When a risk is accepted, internal audit continues to review and analyze the issue, and may bring the matter up for discussion with the Administrator and/or the Board. The first comment involved the Auto Adjudication program for low-risk claims, where changes are being postponed until new medical codes are implemented. The second comment was with respect to safeguards for payments received by Collections. Management has determined that the cost to implement controls would outweigh the benefit. Mr. Smith asked how much money was involved. Ms. Murdock will research and provide a response. Management believes if a check is lost, invoices will continue, usually generating an employer inquiry, and this inquiry should mitigate the risk.

Ms. Falls asked why the outstanding comments regarding vocational rehabilitation were not being covered at this meeting. Ms. Murdock stated that due to time constraints, all outstanding comments can't be covered at one meeting. A permanent list of all comments is maintained for reference and to provide a historical perspective.

Returning to acceptance of risk, Ms. Murdock stated this means the appropriate person in charge believes controls are adequate and no changes are necessary. If the Administrator is uncomfortable with accepting risk, Internal Audit will revisit the issue with the section. Cost/benefit analysis frequently comes into play. Per a question from Mr. Smith, Ms. Murdock stated risk encompasses both financial exposure and probability of occurrence.

Some changes to the audit plan were reviewed, including a new upcoming audit with respect to Disabled Workers' Relief Fund (DWRF). Internal Audit staffing remains sufficient to manage current projects, while continuing to evaluate projects based on risk and priority. Mr. Haffey noted internal auditing is a growing area in the business community as a whole.

2. Motion for Board Consideration

A. For Second Reading

1. Survivorship Rule 4123-17-02

Michael Glass, Director, Underwriting and Premium Audit, presented a second reading of proposed amendments to Ohio Administrative Code Rule 4123-17-02, which addresses the transfer of claims experience and liabilities. The proposed rule amendments address BWC's concern that sale transactions would be artificially structured to avoid successor liability for the previous employers' worker compensation claims.

Mr. Glass reviewed the four situations where successor liability would be found, even if the transaction occurred through a third party:

- The purchaser expressly or impliedly agrees to assume the obligations;
- The transaction is a *de facto* merger or consolidation;
- The successor is a continuation of the predecessor; or
- The transaction is entered into for the purpose of escaping workers' compensation obligations.

In item four above, the word "fraudulent" was stricken due to concerns that this term may be too strictly defined in a legal sense, and would not encompass misrepresentation. BWC sought further input from stakeholders as to the changes, but did not receive any comments. Mr. Haffey mentioned that his business is seeing an increase in business combinations, so this is a timely clarification to this rule.

Mr. Smith moved that the Audit Committee recommend that the Bureau of Workers' Compensation Board of Directors approve the Administrator's recommendation to amend Rule 4123-17-02 of the Administrative Code, "Basic or Manual Rate," to address employer successor issues. The motion consents to the Administrator amending Rule 4123-17-02 as presented here today. Mr. Harris seconded and the motion was approved by unanimous roll call vote.

B. For First Reading
1. Reserve Discount Rate and Financial Metrics

Tracy Valentino, Chief of Fiscal and Planning, initially reviewed a written description of the process for developing the reserve discount rate. Both Mr. Smith and Mr. Bryan praised the process. Ms. Valentino commented that the process is consistent with establishing a conservative rate, utilizing Government Accounting Standards Board (GASB) Statement No. 10 and Actuarial Standard Practice No. 20. These standards require examining past practices, historical and future payment patterns, utilization of explicit risk provisions, and consideration of a risk-free investment yield.

The process memo included a chart of the BWC reserve discount rate from 1991-2009. Mr. Matesich questioned the .5% reduction in 2009, and proposed .5% reduction for 2010, by noting that the largest reduction in any prior year was .3%. Ms. Valentino replied that past reductions were made very slowly and subject to non-mathematical influences. She noted that the reductions for the past two years are reasonable, and reserve balances are staying steady even with a larger reduction. Ms. Falls noted the current process was not in place until after 2007, and the Board Governance Guidelines did not provide for Board concurrence with the Administrator's decision of the discount rate until 2008. Since the statute gives the Administrator the authority to establish the discount rate, Ms. Valentino said the topic was rarely discussed with the Oversight Commission prior to the advent of this Board.

The questions as outlined in the process document are:

- Is the proposed rate consistent with BWC practice of establishing a conservative discount rate? As outlined in the memo, yes.
- Is the proposed discount rate consistent with industry standards? As analyzed in the board materials, yes.
- Is there a decreasing or increasing return on BWC's investment portfolio? As shown in the materials, the 2005 to 2009 average annual return is 5.12%, the 2000-2009 average annual return is 4.53%.
- Are there changes in BWC's investment strategy? Yes, as outlined in the memo from the CIO.
- Do we anticipate changes in the financial markets? The March 3, 2010 memo by Bruce Dunn, Chief Investment Officer, states the average annual returns are 4.53% for 2000-2009, and 5.12% for 2005-2009. These figures are within the trends for corporate and treasury bonds for the same period. The recommended 4% reserve discount rate was reasonable in light of these returns.

Ms. Valentino advised the recommended 4% reserve discount rate will be applied to the March 31 actuarial reserve audit, and any adjustments will be posted in the May financial statements. Per a question from Mr. Haffey, Guy Cooper from Mercer Consulting stated the 4% reserve discount rate is well within the appropriate range.

Ms. Valentino then addressed financial metrics. The process established in the Net Asset Policy to determine the Net Leverage Ratio and Funding Ratio was followed. Private sector metrics, AM Best, Wards and other state funds were reviewed. Any changes to the Net Asset Policy or these two ratios require Board approval, which will occur at the April meeting.

The Funding Ratio (funded assets v. funded liabilities) currently is a guideline of 1.02 to 1.35. The proposed guideline is 1.15 to 1.4. Deloitte recommended a range of 1.2 to 1.5. However, the 1.4 ceiling targets net assets at $5.8 billion, while a 1.5 ceiling would be over $7 billion. Ms. Falls commended the staff's efforts but added that the history and rationale for these ratios should be put in written form.

Mr. Bryan asked if the lower-end increase would affect premium pricing. John Pedrick, Chief Actuarial Officer, responded that premium pricing does not have a contingency load for risk. If the investment portfolio continues to produce similar returns, BWC can build net assets and have a cushion left to absorb risk. If investment returns fall below what is anticipated, then premiums may be impacted. But it is more prudent to factor in risk, rather than face the possibility of a dramatic increase in premiums if investment returns fall below expectations.

Mr. Harris voiced agreement that employers are better off with predictability and stability. Ms. Falls reminded the Directors that the Funding Ratio is a guideline. If our net asset level would drop below 1.02, that would be a red light. If our net asset light would drop below 1.15, it would be an amber light.

Ms. Valentino next discussed the Net Leverage Ratio, which reflects exposure to pricing or estimation errors. It is particularly affected by market value changes, as BWC must mark its investments to market. This ratio has varied greatly over the last ten years, from 2.2 in 2000 to 39.9 in 2003. The proposed recommendation is a guideline of 3.0 to 7.0, as opposed to the current guideline of 3.0 to 8.0.

Other types of insurance industry measures, such as Net Loss Ratio and Expense Ratio, are included in the report but do not have to be Board-approved. Ms. Valentino reviewed the rationale for adjusting the guidelines associated with these measures.

With Board approval, the revised guidelines would be reflected in the April financial statements that will be reviewed by the Board in May.

<u>DISCUSSION ITEMS</u>

1. Open Discussion with Internal Auditor

Caren Murdock, Chief of Internal Audit, reported that Internal Audit staff is currently involved in 10 projects, and continues to evaluate risk for the 2011 audit plan. She thanked the directors for their input and discussion concerning risk assessment. A draft audit plan will be completed in April for presentation at the June meeting.

Pre-planning sessions have commenced for the external audit, which will begin in May. Internal Audit again plans to devote 1,000 hours to assisting the external audit. Mr. Haffey noted he has also met with the external auditors.

2. Committee Calendar

This item was not discussed due to time constraints.

3. Litigation Update (Executive Session)

Upon motion by Mr. Haffey, seconded by Mr. Matesich, and approved by unanimous roll call vote, the Committee entered executive session to discuss pending litigation at 9:30 AM with James Barnes, General Counsel.

When the Executive Session concluded, Chairman Haffey called for a recess at 9:45 AM, and stated the Committee would reconvene following the March 26, 2010 Board of Directors meeting.

CALL TO ORDER – MARCH 26, 2010

Mr. Haffey reconvened the meeting at 10:16 AM and roll call was taken. All committee members were present. Additional Directors present included James Hummel, Thomas Pitts, Alison Falls, David Caldwell, and Charles Bryan. Assistant Attorney General John Williams and General Counsel James Barnes were also present.

1. Inspector General Report (Executive Session)

Upon motion by Mr. Haffey, seconded by Mr. Smith, and approved by unanimous roll call vote, the committee entered executive session to discuss matters required to be kept confidential by state law at 10:17 AM for a presentation by Joe Montgomery of the Inspector General's Office.

ADJOURNMENT

When the Committee returned from Executive Session, Mr. Haffey asked for a motion to adjourn the meeting. Upon a motion by Mr. Smith, seconded by Mr. Matesich, the motion to adjourn was approved by unanimous roll call vote at 10:45 am.

Prepared by Jill Whitworth, Staff Counsel
March 26, 2010