# JOINT HEARING

**Budget Subcommittee No. 5 on Corrections, Public Safety, Judiciary, Labor and Transportation**
**Senator Maria Elena Durazo, Chair**

**Senate Labor Public Employment and Retirement**
**Senator Dave Cortese, Chair**

**Senate Banking and Financial Institutions**
**Senator Anna Caballero, Chair**

Monday, February 8, 2021
9:00 a.m. – State Capitol – Senate Chamber

***Informational Hearing: Audit of Employment Development Department's Performance and Management Related to Californians Unemployed by COVID-19 Shutdowns***

## Panels

I. Welcome and Opening Remarks

II. Overview of Audit Findings and Recommendations
- Elaine M. Howle, California State Auditor
- Bob Harris, Principal Performance/Policy Evaluator

III. Comments and Responses to the Audit
- Rita Saenz, Director, Employment Development Department
- Nancy Farias, Chief Deputy Director of External Affairs, Legislation and Policy
- Carol Williams, Chief Deputy Director of Operations
- Kevin Matulich, Deputy Director of Legislative Affairs

IV. Bank of America
- John Lawlor, Managing Director Municipal Banking and Markets
- Faiz Ahmad, Managing Director Transaction Services
- Bill Fox, Managing Director Compliance and Operational Risk for Financial Crimes and Fraud

V. Public Comment

VI. Closing Comments

## Background

*Core Points:*

- Created as a part of the Social Security Act of 1935, the Unemployment Insurance (UI) System is a joint federal-state program: the federal government sets the program rules and the State implements the program.

- For more than 85 years, the UI system has formed the backbone of the social safety net for American workers facing unemployment due to no fault of their own. For example, from March 2020 to November 2020, EDD processed *more than 17 million claims* and paid out *more than $111 billion* in UI benefits due to the COVID-19 pandemic.

- In the aftermath of the Great Recession (2008-2014) and the COVID-19 pandemic, the unemployment insurance system in nearly all states, but particularly California, showed extreme distress.

- This hearing will review recent and historic findings from the State Auditor on the failings of California's unemployment insurance system and steps that will be taken to address these challenges.

*What is the Unemployment Insurance System? How does it work?*

Prior to the Great Depression (1929-1938), neither the federal government nor states provided wage replacement benefits due to unemployment. While California experimented with limited programs that connected unemployed workers with employers with job openings prior to the 20th Century, there was no governmental focus on mid and long-term unemployment due to economic shocks or macroeconomic conditions.

With the onset of the Great Depression, and the ensuing surge in the unemployment rate to 25%, this quickly changed. Reflecting the emerging cooperative federalism norm of Roosevelt's New Deal, the Social Security Act of 1935 created a comprehensive federal-state Unemployment Insurance (UI) System in the United States. Specifically, the Act provided that the federal government sets the baseline rules of the UI System, partially funds the administration of the UI system, and serves as a fiscal backstop, but it falls to the states to implement these rules.

For example, the federal Act requires states to provide cash benefits to unemployed workers who are unemployed through no fault of their own. These benefits are funded through employer-paid payroll taxes assessed as a percentage of a worker's pay. The employer's tax rate is *experience rated*, which means that the employer will (theoretically) pay a high tax rate and more in unemployment insurance taxes if they lay off significant numbers of workers. Beyond that, the states retain significant discretion in the structure of their UI programs. This includes eligibility rules, the amount of an employee's wages that are taxed, and benefit amounts.

In California, for example, unemployment insurance taxes are levied against a worker's first $7,000 of wages. The current wage base was first set in 1984 in both federal and California statutes, and has not been updated since. Only Arizona has a similarly low UI wage base – high population states (like New York, Texas, and Florida) have higher wage base. Even reputed low tax states like North Dakota, South

Dakota, and Mississippi have higher UI wage bases.[1] Due to its low taxable wage base, California's unemployment insurance system is functionally insolvent even during strong economic times and the Employment Development Department does not have similar resources available for the administration of its UI system in comparison to other states and their relevant departments.

*The Great Recession, COVID-19, and California's Unemployment Insurance System*

In the past decade, California's unemployment insurance system was severely tested and, unfortunately, it has not performed well. Both during the Great Recession and the current COVID-19 pandemic, both unemployment insurance claimants and businesses have reported significant challenges with reaching and communicating with the Employment Development Department (EDD) about unemployment insurance claims. During both crises, constituents reached out to their elected representatives for assistance, and the Legislature responded by assisting constituents with their UI issues, as well as holding a series of oversight hearings and requesting an audit of EDD's UI program by the State Auditor.

Troublingly, some of the issues that the State Auditor uncovered during the Great Recession remain challenges during the current COVID-19 pandemic. For example, the State Auditor recommended in 2011 that EDD implement a *recession plan* in order to address the surge in unemployment claims from an economic downturn. Similarly, the State Auditor also recommended that EDD adopt best practices in the *management of their call centers* during the Great Recession. *In both cases, the State Auditor found that EDD has failed to adopt these Great Recession era reforms, perpetuating avoidable challenges during the COVID-19 pandemic*. In a written response to the State Auditor's report, EDD acknowledges these failures and commits to adopting the State Auditor's recommendation.

Yet, the challenges facing EDD and the UI system in the midst of the COVID-19 pandemic are also distinct from to what EDD faced during the Great Recession. First, there is an issue of scale: during the height of the Great Recession (2009-10), EDD received 3.8 million claims in each of those years. In the first *six months* of 2020, *EDD received 6.5 million claims*. Due to the lockdown, California's unemployment rate jumped from *4.3% in February 2020 to 16.2% in April of 2020*. By November of 2020, EDD had processed ***more than 17 million claims***, including PUA claims. This equates to ***more than $111 billion*** in unemployment insurance benefits. The scale, scope, and speed of the COVID-19 pandemic is simply unprecedented, and it caught EDD unprepared, as it did nearly all governmental entities.

Second, faced unique challenges in implementing the federal government's response to the COVID-19 pandemic. On March 27, 2020, the former administration signed the Coronavirus Aid, Relief, and Economic Security (CARES) Act, which extended unemployment insurance benefits to independent contractors through the *Pandemic Unemployment Assistance (PUA)* program. This extension of wage replacement benefits to independent contractors and business owners, *which is 100% federally funded*, was an unprecedented and untried program, and it represented an attempt to provide wage replacement benefits to the broadest range of workers impacted by COVID-19.

Unfortunately, as structured by the federal government, the PUA program did not have sufficient anti-fraud protections in place. Unlike with traditional unemployment insurance benefits, where employer payroll reports to EDD serve as a verification tool of continued unemployment, the PUA program operated entirely on self-attestations. During the Great Recession, the federal government extended no comparable benefit program, and therefore fraud remained negligible.

[1] The taxable wage bases for these states are $37,900, $15,000, and $14,000, respectively.

This was not the case with the PUA. Due to the lack of anti-fraud standards, fraud rose dramatically in the unemployment insurance system – ***EDD reports that 95% of all of the detected UI fraud comes from the PUA program***. This huge surge in fraud has led to elevated anti-fraud efforts by both EDD and EDD's UI benefit card vendor, Bank of America, leading to benefit delays and additional friction in benefit administration. Moreover, this increase in fraud has triggered intense concern from the media and citizens, undermining Californians trust in EDD and the UI system.

*Looking Towards the Future: The February 8th Joint Senate Hearing*

The Senate Budget Subcommittee Number 5 (Corrections, Public Safety, Judiciary, Labor and Transportation) and the Senate Standing Committee on Labor, Public Employment and Retirement will hold a joint hearing on the State Auditor's recent audits on the Employment Development Department's management and performance of the UI system during the COVID-19 pandemic (see Appendix A for a summary of the audit), and its approach to fraud prevention (see Appendix B for a summary of the audit). The Committees will hear from both the State Auditor and the Employment Development Department on the audits, the audits' recommendations, and future initiatives to address the managerial and programmatic shortcomings uncovered by the Auditor and her team. Additionally, the Committees with explore:

1) What managerial and programmatic challenges led to benefit delays during the COVID-19 pandemic?

2) What specific actions is the Department taking to resolve these programmatic and managerial challenges?

3) In the face of two "once-in-a-lifetime" crises, the unemployment insurance system has not fared well. What policies can the Legislature and the Department implement now and post-pandemic to ensure that our UI system operates as designed?

# APPENDIX A: EDD Audit Summary & Recommendations

(From *Employment Development Department: EDD's Poor Planning and Ineffective Management Left It Unprepared to Assist Californians Unemployed by COVID-19 Shutdowns* (State Audit Report Number: 2020-128/628.1))

In March 2020, government directives ordered businesses to close and residents to stay at home in response to the COVID-19 pandemic (pandemic). Millions of Californians were left unemployed and in critical need of assistance to replace some of the income on which they relied to pay for essentials such as housing and food. The Employment Development Department (EDD) administers the State's unemployment insurance (UI) program. The economic shutdowns in early 2020 led to historically high numbers of UI claims in a very short time (claim surge), and further shutdowns began in December 2020, raising the potential for additional spikes in unemployment. This audit reviewed EDD's response to the claim surge, its handling of the resulting backlog of unpaid claims, and the assistance it has provided to individuals through its call center. This audit report concludes the following:

EDD has presented unclear information about its claim backlog. In December 2020, EDD publicly reported a backlog of about 685,700 claims. However, fewer than 20,000 of these claims were waiting for payment because of EDD's failure to resolve an issue with them. EDD's presentation of backlog information has led to confusion about its performance during the pandemic. Nevertheless, when claims rose dramatically in mid-March, EDD's inefficient processes contributed to significant delays in its payment of UI claims. Specifically, EDD was unable to automatically process nearly half of the claims submitted online between March and September 2020; instead, many of these claims required manual intervention from staff. As a result, as of September 2020, the timeliness of payments to claimants had declined when compared to the year before. Hundreds of thousands of claimants waited longer than 21 days—EDD's measure of how quickly it should process a claim—to receive their first benefit payment. Beginning in March 2020, EDD began modifying its practices and processes to increase the rate at which it automatically processes online claims, eventually reaching an automation rate of more than 90 percent by November 2020. However, it is unlikely to sustain that rate when it returns to post-pandemic operations because of the short-term nature of some of the automation measures it has taken to address the backlog.

**Because EDD Responded to the Claim Surge by Suspending Certain Eligibility Requirements, Many Californians Are at Risk of Needing to Repay Benefits.**

In March 2020, the secretary of the Labor and Workforce Development Agency (agency secretary) directed EDD to pay claimants UI benefits before determining whether they met key program eligibility requirements, and EDD expanded this directive to include most program eligibility determinations. In April 2020, the agency secretary further directed EDD to temporarily stop collecting the certifications claimants must regularly submit that assert they remain eligible for benefits. Although both directives were designed to provide Californians with benefit payments as quickly as possible, the United States Department of Labor had not waived the federal requirements addressed by the directives and has since questioned the actions EDD took. As a result, EDD now faces the challenge of processing delayed determinations and certifications of eligibility, which will require significant time and resources, and it has not adequately planned how it will address this impending workload. These actions also removed a barrier to fraud, and claimants who applied in good faith may have to repay the benefits they received if EDD finds them retroactively ineligible for some or all of those benefits.

## EDD Took Uninformed and Inadequate Steps to Resolve Its Call Center Deficiencies.

Even before the claim surge, EDD struggled to answer claimants' calls. Once the claim surge began, EDD's call center performance deteriorated dramatically: it answered less than 1 percent of the calls it received. EDD quadrupled its available call center staff to more than 5,600 people in response to its call center problems, but these staff were often unable to assist callers and only marginally improved the percentage of calls it answered. Despite knowing for years that it had problems in the call center, EDD has not yet adopted best practices for managing the call center or for providing assistance to callers—such as tracking the reasons why claimants call and whether it resolves callers' issues—leaving it less prepared to effectively assist the many Californians attempting to navigate the claim process for the first time as a result of the pandemic.

## Despite Multiple Warnings, EDD Failed to Prepare for an Economic Downturn.

During the Great Recession of 2008 and 2009, EDD experienced many problems similar to those we note in this report. Further, it has been aware of deficiencies with its claim process and call center for years. Nonetheless, in March 2020, EDD had no comprehensive plan for how it would respond if California experienced a recession and UI claims increased correspondingly. The 2020 claim surge was unprecedented and would have presented significant challenges no matter how prepared EDD was, but it failed to act comprehensively to prepare for downturns and to address known deficiencies. As a result, its areas of weakness became key deficiencies in its response to the claim surge, and these were a cause of serious frustration for unemployed Californians in need of assistance.

**Selected Recommendations:**

***Legislature***

The Legislature should require EDD to do the following:

- Report at least once every six months on its website the amount of benefit payments for which it has required repayment and the amount repaid.
- Develop a recession plan so that it is well prepared to provide services during economic downturns. The planning process should consider lessons learned from previous economic downturns, including the recent pandemic-related claim surge.

***EDD***

By March 2021, EDD should revise its public dashboards about the number of backlogged claims to clearly describe the difference between those waiting for payment and those that are not.

By June 2021, EDD should determine how many of its temporary automation measures for claims processing it can retain and by September 2021, it should make those a permanent feature of its claims processing.

To address its deferred eligibility determinations, EDD should immediately begin performing a risk assessment of its deferred workloads and determine the most appropriate order in which to progress through the work.

To improve its call center performance, by May 2021 EDD should begin tracking the reasons why callers need assistance and tracking whether it resolves caller issues successfully.

**Agency Comments**

EDD acknowledged that it must make improvements to its administration of the UI program. It agreed with all of our recommendations and indicated it would implement all of them.

# APPENDIX B: EDD Audit Summary & Recommendations

*(From Employment Development Department: Significant Weaknesses in EDD's Approach to Fraud Prevention Have Led to Billions of Dollars in Improper Benefit Payments (State Audit Report Number: 2020-128/628.2))*

The Employment Development Department (EDD) is responsible for administering the State's unemployment insurance (UI) program, which provides partial wage replacement benefits to eligible Californians who have become unemployed, including those affected by the COVID-19 pandemic (pandemic). Since the surge in pandemic-related California unemployment claims began in March 2020, individuals, news organizations, and law enforcement officials have reported many cases of potential and actual UI fraud. Not surprisingly, the pandemic conditions increased EDD's UI workloads and also resulted in changes to federal UI benefit programs, both of which have created a greater risk of fraud. We assessed EDD's response to increased fraud risk during the pandemic—such as allegations of impostor fraud, which occurs when a perpetrator uses someone else's personal information to fraudulently collect benefits—and evaluated its overall efforts to detect fraud. This report draws the following conclusions:

**EDD's Fraud Prevention Approach During the Pandemic Was Marked by Significant Missteps and Inaction**

EDD did not take action to bolster its fraud detection efforts until months into the pandemic. As a result, its data show that it paid about $10.4 billion in claims that it has since determined may be fraudulent. Even as late as December 2020, EDD was allowing claimants to continue to collect benefits using suspicious addresses because it did not establish payment blocks for their claims. Further, $1 billion of the $10.4 billion paid for suspicious claims was the result of EDD's decision to remove a key safeguard against payment to claimants whose identities it had not confirmed. EDD staff misunderstood the importance of that particular safeguard and, from April to August 2020, made payments to claimants despite concerns about the legitimacy of their identities.

**EDD's Lack of Preparation Left it Unable to Effectively Address Two High Profile Situations**

Because of fraud concerns, EDD directed Bank of America to freeze 344,000 debit cards (accounts) that it uses to provide claimants with benefit payments. However, EDD did not have a plan to ensure that it could selectively unfreeze accounts belonging to legitimate claimants, has been slow to provide clear information about its role in freezing these accounts, and does not have a full understanding of which accounts are frozen. Additionally, EDD was unprepared to prevent payment for fraudulent claims filed under the names of incarcerated individuals—which it estimated to total about $810 million. EDD had told the Legislature for years that it was considering adopting a cross-match between claim and incarceration data. However, because it had not developed the capacity to match data between its claims system and the data from state and local correctional facilities, it did not detect these fraudulent claims until after the fact.

**EDD Has Relied on Uninformed and Disjointed Techniques to Prevent Impostor Fraud**

EDD has not established a centralized unit that is responsible for managing its fraud detection efforts, and it does not reliably track potential fraudulent activity from detection to resolution. As a result, EDD's UI program is at a higher risk for fraud. Further, it does not monitor or assess its numerous fraud prevention and detection tools to determine whether they are successful in mitigating fraud. Consequently, EDD may well be using ineffective fraud prevention and detection techniques and delaying payments to legitimate claimants while it puts their claims through additional and unmerited review.

**Summary of Recommendations**

***Legislature***

To protect against fraudulent UI claims, the Legislature should amend state law to require EDD to regularly cross-match its claims against data from state and local correctional facilities.

To ensure that EDD effectively protects the integrity of the UI program, the Legislature should amend state law to require EDD to, by January 2022, and biannually thereafter, assess the effectiveness of its fraud prevention and detection tools, eliminate those that are not effective, and reduce duplication in its efforts.

***EDD***

To ensure that it does not suspend critical safeguards, EDD should plan in advance which UI fraud prevention and detection mechanisms it can adjust during recessions to effectively balance timely payment with fraud prevention.

To provide timely access to benefits for legitimate UI claimants with frozen accounts, EDD should immediately obtain and review a comprehensive listing of benefit accounts that are frozen and, by March 2021, begin the process of unfreezing legitimate accounts.

To ensure that it can approach UI fraud prevention in a comprehensive and coordinated manner, EDD should do the following:

- By March 2021, establish a central unit responsible for coordinating all fraud prevention and detection efforts.
- By May 2021, develop a plan for how it will assess the effectiveness of its fraud prevention and detection tools.

**Agency Comments**

EDD stated that it undeniably struggled to timely distribute benefits to the millions of newly unemployed Californians and simultaneously prevent fraudulent claims. It agreed with all of our recommendations and indicated that it will implement them all.