Montana State Fund
5 South Last Chance Gulch P.O. Box 4759
Helena, MT 59604-4759
Phone: 406-444-6500 Fax: 406-444-5963
E-mail: mbarry@mt.gov

MEMORANDUM

DATE: Friday, November 27, 2009

TO: Legislative Finance Committee

FROM: Montana State Fund

SUBJECT: **Response to Montana State Fund 2010 Budget Analysis**

The following is a written response to the report "Montana State Fund 2010 Budget Analysis" dated November 19, 2009. Montana State Fund (MSF) management is pleased to provide this response to the Legislative Finance Committee in order to comment, correct or clarify sections of the report. MSF management has also provided a memorandum to the Legislative Finance Committee dated October 23, 2009 on the subject of target policy holder equity. That memorandum contains additional explanation the committee should consider when reviewing the Legislative Finance Division report on MSF.

The goal and purpose of MSF is to provide an option for Montana business to insure their liability for workers' compensation at reasonably stable rates. MSF currently has the financial capacity for safe and sound operations while also providing a stable market for insurance coverage. While MSF is currently financially sound, MSF also has a goal to continue to progress to an appropriate level of financial strength over the long term. At the same time, MSF exists to support Montana businesses and provide affordable insurance without significant fluctuations in their premium.

The following response to the report provides a summary of MSF's response the report section followed by a more detailed technical discussion. MSF is available to answer any questions about the report and the response.

MSF Premium Rates

Summary

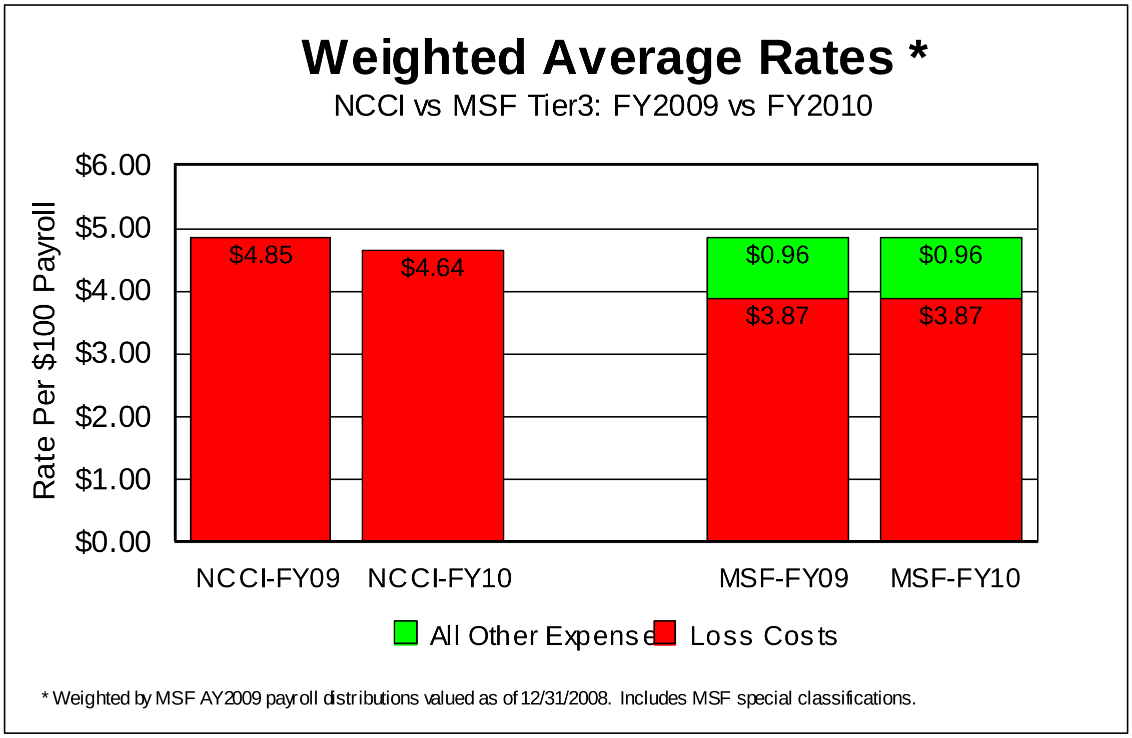
The MSF Board of Directors approved a 0% overall rate change for rates effective July 1, 2009 (FY 2010). MSF has been able to provide a stable rate level environment for Montana businesses over the last 5 years. The following table provides a recent history of rate level changes. The FY 2009 MSF loss costs were approximately 20% below the NCCI

loss costs. The NCCI reduction in their loss costs for FY 2010 slightly reduces this differential.

Montana State Fund Rate Level Changes	
Effective Date	Manual Rate Change
7/1/2003	11.6%
7/1/2004	9.5%
7/1/2005	3.0%
7/1/2006	2.4%
7/1/2007	-1.0%
7/1/2008	-3.0%
7/1/2009	0.0%

Discussion
Loss Costs Decrease an Average of 2.2 Percent
Loss Cost Multipliers Increase 4.5 Percent

The LFD report states that the NCCI loss cost change was -2.2% while the MSF change in LCMs is +4.5%. The differential is not attributable to an increase in MSF operating expense as identified in the report but is explained by the relationship of MSF rates to NCCI loss costs. See the chart below:



	Rates Effective: 07/01/2008	07/01/2009	Change
NCCI Filed Loss-Costs	$4.846	$4.638	-4.3%
MSF Estimated Loss-Costs	$3.867	$3.868	0.0%
All Other Expense & Factors	$0.959	$0.958	-0.1%
MSF Tier3 Rates	$4.826	$4.826	0.0%
MSF Loss-Cost Multiplier	0.996	1.041	4.5%
MSF vs NCCI Est. Loss-Costs	-20%	-17%	

While MSF and all private carrier rates are expressed in relationship to NCCI estimated loss costs, the underlying components can differ. For the past several years, MSF rates reflect estimated loss costs approximately 20% less than estimated by NCCI (that is, we do not need to charge as much as estimated by NCCI to cover the cost of benefits and claim administration, based on our consulting actuary's analysis).

NCCI loss costs decreased by an estimated average 2.2% across the statewide insured market. This change is based on data from approximately three years ago. The NCCI loss costs applicable to the MSF book of business decreased by 4.3%. However, MSF rates already reflect loss costs lower than NCCI's. There was no material change in MSF estimated loss costs nor MSF's provision for general expense and other factors. But because the NCCI loss-costs (applicable to MSF's insured book of business) decreased, our loss cost multiplier increased to result in a 0% rate change.

The LFD report lists the LCMs for the five rate tiers of MSF for FY 2009 and FY 2010 in Figure 1 of the report on page 3 of 8. As a comparison, the following table lists the filed LCMs for the top 10 workers compensation insurance companies writing premium in Montana in calendar year 2008. The weighted average LCM for the five MSF rate tiers is 1.025. The weighted average LCM for the top 30 private carriers in Montana is 1.259. The weighted average is calculated by the amount of premium the top 30 carriers wrote in 2008 while the weighted average for MSF is calculated by the amount of premium written in each tier. MSF rates are, on average, 19% less than average private carrier rates.

Company Name	LCM
Liberty Northwest Ins. Corp	1.195
Employers Compensation Ins. Co. (Fremont Employers)	1.330
American Zurich Ins. Co.	1.028
National Union Fire Ins Co of Pittsburgh, PA	1.639
New Hampshire Ins Co	1.393
American Home Assurance Co.	1.639
Victory Insurance Company	1.137
The Ins Co of the State of PA	1.639
Liberty Mutual Fire Ins. Co.	1.153
Rochdale Insurance Company	1.220

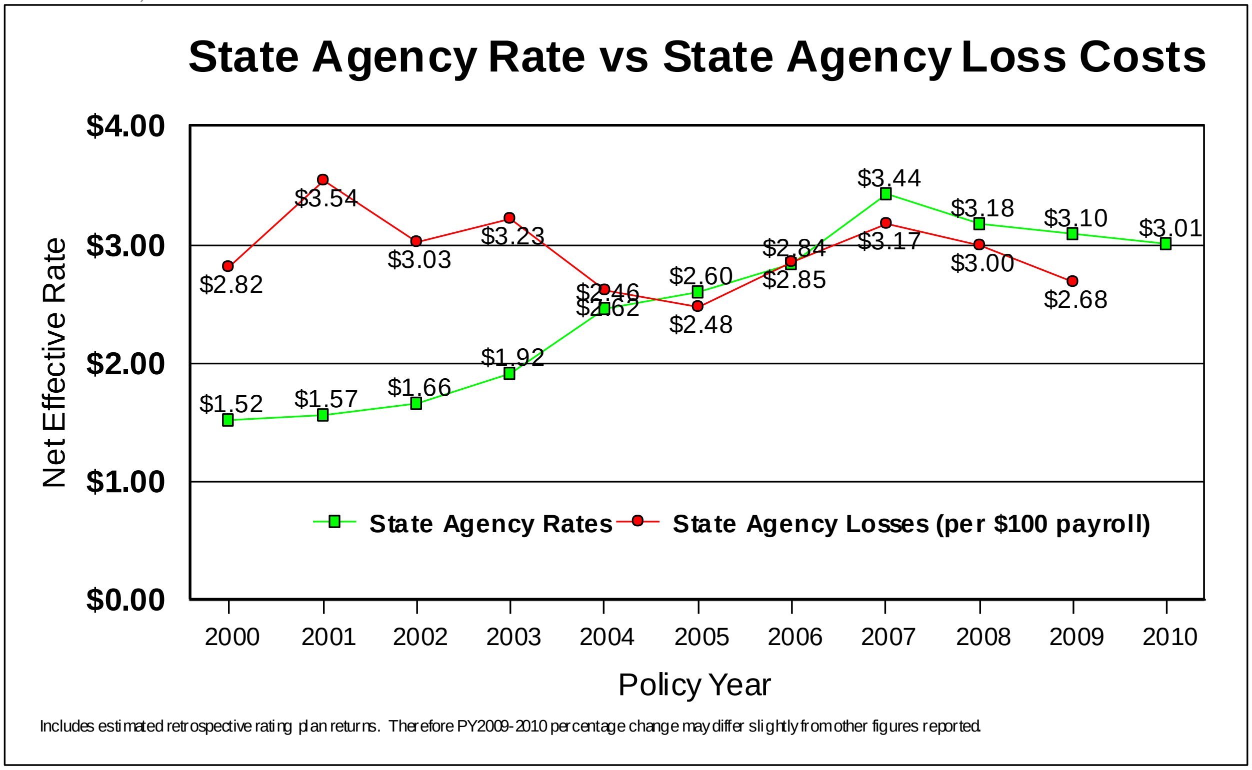
State Agency Loss Costs Generally Decrease

Summary

Overall the net reduction to state agencies is -4.6% for FY 2010. In addition, state agencies have the potential to receive premium returns of $750,000 and $600,000 for their FY 2008 and FY 2009 premium, respectively based upon their loss experience of their return premium program for those years.

Discussion

The report identifies that state agency loss cost rates generally decrease for FY 2010. Between the adjustment to class rates for state agencies and other pricing considerations, the net rate for FY 2010 is a reduction of approximately -4.6% over the FY 2009 net rates in effect. In addition, state agencies have an opportunity to receive a premium return based on their loss performance in previous years. Current estimates are state agencies will receive approximately $750,000 for FY 2008 and $600,000 for FY 2009. State agencies are currently offered a plan that provides for a return on premium if losses are less than expected relative to their rates but is held harmless if losses are greater than expected. To the extent that state agencies are successful in controlling losses, state agency rates will decrease such that savings are then earned up front rather than being contingent upon actual results. The following chart shows the history of state agency losses versus premium charged over the past 10 years:



Changes to MSF Equity

Summary

The MSF independent consulting actuary recently concluded, "MSF's financial position is adequate for safe and sound insurance operations". At the same time the actuary noted, "An important priority continues to be building equity to achieve greater financial strength." MSF will continue a long term goal of achieving an appropriate level of equity while ensuring a stable market for Montana business to insure their workers compensation exposure.

Discussion

The MSF comments on this section of the report relate to differences in interpretation of material contained in the LFD report. MSF management believes it is important to clarify these differences so the reader may have a balanced understanding of the issues relating to MSF equity levels.

MSF prepares an annual strategic business plan approved by the MSF Board of Directors. The business plan includes key success measures from the MSF financial projections for the fiscal years plus two additional future years. The FY 2010 MSF business plan targets net income for the year of $25 million. Figure 4 of the LFD report reduces this amount by "contribution to equity" of $10.1 million. The "contribution to equity" is the anticipated amount of equity growth anticipated at the time MSF establishes the overall rate level change applicable each July 1. The $10.1 million of identified "contribution to equity" is actually net income to MSF and is not a deduction. MSF believes the LFD report is trying to state that after achieving the "contribution to equity", MSF will have an additional $15 million available to either make an additional increase to policy holder equity or provide a dividend to policy holders demonstrating and achieving safer work environments for their employees.

Page 5 of 8 of the LFD report contains the following statement.

> ***If the equity and investment income are not sufficient, funding for providing benefits in the New Fund would come from the state's general fund.***

Considering the current structure of MSF and risk management and mitigation practices MSF management has put in place, MSF would strongly disagree with the statement.

- MSF currently has over $200 million of policy holder equity. The independent consulting actuary utilized by MSF has identified their high end of their loss reserve estimate range would be approximately $73 million more than the loss reserves MSF has included in their audited financial statements. Even if losses developed adversely to the additional $73 million, MSF would still have approximately $130 million in policyholder equity. This level of surplus would be approximately 64% of annual earned premium for FY 2009 of $204 million and greatly exceeds the minimum requirement in law of 25% of annual earned premium.
- Given the MSF policy holder equity of over $200 million, MSF would have to realize a loss of almost 20% on the invested asset base of over $1 billion in order for equity to be reduced to 0. This would need to be realized losses and if this occurred, it would be an indication of a significant national financial disaster. The national and Montana economy has experienced the worst financial crisis since the Great Depression. MSF has experienced a slight decline (approximately 7%) in policy holder equity as a result but remains financially sound.
- MSF has demonstrated that operational changes and actions are and will be put in place to address changes to key measures that are other than expected.

The last paragraph on page 5 of 8 of the LFD report states,

> ***Benefit and claims cost incurred are MSF's estimate of the total costs of benefits and claims needed as a result of injuries occurring in a specific fiscal year.***

This is an incorrect understanding of incurred losses reflected in MSF's audited financial statements. Incurred losses as recorded in the MSF financial statements are the estimated costs for claims occurring in the current year <u>*plus*</u> any changes to the estimated costs of claims that occurred in previous years and changes to estimated reinsurance recoveries. It is not isolated to costs of injuries occurring in the current year but also includes changes in the estimated costs of injuries that occurred in previous years.

The changes in equity noted in Figure 6 differs from the changes in equity as presented in either the GASB based or Statutory based audited financial statements of MSF. The following table shows the changes in equity from the audited statements and differs significantly from the total $17 million indicated in LFD's Figure 6.

Montana State Fund Change In Equity from Audited Financial Statements				
	Governmental Accounting Reporting Basis		Statutory Accounting Reporting Basis	
Year	Equity Amount	Change	Equity Amount	Change
1999	144,363,000		133,519,729	
2000	138,264,000	(6,099,000)	138,768,376	5,248,647
2001	168,982,000	30,718,000	150,879,539	12,111,163
2002	180,715,283	11,733,283	158,498,995	7,619,456
2003	163,093,815	(17,621,468)	121,599,417	(36,899,578)
2004	142,772,178	(20,321,637)	127,492,156	5,892,739
2005	168,674,601	25,902,423	148,353,871	20,861,715
2006	157,584,509	(11,090,092)	163,101,495	14,747,624
2007	201,605,162	44,020,653	199,168,517	36,067,022
2008	224,551,475	22,946,313	216,564,182	17,395,665
2009	217,621,730	(6,929,745)	201,031,900	(15,532,282)
Total		73,258,730.00		67,512,171

In further analyzing Figure 6, MSF notes that for FYs 1999 through 2002, the amount of change in equity is determined using the column titled "Projected Losses". However, the calculation changes so that for FYs 2003 through 2009, the column titled "Benefits and Claims" is used to determine changes in equity. Projected Losses are the MSF consulting actuary's most recent estimate of the ultimate cost for the fiscal year. Benefits and Claims are the incurred losses from the MSF audited financial statements. Benefits and Claims would include the estimated costs of injuries occurring in the current year plus the estimated change in the costs of claims occurring in prior years. By using a combination of the columns as reflected in the LFD report, there is duplication of the changes in the actuarial estimate of costs for injuries in previous years. The reason the LFD report uses a combination of the two columns is unclear. The following two tables depict the calculated change in equity using a consistent formula for all fiscal years rather than jumping from one column to another as is the case in the LFD report. The first table is the change in equity using the "Projected Losses" column. The second table shows the change in equity using the "Benefit and Claims" column.

Figure 6 (Projected Losses)
Montana State Fund - New Fund
Changes in Equity
FY 1999 - FY 2009

Fiscal Year	Estimated Loss Ratio	Net Earned Premiums	Investment Income	Projected Losses	Operational Costs	Dividends	Changes to Equity (Projected Losses)
FY 1999	117.78%	$70,170,000	$29,661,000	$81,328,000	$17,358,000	$9,992,000	($8,847,000)
FY 2000	111.72%	70,657,000	29,905,000	77,751,000	20,336,000	6,951,000	(4,476,000)
FY 2001	133.31%	74,500,306	48,848,000	99,320,000	24,332,000	4,995,000	(5,298,694)
FY 2002	111.41%	92,971,868	26,807,673	101,237,000	26,674,100	4,001,224	(12,132,783)
FY 2003	103.51%	117,776,580	46,166,631	125,152,000	28,957,134	2,949,597	6,884,480
FY 2004	83.86%	139,360,612	14,994,923	125,685,000	34,834,291	1,909,856	(8,073,612)
FY 2005	72.66%	189,378,858	35,920,969	138,508,000	35,924,966	5,004,416	45,862,445
FY 2006	69.39%	211,892,198	11,756,456	156,813,000	36,916,161	5,001,042	24,918,451
FY 2007	66.10%	238,202,708	59,893,136	162,525,000	36,833,942	7,000,966	91,735,936
FY 2008	69.00%	230,965,306	32,974,730	166,513,000	40,656,444	0	56,770,592
FY 2009	69.97%	203,976,354	34,299,010	149,508,000	40,713,753	3,996,599	44,057,012
Total		$1,639,851,790	$371,227,528	$1,384,340,000	$343,536,791	$51,801,700	$231,400,827

Figure 6 (Benefit and Claims)
Montana State Fund - New Fund
Changes in Equity
FY 1999 - FY 2009

Fiscal Year	Estimated Loss Ratio	Net Earned Premiums	Investment Income	Benefits & Claims	Operational Costs	Dividends	Changes to Equity (Benefits and Claims)
FY 1999	117.78%	$70,170,000	$29,661,000	$48,773,000	$17,358,000	$9,992,000	$23,708,000
FY 2000	111.72%	70,657,000	29,905,000	68,434,000	20,336,000	6,951,000	4,841,000
FY 2001	133.31%	74,500,306	48,848,000	73,785,000	24,332,000	4,995,000	20,236,306
FY 2002	111.41%	92,971,868	26,807,673	89,730,999	26,674,100	4,001,224	(626,782)
FY 2003	103.51%	117,776,580	46,166,631	151,964,040	28,957,134	2,949,597	(19,927,560)
FY 2004	83.86%	139,360,612	14,994,923	139,232,097	34,834,291	1,909,856	(21,620,709)
FY 2005	72.66%	189,378,858	35,920,969	159,612,313	35,924,966	5,004,416	24,758,132
FY 2006	69.39%	211,892,198	11,756,456	192,699,378	36,916,161	5,001,042	(10,967,927)
FY 2007	66.10%	238,202,708	59,893,136	208,627,247	36,833,942	7,000,966	45,633,689
FY 2008	69.00%	230,965,306	32,974,730	201,333,093	40,656,444	0	21,950,499
FY 2009	69.97%	203,976,354	34,299,010	185,513,924	40,713,753	3,996,599	8,051,088
Total		$1,639,851,790	$371,227,528	$1,519,705,091	$343,536,791	$51,801,700	$96,035,736

Using consistent formulas, the change in equity for MSF is either $231 million or $96 million which is significantly different from the amount depicted in the LFD report. MSF believes the most appropriate determination of changes in equity over time is to use the audited financial statements of MSF.

MSF has prepared a memorandum titled "Target Policy Holder Equity" which explains MSFs consideration in establishing policy holder equity levels. MSF encourages the committee to review that memorandum. As identified in the memorandum, MSF's current financial position continues to provide for safe and sound business operations while allowing MSF to establish the steps to achieve MSF's long-term target equity level while also maintaining a stable insurance market for MSF policy holders. MSF continues address and take steps to build equity to achieve appropriate financial strength.

OPERATIONAL EXPENDITURES

Summary

Operational expenditures for MSF are funded through premiums and investment income. In addition, the building provides the opportunity for a long term investment in a capital asset that will appreciate over time.

Discussion

For FY 2010, MSF's Board of Directors approved budgeted operational expenditures of $56.4 million for MSF and the Old Fund. The FY 2009 actual MSF and Old Fund operational expenditures were $50.2 million. The FY 2010 Budget reflects a $6.2 million or 12.4% increase in operational expenditures from the FY 2009 level. The following three areas are noted to correct the variance amounts noted in the LFD report.

Personal Services: The budget increase includes estimates for an additional 1.5 FTE compared to FY2009 and a 7.3% increase in employee benefit costs including health care benefits.

FY 2010 Budget	FY 2009 Actual	Dollar Increase
$22,770,780	$21,172,011	$1,598,769

Supplies and Materials: The MSF building is separated from other costs in this category to identify how the building set up and move are driving budget increases. The FY10 Budget includes expenditures of $1,281,780 for workstation, training room, and conference room computer hardware and installation associated with the new building.

	FY 2010 Budget	FY 2009 Actual	Dollar Increase/(Decrease)
MSF Building	$1,281,780	$2,211	$1,279,569
All Other	$391,012	$460,591	($69,579)
Total	**$1,672,792**	**$462,802**	**$1,209,990**

Equipment and Intangible Assets: The FY 2010 Budget includes expenditures of $3,971,839 for database servers, Intel servers, storage, storage network, tape library, telecommunications equipment and installation, network equipment and installation, workstation/office equipment/furnishings and installation. The equipment and intangible asset expenditures will be expensed over the assets useful life as is standard accounting practice.

FY 2010 Budget	FY 2009 Actual	Dollar Increase
$4,673,639	$1,614,586	$3,059,053

MSF has deferred expenditures for replacement information technology equipment in recent years so the purchase would be made in FY 2010 as part of the planned move into the new MSF building. With the deferred purchase plan in place, much of the information technology equipment is no longer under maintenance contracts with the manufacturer and as a result MSF would be making or would have made these purchases regardless of the move to the new building.

MSF considers the building as a long term investment in a capital asset. The building will appreciate in value over time. MSF has analyzed the cost benefit of the new building comparing the cost of renting equivalent space as compared to an owner occupied building. That analysis indicates that over a 30 year period, the conservatively calculated advantaged to an owner occupied facility amounts to approximately $46.5 million.

In Summary

MSF is managing a number of risk factors to provide a financially safe and sound worker compensation insurance operation while continuing to address and take steps to build equity to achieve appropriate financial strength. Ultimately, MSF balances the goal of ensuring financially sound operations with the goal of providing a stable worker's compensation insurance market for Montana businesses. Given the current economy and other uncertainties, MSF has demonstrated the ability to weather financial downturns and continue to fulfill its statutory and business mission.