MONTANA STATE FUND
2010 BUDGET ANALYSIS

A Report Prepared for the

Legislative Finance Committee

By

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INTRODUCTION

The Montana State Fund (MSF) provides Montana employers with an option for workers' compensation and occupational disease insurance and guarantees available coverage for all employers in Montana. The management and control of MSF is vested solely in the Board of Directors (board).

Statute requires that MSF present the board approved budget to the Legislative Finance Committee no later than October 1 for their review. While the Legislative Finance Committee reviews the MSF 2010 budget, it has no authority to require MSF to change its budget unless it amends statute, which currently exempts the MSF from the Legislative Finance Act. The only entity charged with overseeing and approving budgets, operations, and expenditures of MSF is the Board of Directors.

This report discusses the analysis of the MSF board approved 2010 budget, which is attached. In summary, the report outlines the following:

- Loss costs for employers will decrease an average of 2.2 percent
- Loss costs for state agencies generally decrease
- Loss cost multipliers increase about 4.5 percent
- Achievement of target equity targets
- Operational expenditures

The budget sets forth the anticipated revenues and planned expenditures for FY 2010. The budgeted revenues are based on premium rates established by the board in May 2009.

MSF PREMIUM RATES

One of the first steps in determining the amount of anticipated revenues for the budget is to determine the premium rates that will be charged for workers' compensation insurance policies during the year. The MSF premium rating process is used to determine the final amount of premium a Montana business will pay for its workers' compensation insurance during the year. There are several components to premium rates. The general formula for the rate is illustrated below:

- NCCI loss cost X loss cost multiplier = manual rate
- Manual rate X increase limits of employers liability
- X experience modification factor (if applicable)
- X construction credit factor (if applicable)
- X scheduled rating modifier
- – volume discount (if applicable)
- + terrorism charge
- + expense constant

Loss Costs Decrease an Average of 2.2 Percent

The first component of the rate is the loss costs or the cost for providing indemnity and medical benefits to the injured worker. The National Council on Compensation Insurance (NCCI) develops advisory loss costs for workers' compensation in Montana. The costs include the costs to the insurer directly related to the benefit claims and the cost for administering or managing the claims. The costs are issued by job classification, also referred to as a class code. During the May 2009 meeting, the board approved using NCCI loss costs as a basis for MSF rates for all class codes except Agricultural Productions and the class codes used by state agencies and municipal governmental entities. For FY 2010, NCCI loss costs have an average 2.2 percent decrease from the loss costs filed by NCCI in the previous year. The 2.2 percent is an average for all industries. Actual amounts vary by industry and class code.

Loss Cost Multipliers Increase 4.5 Percent

Once the board establishes the loss costs, it approves the loss cost multipliers used in MSF rating tiers. The loss cost multiplier includes the costs to operate MSF in FY 2010, reductions for investment income, and the amount of funding needed for equity. Loss costs multiplied by the loss cost multiplier result in the manual rate for businesses insuring with MSF.

The effect of the loss cost multipliers assigned to the various rating tiers is to increase or decrease the loss costs charged an employer in the manual rate. If a business has no or few workers' compensation claims with low claim costs it receives a low experience rating by NCCI. If a business has a low experience it is placed into a rating tier with lower workers' compensation costs for premiums. As the experience relating to workers' compensation insurance costs increases or if the business has less than $5,000 in annual premiums the businesses are placed in higher rating tiers.[1] The board has approved the use of 5 rating tiers, with tier 1 assessed the lowest premiums and tier 5 assessed the highest.

The FY 2010 MSF rating tiers for MSF based on the NCCI experience modifiers for FY 2010 and the corresponding loss cost multiplier compared to the loss cost multiplier used for FY 2009 are presented in Figure 1. As shown, the loss cost multiplier adopted by the board increases about 4.5 percent for all rating tiers.

Figure 1
MSF Loss Cost Multipliers
FY 2010 Compared to FY 2009

Experience From	Modifier To	Tier	FY 2009 Loss Cost Multiplier	FY 2010 Loss Cost Multiplier	Percentage Change
0.01	0.79	Tier 1	0.871	0.911	4.59%
0.80	0.94	Tier 2	0.931	0.973	4.51%
0.95	1.24	Tier 3	0.996	1.041	4.52%
1.25	1.74	Tier 4	1.195	1.249	4.52%
1.75	& above	Tier 5	1.593	1.665	4.52%

The increases are based on increased operating costs, decreased rate of return on cash flows or investments, and decreased contribution to equity. For FY 2010, the board approved MSF management recommendations for loss cost multipliers based on an assumed rate of return on cash flows of 3.25 percent and an estimated 5.4 percent contribution to equity. The assumed rate of return on cash flows is decreased 0.25 percent from FY 2009 premium rates. While the assumed rate of return is set conservatively at 3.25 percent over time, the budgeted rate of return on investments for FY 2010 is $46.7 million or 5.01 percent.

The contribution to equity percentage included in premium rates was reduced from 6.8 percent in FY 2009 to 5.4 percent in FY 2010. For further discussion of the impacts of the contribution to equity component refer to the discussion on Changes to MSF Equity.

The effect of decreased average loss costs and increased loss cost multiplier is that the average change to the manual rate is zero. An employer's paid premiums can still increase or decrease based on whether their workers safety record in the last three years and other considerations by MSF.

State Agency Loss Costs Generally Decrease

As discussed above, the NCCI loss costs are not used for state agencies. Figure 2 shows the board adopted FY 2010 loss costs for state agencies compared to the FY 2009 loss costs.

[1] If an employer has annual premiums greater than $5,000 they are generally experience rated by NCCI. By board policy employers with less than $1,500 in annual premiums are charged in Tier 4 regardless of experience, employers with annual premiums between $1,500 and $5,000 are place in Tier 4 to begin with and can advance as high as Tier 2 based on their workers' compensation insurance claims and accident history.

Figure 2
Loss-Cost Modifications
Approved May 1, 2009

Class Code	Class Description	MSF FY 2009 Loss - cost	MSF FY 2010 Loss - cost	Loss - cost Change
7424	State Aircraft Operation NOC: Flying Crew	6.24	5.81	-6.89%
7721	State Penal Institution: All Other Employees	5.01	5.71	13.97%
7722	State Highway Patrol Officers	4.18	4.3	2.87%
8743	Municipal: Professional or Administrative	1.19	1.14	-4.20%
8744	State Hospital: All Other Employees & Drivers	1.37	1.24	-9.49%
8811	State: Clerical Office Employees	1.88	1.82	-3.19%
8834	State Hospital: All Other Employees & Drivers	14.86	13.78	-7.27%
9411	State Highway Dept: Admin or Non-Professional	2.1	2.21	5.24%
9412	State: Administrative or Non-Professional	2.26	2.17	-3.98%
9421	State Highway Dept: All Others & Drivers	11.34	10.92	-3.70%
9422	State: All Other Employees Noc & Driver	9.49	9.43	-0.63%
9424	Municipal: Relief Workers	7.22	6.77	-6.23%
9427	Community Service Workers	7.22	6.77	-6.23%

Changes are based on the loss experience of the various state agencies for each of the class codes. The final amount of premium costs incurred by state agencies will be modified by their related experience rating, loss cost multiplier, and other factors.

BUDGETED NET EARNED PREMIUMS

Based on the premium rate decision discussed above, the MSF board adopted a budget for net earned premium revenues of $186.5 million, which is a reduction as compared to FY 2009 net earned premiums, both budgeted net earned premiums ($211.5 million) and actual net earned premiums ($204.0 million). The reduction is based on a number of factors including the number of policies to be written, wage growth, retention rate, and manual rate change. Figure 3 presents the factors adopted for the FY 2010 budget as compared to those from the FY 2009 budget.

Figure 3
Revenue Factors for Budget Projections

	Budgeted FY 2009	Budgeted FY 2010
Policies Written	30,300	28,980
Manual Rate Change	3.00%	0.00%
Wage growth	4.00%	0.00%
Retention rate	88.00%	88.00%

CHANGES TO MSF EQUITY

A significant difference between MSF and other state agencies reviewed by the Legislative Finance Committee is that net earned premium revenues are collected in the current fiscal year and are used to pay benefits for injuries incurred during the year and the benefits relating to those injuries in subsequent years, in some cases 40 to 50 years in the future. As a result, the revenues collected in FY 2010 must be available to pay benefits and claims potentially until FY 2060. The net earned premium needed to pay future benefits is set aside as loss reserves. Remaining premium revenues, the portion of the premium assessed for contribution to equity, can result in increased equity set aside for unanticipated increases in the costs of providing benefits to injured workers. To illustrate this Figure 4 shows the net premiums for FY 2010, the related costs of providing benefits currently estimated for injuries incurred in FY 2010, budgeted operational costs, offsetting investment income for FY 2010, the amount of contribution to equity charged ratepayers in FY 2010, and the estimated offsets for the reinsurance program which are not budgeted by the board. MSF's Board of Directors (board) approved rate of 5.4 percent for contribution to equity for FY 2010 or $10.1 million.

Figure 4
Montana State Fund
(in thousands)

	FY 2010
Net Premiums	$186,520
Current and Future Benefit Costs	157,285
Operational Costs	57,828
Bad Debt Expense	3,500
Loss on Operations	($32,093)
Investment Income	46,700
Reinsurance Program	10,379
Contribution to equity	(10,072)
Net Income after contribution to equity	$14,914

It should be noted that looking at the future costs of providing benefits to workers injured in FY 2010 and the funding that could be set aside for contribution to equity charged in FY 2010 provides a significantly different picture of remaining net income from the $25.0 million proposed in the MSF 2010 strategic business plan and adopted by the board. Net income, either total or after contribution to equity is set aside, is not included in MSF's budget. The $10.1 million difference is the result of reducing unbudgeted net income by the amount needed to set aside the contribution to equity.

If the cost of providing future benefits increases beyond what was set aside in the loss reserves, known as adverse development, the amount of the loss reserves must be increased. As MSF cannot go back to businesses who paid the premiums several years previously, the funding for adverse development comes from either the equity of MSF or from investment income. In FY 2009 equity decreased $15.5 million when compared to FY 2008. A portion of the reduction in equity resulted from the effects of the economic recession and its impact on investments. 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.

To examine the effects of adverse development on equity over the last 11 years, Figure 5 provides an overview of premiums collected, projected ultimate losses, and operational costs by year. It should be noted that in workers' compensation insurance the costs of providing benefits to workers are not fully determined in the first few years after a serious accident. The costs of benefits mature over time, with the more current years subject to increases as claims information and potential medical and indemnity costs develop. As can be seen, from 1999 through 2004 MSF required $197.5 million above collected net premiums to fund benefits and claims and operating costs. This funding came from investment income, reinsurance, or equity.

Figure 5
Montana State Fund - New Fund
Cost of Ulimate Losses
FY 1999 - FY 2009

Fiscal Year	Estimated Loss Ratio	Net Earned Premiums	Projected Ultimate Losses	Operational Costs	Funding Remaining
FY 1999	117.78%	$70,170,000	$81,328,000	$17,358,000	($28,516,000)
FY 2000	111.72%	70,657,000	77,751,000	20,336,000	(27,430,000)
FY 2001	133.31%	74,500,306	99,320,000	24,332,000	(49,151,694)
FY 2002	111.41%	92,971,868	101,237,000	26,674,100	(34,939,232)
FY 2003	103.51%	117,776,580	125,152,000	28,957,134	(36,332,554)
FY 2004	83.86%	139,360,612	125,685,000	34,834,291	(21,158,679)
FY 2005	72.66%	189,378,858	138,508,000	35,924,966	14,945,892
FY 2006	69.39%	211,892,198	156,813,000	36,916,161	18,163,037
FY 2007	66.10%	238,202,708	162,525,000	36,833,942	38,843,766
FY 2008	69.00%	230,965,306	166,513,000	40,656,444	23,795,862
FY 2009	69.97%	$203,976,354	$149,508,000	$40,713,753	$13,754,601
Totals		$1,639,851,790	$1,384,340,000	$343,536,791	($88,025,001)

Other financial resources and costs effect equity. Investment income is a portion of the funding used to offset premium costs. Dividends paid to businesses reduce equity. To further examine the effects of adverse development has had on equity, Figure 6 expands on the information included in Figure 5. . The figure is used to give the reader a general idea of the effects of adverse development and does not reflect all accounting adjustments to equity including gain or loss on sale of investments, securities lending expenses and incomes, or penalties and interest.

In addition to net earning premiums, projected ultimate losses, and operational costs, the figure provides investment income, benefit and claims costs incurred, and dividends. 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. These estimates are included as part of the financial statements. As can be seen, in the earlier years the projected losses are significantly higher than the incurred benefit and claim costs. Comparing these two columns gives the reader a better idea of the amount of adverse development occurring over the period on a year by year basis. As expected, in later years the incurred benefit and claim costs estimated by MSF exceed the current estimated losses. Figure 6 uses the higher of projected ultimate losses or incurred benefits and claims to determine the changes to equity.

Figure 6
Montana State Fund - New Fund
Changes in Equity
FY 1999 - FY 2009

Fiscal Year	Estimated Loss Ratio	Net Earned Premiums	Investment Income	Projected Losses	Benefits & Claims	Operational Costs	Dividends	Changes to Equity
FY 1999	117.78%	$70,170,000	$29,661,000	$81,328,000	$48,773,000	$17,358,000	$9,992,000	($8,847,000)
FY 2000	111.72%	70,657,000	29,905,000	77,751,000	68,434,000	20,336,000	6,951,000	(4,476,000)
FY 2001	133.31%	74,500,306	48,848,000	99,320,000	73,785,000	24,332,000	4,995,000	(5,298,694)
FY 2002	111.41%	92,971,868	26,807,673	101,237,000	89,730,999	26,674,100	4,001,224	(12,132,783)
FY 2003	103.51%	117,776,580	46,166,631	125,152,000	151,964,040	28,957,134	2,949,597	(19,927,560)
FY 2004	83.86%	139,360,612	14,994,923	125,685,000	139,232,097	34,834,291	1,909,856	(21,620,709)
FY 2005	72.66%	189,378,858	35,920,969	138,508,000	159,612,313	35,924,966	5,004,416	24,758,132
FY 2006	69.39%	211,892,198	11,756,456	156,813,000	192,699,378	36,916,161	5,001,042	(10,967,927)
FY 2007	66.10%	238,202,708	59,893,136	162,525,000	208,627,247	36,833,942	7,000,966	45,633,689
FY 2008	69.00%	230,965,306	32,974,730	166,513,000	201,333,093	40,656,444	0	21,950,499
FY 2009	69.97%	203,976,354	34,299,010	149,508,000	185,513,924	40,713,753	3,996,599	8,051,088
Total		$1,639,851,790	$371,227,528	$1,384,340,000	$1,519,705,091	$343,536,791	$51,801,700	$17,122,735

* As the incurred benefit and claim costs are MSF estimates of the final costs for workers' injuries during the year recorded in the financial statements, Figure 6 utilizes benefits and claims costs to calculate changes to equity for FY 2003 and beyond.

As shown in Figure 6, in 7 of the last 11 years, revenues from premiums and investment incomes has been exceeded by the projected costs of providing the benefits to workers injured in that year, operational costs, and dividends. This figure demonstrates the need to have adequate equity, funding adverse development. For this reason, the public policy question for the legislature is "What is the level of equity necessary to ensure taxpayers are not required to supplement claims costs in the New Fund?"

Current statute provides authority to the board to establish premium rates and the level of policy holder equity. MSF uses actuarial analysis to assist the board in making rate decisions including the amount of equity the board should require to ensure that MSF is financially strong. MSF's actuary compared MSF equity to A-rated State Funds and determined that the suggested equity range would be between $227 million and $407 million. MSF equity measured at June 30, 2009 is $26 million below the lower end of this range.

Included in the various measurements used to establish this range is the reserve to equity ratio discussed by the actuary in previous analyses. One of the actuary's conclusions reported in the analysis of policyholder equity adequacy is that based on peer company benchmarks, MSF's current policyholder equity appears to face greater risks form adverse reserve development than future business results. Adverse reserve development is benchmarked using the reserve to equity ratio. Reserve to equity ratios reflect the multi-year nature of an insurer's obligations, in other words the insurers need to pay benefits over a long period of time. Insurers with a large reserve to equity ratio have a greater risk of having equity depleted by relatively small errors in loss reserve estimates that result in adverse development. The lower the reserve to equity ratio, the greater the financial strength of the insurance company. According to MSF's actuary, MSF needs stronger than average policy holder equity to address its potential for greater volatility due to the lack of underwriting diversification resulting from writing one highly regulated type of insurance, in a single state, with a requirement to provide a guaranteed market.

Due to the continuing significance of the contribution to equity component included in MSF premiums, equity's role in the financial strength of MSF, and actuarial recommendations on reserve to equity ratio targets, the LFC requested that the MSF report on the Board of Directors plan to achieve the actuarial recommended loss reserve to equity targets of between 2.0 and 2.5 to 1.0 by FY 2014. MSF includes a plan for the reserve to equity targets for the next 3 years in their strategic business plan. A review of the reserve to equity targets since FY 2003 shows that MSF has not been able to meet the projected targets. Figure 7 shows the projected loss reserves included in MSF strategic business plan since FY 2003, and the actual reserve to equity ratio achieved.

Figure 7

Loss Reserve to Equity Target

	FY 2003	FY 2004	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012
FY 2003 Strategic Plan	2.09	2.07	2.05							
Actual	3.40	3.55	3.45							
FY 2004 Strategic Plan		2.64	2.60	2.56						
Actual		3.55	3.45	3.62						
FY 2005 Strategic Plan			3.23	3.70	2.88					
Actual			3.45	3.62	3.41					
FY 2006 Strategic Plan				3.75	3.78	3.75				
Actual				3.62	3.41	3.47				
FY 2007 Strategic Plan					3.42	3.24	3.00			
Actual					3.41	3.47	4.05			
FY 2008 Strategic Plan						3.52	3.20	2.91		
Actual						3.47	4.05	4.24		
FY 2009 Strategic Plan							3.17	2.98	2.77	
Actual							4.05			
FY 2010 Strategic Plan								4.24	3.88	3.55

MSF has increased projected loss reserve to equity targets over its planned targets since FY 2003. For example, in FY 2003 MSF projected the FY 2005 loss reserve to equity target would be 2.05, in FY 2004 they increased the projection to 2.60, and in FY 2005 they again increased the projection to 3.23. The effect of not attaining these projections is that a significant percentage for contribution to equity is included in ratepayer premiums.

It also shows that MSF actual loss reserve to equity ratios have increased significantly between FY 2003 and FY 2009, from 3.4 to 4.05. Not only is MSF not achieving the recommended equity targets, it's performance related to this measurement declined significantly in FY 2009 from 3.47 in FY 2008 to 4.05 in FY 2009.

The legislature may wish to request MSF continue to provide:

- Updates on the MSF challenges in relation to its ability to attain projected loss reserve to equity targets
- An update on the board's proposed plan to achieve these targets

OPERATIONAL EXPENDITURES

Operational expenditures for MSF are funded through premiums. Increases or decreases in operational expenditure result in changes to the loss cost multiplier used to determine a business's premium rate. In FY 2010 MSF has budgeted operational costs of $56.4 million. Increases in operational expenditures are included in three main budget categories:

- Personal services - $632,374
- Supplies and materials - $1,209,990
- Equipment and intangible assets - $2,790,626

The board approved an additional 1.5 FTE compared to FY 2009 and $5.85 million for operating expenses and equipment and intangible assets for MSF's new building.

The costs related to supplies and materials and equipment and intangible assets may be one-time only. Operating expense increases included $1.2 million in computer hardware. In FY 2008 and FY 2009 MSF postponed purchasing new personal computers and other computer hardware under its old computer replacement cycle due to plans to move into the new MSF building. In addition, $3.97 million of the $4.67 million budgeted for equipment and intangible assets is to be used to purchase new computer and office equipment for the new building. The costs for computer equipment are $2.3 million and office equipment is $1.65 million. The board has not yet adopted a revised replacement schedule for computer purchases. Office equipment for the new space will not require replacement for several years.

Finally, MSF budgets rent costs of $352,138 in FY 2010 for leased space in its current building and two other locations housing MSF personnel, field office space, and parking. During its September board meeting, the MSF controller notified the MSF Board of Directors that MSF would no longer be paying rent for its building when they moved into the new building. It is estimated the new building will reduce $24.7 million in cash and investments that generate investment income from the asset sheet of MSF. The assets will be replaced with investments with land and buildings.

Using the budgeted return on investment for FY 2010 of 5.01 percent, the $24.7 million in cash or investments would have generated $1.24 million in interest income. The reduction in rent costs due to the new building does not offset the loss on investments due to the elimination of the cash and assets used to finance the new building.

The legislature may wish to request that MSF present a plan on how it will offset the reduction in return on investments due to the purchase of land and new office space.

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