MSF REVISED RECOMMENDATIONS FOR LFC CONSIDERATION

A Report Prepared for the

Legislative Finance Committee

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INTRODUCTION

At their October 9, 2007 meeting, the Legislative Finance Committee (LFC) heard a staff report on the budget of the State Compensation Insurance Fund, commonly referred to as the Montana State Fund (MSF) and a presentation by MSF management. At the request of the LFC, Legislative Finance Division (LFD) staff met with MSF management to try and resolve MSF concerns related to recommendations included in the report. This report discusses the various concerns raised by MSF management and provides revised legislative options for consideration. MSF continues to disagree with the recommendations in the report. It would appear MSF management believes no changes to statutes discussed below should be considered by the legislature.

The Montana State Fund 2008 Budget Analysis report by LFD staff discussed three new concerns related to the MSF 2008 budget:

- The budget is presented on a cash basis
- Dividends are declared in years with combined ratios above 100 percent
- The contribution to equity minimum amount does not appear to be sufficient for the risks insured by the state fund and is not indentified as a separate item in the budget

Each concern and the revised recommendations made to address MSF concerns is presented below.

BUDGET PRESENTED ON CASH BASIS

The MSF budget is presented on a cash basis as opposed to a full accrual basis. According to statute, MSF is required to include the entire expense of administering the state fund in its estimated budget. In a verbal discussion with the code commissioner, prior to the October 2007 LFC meeting, as to the meaning of the entire expense of administering the state fund, the code commissioner looks to the intent of the legislature in including in statute the phrase "with due regard to the business interest and contract obligations of the state fund" to provide additional clarification on the entire expense. It would appear to the code commissioner that business interests would include underwriting losses, which are accrued but not yet incurred, as items of significant interest to the state fund board in the planning process finalized in the budget document, and as such should be included in the budget.

According to MSF management, the MSF budget is built based on the anticipated cash flows for the fiscal year as it compares to estimated revenue and expenditure flows during the year including estimated claim payments. In other words, the budget is used to monitor the amount of cash MSF will have in a given year. The budget looks at the cash received in premiums and interest revenues and subtracts the cash paid out for claims and the operating costs of MSF during the year. The determination of the adequacy of the amount of premium revenue over the life of the claim is not part of the budget planning process. It is part of the rate planning process considered by the Board.

As part of the process to resolve this issue, LFD staff requested a formal legal opinion from the code commissioner. The opinion states that it appears that including "accrued liabilities" as part of the "entire expense of administering the state fund for the succeeding fiscal year" would fulfill the statutory requirement to have the budget for the state fund include "due regard to business interests and contract obligations of the state fund" and would adhere to the stated objective of the 1991-1992 Select Committee on Workers' Compensation to keep the legislature informed of any potential unfunded liability. In light of this opinion, it appears MSF should comply with the statute as written and develop budgets presented on an accrual basis rather than a cash basis as has been the past practice. A copy of the full opinion is attached to this report.

The legislature may wish to consider legislation to further define the reporting basis of the financial information to be used for the estimated budget approved by the MSF board.

DIVIDENDS DECLARED IN YEARS WITH COMBINED RATIOS ABOVE 100 PERCENT

The MSF 2008 Budget Analysis states that the legislature may wish to consider legislation to include the combined ratios as a component of the determination of the appropriateness of the surplus used to pay declared dividends. Combined ratios are a measurement of whether premium rates have been adequate to cover benefits costs, operating costs, and dividends. Combined ratios above 100 percent are an indication that premiums may not be sufficient to support benefits, operating costs, and dividends.

MSF is required to consider investment income as part of their overall determination of rates. Combined ratios do not include investment income as part of their calculation. The operating ratio is used to measure the effect of investment results on operations. Investment earnings can be used to reduce overall premium rates by offsetting some operational costs. When discussing this issue MSF management pointed to the operating ratio as a measure of the effect of investment income. If the legislature determines it wishes to clarify the conditions dividends can be declared, using the operating ratio rather than the combined ratio could be a better indication of the advisability of declaring a dividend. It would ensure dividends were not declared in years when MSF suffers net operating losses as occurred in FY 2003 and FY 2004.

In consideration of the effect of investment earnings on the profitability of MSF and the resulting reduction in premium rates, LFD staff has revised their original recommendation. The revision is presented below.

The legislature may wish to consider legislation to further define the term appropriateness of the surplus used to pay declared dividends.

CONTRIBUTION TO EQUITY

MSF maintains surplus funds or equity to insure against higher than anticipated increases in loss reserve requirements or increased loss adjustment expenses. Included in the 2007 equity analysis, conducted for the MSF by an independent actuary, is a recommendation to set the reserve to equity target in the range of 2.0 - 2.5 /1.0 or $286 to $358 million in equity at FYE 2008. The analysis states that the June 30, 2006 equity position of $163 million places MSF below the lower end of the range indicated by A- state funds or median private carriers.

The 2008 Budget Analysis report outlines a legislative option to revisit whether the current minimum surplus requirements of 25 percent of net premium should be changed to reflect a reserve to equity target in the range of 2.0 - 2.5/1.0. The current statutory requirement set the minimum in this period at about $55.5 million, well below MSF equity position of $163 million as of June 30, 2006.

The legislature has passed “The Risk-Based Capital (RBC) for Insurers Act”, which addresses risk-based capital requirements for domestic and foreign insurers providing property and casualty, and life and disability insurance. MSF management believe these requirements adjust equity requirements without a specific target. According to MSF, RBC language is already contained in the statute applicable to MSF equity. According to the equity analysis prepared for MSF, RBC benchmarks focus on what point is equity weak enough that a regulator should consider intervention. They do not determine capital adequacy in terms of financial strength of the company. According to the equity analysis, $114 million would have been the benchmark under NAIC risk based capital requirement. While this is significantly more than the 25 percent of net premium, it may not be an indication of the financial strength of MSF.

A.M. Best, a rating agency and analyst of capital adequacy of insurance companies, issues ratings to insurance companies based on their financial strength. A discussion of the process used by A.M. Best was included in the equity analysis. The process examines:

- Various sources of risk to an insurer’s financial condition
- Interrelationship between different sources of risk

- Qualitative as well as quantitative factors
- Past and future risk factors and indicators of the insurer's strength
- Comparative position of the company versus its "peer"

As stated above comparing the equity position of MSF at June 30, 2006 with A- rated state funds places MSF below the lower end of the range as indicated by A- state funds. Statute could be amended to include a requirement to adopt a minimum equity target at the lower end of the range indicated by A- state funds. This would further define the minimum equity target without including a fixed ratio.

The legislature may wish to revisit whether a minimum equity target of 25 percent of net earned premium should be increased and by what methodology.

Contribution to Equity as a Component of the Loss Cost Multiplier

The 2008 Budget Analysis also discussed the contribution to equity component of the loss cost multiplier assessed rate payers. MSF management maintains including this component of income as a budget category is not feasible because the contribution to equity does not develop over a one-year period of time and the recommendation does not take into account the effect of discounting due to investment income. In addition, MSF management maintain that contribution to equity is a component of the rate making process and not the budget process. It should be noted that the rates determine the amount of net premium included in the budget considered by the board.

While the final determination of the amount of contribution to equity that is realized from premiums received in any given year can be 30 to 40 years, MSF receives the premium revenue which includes contribution to equity assessments in the current budget year. The discounted amount of revenue related to contribution to equity can be determined. Recognizing the amount of revenue anticipated for contribution to equity in the budget allows the board to make decisions and manage towards maintaining this amount of equity which is assessed ratepayers. Ratepayers may wish to know that the amount of premium paid for contribution to equity is budgeted as such and not used for general operations or other costs of MSF.

Therefore, the legislature may still wish to consider legislation to require MSF budgets to include a separate budgeted category for contribution to equity using the discount factor for that year.

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