MONTANA LEGISLATIVE BRANCH

Legislative Fiscal Division

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Legislative Fiscal Analyst
CLAYTON SCHENCK

DATE: November 16, 2006

TO: Legislative Finance Committee

FROM: Kris Wilkinson, Fiscal Analyst

RE: Montana State Fund Written Response to 2007 Montana State Fund 2007 Budget Analysis

At the October 13, 2006 Legislative Finance Committee (LFC) meeting, the committee requested the Montana State Fund (MSF) respond to the issues included in the Montana State Fund 2007 Budget Analysis. The budget analysis was included in the packet the LFC received for their October meeting under tab 13. Attached please find their written response.

The Montana State Fund 2007 Budget Analysis will be presented to the committee during the November 28, 2006 meeting, followed by the MSF response to the issues as discussed in the attached document. The MSF response provides a brief summary of the causes of the issues, including the difficulty of establishing estimates included in the budget and used to establish employee incentive payments. The response does not include or outline any anticipated changes to MSF processes or procedures to address the concerns.

As you are aware, MSF is required by statute to present their budget to the LFC. However, the MSF Board of Directors is solely responsible for the approval of the budget, declaration of dividends, and determination of employee incentive payments.

Thank you for your consideration of this material.

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MONTANA STATEFUND

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November 3, 2006

Legislative Finance Committee
PO Box 201711
Helena, MT 59620-1711

Dear Committee Members:

The Legislative Finance Committee has requested Montana State Fund to respond in writing to the issues raised in the October 9, 2006 report titled *MONTANA STATE FUND 2007 BUDGET ANALYSIS,* as prepared for the Committee by Kris Wilkinson, Legislative Fiscal Analyst. These issues as listed on page 7 of the report were as follows:

- *Potentially under-budgeting net earned premium revenues*
- *Budgeting personal services at higher rates than indicated*
- *Setting incentive payment measurements for net earned premiums at levels below historic averages, with the effect of making it easier to attain the measurements*
- *Dividend policies which allow for payment of dividends for years when MSF suffered operating losses*
- *The LFC should be aware that within the next few years, the legislature could be required to offset growing Old Fund liabilities with general fund.*

Montana State Fund (MSF) is providing this response to the above.

Background

Workers' compensation is mandatory insurance coverage for employers in Montana.

MSF provides a competitive option for an employer to purchase workers' compensation insurance. MSF competes with other insurance carriers to provide coverage to businesses in the state.

MSF serves as the guaranteed market for Montana. If an employer cannot obtain insurance coverage from a private carrier, MSF is required to insure the employer regardless of loss experience, size of premium or the hazardous exposure of their type of business.

- The premium revenue MSF generates in Montana's competitive workers' compensation insurance market, along with investment income, is the only funding source for the payment of wage loss and medical benefits for injured employees and also for the operating expenses of MSF.

- MSF is organizational and operationally structured much like a private carrier to meet insurance business needs. A board of directors appointed by the Governor has responsibility for:

    - Establishing rates
    - Establishing surplus (equity)
    - Declaring any dividends
    - Annual Budget
    - Annual Strategic Business Plan
    - Annual Financial Report

- Section 39-71-2331, MCA establishes the following,
  "... In determining premium rates, the state fund shall make every effort to adequately predict future costs. ***When the costs of a factor influencing rates are unclear and difficult to predict, the state fund shall use a prediction calculated to be more than likely to cover those costs rather than less than likely to cover those costs.*** Unnecessary surpluses that are created by the imposition of premiums found to have been set higher than necessary because of a high estimate of the cost of a factor or factors may be refunded by the declaration of a dividend as provided in this part." (Emphasis added)

A) Potentially under-budgeting net earned premium revenues

Annually, MSF provides an estimate of premium revenues that are anticipated for the upcoming fiscal year. These estimates are used as a basis for projecting the variable costs MSF absorbs each year from its insurance business. These variable costs include for example the benefits paid on claims and the costs of managing claims for injured employees. Commissions paid to independent insurance agents also vary with the level of premium and exposure MSF insures.

Premiums can vary from year to year based on a variety of factors. These factors include, but are not limited to:

- Annual Premium Rate changes

Montana State Fund Rate Actions	
Effective Date July 1, of	MSF Rate Change
1996	-15.4%
1997	-5.6%
1998	-3.0%
1999	-2.0%
2000	0.0%
2001	2.7%
2002	2.8%
2003	11.6%
2004	9.5%
2005	3.0%
2006	2.4%

- Loss experience of individual accounts that may affect the underwriting of that account and the ultimate premiums they pay.

    - Individual policy premium levels are impacted by type of industry, payroll size, loss experience, and pricing activity. If the available pool of policies insured by MSF were constant from one period to the next, it would be relatively simple to apply the compound impact of the aforementioned factors to estimate future net earned premium. However, businesses regularly cease operations due to the sale of the business, relocation of the business, or merger with or acquisition by another entity. At the same time, new businesses emerge to take the place of those that have been dissolved. In addition, many existing and ongoing businesses have the ability to grow or shrink their payroll in response to economic conditions and their level of business activity.

- Level of competition and the desire of insurance carriers to write business or not write business in the state.

    - MSF experienced a 55% increase the amount of reported payroll we covered for employers insured in 2002 and 2003. This significant increase was the result of an unanticipated market shift in the number of private insurance carriers willing to write workers' compensation insurance in Montana. In other words, private companies quit writing workers' compensation insurance in Montana and MSF, as the guaranteed market, insured these businesses. Also, as provided to the Committee, MSF increased premium rates charged to customers by a combined 21% in fiscal years 2004 and 2005. Such increases generally would allow private carriers the ability to competitively price business and take that business from MSF. We expected to experience lower customer premium retention. On the contrary, MSF experienced a significant increase in new and retained business as private carriers continued to elect not to insure in Montana. Certainly, the greater than expected increase in premiums creates a significant impact on our staffing work loads to be able to provide service to this level of new business.

  - Further influencing this issue is the fact that private insurance carriers have the ability to influence market availability by their attraction to various industry segments, geographic regions, and account sizes. MSF, as the guaranteed market does not have a similar capability and, therefore, has an obligation to provide an insurance market for all employers regardless of size or industry. Of the approximately 28,000 policies currently insured by MSF, 3% account for almost 40% of our premium revenue. It is typically these larger accounts that are most attractive to other carriers, especially since they, in many cases, write the other supporting lines of business such as general liability and property insurance.

- Economic factors such as an increase in economic development increasing the opportunities for new businesses or payroll growth of existing businesses.

- Changes in the mix of business insured by MSF.

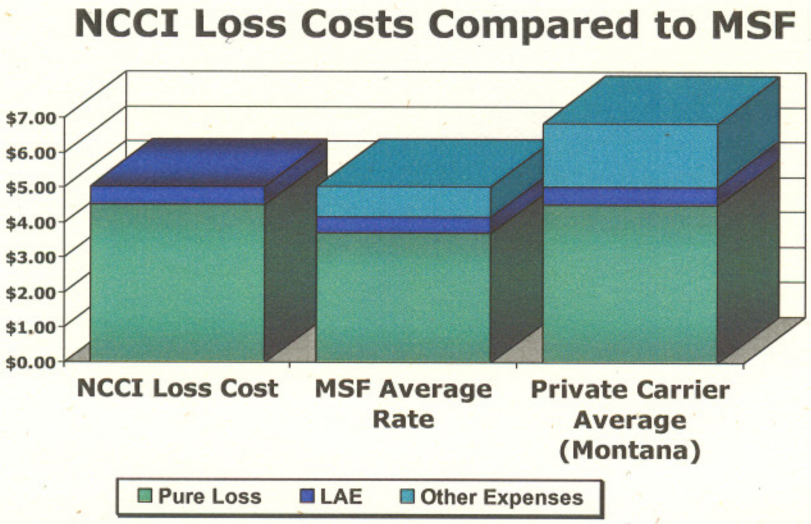
- Cost of reinsurance programs and catastrophic loss protection.

MSF evaluates each of these factors and others in estimating the premium for the year based on our analysis of market and economic trends. However, as is exemplified in the projections provided to the Committee on tax revenues and estimates of a significant ending General Fund balance, such estimates are subject to a great deal of variability due to changing economic and market conditions. The table below was provided to the Committee to show the change in the amount of employer insured payroll covered by MSF.

Accident Year	Insured Payroll	% Change from Prior Year
2000	$2,415,321,416	6.4%
2001	$2,406,908,301	(0.4%)
2002	$3,078,556,347	27.9%
2003	$3,721,761,028	20.9%
2004	$3,790,281,821	1.8%
2005	$4,118,575,001	8.7%
2006 Estimate	$4,412,101,000	7.1%
2007 Projection	$4,616,914,835	4.6%

Approximately 94% of all MSF costs are variable or in other words, based upon premium. Because of this, underestimating revenue is actually more of a penalty than a reward since the attendant additional costs must be absorbed into a budget that was formulated on a potentially under estimated amount.

We understand the concern for under estimating our premium revenue is the possibility of establishing rates that exceed our need. This is simply not true as demonstrated by the competitive rates MSF offers as compared with other insurance carriers operating in the state. Kris Wilkinson explained in her report that NCCI files "loss costs" for the state (estimated cost of claims and claims administration expenses) and insurance carriers add a "loss cost multiplier" to cover their other expenses such as general overhead and to include anticipated investment income on the future cash flows on the premiums collected. The following graph indicates that MSF rates including the loss costs and all other operating expenses are at the same level as the NCCI loss costs. This means the loss cost multiplier for MSF is 1.0 while on average other insurance carriers' loss cost would be approximately 1.36 or 36% higher. This fact allows Montana employers to have access to competitive workers' compensation insurance rates.



B) Budgeting personal services at higher rates than indicated

MSF establishes the budget for the number of positions needed for the work loads anticipated by the estimated premium earnings. If we estimate premium below where it actually falls, our staffing levels may not be adequate to service the business we insure.

While we aspire to expeditiously attract qualified applicants for open positions at the identified market value, this is not always possible. Generally speaking, MSF position salaries are established at 5% below the comparable national market average. Since there are very few property and casualty insurance carriers (not to mention workers' compensation specialists) located in the state, we often find ourselves competing on a national level to attract the unique skill sets required for our professional level positions. For that reason, we budget open positions at full market value to allow ourselves appropriate flexibility in the selection process.

In previous years, MSF has established a vacancy savings factor as part of the budget for personal services. However, as explained, it has been difficult to attract qualified professional level employees with the insurance knowledge and background. MSF has experienced recruiting costs over the amount budgeted that offset any savings as a result of vacancies. In addition, MSF has incurred costs over amounts budgeted for temporary services to absorb the staff shortages from not being able to fill positions. As a result, MSF removed the vacancy savings factor from the budget. MSF observed a change in this trend in FY 2006 and therefore included a vacancy savings factor of 3.4% in the FY 2007 budget.

In summary, when MSF experiences vacancies, we are also incurring additional expenses not anticipated in the budget including use of temporary services and recruiting costs that offset any savings in the budget.

C) Setting incentive payment measurements for net earned premiums at levels below historic averages

MSF premium estimates are based on the best information available at the time the estimate is made. Typically premium estimates are established in the March to May time period as it is necessary for strategic business planning, budgeting and rate making for the following fiscal year. This is before the current year is completed as to expenses and premium collections and before premium renewals for the following year are known. It is not in the best interest of MSF to underestimate annual premiums as it is important that expenses necessary for that volume of premium be accurately estimated as well.

It is not a significant factor in our incentive plan, but as premium estimates impact other items in our resource planning and budget process, it is necessary that we establish a focus on this aspect of our business each year. The weighting of the net earned premium component of the incentive plan is 5%. This means the maximum payout resulting from this element for outstanding performance is 1.5% (President/CEO), 1.125% (VPs), and 0.75% (All other employees).

As discussed previously, there is a considerable amount of variability surrounding the development of a net earned premium estimate, many of which are outside of the control of Montana State Fund. While a comparison of estimated revenues to actual amounts written is a possible comparison, it is not a reasonable basis to assume intent to under estimate premium. A more appropriate tool to measure the quality of an estimate would be to judge its value based upon the information known at the time the estimate was made, in other words historic actual performance and trends available at the time the estimate is made. MSF evaluates trends of prior years, anticipated rate level changes and expected changes in market dynamics and competition in evaluating and planning premium estimates for the upcoming year to establish our best estimates for premium.

D) Dividend policies which allow for payment of dividends for years when MSF suffered operating losses

MSF dividends are *paid out of existing equity* (surplus) at the time declared and not out of future premiums needed to pay future losses. MSF establishes a provision for the unpaid losses before determining the amount of equity. The evaluation of equity adequacy MSF undertakes each year to determine if a dividend is safe to declare, states equity in terms of undiscounted losses and LAE reserves. In other words, the dividend evaluation assumes no future investment income will be needed to pay the claim losses since these losses are stated at their full undiscounted basis. Therefore, the adequacy of equity in determining whether to allow a dividend is independent of the availability of future investment income on the assets supporting the loss reserves. Dividends are only declared to the extent that MSF determines that its equity position is adequate to support the risks inherent with long term claim liabilities and that satisfactory progress is being made to meet its long term financial goals. A decision of the board to declare a dividend is supported by consultation with the independent actuary to determine whether a dividend is appropriate.

In addition, MSF must provide incentives for safe workplaces and reward those employers who have demonstrated a commitment to safety and reduction of loss experience. If it were not for these employers, MSF financial results could be significantly worse than the actual results stated.

E) The LFC should be aware that within the next few years, the legislature could be required to offset growing Old Fund liabilities with General Fund

The ending net assets balance for the Old Fund as of June 30, 2006 is ($21.9) million. This includes additional development on the remaining claims of $5 million. Based on the expected payment patterns for the remaining claims, MSF estimates the remaining assets will be available to pay claims until FY 2013. At that time, the General Fund will be required to fund claim payments, currently estimated to end by 2045.

In addition, the Montana Supreme Court recently issued their ruling on the Stavenjord case making its effect retroactive to 1987 claims. MSF had estimated the costs to Montana State Fund (claims on or after July 1, 1990) to be in the range of $14 to $19 million and the Old Fund costs to be an estimated $5 to $7 million. The Supreme Court did rule that this retroactive applicability did not include claims closed by either court order or settlement. Excluding these claims will reduce the initial cost estimates but additional review is necessary to assess the ultimate cost of this court ruling.

If you have any questions, please don't hesitate to contact me.

Sincerely,

Larry Hubbard by Mark O'B

Laurence A. Hubbard
President/CEO