MONTANA STATE FUND
2008 BUDGET ANALYSIS

A Report Prepared for the

Legislative Finance Committee

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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 the state fund is vested solely in the Board of Directors (board).

Statute requires that MSF present the approved budget to the Legislative Finance Committee no later than October 1 for their review. While the Legislative Finance Committee reviews the MSF 2008 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 2008 budget, which is attached. It raises several issues, including:

- The budget is presented on a cash basis, which may not provide sufficient management information to make appropriate decisions and may not include the entire expense of administering the state fund as required by law
- Dividends were declared in years when the MSF combined ratios were above 100 percent, which is an indication that premiums may not have been adequate to cover the benefit costs, operating expenses, and dividends of MSF
- Equity is below the amount recommended in the equity analysis completed by the MSF actuary, and the funds included in the rates to increase equity are not separately budgeted

BUDGET PRESENTED ON CASH BASIS

There are two ways to account for costs:

1) cash basis; and
2) accrual basis.

Cash basis includes program costs paid during the year. Accrual basis includes program costs paid during the year and estimates of costs in future periods related to the current year.

The MSF budget is presented on a cash basis as opposed to a full accrual basis, which state agencies are required to follow. State accounting policy recognizes expenditures as soon as the related liability is incurred, regardless of the timing of the related cash flows. In other words, you include the costs in the financial information used for the budget even if you don't have to pay them in that reporting period. Expenses which have been incurred but not yet paid are accrued. For example, Medicaid is required to record accruals for estimates of the costs of medical visits provided during the fiscal year which haven't been billed to Medicaid by the end of the fiscal year. Accrued expense costs are used as part of the determination of the actual costs of providing services, are included in the budget base, and thus flow into the agencies' budgets. Eliminating accrued expenditures from the budget presents an incomplete picture of the financial status because the total cost of operating the enterprise is not included. [1]

By statute, MSF is required to include the entire expense of administering the state fund in its estimated budget. The statement of revenue and expenses and changes in equity shows the annual operating results for the MSF. Major categories such as net premium earned or net operating profit or loss from the statements are included as categories in the budget approved by the MSF board. However, because the categories on the audited statement include estimated costs and the budget is done on a cash basis and does not include estimated costs, it is difficult to determine if the budget includes the entire expense of operations as required by law.

[1] MSF is considered a component unit of the State of Montana. As such their financial activity is included in the state's Comprehensive Annual Financial Statements issued each year. Component units are included in the state's financial statements because the relationship to the state is such that exclusion would cause the financial statements to be misleading or incomplete.

Underwriting profits or losses provide information on the cost of operating the state fund. Figure 1 shows actual underwriting profits or losses of the MSF from FY 2000 through 2006 as reported in the audited statutory financial statements. As shown above, when accrued liabilities are included in the costs, as required for statutory statements of revenue and expenses, MSF has suffered underwriting losses ranging from $62.7 million in FY 2003 to $4.9 million in FY 2005. MSF uses investment income and equity to offset the underwriting losses.

Figure 1
Montana State Fund
Underwriting Profit/Loss

Fiscal Year	Underwriting Profit/Loss
FY 2000	($18,258,340)
FY 2001	(21,642,627)
FY 2002	(21,635,674)
FY 2003	(62,770,162)
FY 2004	(32,617,032)
FY 2005	(4,990,843)
FY 2006	($13,289,873)

In FY 2006 the difference between net earned premiums and operational expenses and benefits (underwriting profit) on a cash basis is $42.4 million, as shown on page 1 of the MSF Fiscal Year 2008 Annual Budget Request. However, over $12 million of these costs are for the Old Fund, so the underwriting profit for the New Fund is at least $12 million higher. The actual underwriting loss on the FY 2006 statutory statements is $13 million for the New Fund, a difference of $67.4 million.

MSF officials stated they use the cash basis because the accrual basis requires estimates of costs which are paid over the life of the claim, sometimes for a period 30 to 40 years in the future. However, the financial statements include estimates of these costs and according to the audit opinion present fairly the results of operations of MSF. MSF believes the annual budget should continue to be presented on a cash basis as the full accrual is presented in their financial statements and the cash basis presents the board with a mechanism to track the cash payments on claims.

The insurance industry does not appear to have a standard regarding the basis of the financial information used to present the budget. Staff contacted National Council on Compensation Insurance (NCCI) representatives to determine which basis of accounting was used as an industry standard. NCCI representative believe both methods are used.

The legislature may wish to consider legislation to 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

While preparing the budget on an accrual basis could provide management a clearer picture of the entire expense of operating the MSF, it would not determine if declaring dividends was supported by the rates, as dividends are not budgeted. One method widely recognized as a determination of whether premium rates have been adequate is the combined ratio. Combined ratios are used as a measure of the adequacy of premiums to cover both the benefit costs and operating expenses of the benefit system. Combined ratios of 100 percent or lower are considered an indication the net premium charged was sufficient to cover the costs of medical and indemnity payments and loss reserves, insurer operating expenses, and dividends. NCCI recommends a combined ratio of 100 percent or less for workers compensation insurance companies. The combined ratios of MSF for the period FY 2000 through FY 2006 are presented in Figure 2. As shown, the board declared dividends throughout this period.

Figure 2
Montana State Fund
Combined Ratios

Fiscal Year	Net Premium	Losses	Expenses	Dividends	Combined Ratios
FY 2000	$70,656,612	$65,327,377	$23,587,575	$6,950,716	135.68%
FY 2001	74,510,374	71,606,236	24,546,765	4,995,259	135.75%
FY 2002	92,971,868	86,699,328	27,908,214	4,001,224	127.57%
FY 2003	117,776,580	146,912,095	33,634,647	2,949,597	155.80%
FY 2004	139,360,612	136,267,288	35,710,356	1,909,856	124.78%
FY 2005	189,378,858	152,545,131	41,824,570	5,004,416	105.28%
FY 2006	$211,892,198	$180,614,395	$44,567,676	$5,001,042	108.63%

As shown in Figure 2, throughout the period the combined ratios of MSF have been above 100 percent. Because the ratio is over 100 percent there is a concern that premiums may not have been adequate to cover the benefit costs, operating expenses, and dividends of MSF.

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.

CONTRIBUTION TO EQUITY

MSF offsets underwriting losses and pays dividends using investment income generated from loss reserves and equity and contributions to equity assessed all ratepayers through the loss cost multiplier. The loss cost multiplier is used to recover costs associated with providing workers' compensation insurance, including general overhead costs and contribution to equity that are not included in the loss costs established for various job classes. If the investment income is not sufficient to cover operating losses and dividends, MSF reduces equity (surplus) to pay for the costs. Statute allows MSF to pay dividends if there is an excess of assets over liabilities, including necessary reserves and an appropriate surplus as determined by the board.

The legislature has recognized the importance of equity through statute, which requires a minimum surplus of 25 percent of annual earned premium to secure MSF against risk inherent in or affecting the business of insurance and not accounted for or only partially measured. This is considered by MSF to be a reserve to equity target ratio of 4 to 1.

At June 30, 2006 equity was $163 million, well above the minimum 25 percent of earned premiums of $55.5 million. Risks which may not have been accounted for include adverse court rulings and increased costs for indemnity or medical claims. The potential for such risks is illustrated by the potential effects of an adverse court ruling in the Satterlee case currently before the Supreme Court. Should the Supreme Court rule for the plaintiff, the estimated cost impact to the New Fund is between $135 and $186 million.

As stated above, MSF has used investment income to offset operating losses and pay dividends. In FY 2003, the amount of investment income was not sufficient to offset operating losses and pay dividends. MSF's net loss after dividends was $37.4 million. Equity was reduced in this period by more than $36.9 million or 23.6 percent to offset these costs.

The 25 percent statutory minimum may not be sufficient to secure MSF against such adverse risks. Included in the 2007 equity analysis conducted for the MSF is the statement that the continued recommendation is to set the reserve to equity target in the range of 2.0 to 2.5 percent or $286 to $358 million in equity at FYE 2008. The analysis includes the statement "*MSF's 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*." This would require MSF to set aside an additional $103 million in FY 2008 to achieve the lower end of the range. The analysis also recommends equity targets to reach this range in 5 to 7 years, or a $14.7 to $20.6 million increase to equity each year. It should be noted that the reserve to equity target changes each year, usually increasing, and new reserve to equity targets may require additional amounts to be included in equity.

MSF rates include a component assessed to all policyholders for contribution to equity as part of the loss cost multiplier. For FY 2008 the board approved contribution to equity of 7.4 percent of net earned premium or $16.4 million. This amount would be in addition to the interest earned from investments. If MSF is able to maintain or reduce budgeted costs, does not have significant adverse loss development, and does not have significant unbudgeted costs such as dividends and performance incentives, approximately $16.4 million should be available and could be used to move MSF's contribution to equity closer to the recommended amount. It should be noted that in previous years the contribution to equity above a portion of investment income does not appear to have been realized.

MSF's budget proposal does not include a contribution to equity component as a separate amount. Not including a budget category for contribution to equity makes it difficult to determine the amount the board has approved and to track MSF's actual contribution to equity above investment income.

The legislature may wish to:

- revisit whether 25 percent of net premium minimum should be changed to current industry practices reflecting a reserve to equity target in the range of 2.0 to 2.5 percent
- requiring MSF budgets to include a separate budgeted category for contribution to equity

PREVIOUS AREAS OF CONCERN

The 2007 budget analysis included several areas of concern, including:

- potentially under-budgeting net earned premium revenues making it easier to attain incentive payment measurements
- budgeting personal services at higher rates than indicated
- dividend polices which allow for payment of dividends for years when MSF suffered operating losses

The full report is attached as an addendum to this report.

It appears MSF is potentially under-budgeting net earned premium revenues in FY 2008. MSF FY 2008 budgeted net earned premium is $11.2 million less than FY 2007 projected net earned premiums. FY 2007 projected net earned premiums are $18.7 million higher than budgeted, or 8.7 percent over the budgeted amount. Net earned premium is used for measurement of employee incentives. Net earned premium itself is used as a separate measurement and is also a component of the calculation of net operating income, fiscal year loss ratio and the expense ratio. These measurements make up 70 percent of the weighting factors used in the calculation of employee incentives. Underestimating net earned premium can make it easier to achieve the majority of the incentive payment goals. While the state uses many estimates in their budgeting process, they do not include the measurements as a basis of incentive payments to employees.

Vacant positions within an agency generate savings as the budgeted costs for personal services are not realized during the period the position is vacant. Personal services were budgeted using a vacancy rate of 2 percent, a decrease of 1.5 percent from the FY 2007 budget. However, the vacancy rate is not applied to smaller departments so the actual budgeted vacancy rate is less than 2 percent. We noted in the 2007 budget analysis the 9.3 percent of all positions were vacant at FYE. Actual vacancies remain higher than 2 percent, resulting in personal services budgeted at higher rates than indicated.

As discussed above, MSF continues to declare dividends in years when MSF suffers operating losses. Since FY 2000 the MSF board has declared $38 million in dividends even though, according to the audited financial statements, MSF has incurred underwriting losses in each of these years and has had a combined ratio of over 100 percent during this same period.

Old Fund Unfunded Liability Continues to Grow

As of June 30, 2006, the estimated unfunded liability associated with the Old Fund is $21.9 million, in increase of $6.3 million since June 30, 2005. Using this liability it is estimated Old Fund reserves will be depleted in 2013, at which time the general fund will need to pay remaining claims.