HJ 25

Why Restructure Montana State Fund?

Prepared by Montana State Fund

Montana State Fund was requested to provide rationale supporting limited restructuring of Montana State Fund ("MSF") by the Economic Affairs Interim Committee work group at its December 18th meeting. To date, much of the discussion has been focused on the appropriate regulatory oversight of MSF and "why" oversight should be the primary responsibility of the Commissioner of Securities and Insurance ("CSI"). As discussed below, perhaps the question should be "why not?" While there remain a number of public policy issues surrounding MSF ties to state government services and programs, the following addresses why regulatory oversight by CSI is appropriate and suggests that duplicate oversight by legislative process is unnecessary.

Insurance Companies are Regulated by the Montana Commissioner of Securities and Insurance.

MSF, a workers' compensation insurance company, is an **independent non-profit public corporation** (§39-71-2313, MCA), and is managed solely by a board of directors appointed by the Governor. The Legislature specifically provided that MSF function with all powers necessary and appropriate as a private insurance company (§39-71-2316, MCA). MSF's premium revenue comes solely from its operations and insured businesses and not from general taxpayers or taxes. MSF is in the business of insurance.

All workers' compensation insurers, except for self-insured employers and Montana State Fund, must comply with the regulatory provisions of Title 33 – the Insurance Code. (§33-1-102, MCA). One of the most important consumer protection responsibilities of the CSI is to ensure companies are capable of paying claims when they are due. The Insurance Code contains the "Risk Based Capital for Insurers Act" (§ 33-2-1901, MCA) which includes criteria for measuring Risk Based Capital ("RBC"). The Act sets for a method of measuring the minimum amount of capital appropriate for a reporting company to support its overall business operations in consideration of its size and risk profile. RBC is intended to be a minimum regulatory capital standard and not necessarily the full amount of capital that an insurer would need to maintain. RBC is not the only tool utilized in determining financial solvency of an insurance company, but it is one of the tools that give regulators legal authority to ensure financial solvency of an insurance company. While current law requires MSF to maintain a level of equity (surplus) above RBC levels, those levels requiring company or regulatory action or control are not defined and there is no independent regulatory process in place to protect against insolvency. Regulation under the Insurance Code would provide these additional safeguards.

In addition, the Insurance Code provides for regulation of workers' compensation insurance ratemaking regulation. MSF and private insurers adhere to many of the same manuals and forms filed by the National Council on Compensation Insurance (NCCI). That organization is authorized by the CSI to file advisory loss costs, rules and classifications related to workers' compensation insurance in Montana. Currently, MSF is not required to comply with the loss costs, rules and classifications promulgated by the NCCI. Regulation under Title 33 would place MSF under the same requirements as all other insurance companies. In its report of February 2009, the Legislative Audit Division conducted a performance audit of MSF corporate governance practices.[1] While recognizing several legislative oversight functions, the auditors concluded:

> "The Montana State Fund Board of Directors currently functions without regulatory supervision of Montana State Fund insurance operations. This may increase the legal compliance risks to which the board is subject as a governance entity."
> [Report, p. 15].

In comparing MSF oversight to that of private insurers, the auditors recognized limitations in legislative oversight, stating "the legislature's oversight activities are limited to those that are normally conducted for state agencies and do not, by themselves, constitute a system of regulatory supervision." [Report, p. 13]. Furthermore, the auditor observed "[u]nder a system of regulatory supervision, insurers are subject to specialized reviews by organizations with appropriate subject matter expertise. . . [n]either the legislator nor its component committees or staff divisions have appropriate subject matter expertise relative to insurance regulation." [Report, pp. 13 – 14].

Finally, there are 23 state funds in the U.S. established by their respective state laws. The majority, 18, are regulated by the insurance department in their state. The remaining state funds are predominantly monopolistic state funds regulated as any other state agency and limiting the opportunity for competitive comparisons for workers' compensation insurance coverage.

Historical Context.

While MSF's history dates back to 1915, more recent history provides context for discussion of restructuring MSF. During the 1989 regular legislative session efforts were focused on establishing the state fund as a new mutual insurance company and to ensure the solvency of the new state fund. SB 428 resulted in the creation of the State Compensation Mutual Insurance Fund – a domestic mutual insurance company that would be regulated by the State Auditor (Insurance Commissioner). An unfunded liability of $157.3 million existed at the time.

[1] A Report to the Montana Legislature, Montana State Fund Corporate Governance Practices, February 2009, 08P-08.

A significant reason why an unfunded liability existed is due to artificial and politically established rates that were inadequate to cover the liabilities incurred by the fund. The "fix" included requiring MSF to be managed like an insurance company, not a state government agency, and that its rates be neither excessive, inadequate or unfairly discriminatory. The law also required MSF to be self-supporting with no taxpayer support through the general fund.

In less than six months after the new mutual became effective in January 1990, a Special Session of the legislature convened in May of 1990 to address the continued financial deterioration of MSF. Due to the significant obligation to injured workers, the legislature assumed public responsibility for implementing changes needed to restore the fiscal health of MSF. During the special session, the liabilities for pre-July 1, 1990 claims (Old Fund) and post-July 1990 claims (New Fund) were legally separated, effective July 1, 1990. The legislature also provided for separate funding sources. The "Old Fund" was to be supported by any remaining premiums for wages prior to July 1, 1990, and by payroll tax and bond proceeds. The "New Fund" or the current Montana State Fund was to be self-supporting from premiums on wages on or after July 1, 1990. In addition, MSF's "regulation" reverted to the Legislature because of its precarious financial condition and the political uncertainty of significant pending rate increases.

Over the past 23 years, MSF has successfully improved operations, customer service, rate adequacy and financial stability. Many of these achievements were due to the structure put in place with an independent Board of Directors and the continued legislative support that enabled MSF to function like an insurance company - although with a very important public purpose of guaranteeing insurance for smaller and high-risk employers.

Increasingly, legislative institutional knowledge has diminished over time and few legislators recall the circumstances that led to the near financial ruin of MSF. In fact, legislators today often question why there exists an "Old Fund" liability and why MSF is not responsible for those liabilities, even though the current MSF customers were not responsible for those liabilities in the first place. The time is ripe for consideration of returning MSF to regulatory oversight by the Commissioner of Securities and Insurance.

MSF's Long-Term Financial Stability Must be Based on Sound Insurance Management Practices, not Politics.

While the Legislature has specifically required MSF to be "neither more nor less than self-supporting" (§39-71-2311, MCA), recent legislative attempts to politically regulate rates threatens the long-term financial stability of MSF and the Montana workers' compensation system. (See, SB 173)[2]. Whether or not legislation is intended to adversely impact the financial

[2] SB 173, 63rd Legislature, as amended; "AN ACT GENERALLY REVISING STATE WORKERS' COMPENSATION INSURANCE FUND LAWS . . . PROHIBITING THE STATE COMPENSATION INSURANCE FUND FROM RAISNG RATES TO PAY FOR CLAIMS RELATED TO ACCIDENTS OR OCCUPATIONAL DISEASES THAT OCCURRED BEFORE JULY 1, 1990 . . ."

health of MSF, the fact remains, there are no constraints to balance political decisions with sound insurance financial management practices. The more financially strong MSF becomes the more its assets become a target and, the more the risk of future insolvency due to political decisions, rather than sound insurance decisions and sound insurance regulation.

There is an indirect threat to a stable and competitive workers' compensation market in Montana when politics surround MSF oversight, particularly when rate adequacy is uncertain. Like most businesses, private insurance companies want to do business in states that provide a certain and predictable market. When rates for the single largest workers' compensation insurer in a state are subject to political decisions rather than insurance financial standards, private insurers are less likely to do business in that state. By ensuring that both MSF and private insurers operate under the same rate adequacy and financial standards, a more stable, predictable and competitive market can be maintained – that's good for Montana.

By providing for oversight under the Insurance Code, more objective standards for financial solvency provide greater assurance to Montana that MSF will meet its long-term obligations and contribute to a stable workers' compensation system for another century.

The Same Rating Organization (NCCI) Files Loss Costs Used by Private Insurers and MSF.

As previously noted above, MSF, like private insurers, generally follows the manuals, rules and advisory loss costs promulgated by NCCI. NCCI's authority to file advisory loss costs used by insurers in setting rates is overseen by CSI. While some differences between MSF regulation and private insurer regulation will necessarily remain due to MSF's "guaranteed market" responsibility, a majority of the Insurance Code regulations relating to workers' compensation insurance rates, filings, procedures and forms would apply to MSF making it easier for businesses to compare insurance companies when purchasing workers' compensation insurance. MSF believes providing for regulatory compliance with the Insurance Code will foster a more stable workers' compensation market in Montana. Regulation under the Insurance Code will better ensure MSF's business practices are monitored and regulated substantially the same as those of other insurance companies.

Duplicative "Over-Sight" is Unnecessary.

State law gives CSI the authority to examine "the affairs, transactions, accounts, records, and assets" of an insurance company "as often as the commissioner considers advisable" and "not less frequently than every 5 years." (§33-1-401, MCA).

In addition, the Insurance Code also requires reporting and filing of the financial condition of all insurance companies both annually and quarterly to CSI. State law also requires all insurance companies to provide an annual report of the Risk Based Capital of the insurance company which provides the information necessary for CSI to implement early intervention processes if the insurance company's measure falls below required parameters. (§33-2-701 and 1903, MCA).

These laws provide CSI with the ability to take regulatory actions to address distressed financial conditions of an insurance company. MSF would fall under these legal requirements. Under current law, MSF provides various reports to the Legislative Finance Committee, the Economic Affairs Interim Committee and the Legislative Audit Committee, but unless there is a change in a law related to MSF, there is no required regulatory action.

Under the proposed legislation, CSI would be able to report the financial condition and any operational review findings to the legislature as well as the regulatory actions the Commissioner has imposed on MSF to keep the legislature informed of MSF's operations and financial condition.

For these reasons, legislative review of MSF's reserves and rates under §39-71-2361 and 2362, MCA is unnecessary duplication of oversight responsibilities. Whether additional changes to the Legislative Audit Division's oversight is appropriate is a topic for further discussion.