

Actuarial Report on Montana State Fund

**REPORT TO MONTANA STATE LEGISLATURE
ECONOMIC AFFAIRS INTERIM COMMITTEE**

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FINANCIAL RISK ANALYSTS, LLC

Agenda

- Purpose and Scope of Review
- Uncertainties
- New Fund Reserves as of June 30, 2015
- Rates Effective July 1, 2015
- Policyholder Equity
- Old Fund Reserves as of June 30, 2015
- Recommendations



FINANCIAL RISK ANALYSTS, LLC

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Purpose and Scope

- Financial Risk Analysts was engaged by Commissioner of Securities and Insurance (“CSI”) to support required annual review of Montana State Fund
- Scope included:
 - Review loss reserving methodologies and estimates for New Fund
 - Review rates and pricing methodologies
 - Discuss policyholder equity levels and considerations
 - Comment on loss reserve estimates for Old Fund
- Process
 - Review actuarial reports of State Fund’s external actuaries (Towers Watson or “Towers”) and Legislative Audit Division’s actuaries (AMI Risk Consultants, Inc. or “AMI”)
 - Provide independent analysis, where necessary

Uncertainties

- Towers actuaries identified in their reports factors that create materially more uncertainty than is usual for analyses of this nature, including changes in:
 - Statutory benefits
 - Volume and mix of State Fund business
 - State Fund operations, including claim handling and case reserving
 - Economic environment
- Financial Risk Analysts concurs with Tower’s view regarding elevated levels of uncertainty
- Necessitates significant adjustments, assumptions, and judgments in application of actuarial methods
- Creates wider range of financial projections than might otherwise be expected

Uncertainties related to HB334

- HB334 was projected to reduce workers compensation benefit costs in Montana by 22.4% (per NCCI)
 - termination of medical benefits for PPD 60 months after injury (-12.1%)
 - allowing insurers to designate treating physicians (-8.5%)
 - elimination of PP awards for class 1 permanent impairment rating (-1.7%)
- State Fund reduced rates and immediately began to set reserves assuming full benefit from HB334 would be realized
- Court challenge to class 1 impairment has been heard; awaiting decision
- Challenge(s) to 60 month limitation on medical benefits likely once issue becomes “ripe” (after 7/1/2016)
- HB334 allows medical panel to make exceptions to 60 month limitations on medical benefits in certain cases
- Any material erosion of expected benefit from HB334 from courts or medical panels would impact adequacy of State Fund’s rates and reserves

Reserves for New Fund

- Towers applied multiple actuarial methods and made differing adjustments to deal with the numerous factors causing material uncertainty for State Fund reserves
- We believe the methodologies, assumptions, and adjustments made by Towers are generally reasonable

Reserves for New Fund

as of June 30, 2015 (\$ millions)

UNDISCOUNTED

	<u>Low Range</u>	<u>Central Estimate</u>	<u>High Range</u>
Towers Watson	703	780	888
Financial Risk Analysts	785	859	933
Difference	+82	+79	+45

NEW FUND CARRIED RESERVES

State Fund		813	
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- FRA central estimate is \$79 million above Towers central estimate
- AMI central estimate was \$62 million above Towers at June 30, 2014
- State Fund booked reserves \$32 million above Towers central estimate
- Booked reserves are within FRA range therefore we believe reasonable

Rates Effective July 1, 2015

- Towers appears to have used approaches that follow generally accepted actuarial ratemaking principles
- Towers methodologies, assumptions, and adjustments appear to be reasonable
- Based on Towers analysis, State Fund implemented -5% rate change effective July 1, 2015
- Assuming a 2.5% future investment yield, new rates expected to provide contribution to policyholder equity of 0% of premium
- Towers does include 5% provision for adverse loss deviation

Rates Effective July 1, 2015

- Actuaries for the Legislative Audit Division have not yet completed review of the July 1, 2015 rate analysis
- FRA independent analysis of indicated rates began with ultimate losses slightly higher than those selected by Towers but did not include adverse deviation provision
- FRA analysis suggested rate change of -7.4% to achieve target contribution to policyholder equity of 0% of premiums, with the difference relative to Towers indication driven largely by our removal of adverse deviation provision
- Despite differences in indications, we believe that -5% rate change implemented by the State Fund was reasonable

Policyholder Equity Overview

- Policyholder equity is difference between assets and liabilities
- Insurance companies are required to hold policyholder equity to absorb fluctuations in underwriting, investment, and operations performance
- Key risks that can drive adverse performance include:
 - Premium rates are set in advance and could prove to be inadequate
 - Loss reserves are estimates of future costs made at a point in time and could prove to be inadequate
 - Asset values can fluctuate based on market and interest rate movements and investment returns can fall short of expected levels

Policyholder Equity Overview

- There is no single measure or standard for appropriate level of policyholder equity
- Financially stronger, more highly rated insurers generally hold higher levels of policyholder equity
- Insurers holding lower levels of policyholder equity generally have higher risk of insolvency or impairment
- Common measures of appropriate levels of policyholder equity include:
 - Insurance regulatory standards, including risk-based capital (“RBC”) models and simple premium to equity ratios. Regulatory standards are minimum requirements; prudent managers reserve above the minimums
 - Competitor benchmarks (other state WC funds and private WC carriers)
 - Economic capital modeling based on assessing and quantifying key risks

State Fund Financial Performance Metrics

Fiscal years ending of June 30 (\$ millions)

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Net Earned Premiums	211.9	238.2	231.0	204.0	166.3	173.6	150.5	156.1	165.3	164.6
Net Loss & LAE Reserves	590.7	679.2	752.3	813.3	838.8	874.8	889.9	902.8	924.6	895.5
Operating * Earnings	15.1	25.9	32.1	12.6	23.2	26.4	29.8	41.4	53.7	83.4
Policyholder Equity	163.1	199.2	216.6	204.4	241.5	296.3	317.7	372.3	443.9	516.9
Policyholder Dividends	5.0	7.0	0.0	4.0	2.0	4.0	6.0	10.0	12.0	20.0

* Prior to policyholder dividends;
2015 earnings includes reduction in reserve strengthening provision of \$32 million

State Fund Policyholder Equity

as of June 30, 2014

- Towers performs an analysis annually to assess the State Fund's policyholder equity and to assess potential for policyholder dividends
- Based on its assessment of regulatory, competitor, and economic capital model benchmarks, Towers observed that the State Fund was in a strong financial position as of June 30, 2014
- Towers concluded that the State Fund had financial performance and strength to pay a moderate to large dividend
- Based on the Towers analysis and other considerations, a dividend of \$20 million was declared

State Fund Policyholder Equity

as of June 30, 2015

- Towers provided its latest assessment of the State Fund's policyholder equity and potential policyholder dividend at State Fund Board of Directors meeting on November 20, 2015, subsequent to issuance of our written report
- Our initial assessment of this latest Towers analysis was provided to CSI via a letter dated November 23, 2015
- Based on its analysis, Towers observed that the State Fund was in a strong financial position as of June 30, 2015
- Towers concluded that the State Fund had financial performance and strength to pay a large dividend
- Based on the Towers analysis and other considerations, a dividend of \$35 million was declared

State Fund Policyholder Equity as of June 30, 2015

- Financial Risk Analysts believes that State Fund's policyholder equity is in the upper end of the range for well capitalized WC specialists as of June 30, 2015
- Given the extraordinary uncertainty currently faced by Montana WC insurers related to challenges to key provisions of HB334, we believe that State Fund being in upper end of range makes sense at this time
- Invalidation of HB334 key provisions on constitutional grounds could negatively impact reserves and equity of State Fund by more than \$200 millions of dollars
- We believe that setting rates to target no further growth in in policyholder equity makes sense as long as conditions do not change
- The appropriate level of policyholder surplus is a function of many factors and should continue to be reassessed regularly as conditions change and particularly as challenges from HB334 evolve

Reserves for Old Fund as of June 30, 2015 (\$ millions)

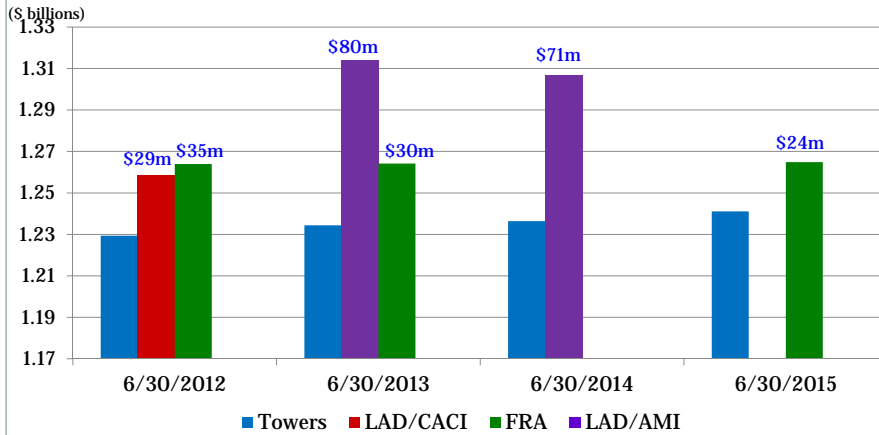
UNDISCOUNTED

	<u>Low Range</u>	<u>Central Estimate</u>	<u>High Range</u>
Towers Watson	33	36	79
AMI		102 #	
Financial Risk Analysts	43	60	86

AMI ultimates as of June 30, 2014 updated for paid losses at June 30, 2015

- Towers central estimate slightly above low end of their range
- FRA and AMI estimates significantly above Towers
- Previous Towers estimates have persistently developed adversely
- We concur with AMI that the Towers central estimate appears low

Old Fund Ultimate Losses Central Estimates Over Time



Note: Numbers above bars are differences to Towers; FRA did not do analysis at 6/30/2014

Historical Changes Old Fund Ultimate Losses Towers Watson

CHANGE IN PRIOR YEAR ESTIMATED ULTIMATES			
Fiscal Year	Indemnity	Medical	Total
2008-09	-\$0.5 m	\$4.7 m	\$4.2 m
2009-10	-0.6 m	3.0 m	2.4 m
2010-11	0.0 m	3.1 m	3.1 m
2011-12	0.1 m	3.6 m	3.7 m
2012-13	0.4 m	4.6 m	5.0 m
2013-14	-0.5 m	2.4 m	1.9 m
2014-15	1.3 m	3.5 m	4.8 m
7 Year Total	\$0.1 m	\$24.9 m	\$25.0 m

Note: From prior year for same accident years: + indicates unfavorable, - indicates favorable

Case Reserves

- In prior reviews of State Fund on behalf of CSI, we observed that State Fund claim examiners were reserving in aggregate at levels far above Towers' indicated reserve needs for most years in the Old Fund and many early years in the New Fund

Medical and Indemnity Losses at June 30, 2015

Years	Case Reserves	Towers Indicated	Difference
All Old Fund	\$111m	\$36m	(\$75m)
New Fund 7/1/90-00	132m	103m	(29m)

- We recommended that claim reserve study focused specifically on quantifying the level of case reserve redundancy should be considered
- The State Fund engaged Deloitte Consulting who will present its findings during this meeting

Recommendation 1 - Reserves for New Fund

- State Fund management has in recent years reserved well above the levels indicated by the Towers central estimates for the New Fund
- We recommend that management continue to give consideration to both the current elevated level of uncertainty and the position of the Towers selections relative to the range of indications from their actuarial methods when determining New Fund carried reserves

Recommendation 2 – Policyholder Equity

- We believe State Fund policyholder equity is in the upper end of the range for well capitalized workers compensation specialists as of June 30, 2015
- We believe that this level of policyholder equity positions State Fund to withstand possible material impairment from adverse court decisions on benefits of HB334, should such occur
- We recommend setting rates to target no further growth in policyholder equity unless and until conditions change
- To the extent that policyholder equity grows because operating profits exceed expected levels, excess equity can be returned to policyholders through dividends
- To the extent that extraordinary levels of uncertainty and risk related to HB334 are reduced as court and other challenges are resolved, any remaining excess equity can be returned through dividends

Recommendation 3 – Ratemaking Methodologies

- Given its current strong policyholder equity level, we recommend that State Fund and its actuaries remove the provision for adverse loss deviation in its rate level indications going forward

Recommendation 4 - Case Reserve and Claim Management Practices Review

- State Fund management concurred with almost all of the recommendations made by Deloitte Consulting
- We support implementation by State Fund of Deloitte's recommendations

Recommendation 5 – Reserves for Old Fund

- Based on our methodologies and selected ultimates, the metrics presented in our report, our review of reports by AMI and CACI on behalf of LAD at recent fiscal year ends, and findings of the 2015 Deloitte claim file review, we believe that the Towers central estimates for the Old Fund may be low
- We recommend that the Fund, LAD, and the legislature carefully review the results of the latest Towers, AMI, CACI and Financial Risk Analysts reserve analyses when assessing the magnitude of remaining Old Fund liabilities

Questions?



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