BUSINESS & LABOR
EXHIBIT NO. 11
DATE 1/19/09
BILL NO. SB360

OVERSIGHT OF MSF PROVIDED THROUGH THE LEGISLATIVE AUDIT COMMITTEE COMPARED WITH THE OVERSIGHT OF PRIVATE INSURANCE COMPANIES PROVIDED THROUGH THE STATE AUDITOR'S OFFICE

A Report Prepared for the

Legislative Finance Committee

By

Kris Wilkinson, Fiscal Analyst II

May 22, 2008

Legislative Fiscal Division

www.leg.mt.gov/css/fiscal

INTRODUCTION

The Subcommittee on Montana State Fund (MSF)/Workers' Compensation Insurance requested information on the oversight of MSF provided through the Legislative Audit Committee as compared with the oversight of private insurance companies provided through the State Auditor's Office (SAO). The purpose of this report is to provide information and contrast the reviews conducted by the Legislative Audit Division (LAD) through their financial-compliance audit and contracted actuarial report completed annually at the MSF and the financial examinations and market conduct reviews completed on private insurance companies by the State Auditor's Office.

DIFFERENCES AND SIMILARITIES IN THE REVIEWS

MSF and private insurance companies operating in Montana have similar reviews conducted by various entities. However, there are some differences. Figure 1 shows the examinations conducted for both MSF and private insurance companies.

Further discussion of the difference and similarities between MSF and private insurance company reviews is presented below.

Figure 1
Similarities and Difference in Reviews of
Montana State Fund and
Private Workers' Compensation Insurance Companies

	Montana State Fund	Private Insurance Companies
Audited Financial Statements		
Governmental Financial Statements	X	
Statutory Financial Statements	X	X
Actuarial Opinion	X	X
Independent Verification of Loss Reserves (financial exam SAO)	X	X
Market Conduct Examination		X
Annual Financial Analysis (desk review)		X
Quarterly Financial Analysis (desk review)		X
In Depth Financial Examinaition (Not less than every 5 yrs)		X

MONTANA STATE FUND

The MSF is considered a unique state agency providing workers' compensation insurance to Montana businesses. MSF is under the sole management and control of an independent board which makes decisions on the operations of the MSF including:

- budgetary decisions
- approval of premium rates
- approval of dividend payments
- determination of salary increases and bonus payments
- provision of contributions to equity

The legislature provides oversight of MSF through the Legislative Audit Committee in relation to the annual financial audit conducted on the MSF financial statements and an independent contracted actuarial opinion, and through the presentation of the MSF board approved budget to the Legislative Finance Committee.

Statute requires the Legislative Audit Division perform three main functions in relation to MSF:

- 1. 39-71-2361, MCA requires LAD to annually conduct a financial and compliance audit of MSF. The purpose of the audit is to provide an opinion on whether the financial statements of MSF present fairly, in all material aspects, the financial position of MSF as of a certain date
- 2. Statute also requires the audit include evaluations of the claims reservation process, the amounts reserved, and the current report of MSF's actuary, in part to ensure that the New Fund is financially sound
- 3. 39-71-2362, MCA requires that the legislative auditor review the rates established by the board of MSF to determine if the rates are excessive, inadequate, or unfairly discriminatory. This portion of the examination is conducted by an independent actuary contracted by the LAD

MSF is considered a component unit of the State of Montana. Component units are those governmental agencies for which the State of Montana is financially accountable. The State of Montana would be financial accountable for the liabilities of MSF if premiums charged were not sufficient to cover losses over the benefit period which extends 40 years or more. This has occurred with the Old Fund.
The independent actuary also examines MSF loss reserves. Benefits for workers' compensation are paid over an extended period of time, in some cases more than 40 years after the accident occurs and the premiums have been collected. The amount of the premiums set aside to pay these future benefits are the loss reserves of MSF. Part of the review conducted by the independent actuary gives an opinion on the adequacy of these reserves. Determination that the loss reserves are not adequate could be an indication that the premium rates charged were not sufficient to cover future benefits.

For a discussion on what the most recent financial compliance audit and independent actuarial review say in regards to MSF see Appendix A attached to this report.

STATE AUDITOR'S OFFICE FINANCIAL EXAMINATION OF PRIVATE INSURANCE COMPANIES

Private insurance companies are required to file audited financial statements and actuarial opinions annually with the State Auditor's Office. During financial examinations, the State Auditor's Office conducts separate examinations of the loss reserves of insurance companies using certified actuarial staff to make determinations of the adequacy of the reserves and the premium rates charged. In addition, the SAO conducts additional reviews to ensure the financial soundness of the private insurers. This is done to protect the consumer as private insurance companies do not have the additional resources of the State of Montana to offset any unfunded liabilities. The State Auditor's Office conducts financial examination of insurers domiciled in Montana. For insurers domiciled in other states, the State Auditor's Office accepts examinations conducted by the insurer's home state when the home state is accredited with the National Association of Insurance Commissioners (NAIC). Currently, all states are accredited with NAIC. SAO completes market conduct examinations on primarily domestic insurers, but has the authority to complete examinations of foreign insurers when considered necessary.

Market Conduct Examinations

The focus of market conduct examinations is to review insurance company actions in regard to sales, advertising, rating, and the handling of claims. This type of examination is not conducted for MSF. The National Counsel on Compensation Insurance (NCCI) files advisory loss costs and class plans for workers' compensation insurance in Montana. Loss costs reflect the costs of providing indemnity and medical benefits to injured employees within certain job classifications or class codes. Private insurance companies are required to file rates and all rating plans with the SAO. The rates are based on the NCCI loss costs modified by various components. The base rate for an insurer is the NCCI loss costs loaded with two components: private insurer expenses and loss costs modifications, if any. These two components combined are referred to as the loss cost multiplier. The insurer can deviate up of down from the NCCI loss costs via the loss cost modifier to reflect either better or worse overall experience of the insurer as compared to the statewide NCCI loss costs.

The insurer's base rate is utilized to determine the premium for each individual employer. Additional components include experience modification, premium discounts, expense constants, schedule rate modifiers. These components are applied to the individual employer's base rate to take into account individual risk characteristics of the employer that are not reflected in the insurer base rates. The private insurance company provides historical background and actuarial support for their rates.

Private insurance companies file their proposed rates on SAO forms. The Workers' Compensation Loss Cost Insurer Filings include:

- Effects of the proposed revisions to manual rate levels
- Premium level change or the change in collected premium
- Loss cost modifications

- Total production expense
- General Expense
- Taxes, licenses, and fees
- Profit and contingencies
- Discussion on how investment income is taken into account
- Expected loss and loss adjustment expense ratio
- Impact on premium generated by expense constants and minimum premiums
- Impact on premium of premium discounts and expense graduation included in retrospective rating
- Loss cost multiplier as indicated by the above data
- Loss cost multiplier selected by the insurer
- Expense constant
- Premium discount
- Actuarial support

The SAO examines the information included in the insurer filings and for some filings approves or disapproves the rates prior to their implementation. The MSF board determines the rates for MSF. The independent actuary contracted by LAD determines the adequacy of MSF rates, completing their report of the rates 4 ½ months after the rates are first implemented.

Once the companies file their rates with SAO they are required to follow them. The market conduct examination is designed to insure this occurs. In addition, SAO staff follow-up on consumer complaints regarding sales, advertising, rates or handling of claims for private insurance companies. As discussed above, LAD's contracted actuarial report includes determination if the rates are excessive, inadequate, or unfairly discriminatory. The actuary does not include market conduct examination procedures, nor is there a mechanism for consumer complaints regarding MSF's actions in relations to claims handling, sales, or advertising to be independently examined and resolved.

Financial examinations

The goals of financial regulation (both examinations and analysis) conducted by the SAO are to:

1) Indentify companies experiencing financial problems currently, or possessing the greatest potential for developing financial problems in the future
2) Define and evaluate areas of performance in troubled companies negatively affecting results
3) Verify the correctness of reported financial data
4) Protect consumers

Private insurance companies file financial information with the National Association of Insurance Commissioners (NAIC). The insurance companies' annual statements are formatted onto a prescribed reporting form. The SAO then analyzes the information using the NAIC financial analysis solvency tools included in the NAIC financial analysis handbook. The NAIC financial analysis handbook addresses three levels of analysis.

The objective of level 1 analysis is to perform sufficient analysis on year-end results to determine the areas and extent for which additional procedures may be warranted. In addition to a detailed review of the insurers annual statutory financial statements, the analysis includes reviews of::

- Annual Audited Financial Reports, presented on the statutory accounting basis
- Actuarial opinion
- Management's Discussion and Analysis
- NAIC Annual Scoring Results
- IRIS Ratios
- NAIC Company Profile Report

In addition, the insurer's past regulatory history, accuracy of filing, age of insurer, stability of business plan, and knowledge of company's operations may affect the extent to which Level 2 or Level 3 procedures are considered necessary.

IRIS ratios examined include:

- Gross premiums written to policyholders surplus
- Net premiums written to policyholders surplus
- Change in net premiums written
- Surplus aid to policyholders surplus
- Two-year overall operating ratio
- Investment yield
- Gross changes in policyholder surplus
- Change in adjusted policyholder surplus
- Adjusted liabilities to liquid assets
- Gross agents balances (in collection) to policyholders surplus
- One-year reserve development to policyholder surplus
- Two-year reserve development to policyholder surplus
- Estimated current reserve deficiency to policyholder surplus

NAIC Annual Scoring Results focus on financial position, results of operations, cash flow and liquidity, and leverage.

If issues or concerns are noted in the level 1 analysis additional work is completed to determine if the company is at risk of financial problems. SAO conducts quarterly and annual reviews of private insurance companies' financial information. Every 3 to 5 years, the SAO conducts an in depth examination of the insurance companies and examines the affairs, transactions, accounts, records, and assets of the insurer.

When companies are found to be in hazardous financial condition, the SAO has the statutory authority to require the insurers to take certain actions. These could include supervision conducted by SAO supervision, cessation of new business, infusion of additional capital, and filing of plans of corrective action. If corrective action is ineffective, SAO has the authority to initiate court-ordered rehabilitation or liquidation.

The LAD audit of MSF does not include examination of the various ratios or include scoring results as MSF does not currently submit its information to NAIC to be scored. However, unlike private insurance companies, the State of Montana would be financial accountable for the liabilities of MSF if premiums charged were not sufficient to cover losses over the benefit period.

SUMMARY

Both MSF and private insurance companies are required to have audited financial statements, actuarial opinions, and independent verification of loss reserves conducted by an independent actuary. Private insurance companies are also required to file rates, have market conduct examinations to review insurance company actions in regard to sales, advertising, rating, and the handling of claims, have annual and quarterly desk reviews as well as in depth financial examinations conducted every 5 years.

It would appear the legislative oversight provided by the Legislative Audit Committee is sufficient to ensure the financial statements of MSF are fairly presented, and that the rates are not considered excessive, inadequate, or unfairly discriminatory. If the legislature wishes assurances that MSF's actions in regard to sales, advertising, rating, and the handling of claims are appropriate the legislature could request LAD include a performance audit of these areas in the future or as part of the current performance audit currently being conducted by LAD.

APPENDIX A

What the Audit and Actuarial Opinions Say

The December 2007 financial audit of the MSF issued an unqualified opinion on the financial statements, which means that a reader can rely on the financial information presented in the financial statements.

In the latest report, the independent actuary estimated the outstanding required reserves for the MSF as of 6/30/07 using assumptions slightly different from those utilized by the actuary contracted by MSF. The independent actuary's best estimate of 6/30/07 reserve estimates is $697,433,026. The best estimate of MSF contracted actuary of the 6/30/07 reserves estimates is $598,109,595, a difference of $99 million. According to the actuarial report, a comparison of the two reserve estimates shows that a significant difference exists between the estimated outstanding loss reserves for the New Fund. In part, these differences are due the customized and adjusted actuarial techniques employed by MSF actuary. The actuary report goes on to state that based on a review of data, formulas, and methodology employed in the 6/30/07 actuarial report prepared by the MSF contracted actuary, that on an undiscounted basis, the estimate of $598,109,595 would fall at the lower end of the range of reasonable reserve estimates established by the independent actuary.

When claims are initially reported, loss reserves are established using current information and assumption. Additionally, insurers and MSF establish reserves for claims/losses that have been incurred but not reported (IBNR). Ideally, loss reserves will be adequate to pay benefits to the injured parties over the length of the claim. In some instances it becomes evident that the loss reserves initially established will not be sufficient to pay the entire claim. When an insurer becomes aware that established loss reserves are inadequate, the loss reserve must be increased. The increase is referred to as adverse loss development. Unfortunately, MSF can not collect additional premium to provide for the additional loss reserve. Therefore, adverse loss development costs reduce income and effect surplus in the years they are recognized.

Adverse loss development on MSF estimated reserves during FY 2008 was approximately $35 million as of 5/2/08, according to the MSF actuary. This indicates that the estimate for loss reserves of $598 million needs to be increased by $35 million or 6 percent in FY 2008. The increase will be included in the loss incurred expense in FY 2008 and have the effect of decreasing the FY 2008 expected income by $35 million.

The report also states that due to the Old Fund's current deficit position, the entire amount of investment income that is assumed will be earned on the loss reserves is unlikely to be earned. Thus, the current deficit position of the Old Fund is likely understated if discounted loss reserves are booked. The notes to the audited financial statements of MSF for the year ending June 30, 2007 state that estimated claims payable for the Old Fund is presented on a discounted basis . MSF discounted its actuarially determined unpaid balances by a factor of 5.0 percent for the Old Fund.

The independent actuary also reviewed the premium rates of MSF effective 7/1/2007. The report states that on a discounted for investment income basis, the indication is that MSF will have a contribution to equity of 2.3 percent. This means that MSF will have funding to put aside into equity or surplus if the investment income is considered as part of the overall revenues used to offset operating losses. Therefore, the investment income needed to offset the underwriting deficit is not available to fund dividends, make contributions to equity, or offset adverse loss development.