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MONTANA STATEFUND

PROTECTING MONTANA WORKERS AND BUSINESSES EVERY DAY.

Montana State Fund's guide to the Workers' Compensation System

HISTORY OF WORKERS' COMPENSATION

The need for a fair and equitable system of workers' compensation evolved out of the industrial revolution. As economic and industrial activities flourished, the number of work injuries also grew. This problem was first addressed in Europe during the 1800s, and by the turn of the century the movement had spread to the United States. Laws were enacted by most states in the early 1900s to provide workers who were injured on the job with prompt, equitable and guaranteed benefits. Injured employees received medical care and disability income regardless of fault. Employers were protected from potentially catastrophic lawsuits in exchange for specific and certain benefits to the employees. The worker was prohibited from filing suit while the employer was obligated to pay the mandated benefits. This compromise is known as "exclusive remedy," and remains the basis for our workers' compensation system today.

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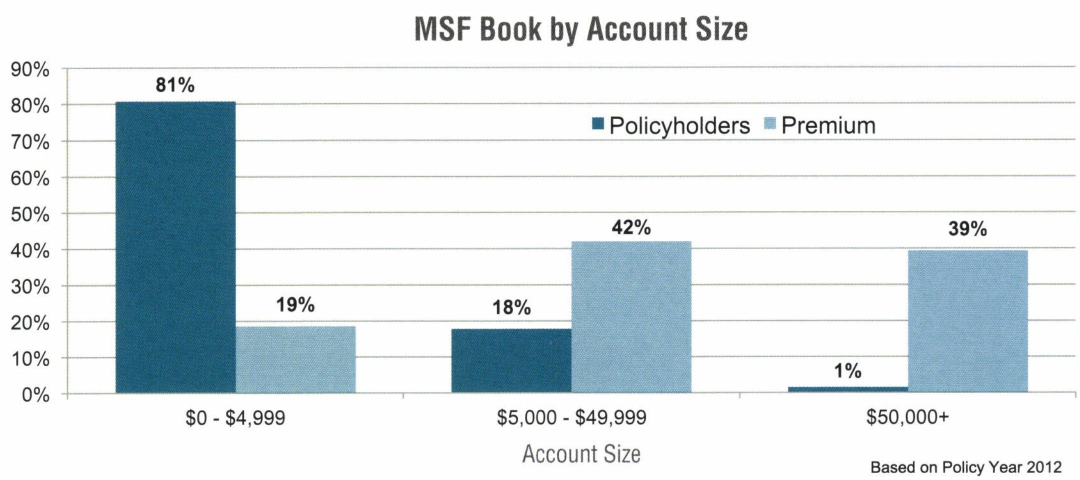
HOW DOES WORKERS' COMPENSATION DIFFER FROM OTHER TYPES OF INSURANCE?

Workers' compensation benefits are defined in law for both indemnity (wage loss) and medical payments. However, unlike health insurance, there are no deductibles or caps on medical benefits. For workers' compensation insurance, premiums are established long before the number, severity, duration or cost of claims can be known. Case and actuarial reserves are established as claims occur, but the ultimate cost of those claims is not known for many years, sometimes taking as long as 40 to 50 years. Catastrophic and/or unanticipated events may also occur, which are not covered by annual premiums. Workers' compensation premium is paid wholly by the employer; employees do not share in covering the cost of the premium. In addition, when an accident occurs to an employee, the insurance organization pays the costs of that claim. The employee does not have any copayment requirements. Because of this, workers' compensation is quite different from all other goods and services where the price is established after most costs of production and delivery are known. These insurers need to maintain significant reserves and contingency funds to ensure they are able to meet their long-term obligations.



MSF predominantly serves small businesses in Montana. However, the premium volume from larger employers enables MSF to maintain lower and more stable rates as well as a high level of customer service for all policyholders.

Timeline of key events related to workers' compensation issues (1987-2011)

July 1, 1987

- *Payroll tax of 0.3% placed on employers because of the unfunded liability in the State Fund (Old Fund).*

1989 regular legislative session

- *Creation of State Compensation Insurance Fund as a domestic mutual with regulation by the Insurance Commissioner.*

WHY IS THERE A MONTANA STATE FUND?

In most states (including Montana) workers' compensation is mandatory and employers must purchase insurance coverage or be subject to penalties and exposure to lawsuits by employees. With enactment of state workers' compensation laws, the need for workers' compensation insurance created its own set of problems. Employers feared they would be forced out of business if refused coverage by insurance companies. They also worried that insurance carriers might deny coverage or impose excessive premium rates that would be a financial burden. In response, state legislatures provided for a guaranteed market for workers' compensation insurance by implementing **one of three models**:

1. Assigned risk
2. State monopoly
3. A competitive state fund

ASSIGNED RISK

There are a number of states where private insurance carriers or the state fund (if one exists) can reject both small and large businesses for workers' compensation insurance. When employers cannot get coverage, they are put into the assigned risk plan and are "assigned" to an insurance company. Assigned-risk plans generally have rates that are higher than the voluntary market because of the volatility, of the assumed degree of risk of the employers or even of the industries that are being placed in the assigned risk plans.

STATE MONOPOLY

In monopoly states, all coverage is provided by a state agency (State Fund). There are no private insurers and no competition. This is the system in use by the states of Washington, Wyoming, North Dakota and Ohio.

A COMPETITIVE STATE FUND

This is the system that has basically been in place in Montana since 1915, which gives employers three options for purchasing their insurance:

- Develop a self–insurance program (plan 1)
- Purchase from a private company (plan 2)
- Purchase from Montana State Fund (plan 3)

This system provides the most options and flexibility for employers. It also protects the interests of the majority of Montana businesses by fostering a competitive marketplace– resulting in pricing that can be as low as prudently possible. While Montana State Fund does not pay taxes because of its public, nonprofit status, it must serve as the guaranteed market for Montana businesses and cannot refuse to insure except for nonpayment of premium. It cannot leave the state when there are adverse market conditions. Private carriers have the ability to move in and out of the state based on opportunity and profit. Montana State Fund offers employers a stable, locally controlled, reliable and competitively priced source for workers' compensation insurance, regardless of the size or risk of the business.

Montana comprises less than seven-tenths of 1 percent (0.7%) of the national workers' compensation market.

1989 June special session

- *HB 56–Transfer of $20 million from the General Fund to workers' compensation tax account.*

1990 May special session

- *Payroll tax on employers modified to 0.28%.*
- *Liability of State Fund separated into claims that occurred before July 1, 1990 (Old Fund), and claims that occurred on or after July 1, 1990 (New Fund—now called Montana State Fund).*
- *The Old Fund became funded by the payroll tax. MSF would administer the Old Fund on behalf of the legislature, but have no liability or funding responsibilities.*
- *MSF received $12 million startup and then became funded solely by insurance premiums and investment income from premiums.*
- *Any dividends declared by MSF were required to be transferred to the Old Fund.*
- *Legislative oversight was increased and regulation by the Insurance Commissioner ended June 30, 1990.*

MONTANA STATE FUND OPERATIONS

By law, MSF is designed to be self-supporting from premium and investment revenue and is not funded by taxpayer dollars. MSF was created by the legislature to function as a self-supported insurance company conducting business in a competitive market. Because it is a public entity, Montana State Fund is subject to open meeting laws and constitutional requirements in regard to investments. However, recognizing that MSF needs to operate competitively, the legislature has granted exceptions from state pay, classification, employee leave plans, budgeting and certain purchasing requirements. MSF is attached to the executive branch of state government through the Department of Administration.

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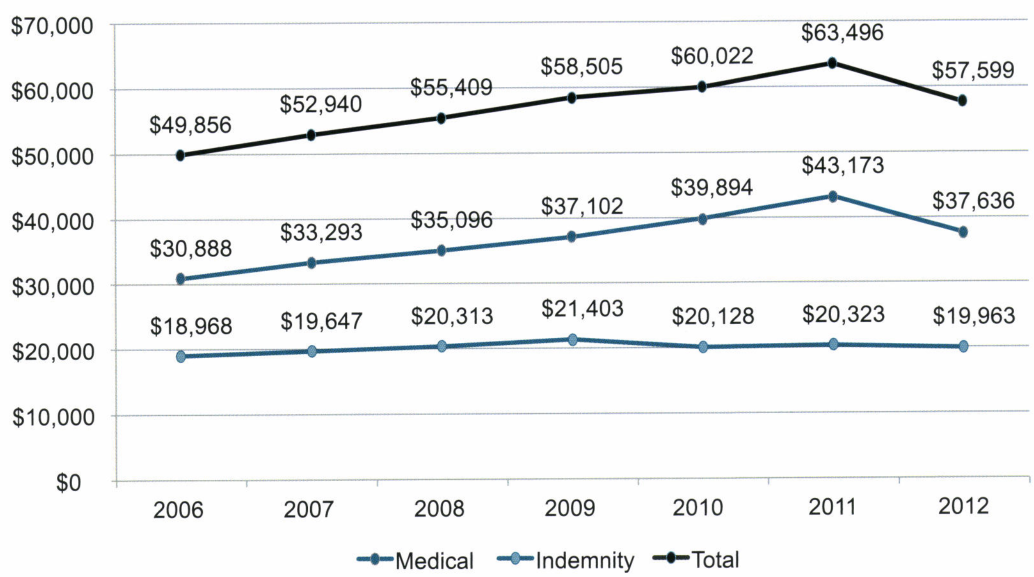
LEGISLATIVE OVERSIGHT

The legislature maintains legislative oversight of MSF. The Legislative Audit Division (LAD) of the state of Montana performs an annual review of rates and MSF's financial condition to ensure that MSF is being run on an actuarially sound and fiscally responsible basis as well as ensuring MSF is complying with applicable state law. Montana State Fund provides legislators a copy of the annual report every year. Beginning in fiscal year 2012, the state Commissioner of Securities and Insurance is to annually review the LAD financial and compliance audits and actuarial rate review, and report any concerns or recommendations to the governor, Legislative Audit Committee and the Economic Affairs Interim Committee (EAIC). The EAIC monitors MSF operations during the interim between legislative sessions; in addition, it appoints two legislative liaisons to the MSF Board of Directors. The Legislative Finance Committee annually reviews the MSF budget as adopted by the MSF Board of Directors. In addition, as for all insurers, the Department of Labor and Industry is the regulator for matters related to workers' compensation claims.

The average wage-loss claim costs about $60,000, although the most catastrophic of claims can cost several millions of dollars. About 67% of workers' compensation claim costs are for medical services, which is a fast-growing driver of Montana claim costs. Wage replacement (indemnity) costs are rising by an average of 1% – 2% per year, consistent with the rise in general wage levels. However, workers' compensation medical costs are rising 6% – 7% per year. The average cost per claim dropped for 2012 due to benefit reforms enacted in HB 334.

Average Cost Per Wage-Loss Claim



• Payroll tax on employers increased to 0.5% .

• Payroll tax of 0.2% placed on employees, sole proprietors, partners, subchapter S-corporation shareholders and members or managers of LLCs.

• MSF board meeting: dividend returns money to state. The $103 million dividend repays $12 million initial funding and pays down Old Fund bonds.

1993 regular legislative session

September 14, 1996

BOARD OF DIRECTORS

The governor appoints MSF's Board of Directors. The board consists of seven individuals who must meet certain eligibility requirements and serve a four-year term on a staggered basis. In Section 39-71-2315, MCA, the legislature granted the management and control of the state fund to the board to function as an insurance company.

The board's specific responsibilities include: ratemaking, declaration of dividends, approving an annual business plan, establishing the annual operating budget, determining appropriate surplus (equity) levels and submission of an annual financial report. The board utilizes major independent accounting and actuarial firms to validate the fund's financial position and reserves, and has the responsibility to hire a CEO of the state fund.

WORKERS' COMPENSATION AND THE LEGISLATIVE PROCESS

In each session, there are on average more than 20 bills introduced regarding workers' compensation issues. A number of these have to do with how benefits are determined and paid, as well as modifications to existing laws. There are a number of constituencies actively involved in the legislative process, including but not limited to:

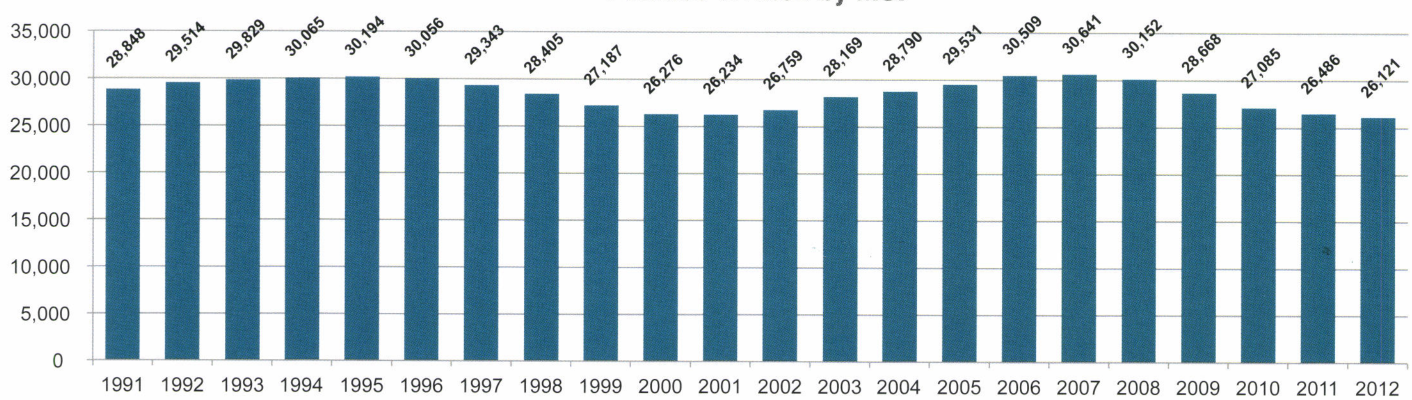
- Employee groups.
- Business organizations.
- Self-insured organizations.
- Attorneys.
- Insurance carriers.
- Medical providers.
- State Auditor's Office.
- Department of Labor and Industry.

Most laws related to workers' compensation are found in Title 39, Chapter 71, of the Montana code. Generally speaking, bills have their first hearing in either the House or Senate business and labor committee. The Department of Labor and Industry is the regulator of the workers' compensation system.

The judiciary plays an active role in interpreting how workers' compensation laws are applied. Disputes that cannot be resolved through informal mediation or in the Workers' Compensation Court are appealed to the Montana Supreme Court. The findings of the Supreme Court can have far-reaching ramifications for the workers' compensation system, which may in turn result in legislative action.

Since the inception of the Montana State Fund in 1990, private carriers have variously expanded and contracted their business volumes in Montana, depending on the business conditions at the time. General economic conditions also affect the number of insured employers. As the guaranteed market, MSF insures any Montana business, offering employers a stable, locally controlled, reliable and competitively priced source for workers' compensation insurance.

Policies Written by MSF



1997 regular legislative session

- *MSF repaid $20 million received by the Old Fund under HB 56 to the General Fund.*
- *SB 67 ended the requirement that dividends must be paid to the Old Fund and set up the test under which the payroll tax could terminate. MSF transfers $63.8 million to the Old Fund.*

December 31, 1998

- *Payroll tax terminated as Old Fund meets the criteria to be considered "adequately funded."*

2002 special session

- *SB 19 transferred $4 million of Old Fund excess to General Fund and set up study committee to report to the 58th legislature on the structure of Montana State Fund.*

THE LEGISLATURE'S ROLE IN CREATING THE OLD FUND AND MSF

BACKGROUND

Between 1987 and 1993 the legislature wrestled with major issues in our state's workers' compensation system. At the core was an estimated unfunded liability of more than $500 million in claim benefits due to injured employees. During the 1980s, workers' compensation insurance premium rates were influenced by the political process rather than actuarially sound analysis. Rates were set at artificially low levels even as the cost of claims increased. Because losses far exceeded premiums collected, the unfunded liability grew at a staggering rate–jeopardizing the entire system. In addition, the underpriced market essentially forced private carriers, who could not remain competitive and still profitably write coverage, to leave the state. Their departures meant that Montana businesses had fewer options for their insurance and placed a greater burden on a flawed system. Once it became clear that the structure was no longer workable, the legislature found it necessary to intervene. During the 1987 session, they made the difficult and unpopular decision to enact a 0.3 percent payroll tax on employers to raise revenues. However, stricter measures needed to be taken.

In 1989, one of the most critical issues confronting the legislature was to bring some semblance of order back into the workers' compensation system. Recognizing that the state's workers' compensation system was in need of a major overhaul, the legislature created a new entity: the State Compensation Mutual Insurance Fund (State Fund). State Fund was structured to operate as a domestic mutual insurance company, and as such, function independently of state agency requirements.

In order to bring more revenue into the system, rates for workers' compensation coverage needed to rise dramatically. However, there was tremendous resistance to rate increases of the magnitude that would be needed to effectively deal with the problem. In June 1989, a special legislative session convened and appropriated $20 million of the General Fund to State Fund. However, this did not address the fundamental underlying issue that rates were inadequate to fund the workers' compensation liabilities going forward as well as providing the needed source of funding for the already existing and increasing losses for claims that had already been filed.

Saddled with mounting liabilities, State Fund would need a dramatic increase in rates to achieve balance in the system. The uproar created was vocal and swift. Increases of this magnitude would be devastating to existing or new businesses in Montana, and were simply unacceptable. It was increasingly apparent that a bold, innovative solution needed to be found to resolve the crisis once and for all.

It was the intent of the legislature that Montana State Fund be run in a business-like manner, solely funded through insurance premiums and investment income. MSF began operations on July 1, 1990.

The legislature reconvened in a special session in May 1990 and took a different approach. Realizing that saddling State Fund with an astronomical debt was unworkable, the legislature separated the liability into claims occurring before and after July 1, 1990. Claims occurring before this date became known as Old Fund. Any claims after that date became the responsibility of Montana State Fund or MSF. In doing this, the state determined that the Old Fund liabilities would be funded by an increased payroll tax on employers and employees. Bonds were sold to cover the unfunded liability and were serviced by proceeds from the payroll tax. MSF administers the Old Fund on behalf of the legislature (MSF is reimbursed for the cost of administering the claims) but has no liability or funding responsibilities. It was the intent of the legislature that Montana State Fund be run in a business-like manner, solely funded through insurance premiums and investment income. MSF began operations on July 1, 1990.

- *HB 363 removed the reserve requirements from the Old Fund and transferred $18.2 million, as well as any future excess, to the General Fund from the Old Fund.*
- *SB 304 created an interim committee to study the structure and role of MSF, and if it would be in the best interest of the state to sell either the Old Fund or the New Fund. The committee was tasked with making recommendations to the 2005 legislature.*
- *SB 360 stipulated that the legislature cannot transfer monies from Montana State Fund to be used for other funds or other programs.*

2003 regular legislative session

- *$800,000 of Old Fund excess transferred to General Fund for a total of $23 million.*

2003 regular legislative session

OLD FUND

There are approximately 827 open claims remaining in the Old Fund, with estimated obligations of $59.16 million as of June 30, 2012. Actuarial predictions are that the final claim will not be paid out until 2050. All Old Fund assets were depleted by June 2011 and, as required by law, the General Fund began to fund the Old Fund at that time. Estimated funding requirements for the Old Fund for FY14 and FY15 will total approximately $13 million.

The $59.16 million liability for remaining unpaid claim benefits as of June 30, 2012, consists of the following estimated unpaid future losses and claims adjustment expenses. Medical at $36.3 million, indemnity benefits at $12.2 million, liability for retroactive court decisions at $2.2 million, claims administration expenses at $7 million and the Department of Labor and Industry assessment at $1.5 million.

The Old Fund liability of $500 million was financed through a combination of payroll tax collections (68%) and monies transferred from MSF (32%). The key events are:

1989

$20 million appropriation of General Fund money to the Old Fund.

1987 – 1998

$349 million in payroll tax collections.

1996 – 1998

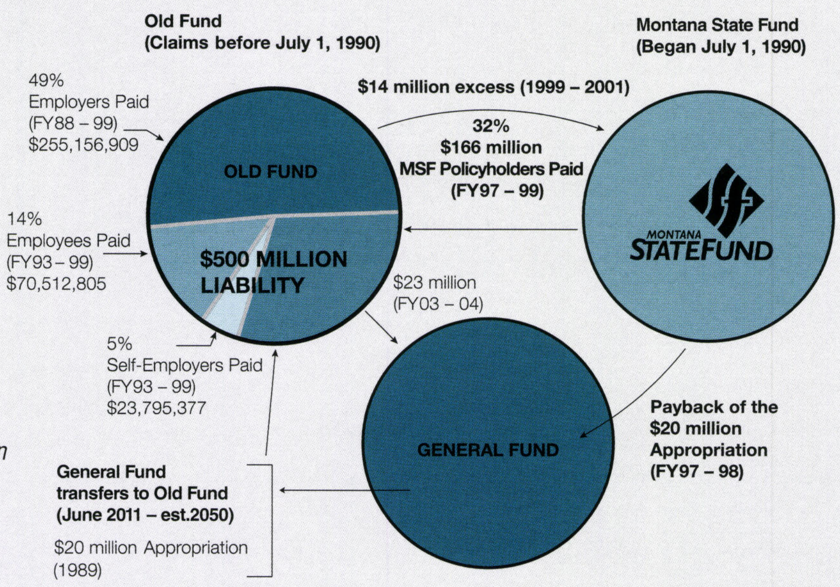
$166 million paid by Montana State Fund to eliminate the Old Fund liability and allow for payments of dividends to policyholders. In recognition of the payment, legislature allowed for any excess beyond actuarial projection in Old Fund to be transferred back to MSF.

1997 – 1998

MSF paid back the 1989 appropriation of $20 million to the General Fund.

1999 – 2001

$14 million in excess returned to MSF.



2002 – 2003

$23 million transferred as legislature determined that all existing contingency reserves and any excess from Old Fund should go to General Fund.

June 2011 – est. 2050

By law, when Old Fund assets are inadequate to pay claims, transfers are to be made from the General Fund to the Old Fund.

- *SB 61 created legislative liaisons to MSF board. Two legislators were appointed as non-voting liaisons to the board. They attend all meetings and receive all board materials. The SB 304 committee determined there would be no sale of MSF and therefore maintained the current structure of MSF as a public, nonprofit competitive state fund with the responsibility of being the guaranteed market for Montana businesses.*

2005 regular legislative session

- *The Old Fund assets were depleted and, as required by law, the General Fund began transfer of funds to pay Old Fund claims and administration costs.*

June 2011

- *MSF Board of Directors adopted a 20% average decrease in rates due to the passage of HB 334 by the 2011 legislature.*

2011

FINANCIAL CONDITION OF THE MONTANA STATE FUND

The legislature intended that Montana State Fund be run in a business-like manner, solely funded through insurance premiums and investment income. In keeping with this legislative mandate, MSF's fiduciary responsibility to Montana is to provide a stable and competitively priced market for workers' compensation insurance–while maintaining a sufficiently strong financial condition so that MSF can serve that role today, tomorrow and long into the future. MSF must never become a liability to the general taxpayers of Montana as happened with the "old fund" when it was managed as the division of workers' compensation under the Department of Labor and Industry.

One of the key metrics of the financial health of an insurance operation, particularly in a "long-tailed" line of insurance such as workers' compensation, is the level of policyholder surplus (equity) relative to the amount of unpaid liabilities. Without equity, an insurance company would be declared insolvent with every minor downturn in asset and liability values. When insurance companies fail, as Montana experienced with the old fund, the result is a large crater of financial damage. This is why it is critical that Montana State Fund maintain a level of policyholder surplus (equity) that is neither excessive nor inadequate for safe and sound insurance operations while continuing to progress toward a prudent level of financial strength.

Montana State Fund has several characteristics that highlight the importance of policyholder equity to absorb adverse scenarios. To address these inherent characteristics Montana State Fund needs stronger than average policyholder equity. Risks inherent to Montana State Fund include but are not limited to:

- Significant long-term obligations associated with workers' compensation claims.
- Montana State Fund writes one line of highly regulated insurance,
- Montana State Fund writes workers' compensation insurance in a single state,
- Montana State Fund provides a guaranteed market,
- Uncertainty from significant Montana benefit changes–most recently HB 334.
- Limited access to raising capital, if needed.
- Montana State Fund's equity must be adequate not only to cover current and next year's obligations, but also to support the long-term strategy.

Montana State Fund's financial position is analyzed annually by an independent consulting actuary. MSF's financial position is compared to regulatory standards, to other state funds, to other competitors and to a peer group of similar-size companies that include regional workers' compensation insurance carriers. MSF's financial condition is rigorously stress-tested against various contingencies such as catastrophic events, a decline in the market value of investments held by MSF to support paying claim liabilities and the potential for increase in the amount of business MSF would assume if other insurance companies decide not to insure business in Montana. For the past decade, the independent actuary has concluded that MSF exceeds all regulatory "red flag" indicators used by the National Association of Insurance Commissioners to determine the viability of insurance companies and states that MSF's current financial condition is "safe and sound" to conduct insurance operations. MSF strives to be not merely "safe and sound" but to achieve financial strength in the long term, for the benefit of Montana employers and employees.

In the past two decades of operation, Montana State Fund has gradually built its financial strength to enable it to maintain highly competitive rates in the Montana insurance market, to foster a more stable rate environment, and to build the capacity to withstand the occasional but inevitable challenges that face all insurance companies. Such challenges range from rare but catastrophically severe loss events, downturns in investment markets, adverse trends in loss reserves, and rate level inadequacies caused by accelerating benefit costs, particularly medical inflation. Over the past decade, MSF's insurance operations have achieved an average annual 4.2 percent return on surplus (equity).

Montana State Fund's long-term track record of financial results has enabled us to build financial strength to meet our obligations to insured Montana employers and injured employees–and to be here as a stabilizing influence both now and well into the future.

MSF began issuing dividends to its policy holders in 1999. Since that time, $96.2 million have been returned in the form of either dividends or loss sensitive plan returns. Each year MSF evaluates its financial condition to determine if a dividend can be returned to MSF customers.

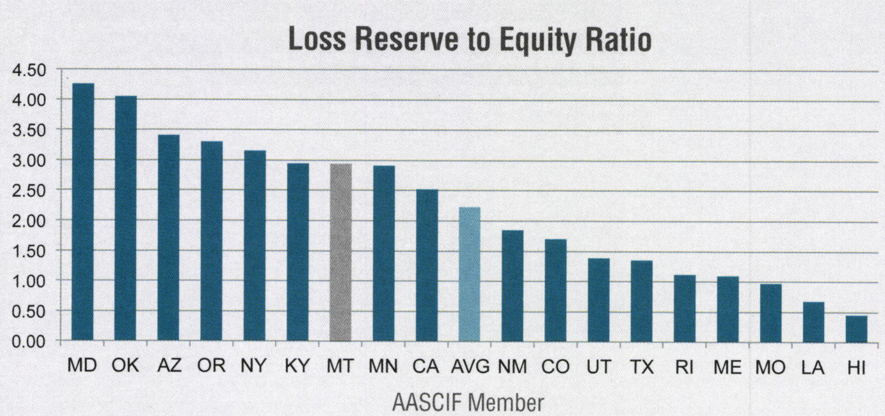
Condensed Income Statement

	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012
Net Premium Earned	230,965,306	203,976,354	166,265,384	173,605,441	150,482,457
Losses Incurred	194,249,598	178,246,355	143,522,935	130,505,434	119,493,828
Loss Expenses Incurred	18,687,513	20,961,369	22,832,149	32,871,562	23,370,622
Underwriting Expenses Incurred	26,946,211	20,497,790	18,861,229	30,480,450	23,517,806
Net Underwriting Loss	(8,918,016)	(15,729,160)	(18,950,929)	(20,252,005)	(15,899,799)
Net Investment Income Earned	44,347,778	47,924,391	44,943,082	44,070,315	44,544,238
Net Realized Capital Gains (Losses)	(113,451)	(13,625,381)	2,183,275	6,424,612	4,888,091
Net Income Before Dividends	32,095,030	12,624,247	23,231,390	26,371,921	29,803,254
Dividend Declared to Policyholders	–	3,996,599	2,001,293	4,004,521	6,001,168
Net Income After Dividends	32,095,030	8,627,649	21,230,097	22,367,400	23,802,086

Condensed Balance Sheet

		FY 2008	FY 2009	FY 2010	FY 2011	FY 2012
ADMITTED ASSETS	**Bonds**	870,571,824	908,459,736	927,438,746	1,001,286,534	1,035,226,381
	Equity Securities	87,443,325	81,742,906	110,790,189	137,532,240	141,839,698
	Real Estate Investments	2,390,151	12,732,565	28,933,345	28,507,880	27,974,845
	Cash and Short-term Investment	24,925,611	33,585,750	29,608,701	19,972,374	26,496,118
	Collateral for Securities on Loan	143,710,845	175,758,454	167,514,931	89,189,742	149,464,962
	Total Investments and Cash	1,129,041,756	1,212,279,411	1,264,285,912	1,276,488,770	1,381,002,004
	Other Admitted Assets	67,574,511	120,704,783	126,858,538	108,417,181	110,799,114
	Total Admitted Assets	1,196,616,267	1,332,984,194	1,391,144,450	1,384,905,951	1,491,801,118
LIABILITIES AND EQUITY	**Reserve for Unpaid Losses**	677,196,077	735,247,613	755,249,037	775,389,747	784,233,347
	Reserve for Unpaid Loss Adjustment Exp.	75,057,223	78,057,100	83,516,303	99,413,137	105,707,227
	Liability for Securities on Loan	143,710,845	175,758,454	167,514,931	89,189,742	149,464,962
	Other Liabilities	84,087,939	139,520,490	143,318,650	124,570,784	134,727,834
	Total Liabilities	980,052,084	1,128,583,657	1,149,598,921	1,088,563,410	1,174,133,370
	Policyholders' Equity	216,564,182	204,400,538	241,545,529	296,342,541	317,667,748

The ratio of loss reserves to policyholder equity is one of several metrics used to evaluate the financial stability and strength of an insurance operation. The higher the ratio, the greater the risk of insolvency due to adverse development in incurred workers' compensation liabilities. The lower the ratio, the greater the financial strength to withstand unexpected adverse conditions. Very low ratios may indicate over-capitalization. Among 18 members of the American Association of State Compensation Insurance Funds (AASCIF) that have reported this statistic to AASCIF, MSF compares favorably. MSF's long-term goal is a ratio of loss reserves to equity in the range of 2.5 to 2.0, consistent with the average among reporting AASCIF members.



MONTANA'S WORKERS' COMPENSATION PREMIUM RATES

On July 1, 2011, MSF implemented a 20 percent rate decrease based on legislation passed during the 2011 legislative session. The Oregon Department of Consumer and Business Services conducts a biennial study on workers' compensation premium rates by state. With the 20 percent decrease in effect, the latest study reflecting rates in effect on January 1, 2012, shows Montana's rates are eighth highest in the nation. The previous study indicated Montana had the highest in the nation. However, Montana's rates continue to be the highest among other states in the Western region.

The bill passed in the 2011 legislative session–HB 334–included the following provisions. The percentage represented next to each provision is the expected impact on loss costs as estimated by the National Council on Compensation Insurance, the state appointed rating organization. The parenthetical is the relevant section of the law in Section 39-71-.

- Permanent partial awards (703) -1.7%
- Termination of medical benefits at 60 months (704) and reopening provisions (new) -12.1%
- Medical fee schedule (704) -2.3%
- Retroactive period (736) +0.5%
- Choice of health care provider (1101) -8.5%

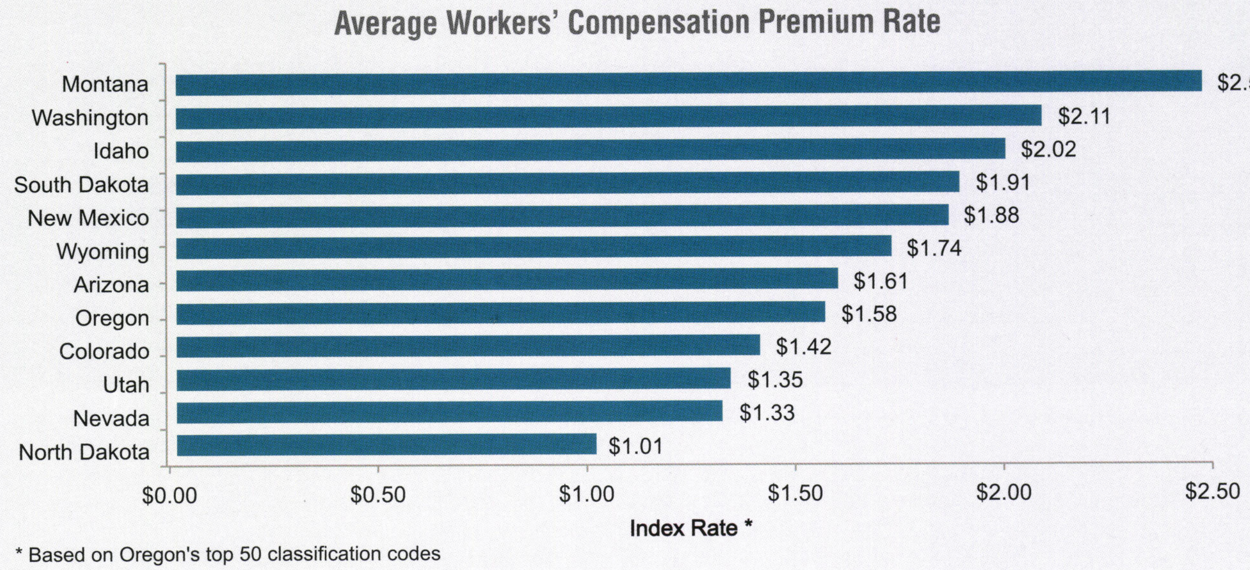
Overall, the impact on the entire Montana workers' compensation system's loss costs is estimated at -22.4 percent.

In addition, there are sections of HB 334 that NCCI analyzed and determined they either do not have a notable cost impact in Montana or the cost impact could not be estimated. These sections are defined as follows.

- Definition of course and scope of employment (407).
- Utilization and Treatment Guidelines (704).
- Require use of Sixth Edition of the American Medical Association Guides to the Evaluation of Impairment (711).
- Settlements (741).
- Stay at Work / Return to Work (1011; new).

On July 1, 2011, MSF implemented a 20% rate decrease based on legislation passed during the 2011 legislative session.

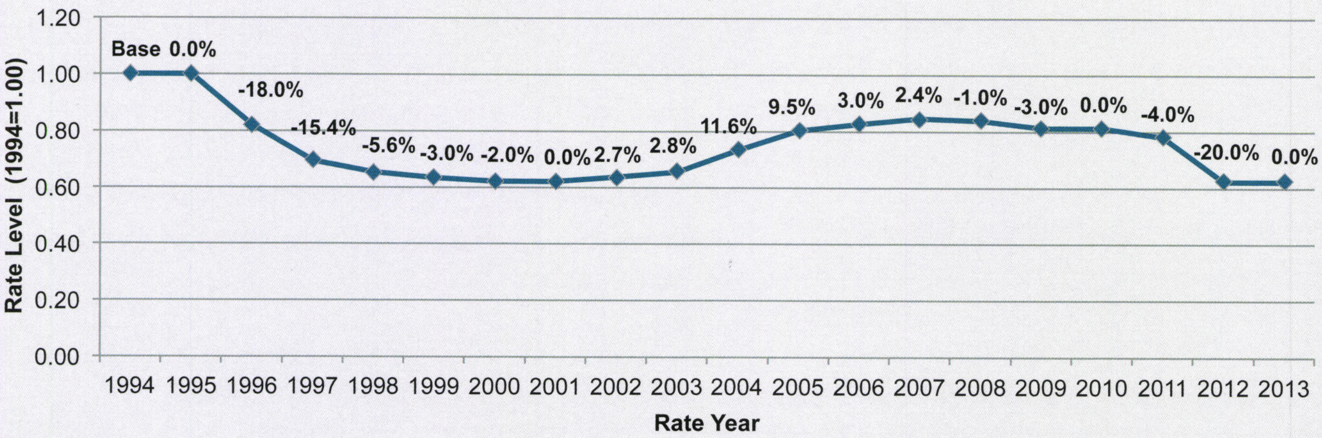
Effective July 1, 2011, these provisions have been in place for one year. It is too soon to tell how effective the changes will be on reducing losses and reducing the costs of workers' compensation. MSF has made a significant investment in adding medically trained staff to improve our claim handling and ensure appropriate medical treatment procedures and practices are applied so that we can realize the savings identified in the legislature while achieving optimal outcomes for injured employees.



Montana was ranked as having the 8th highest workers compensation premium rates in the nation as of January 1, 2012, based on a biennial study by the Oregon Department of Consumer and Business Services. Although the difference has significantly narrowed since passage of the 2011 reform legislation (HB334), Montana workers comp rates remain the highest in the western region. These results take into account differences in the types of industry found in each state.

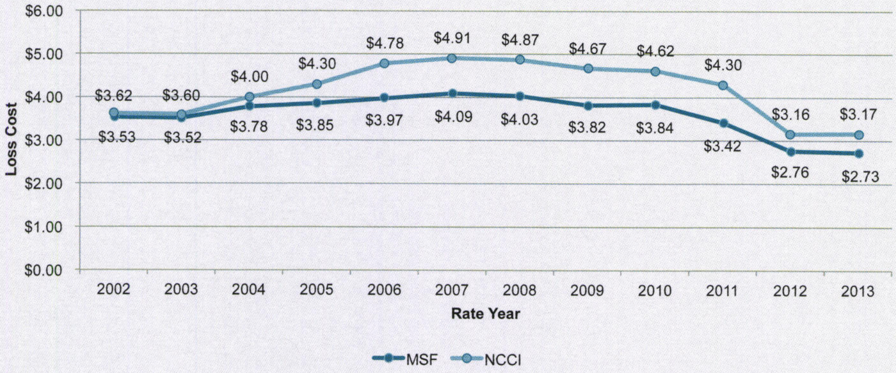
MSF Manual Rate Level

(Weighted Average of Rate Tiers)



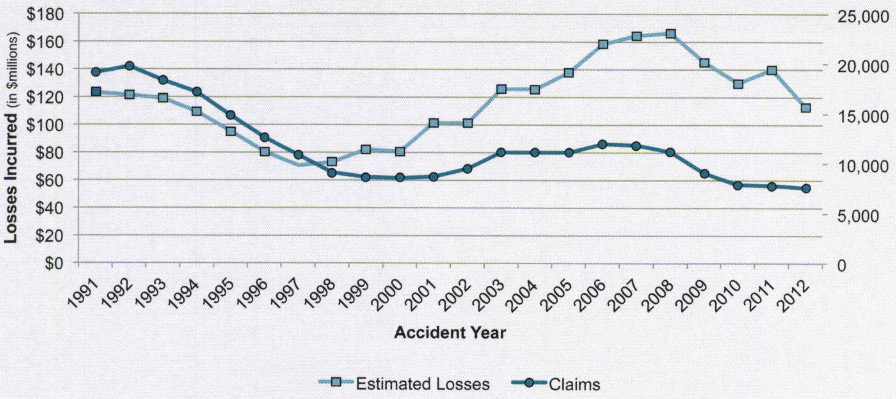
Benefit reforms and moderating medical costs brought rates down in the mid-1990s. By 2000, MSF rates were 38% less than they were in 1995. In the early 2000s, increasing medical costs caused rates to increase nationwide. In the mid-to-late 2000s, MSF rates were relatively stable and slightly declining. With the passage of HB 334, MSF rates were reduced 20% based on NCCI estimates of claim cost savings. Whether or not such savings will be realized will not be known for several years. Today, MSF rates are 38% lower than they were in 1995.

MSF vs NCCI Loss Costs



"Loss Cost" refers to the amount estimated to cover the cost of workers' compensation benefits and claim administration. Loss costs represent approximately 80% of MSF premium rates. In a competitive rating state like Montana, carriers use the NCCI loss cost as the starting point in establishing their rates but may adjust the level for the book of business they write. For the past 10 years, MSF has charged an average of 15% less than NCCI loss costs. MSF's independent consulting actuary has determined that MSF does not need to charge as much as estimated by NCCI.

MSF Losses and Claims Incurred by Accident Year



Since the inception of the Montana State Fund on July 1, 1990, MSF has incurred approximately $2.6 billion in claim liabilities for nearly 260,000 injured Montana employees.

GLOSSARY OF WORKERS' COMPENSATION TERMS

Classification Codes: The classification system groups employers so the rates reflect common exposures. The class code assigned best describes the business and includes all types of labor. The business is classified–not the separate employments or occupations. Policyholders report payroll and pay a premium based on the classification codes assigned to their policies.

Exclusive Remedy: The premise on which the workers' compensation system is based: Workers give up the right to sue their employers in exchange for wage loss and medical benefits for their injuries and occupational diseases.

Experience Rating: A mandatory program that modifies an employer's premium based on a comparison of its experience with the expected experience of an average employer using the same class code(s). The experience modification factor either increases or decreases premium.

Impairment Rating: A medical term that is sometimes confused with disability. An impairment rating is a medical determination wherein the medical provider assigns a numerical rating for whatever type of bodily function has been lost, based on the AMA Guides to the Evaluation of Permanent Impairment.

Incurred Losses: The total of the reserves and paid amounts for claims.

Indemnity Benefits: Payments to a worker with an injury or occupational disease representing wage-loss benefits.

Independent Medical Examination (IME): An examination by a physician, psychologist or panel to obtain an independent evaluation of the employee.

Loss Cost: The amount estimated to cover the cost of workers' compensation benefits and claim administration.

Manual Premium: Payroll, divided by 100, multiplied by the manual rate for the classification code(s) assigned a business.

Maximum Medical Healing (Medical Stability or Maximum Healing): A term used by the medical provider to indicate when further material improvement in the healing process would not be expected by a worker with an injury or OD.

Medical-only Claims (MO): Claims with only medical bills and no indemnity benefits owed or paid.

National Council on Compensation Insurance, Inc. (NCCI): National Council on Compensation Insurance, Inc., manages the nation's largest database of workers' compensation insurance information. NCCI analyzes industry trends, prepares workers' compensation insurance rate recommendations, determines the cost of proposed legislation, and provides a variety of services and tools to maintain a healthy workers' compensation system.

Occupational Disease (OD): A medical condition resulting from employment-related activities that occur over a period of time and not from a single traumatic event on a single day.

Old Fund: Claims occurring before July 1, 1990, and, by law, the financial responsibility of the state of Montana.

Permanent Partial Disability (PPD): A condition in which the worker is able to return to work, but has wage loss and a permanent impairment.

Permanent Total Disability (PTD): A condition in which the worker is not able to perform regular employment.

Premium Rates: Includes loss costs plus general and acquisition expenses, offsets for underwriting programs, offsets for investment income, profit and contingency, taxes (as applicable) and other necessary adjustments.

Rehabilitation Benefits: Benefits provided to a disabled worker who has a permanent impairment, job limitations and an actual wage loss, or a worker with an impairment rating of 15% or greater. To assist the worker in returning to work following a work-related injury or OD.

Reserves: The estimated value of the benefits and claim costs expected over the life of a claim. Paid amounts are not included in the reserve.

State Average Weekly Wage: Established annually by the Department of Labor and Industry, it is the basis for determining maximum weekly benefits under the Workers' Compensation Act.

Social Security Disability Benefits (SSDI): SSDI benefits are payable to disabled individuals through the federal Social Security Administration.

Surplus: A retained earnings account intended to assure that the insurer will be able to fulfill its obligations to policyholders and injured employees. When an insurer reports a surplus, it is not talking about unneeded or excess funds.

Temporary Partial Disability (TPD): A worker prior to maximum healing who can temporarily return to work in a modified or alternative employment, but suffers a partial wage loss, can receive this wage-loss benefit.

Temporary Total Disability (TTD): A physical condition resulting from an injury or occupational disease that results in total loss of wages and exists until the worker reaches maximum medical healing.

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