MONTANA STATE FUND BUDGET ANALYSIS

A Report Prepared for the

Legislative Finance Committee

By

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MONTANA LEGISLATIVE FISCAL DIVISION

INTRODUCTION

Presented in this report is the Legislative Fiscal Division's analysis of the Montana State Fund (MSF) FY 2014 budget request. The report compares this year's request to the MSF budget information from FY2013. Budgets are compared year to year to show any significant changes in programs and associated costs.

In addition, the report will discuss the present status of the Montana State Fund and specifically address:

- MSF Premiums and System Changes
- Industry Workers Compensation Trends
- Manual Rates for State Agencies
- The status of the Old Fund

MSF PREMIUM COSTS AND CHANGES FOR POLICY HOLDERS

The workers compensation insurance industry uses a complex system of data collection, analysis, and trending to determine the final premium cost an employer must pay for workers compensation insurance. Since the goal is to predict a future cost associated with injury claims, the challenge is to correctly predict the number and final cost of claims carried by the provider. The industry relies on nationally recognized firms providing claim data, independent actuary analysis, and internal analysis in an attempt to correctly identify the amount of premium to charge and thus keep the business solvent. Montana State Fund generally operates under these principles, and in doing so, has established its own system to equate premiums to its business operation.

The system that MSF used for final premium calculation in FY2013 is identified as Rating Tier System 2.0. This program and its intrinsic qualities were discussed in last year's budget analysis report and will not be presented for the purposes of this report[1]. However, there is a change to Tier System 2.0 this year that slightly modifies some of the operational limits. This change was accepted by the MSF board for FY2014 and is called the Tier System 2.1. Tier System 2.1 effectively gives credit to those companies that have lower than average accident history and consequently lowers the final premium. Conversely, Tier 2.1 accounts for companies with higher than average accident history by charging increased premiums. Appendix A can be referenced for detailed program changes and shifts in tiers for policy holders.

According to the MSF, changes made implementing the new Tier 2.1 System will be revenue neutral in terms of the credit and debit process of issuing higher or lower premiums based on accident history. However, as will be discussed later in the report, premiums will be reduced on average for MSF clients by 6% based on other program changes.

Changes to Manual Rates Adopted By the Board

As touched on earlier, workers compensation insurance involves a complex system of evaluating past data and establishing trends for predictive purposes. In workers compensation, the data set is typically classified by industry and job classification and involves the costs related to the number of accidents in a given year. The costs associated with accidents per industry are normalized to $100 of payroll and are referred to as loss costs. The lower the number for loss cost, the lower the cost of providing insurance. The National Council of Compensation (NCCI) Insurance is the rating advisory organization most insurers in Montana utilize for loss cost rates. Montana State Fund belongs to NCCI which provides loss costs per industry. Once NCCI loss costs are adopted the data is integrated into the Tier 2.1 system to determine the final premium charged to employers.

Figure 1 shows the aggregate change by industry within the state of Montana as reported by NCCI. This represents an overall reduction of 5.4% in loss cost and can represent that industries are working safer. The aggregate loss cost change this year for MSF is reported to be a reduction of 6 % as compared to FY 2013.

[1] S:\Legislative_Fiscal_Division\LFD_Finance_Committee\LFC_Reports\2012\November\2012_10_dm_Montana State Fund.docx

Figure 1

Montana State Fund New Fund Adopted NCCI Loss costs By Industry			
Industry	Average Change	Maximum Decrease	Maximum Increase
Manufacturing	-5.2%	-30.00%	20.00%
Office and Clerical	-6.3%	-31.00%	19.00%
Goods and Services	-4.8%	-30.00%	20.00%
Contracting	-7.1%	-32.00%	18.00%
Miscellaneous	-3.9%	-29.00%	21.00%
Overall	-5.4%		

Changes to Manual Rates For State Agencies

NCCI loss costs are not used for state agencies. Figure 5 shows the MSF board adopted FY 2014 loss costs for state agencies compared to FY 2013 loss costs.

Figure 2

Montana State Fund New Fund FY 2013/FY2014 State Agency Loss Costs			
Class Description	FY 2013 Loss Cost	FY 2014 Loss Cost	Change in Loss Costs
State Aircraft Operation NOC: Flying Crew	$3.97	$3.26	-17.88%
State Penal Institutions: All Other Employees	4.52	5.18	14.60%
State Highway Patrol Officers	4.49	4.56	1.56%
Municipal: Professional or Adminsitrative	0.79	0.75	-5.06%
State, Hospital, Penal: Prof or Administrative	0.81	0.71	-12.35%
State: Clerical Office Employees	1.39	1.15	-17.27%
State Hospital: All Other Employees & Drivers	8.33	6.99	-16.09%
State Highway Dept: Administrative or Non-Professional	1.33	0.96	-27.82%
State: Administrative or Non-Professional	1.36	1.14	-16.18%
State Highway Dept: All Others & Drivers	8.65	7.90	-8.67%
State: All Other Employees NOC & Drivers	6.97	6.60	-5.31%
Municipal: Relief Workers	4.77	4.51	-5.45%
Community Service Workers	4.77	4.51	-5.45%

Figure 2 shows most of the classification codes used by state agencies have a reduction in loss costs for FY 2014. Any reductions in final premium costs for state agencies will be returned to the fund paying the cost as required by the legislature.

BUDGETARY RISKS ASSOCIATED WITH THE FUNDS

A significant difference between MSF and other state agencies reviewed by the Legislative Finance Committee is that revenues, in this case net earned premiums, are collected in the current fiscal year and used to pay benefits for injuries to workers in the current year and the benefits and claims relating to those injuries in subsequent years, in some cases for 50 to 60 years in the future. The net earned premiums that are collected above what is needed to pay current year benefits and operational costs are set aside in reserves to pay future claims. The major budgetary risk associated with the funds of MSF is that the net earned premiums collected in a year may not be sufficient to pay all benefits, claims, and operational costs associated with injuries over the long period the benefits and claims are paid out. To offset this risk MSF maintains equity and includes a component for contribution to equity in determining final premium cost. As mentioned, this reduction in contribution is the main reason that premium cost will be reduced by 6% for FY2014.

Estimated Revenues, Benefits, and Operational Costs

To determine the changes in equity budgeted in FY 2014, the estimated revenues, benefits, and operational costs are examined. While the budget does not include the anticipated future benefit costs for FY 2014, the strategic business plan includes an expected loss ratio of 73.4% for FY 2014. MSF anticipates $111.7 million in losses or costs associated with accidents occurring in FY 2014 with $24.0 million to be paid in FY 2014 and the remainder set aside for anticipated losses as reserves.

The budgeted premium revenues are used to pay for the cost of injuries to workers occurring in FY 2014. However, MSF's budget includes the costs of all claim benefits that will be paid in FY 2014 for all accident years from 1990 forward. Funding for these claims is set aside in reserves and used as needed. The budget for claim benefits is $118.5 million, of which $24.0 million is estimated to be needed to pay for claims relating injuries occurring in FY 2014.

Figure 3 shows the board approved FY 2014 budget, FY 2013 budget, and FY 2013 actual expenditures for net premium and operational costs by category.

Figure 3

Montana State Fund
New Fund
Estimated Net Premiums and Operational Costs
Compared to FY 2013 Budgeted and Actuals
(in thousands)

Category	Budgeted FY 2013	% Change From FY 2014	Actual FY 2013	Budgeted FY 2014	% Change From FY 2014
Revenues					
Net Earned Premiums	$154,197	-1.36%	$156,062	$152,104	-2.54%
Operational Costs					
Personal Services	23,654	7.01%	24,421	25,311	3.64%
Operating Expenses	21,549	-4.93%	19,283	20,487	6.24%
Equipment and Intagible Assets	466	115.02%	581	1,002	72.46%
Allocated Loss Expenses	3,004	-11.45%	2,653	2,660	0.26%
Total Operational Costs	$48,673	1.62%	$46,938	$49,460	5.37%

Examining the comparison between the board-approved budget and FY 2013 actuals shows:

- Net premium revenues decrease to $152.1 million from FY 2013 actual revenues of $156.1 million under the following assumptions:
  - 25,486 policies written in FY 2014 compared to 25,771 in FY 2013 or a decrease of 1.1%
  - 6 % decrease in manual rate change
  - 3% wage growth
  - 91.9% premium retention
  - $18.8 million in new business premiums
- Total operational budget costs increase by 5.4% from $46.9 million in FY 2013 to $49.5 million in FY 2014 due to:
  - Changes in FTE - 305 FTE in FY 2014 from 289 FTE in FY 2013, a net increase of 16 FTE for FY2014. The additional FTE will be used to support annual business plan projects and enterprise strategy and project management. Annual business plan projects include succession planning, recruitment, claim center upgrades, claim analytics, and workplace safety programs. Enterprise strategy and project management includes policy research, medical payment options, and budget software upgrades.

- Increases for a number of operating expenses compared with FY 2013 actuals including:
  - $456,620 more for equipment
  - $253,715 for additional professional and consulting services
  - $201,911 for projected increases in commissions
  - $142,492 in maintenance contracts
  - $128,049 in recruiting costs
  - $128,049 in additional travel costs

The increased operational costs and the decreased net premium revenues impact the statutory expense ratio. The statutory operating expense ratio is a standard measurement in financial statements for insurance organizations to analyze the cost of operations in relation to net earned premium and allows MSF to compare operational management to competitors and the industry. The statutory operating expense ratio encompasses insurance industry statutory accounting data that is not displayed in an expenditure driven budget. As projected the statutory expense ratio will be 31.3% in FY 2014 meaning that for every dollar collected by MSF $0.313 will be used for operational costs. It should be noted that this estimate is a decrease from the actual statutory expense ratio for FY 2013 of 34.1%. While there is not an industry standard, historically MSF's operating expense ratio has been below that of private insurance companies on a national level.

Achievement of Reserve to Equity Targets

Equity increases through: 1) contributions to equity charged through premiums to Montana businesses insuring with MSF; and 2) investment income. Equity measured at June 30, 2013 was $372.28 million, an increase of $54.6 million from the equity of $317.67 million measured at June 30, 2012. The increase in equity since FY 2012 is comprised of three components:

- Net income after dividends of $31.4 million
- Unrealized gain on investments of $22.2 million
- Changes in non-admitted assets of $0.95 million

Equity is used to fund prior year development on loss reserves and to ensure rate stability. The adequacy of the equity used to offset increases to loss reserves is measured using reserve to equity ratios, as this ratio reflects the multi-year nature of MSF's obligations. The lower the reserve to equity ratio (2.0 to 1.0 compared to 4.0 to 1.0) the greater the financial strength of the insurer and in MSF's case, the lower the risk that the state's general fund will be needed for unfunded liabilities. Private insurers and other state funds maintain similar levels of equity.

For the first time in several years MSF has achieved a ratio within the range recommended by the actuary with a ratio of 2.42 to 1.0. Achieving the target:

- Reduces the long term risk that prior year development may result in an unfunded liability for the New Fund
- Allows the contribution to equity component of the loss cost multiplier to be reduced, thus reducing premiums for all ratepayers

OLD FUND ACTUARIAL ESTIMATES

The state's general fund is responsible for Old Fund claims costs as the reserves set aside to pay claims were not sufficient to pay the ongoing costs. MSF contracts with an actuary to determine the costs of the claims and related administrative costs that are estimated to be paid over the next 37 years. The MSF actuarial central estimate adopted by the board for the Old Fund costs of benefits until benefits are paid off is $51.0 million reflecting:

- Paid claims in FY 2013
- Increased estimates for ongoing medical claims of $4.6 million
- Increased estimates for ongoing indemnity claims of $0.5 million

To provide increased assurance that the actuarial estimates provided by MSF are reasonable, additional reviews are conducted including:

- Legislative Audit Division (LAD) contracts with an actuary to review the rates and determine if the rates are excessive, inadequate, or unfairly discriminatory
- State Auditor’s Office (SAO) contracted with a separate actuary to:
    - Review loss reserving methodologies and estimates
    - Review rates and pricing methodologies
    - Review MSF case reserving practices and levels
    - Comment on the actuarial reports of MSF and LAD

Based on reviewing both the MSF and LAD actuarial estimates, the SAO actuary concluded that the unfunded liability for the Old Fund could be $34.3 million higher than the central estimate (currently accepted at $51.0 million) Therefore, the unfunded liability for the old fund may be as high as $85.3 million..

It will take many years for the final cost of old fund liability to be known, as benefit payments are projected through FY 2051. The SAO actuary noted that one consideration supporting the higher estimate is the adverse development changes that have increased the liability over the last several years. Prior year development on the Old Fund was $5.1 million higher than FY2013 estimation or almost 10% of current unfunded liability.

APPENDIX A

MSF contracts with the National Council on Compensation Insurance (NCCI) to determine loss costs associated by job classification. Loss costs are the costs associated with providing indemnity and health benefits for injured workers and the direct costs for managing the claim over the lifetime of the claim. The loss costs are reported as a rate per $100 of payroll in each job classification. MSF evaluates the loss costs provided by the NCCI and provides a recommendation to the MSF Board to approve the rates as is or a modified cost based on experience and history unique to the Montana workplace. In most cases, the NCCI loss costs are accepted by both management and approved by the board with no adjustments made.

Once the loss costs have been accepted, the MSF uses a tiered system to further equate the final cost of the insurance premium. There are five tiers available for placement with each tier representing the employer's propensity to incur (or not incur) losses in a policy period. The five factors that drive the tier system are:

1) NCCI Experience Rating (if applicable)
2) Three-year claim frequency (over $500)
3) Account size
4) NCCI Hazard Code
5) Claim-free Tenure (over $500)

Each tier has a loss cost multiplier (LCM) assigned that is used as the final factor in determining premium rates. There was a change in the NCCI Experience Rating factor for FY 2014 wherein businesses are no longer experience rated by NCCI if their annual premiums are less than $10,000. This change was implemented on July 1, 2013 and MSF modified Tier System 2.0 to account for the change.

The rating tiers for MSF for FY 2013 and FY 2014 and corresponding rate loss cost multipliers are shown in Figure 1. Tiered Rating 2.0 was designed by the MSF consulting actuary to work in conjunction with the old NCCI experience rating plan. Tiered Rating 2.1 reflects necessary adjustments recommended by the MSF consulting actuary to work in conjunction within the new NCCIA experience rating plan. While the overall impact of the NCCI experience rating plan is cost neutral according to MSF, premiums will decrease this year due to a combination of reductions in loss costs and contribution to equity. Figure 1 reflects only the changes in the loss cost multiplier, the average reduction of 5.4% in loss costs are not shown.

Figure 1

Montana State Fund
New Fund
Rating Tiers
Changes Adopted As of July 1, 2013

	Previous (Rate Tier 2.0) Rating Factor Score and LCM				Current (Rate Tier 2.1) Rating Factor Score and LCM				Change	
Tier	From	To	Loss Cost Multiplier	Premium Rate*	From	To	Loss Cost Multiplier	Premium Rate*	Loss Cost Multiplier	Premium Rate
Tier 1	0.000	0.475	0.801	$801	0.000	0.475	0.790	$790	(0.011)	($11)
Tier 2	0.476	0.700	1.026	1,026	0.476	0.675	1.013	1,013	(0.013)	(13)
Tier 3	0.701	1.025	1.157	1,157	0.676	0.925	1.142	1,142	(0.015)	(15)
Tier 4	1.026	1.300	1.420	1,420	0.926	1.300	1.401	1,401	(0.019)	(19)
Tier 5	1.301	& above	1.977	1,977	1.301	& above	1.952	1,952	(0.025)	(25)

* Premium rate per $1,000 of loss cost

Tier Policy 2.1 has modified the structure and boundary limits slightly for FY 2014. According to the MSF, the change in tier assignment is based on several factors. One reason is the NCCI change in experience rating that was implemented in the Tier 2.1 system discussed earlier. This change has been the first significant update to the experience rating by NCCI since 1998. Another reason, according to the MSF, pertains to normal year to year variance in the loss experience of individual policies used to determine tier assignments.

As one can see in Figure 2, the changes to tier structure have rearranged policy holders somewhat in moving from one tier to the next based on the 2.1 Tier system. MSF predicts the movement in policy holder to tier level will be revenue neutral in conjunction with the change in experience rating modifiers.

The highest movement in policy holders out of a given Tier is a reduction of 560 policies in Tier 5. This would represent a 42 percent reduction in Tier 5 policies. However, since Tier 5 only accounts for 4.0 percent of the total business volume, the change is relatively minor in terms of lost revenue overall and is offset by those tiers that have an increase in policy number. The brunt of the business volume (approximately 77 %) is carried by Tier 2 and Tier 3. For these tiers, the movement is relatively low in terms of overall policies written amount all tiers.

Figure 2

Montana State Fund
Changes to Rating Tiers

	2.0	2.1	Difference
Tier 1	290	335	45
Tier 2	5,299	5,086	(213)
Tier 3	1,920	2,421	501
Tier 4	1,390	1,617	227
Tier 5	1,346	786	(560)
Total	10,245	10,245	0

Figure 3 shows the distribution of policies assigned to a given tier for 2.0 and 2.1 Tier system. 65% of the policies do not change tier given the changes implemented with 2.1 including year to year variance in loss experience. For the remaining 35 % of policies movement up or down can be seen. For example, there are a total of 2421 policies in Tier 3 for system 2.1. Of this total, 989 had no change with the version change from 2.0 to 2.1. 668 policies came from tier 2 and 42 policies came from tier 1 showing movement upward. 564 policies came from tier 4 and 158 policies from tier 5 showing movement downward.

Figure 3

Montana State Fund
Redistribution of Previous Rating Tiers

Previous Tier 2.0		New Tier 2.1 Tier 1	Tier 2	Tier 3	Tier 4	Tier 5	Total
Tier 1	290	174	63	42	10	1	290
Tier 2	5,299	149	4,246	668	99	137	5,299
Tier 3	1,920	10	657	989	213	51	1,920
Tier 4	1,390	2	89	564	659	76	1,390
Tier 5	1,346	0	31	158	636	521	1,346
Total	10,245	335	5,086	2,421	1,617	786	10,245

*Note – Figures 2 and 3 are an example of renewed policies from July 1, 2013 to September 30, 2013 and is not a representation of all policies carried by MSF.