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 2015 budget request. The report compares this year's MSF Board of Director's approved budget information from FY2014. 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 and the cost to administer those 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 will use for final premium calculation in FY2015 is identified as Tier Rating System 2.1. 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]. 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 the numeric changes of applying Tier System 2.1. Although there was no change to the factors and parameters used to place policy holders into their respective tier group, a limit on how many tiers a policy holder can move within will be limited to no greater than 2 shifts. MSF believes this will reduce the amount of "volatility" seen in policy holder movement.

In conclusion, the MSF will use Tier Rating System 2.1 with slight modifications to each Loss Cost Multiplier. Furthermore, this year there will be a zero percent change to annual rate. Last year there was a 6% decrease in premiums largely due to decrease in contributions to equity.

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 provides the standard that most providers utilize for loss cost rates. Montana State Fund contracts with NCCI to provide loss cost information per industry and integrates this into the Tier 2.1 system to determine the final premium charged to employers. By law, the MSF is required to use NCCI for loss cost determination.

Figure 1 shows the aggregate change in NCCI filed loss cost by industry for FY2015. This represents an overall reduction of 3.6% in loss costs associated with accidents expected in Montana and can represent that industries are working safer.

[1]http://leg.mt.gov/content/Publications/fiscal/interim/2013_financemty_dec/Montana-State-Fund.pdf

Figure 1

NCCI Loss Cost Changes from 7/1/2014 By Industry			
Industry	Average Change	Maximum Decrease	Maximum Increase
Manufacturing	-2.8%	-28.00%	22.00%
Office and Clerical	-4.3%	-29.00%	21.00%
Goods and Services	-4.1%	-29.00%	21.00%
Contracting	-4.9%	-30.00%	20.00%
Miscellaneous	-0.8%	-26.00%	24.00%
Overall	-3.6%		

Changes to Manual Rates for State Agencies

NCCI loss costs are not used for state agencies. For ease of business for state agencies, MSF has established a set of classification code rates applicable to and used by Montana state agencies. These classification codes are unique to the state of Montana and are developed solely based state agency loss experience. Figure 2 shows the board adopted FY2015 loss costs for state agency position compared to FY2014 loss costs.

Figure 2

Montana State Fund New Fund FY 2014/FY2015 State Agency Loss Costs			
Class Description	FY 2014 Loss Cost	FY 2015 Loss Cost	Change in Loss Costs
State Aircraft Operation NOC: Flying Crew	$3.26	$2.81	-13.80%
State Penal Institutions: All Other Employees	5.18	4.68	-9.65%
State Highway Patrol Officers	4.56	3.85	-15.57%
Municipal: Professional or Adminsitrative	0.75	0.72	-4.00%
State, Hospital, Penal: Prof or Administrative	0.71	0.56	-21.13%
State: Clerical Office Employees	1.15	1.02	-11.30%
State Hospital: All Other Employees & Drivers	6.99	6.25	-10.59%
State Highway Dept: Administrative or Non-Professional	0.96	0.87	-9.38%
State: Administrative or Non-Professional	1.14	1.17	2.63%
State Highway Dept: All Others & Drivers	7.90	7.99	1.14%
State: All Other Employees NOC & Drivers	6.60	5.47	-17.12%
Municipal: Relief Workers	4.51	4.30	-4.66%
Community Service Workers	$4.51	$4.30	-4.66%

Figure 2 show most class codes for state agencies have a reduction in loss costs for FY2014. A weighted average will show a 6% decrease in retail cost for agencies in FY2015. Any reductions in final premium costs for state agencies will be returned to the fund paying the cost as required by the legislature.

LONG TERM FINANCIAL 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 40 to 50 years in the future. The premiums that are collected, above what is needed to pay current year benefits and operational costs, are set aside in reserves to pay the expected ultimate cost of 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 mitigate this risk MSF maintains equity and includes a component for contribution to equity in determining final premium cost. Contributions to equity for FY2015 will be held consistent from previous year. If the actual claims and expenses result in better than estimated outcomes when premiums are set, the MSF Board of Directors may declare a dividend to be paid to those business that generated better than expected results. For example, during FY2014 the MSF Board of Directors declared a $12 million dividend.

Estimated Revenues, Benefits, and Operational Costs

To determine the changes in budget for FY 2015, the estimated revenues, claim costs, and operational costs are examined. The revenue earned from premiums is invested to pay for the claim indemnity and medical costs for accidents occurring in that year, plus the cost to manage those claims. This pool of money, the premiums paid plus the investment earnings, is used over the lifetime of the claim to pay the cost associated with workers compensation injuries. MSF anticipates $124.8 million in losses or costs associated with accidents occurring in FY 2015. Using the expected net premium of $167.0 million and the loss costs of 124.8 million, the expected lost cost ratio is 74.7%. This compares to the projected FY2014 loss ratio of 73.4%

Figure 3 shows the board approved FY 2015 budget, FY 2014 budget and FY 2014 actual expenditures for net premium and operational costs by category.

Figure 3

Montana State Fund - New Fund
Estimated Net Premiums and Operational Costs
(in thousands)

Description	Budgeted FY 2014	Projected FY 2014	%Change FY 2014 Budget vs Projection	Budgeted FY 2015	% Change in FY2015 from Projected FY 2014
Revenues -----------------					
Net Earned Premiums	$152,104	$163,742	7.65%	$167,039	2.01%
Operational Costs---------					
Personal Services*	25,319	23,459	-7.35%	26,598	13.38%
Operating Costs	20,487	20,967	2.34%	21,731	3.64%
Equipment and Intangible Assets	1,001	845	-15.58%	1,117	32.19%
Allocated Loss Adjustment Expenses	2,660	2,352	-11.58%	2,393	1.74%
Total	$49,467	$47,623	-3.73%	$51,839	8.85%

Examining the comparison between the board-approved budget FY2015 and FY2014 actuals shows:

- Net premium revenues increase to $167.0 million from FY 2014 revenues of $163.7 million under the following assumptions:

    - 25,486 policies written in FY 2014 compared to 25,608 in FY 2015 or an increase of 0.5%
    - No manual rate change
    - 2% wage growth 91.0% premium retention
    - $18.8 million in new business premiums
- Total operational budget costs increase by 8.8 % from $47.6 million in FY 2014 to $51.8 million in FY 2015 due in large part by two main drivers:
    - Increase in the personal services of $2.5 million or 10.3% of the 2014 projection. There are several reasons for this increased budget for FY2015. They are:
        - Vacancies for FY2014 were greater than the planned 3% - this accounts for approximately $1.6 million of the increase in FY2015
        - 14 positions that were expected to be filled in FY2014 did not occur as fast as expected in FY2014
        - Merit or salary increases of 3%
    - An increase in operational expenditures from FY2014 projected by approximately $750,000.

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. This measurement allows MSF to compare operational management to competitors in their industry. As projected, the statutory expense ratio will be 27.2% in FY 2015 meaning that for every dollar collected by MSF $0.272 will be used for operational costs. It should be noted that this estimate is a decrease from FY2014 statutory expense ratio of 31.3%. 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 and has reported two successive years of decreased operational spending compared to revenues gained.

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. Due to the timing of this report, only 3rd quarter estimates were available. Equity measured during the third quarter was $ 427 million, an increase of $ 55 million from the equity of $372 million measured at June 30, 2013. The increase in equity since FY 2013 is comprised of three components:

- Net income after dividends of $ 35.3million
- Unrealized gain on investments of $ 19.4 million
- Non-admitted assets - $82 thousand

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 second time in several years MSF has achieved a ratio within the range recommended by the actuary with a ratio of 2.15 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 38 years. The MSF actuarial central estimate is projected to be roughly $42 million for completing the liability of the old fund claims. However, it should be noted that this projection is a central estimate only and that there is a significant chance that the final payout will be much higher than $42 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 past actuarial estimates, the SAO actuary concluded that the unfunded liability for the Old Fund could be much higher as mentioned prior. It will take many years for the final cost of old fund liability to be known, as benefit payments are projected through FY 2051.

APPENDIX A

MSF is required by law to belong to the National Council on Compensation Insurance (NCCI) to provide 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 FY2014. This change was implemented on July 1, 2013 and modified FY2013 tier referred as Tier System 2.1. The change effectively gives credit to those companies with favorable loss cost (below loss cost average for job classification) and consequently yields lower premiums. Conversely, the NCCI Experience Rating Factor accounts for companies with higher loss costs than average by job classification and yields higher premiums. MSF Tiered plan 2.0 had provisions to perform the same function but will be removed based on the fact that the NCCI change will account for this. The new MSF plan has been reconciled for the NCCI changes in FY2014 and is now called the Tiered Rating 2.1 plan. This Tier system will be used again for FY2015 and has small adjustments to the LCM to keep margins consistent for the business plan.

The rating tiers for MSF for FY2014 and FY215 and corresponding rate loss cost multipliers are shown in Figure 1. No changes to tier boundaries were implemented this year although the loss cost multipliers have been increased over FY2014. Although the chart appears to represent that premiums will be increased this year, due to the decrease of NCCI loss costs by 3.6%, there will be no increase in premium from FY2014 for MSF customers by aggregate.

Figure 1

Montana State Fund New Fund Changes to Loss Cost Multiplier Changes Adopted As of July 1, 2013										
	Previous (Rate Tier 2.1) FY2014				Current (Rate Tier 2.1) FY2015				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	0.790	$790	0.000	0.475	0.826	$826	0.036	$36
Tier 2	0.476	0.700	1.013	1,013	0.476	0.675	1.059	1,059	0.046	46
Tier 3	0.701	1.025	1.142	1,142	0.676	0.925	1.194	1,194	0.052	52
Tier 4	1.026	1.300	1.401	1,401	0.926	1.300	1.465	1,465	0.064	64
Tier 5	1.301	& above	1.952	1,952	1.301	& above	2.040	2,040	0.088	88

* Premium rate per $1,000 of loss cost