



**Report to  
Montana State Fund  
Board of Directors**

**State Auditor Review of Rates**

**Prepared by:**  
*Laurence Hubbard*  
*President/CEO*  
*March 26, 2010*

On January 20, 2010 the Economic Affairs Interim Committee (EAIC) received a presentation from State Auditor, Monica Lindeen, *Regulatory Oversight of Private (Plan 2) Workers' Compensation Insurance Carriers by Commissioner of Securities & Insurance (CSI), What oversight CSI can provide to Montana State Fund (Plan 3)*. This presentation was made as part of EAIC's work on SJR 30, Workers' Compensation Study. At the request of MSF's Chairman at the January 22, 2010 regular meeting of the board, the following report of MSF management will address the recommendation of the State Auditor for CSI to conduct a review of MSF's rates to determine whether those rates are excessive, inadequate or unfairly discriminatory. See, CSI presentation, page 9. The scope of this report *does not* address issues regarding "regulation" of MSF under Title 33, although some discussion of regulation follows in response to public comments made by CSI.

### *Current Rate Review*

Under current law MSF's board is vested with authority to establish rates. MSF's rates are not subject to review by the CSI under current law.

**"39-71-2316. Powers of state fund.** (1) For the purposes of carrying out its functions, the state fund may:

...

(e) adopt classifications and charge premiums for the classifications so that the state fund will be neither more nor less than self-supporting. *Premium rates for classifications may be adopted and changed only by using a process, a procedure, formulas, and factors set forth in rules adopted under Title 2, chapter 4, parts 2 through 4. After the rules have been adopted, the state fund need not follow the rulemaking provisions of Title 2, chapter 4, when changing classifications and premium rates.* The contested case rights and provisions of Title 2, chapter 4, do not apply to an employer's classification or premium rate. The state fund is required to belong to a licensed workers' compensation advisory organization or a licensed workers' compensation rating organization under Title 33, chapter 16, part 4, and *may use the classifications of employment adopted by the designated workers' compensation advisory organization, as provided in Title 33, chapter 16, part 10, and corresponding rates as a basis for setting its own rates.* Except as provided in Title 33, chapter 16, part 10, a workers' compensation advisory organization or a licensed workers' compensation rating organization under Title 33, chapter 16, part 4, or other person may not, without first obtaining the written permission of the employer, use, sell, or distribute an employer's specific payroll or loss information, including but not limited to experience modification factors." [Emphasis Added].

In establishing rates, MSF is required by law to utilize the services of a *qualified* independent consulting actuary who is a member of the American Academy of Actuaries.

**39-71-2330. Rate setting -- surplus -- multiple rating tiers.** (1) The board has the authority to establish the rates to be charged by the state fund for insurance.

*The board shall engage the services of an independent actuary who is a member in good standing with the American academy of actuaries to develop and recommend actuarially sound rates. Rates must be set at amounts sufficient, when invested, to carry the estimated cost of all claims to maturity, to meet the reasonable expenses of conducting the business of the state fund, and to amass and maintain an excess of surplus over the amount produced by the national association of insurance commissioners' risk-based capital requirements for a casualty insurer.*

...

[Emphasis Added].

Since 1990, MSF has utilized actuarial services from several actuaries of Towers Watson (formerly, Tillinghast Towers Perrin). Exhibit 1 is a letter from Russell Greig, FCAS, MAAA, CFA dated January 28, 2010 at management request provides a summary of quality assurance and independence practices employed by Towers Watson to ensure actuarially sound rate recommendations to MSF's board. Towers Watson also utilizes a "peer review" process for draft reports prepared on behalf of MSF and other clients to ensure actuarial soundness of recommendations.

MSF's consulting actuary's are fellows of the Casualty Actuary Society and adhere to a strict Code of Professional Conduct to assure independence and competent and honest actuarial opinions.

In addition to utilization of an independent consulting actuary, rates established by MSF's board are subject to legislative auditor review to determine whether rates are excessive, inadequate, or unfairly discriminatory, and to report findings to the legislature, governor and MSF board.

**39-71-2362. Authority of legislative auditor with respect to state fund.** The legislative auditor *shall review rates established by the board to determine if the rates are excessive, inadequate, or unfairly discriminatory.* Each year, the legislative auditor shall:

- (1) examine the state fund beginning no sooner than October 1 following the end of the fiscal year; and
- (2) report the findings of the examination and rate review to the governor, the legislature, and the board of directors of the state fund.

In discharge of its responsibility the Legislative Audit Division ("LAD") retains the services of a consulting actuary to review the data, processes, and methodologies utilized by MSF's independent consulting actuary in determining rate recommendations to MSF's board of directors. MSF pays for LAD review services.

### *CSI Rate Review*

Insurance industry regulation is contained within Title 33, Montana Code Annotated, and is the responsibility of the State Auditor, Commissioner of Securities & Insurance (CSI). The purpose and intent of insurance company rate regulation is contained in 33-16-101, MCA.

**33-16-101. Purpose and intent.** (1) *The purpose of this chapter is to promote the public welfare by regulating insurance rates as herein provided to the end that they shall not be excessive, inadequate, or unfairly discriminatory, to authorize the existence and operation of qualified rating organizations and advisory organizations and require that specified rating services of such rating organizations be generally available to all admitted insurers, and to authorize cooperation between insurers in ratemaking and other related matters.*

(2) *It is the express intent of this chapter to permit and encourage competition between insurers on a sound financial basis, and nothing in this chapter is intended to give the commissioner power to fix and determine a rate level by classification or otherwise. [Emphasis Added].*

The above law contains the same legal standard for rate appropriateness as provided for MSF in 39-71-2362, MCA. Further, workers' compensation insurance is specifically regulated under Part 10, Chapter 16 by providing for advisory premium rates using data from all providers of workers' compensation insurance. Part 10 reiterates rates may not be excessive, inadequate, or unfairly discriminatory. See, 33-16-1021, MCA. The statute also requires and presumes a competitive market. A competitive market does not exist if long-run profits are deemed unreasonably high in relation to services rendered (excessive rates), and rates are too low if they are clearly insufficient to pay losses and expenses, or would tend to create a monopoly (inadequate rates). Rates are deemed unfairly discriminatory if price differentials do not equitably reflect differences in expected losses and expenses.

The National Council on Compensation Insurance ("NCCI") is the designated workers' compensation rating advisory organization in Montana. NCCI promulgates and files with CSI annually a set of advisory "loss costs" for utilization by private workers' compensation insurers. Under Montana law the NCCI "files" recommended loss costs with the CSI. Importantly, if an insurer utilizes the NCCI advisory loss costs (subsequent to loss cost approval by CSI) and does not file rates below the advisory loss cost, the CSI review ends and the insurer may use those rates upon filing without further review. See, 33-16-1026, MCA. However, if an insurer's rates deviate below advisory loss costs, those rates are subject to further review by CSI. See, 33-16-1027, MCA.

### *Competitive Market*

An underpinning of the Montana Insurance Code is the assurance of a competitive market. As this relates to workers' compensation insurance, the issue of a competitive market is linked to whether insurer rates are inadequate, excessive, or unfairly discriminatory. See, 33-16-1010 and 33-16-1021, MCA. In cases where CSI conducts any investigation regarding workers' compensation rates to ensure insurer rates are not inadequate, excessive or unfairly discriminatory, the CSI must also consider the following:

**33-16-1020. Competitive market -- hearing.** (1) A competitive market is presumed to exist unless the commissioner, after hearing, issues an order stating that a reasonable degree of competition does not exist in the market. The order may not expire later than 1 year after issuance.

- (2) In determining whether a reasonable degree of competition exists, the commissioner shall consider the following factors:
- (a) the number of insurers actively engaged in providing coverage;
  - (b) market shares and changes in market shares;
  - (c) ease of entry into the market;
  - (d) market concentration among plan No. 2 insurers as measured by the Herfindahl-Hirschman index;
  - (e) whether long-term profitability for insurers in the market is unreasonably high in relation to the risks being insured;
  - (f) whether long-term profitability for insurers in the market is reasonable in relation to industries of comparable business risks; and
  - (g) generally accepted and relevant tests relating to competitive market structure, market performance, and market conduct.
- (3) The workers' compensation insurance market may not be determined to be noncompetitive if the market concentration of the 50 largest insurers writing workers' compensation insurance under plan No. 2 satisfied the U.S. department of justice merger guidelines for an unconcentrated market.
- (4) The commissioner's determinations must be made on the basis of findings of fact and conclusions of law.

As part of the presentation before the EAIC on January 20, 2010, CSI provided the attached letter dated January 7, 2010 to Pat Murdo, Research Analyst, referencing the degree of market concentration if MSF were subject to Title 33. Exhibit 2. The CSI concludes that there exists a "highly concentrated market" in Montana, but goes no further in discussing what, if any, action would be taken by the CSI in such circumstances. What is clear is under such a finding the CSI has virtual complete authority to reject or approve rate filings by insurers. This circumstance has the potential of increasing workers' compensation rates for MSF policyholders by forcing divestiture of MSF's market share. MSF's "guaranteed market" responsibility would likely complicate matters in addition to potential disruption of Montana's workers' compensation system.

### *Legislative Confidence in MSF Rates & CSI Rate Review Pros and Cons*

As Montana's legislative policymakers work to address workers' compensation cost drivers there are perhaps inevitable questions regarding Montana State Fund and its operations. SJR 30 is no exception. Legislative reports and national comparisons can add to confusion and misunderstanding of MSF's role and insurance business operations, thereby fostering uncertainty regarding MSF's financial condition and rate levels. CSI's January 20<sup>th</sup> testimony added to this uncertainty by suggesting "we don't know how those rates are set" [Trans. Log 2:31:33]. MSF will continue to support understanding of MSF's rate making processes and operational differences from private workers' compensation insurance companies in order reinforce stakeholder confidence.

## Pros

On its face, the CSI recommendation to "review" MSF rates suggests such review will utilize different standards and actuarial qualifications than currently used by MSF and the Legislative Audit process. Therefore, CSI review may serve to mute speculation that MSF's rates are excessive, inadequate or unfairly discriminatory. A review *could* validate the actuarial soundness of MSF's ratemaking process, methodology and resultant rates by putting an extra set of eyes on the process. At a minimum, CSI would at least know how MSF rates are made and be able to assure legislators that MSF rates are not excessive, inadequate or unfairly discriminatory.

An additional benefit from rate review could be a deeper understanding by CSI's actuary of MSF rate making in anticipation of legislation that places regulatory oversight of MSF under the State Auditor's Office.

## Cons

There are several underlying assumptions in CSI recommended "review" of MSF rates that demonstrate a lack of understanding of MSF's ratemaking process and related legal requirements, and suggest an unbiased review of MSF's rates would not, in fact, result. First, CSI fails to acknowledge the same legal standard for MSF rates exist as that for private insurance companies. Second, CSI implies MSF rates are not reviewed by a *qualified* actuary. Third, CSI suggests such review and/or regulatory oversight will lower workers' compensation rates for Montana employers. Management believes each of these explicit or implicit assumptions is incorrect.

### *Rate Legal Standards*

MSF is subject to the identical rate legal standard as *all* workers' compensation insurers; that is, rates shall not be inadequate, excessive or unfairly discriminatory. While rate standards for private insurers are provided in Title 33, MSF's legal requirement is contained in Title 39. It is incorrect to suggest there are different legal standards for MSF rates. Using the identical legal standards for review of MSF's rates suggests nothing material can be gained from CSI review that is not already achieved under current legislative oversight process.

### *Qualified Actuary*

CSI's presentation and recommendation to the EAIC is based on what appears to be a belief that MSF's rates receive only a "high level" analysis by a qualified independent actuary hired by the Legislative Audit Division. [Trans. Log 2:20 and 2:29:42]. The Commissioner's testimony also apparently assumes MSF's rates are not created or reviewed by any other independent *qualified actuary*. This apparent assumption is contrary to law which requires MSF's board to retain the services of an independent actuary who is a member in good standing with the American Academy of Actuaries. In fact, since 1990 MSF has engaged actuarial services from Towers Watson (formerly Tillinghast Towers Perrin) to provide professional independent actuarial services and is highly qualified to render actuarial opinion. As stated by Commissioner Lindeen

in her testimony at the January 20 meeting of EAIC, an AAA designation “gives great credibility to that actuary.” [Transcript, log 2:25].

Management disagrees with CSI’s suggestion MSF rates receive only a “high level” review for several reasons. First, by law MSF’s rates must be actuarially sound and not inadequate, excessive or unfairly discriminatory. The LAD annually retains the services of a *qualified* consulting actuary to review both MSF current rates *and* loss reserves. For the last several years, LAD has contracted with Casualty Actuarial Consultants, Inc. (CACI) to review the rates and reserve analysis of MSF’s independent consulting actuary. J. Edward Costner, ACAS, MAAA is president of CACI. In CACI’s most recent actuarial report for MSF rates effective July 1, 2009, page 2, they outline the scope of engagement, including “[r]eview MSF rates effective July, 1 2009. The review shall include appropriate analysis of the data used in the rate setting process and the process for setting the overall rate level and rates by class. Based on the work performed, comment and conclude on the reasonableness of the rate setting methodology, formulas, and procedures; and conclude as to whether rates effective July 1, 2009 are excessive, inadequate, or unfairly discriminatory.” While CACI does not independently determine the rate level of MSF, the review is more than mere “high level.”

It is said, if you put 10 accountants in a room you will get 10 different answers to a question. The same may be said for actuaries. When it comes to rates, there is no “right” answer, merely a range of possible answers that are supported by professionally accepted standards of analysis, including methodologies that are widely utilized in that analysis. Ultimately, actuarial science is as much an art as it is a science and requires sound management judgment be applied to actuarial methods.

While no doubt well intended, CSI’s recommendation to review MSF rates does not mean the Legislature will have any greater confidence in the actuarial soundness of those rates than currently provided by MSF’s independent consulting actuary, or LAD’s independent consulting actuary. If anything, any difference in professional opinion regarding rates can only fuel uncertainty and confusion regarding MSF rates. As the Commissioner indicated, the opinion of an actuary credentialed by the American Academy of Actuaries has “great credibility” – how, then, does the Legislature or the MSF board distinguish the validity of opinion from actuaries with presumably equal credibility? The answer lies in the depth of understanding and knowledge of MSF’s operations, history, data, and management. Towers Watson possesses that understanding and knowledge – CSI’s actuary does not have comparable knowledge and understanding. If anything, CSI’s opinion is likely to be more, not less, biased toward an academic application of methodologies and opinions utilized by NCCI that may differ from MSF’s actuaries that use in-depth historical knowledge and judgment of MSF specific trends.

Apparently, the entire purpose of CSI “review” of MSF’s rates is intended to lend credibility that those rates are actuarially sound. CSI represents that their review would be “truly unbiased.” It is somewhat naïve to suggest any company rate is unbiased. In fact, Montana law *requires* MSF rates to be biased toward more conservative estimates. 39-71-2311, MCA, provides in pertinent part:

...

“Premium rates must be set at least annually at a level sufficient to ensure the adequate funding of the insurance program, including the costs of administration, benefits, and adequate reserves, during and at the end of the period for which the rates will be in effect. In determining premium rates, the state fund shall make every effort to adequately predict future costs. *When the costs of a factor influencing rates are unclear and difficult to predict, the state fund shall use a prediction calculated to be more than likely to cover those costs rather than less than likely to cover those costs. . .*” [Emphasis Added].

Notwithstanding the stated cost of \$75,000 for CSI to review MSF rates, there are additional costs associated with presenting data, explaining the data and responding to the reviewer’s findings. These costs could likely be substantially greater to MSF than policymakers may currently appreciate. MSF spends approximately \$60,000 on the class ratemaking services of Towers’ Watson and could spend at least that much defending class rating decisions. At the January 20 EAIC hearing discussion suggested MSF would not need to utilize its own actuarial services in the event CSI conducted a rate review. This is simply not a realistic expectation and is contrary to insurance industry best practice. CSI internal actuary should not both create an individual insurer’s rates *and* review those rates for adequacy. MSF will continue to need, and to pay for, independent actuarial services for rate making and a myriad of other analysis of data supporting our operations. There should not be an expectation of actuarial cost savings for CSI rate review.

### *Lower Workers’ Compensation Rates*

In her testimony before the EAIC, Commissioner Lindeen stated it can be shown in states where the insurers of “last resort” are regulated by the insurance department “you have decreased rates for policyholders as opposed to what we currently have now in Montana.” [Trans. Log 3:04:20]. She went on to suggest a greater opportunity for lower rates if MSF were more closely regulated. CSI provided no data to support this statement. In fact, the testimony suggests data is irrelevant to what rates should be for MSF policyholders. On the contrary, regardless of jurisdiction those states with assigned risk markets of last resort generally have higher rates for assigned risk policyholders. MSF rates *must* be actuarially sound - neither excessive, inadequate, nor unfairly discriminatory. This is the legal standard whether regulated by CSI or not. Policymakers need only look to the Old Fund to see the results of politicizing MSF’s rate making and such comments merely serve to tempt fate.

Interestingly, the legislature initially granted regulatory authority over MSF to the Commissioner of Insurance but rescinded that authority in the 1990 Special Session on the basis that greater legislative oversight was more appropriate. If, workers’ compensation insurance loss costs in Montana are established on an actuarially sound basis, it cannot be suggested that rates would automatically be lower simply because MSF’s rates would be subject to CSI review.

### *Management Recommendation*

On balance, MSF management believes CSI rate review will not materially add value to increased understanding of our rates, rate making process, or rate adequacy. Current law

providing for legislative oversight and Legislative Audit Division actuarial review of MSF rates provides ample mechanisms to assure MSF rates are not excessive, inadequate or unfairly discriminatory. Unlike private insurance companies that are most often domiciled in other states, MSF's as a non-profit, independent public corporation is extra-ordinarily transparent in operations. In particular, our rate making process is conducted in public meetings and subject to review/input by interested parties. No private corporation enjoys the same level of transparency.

Nonetheless, should the legislature desire more forensic review of MSF rates, current law provides ample means to achieve that review. The legislature need only request that review of the Legislative Audit Division, in addition to already mandated review, without further complicating the process. The quality and independence of LAD review should be as thorough and objective as any rate review provided by CSI.