A Report
to the
Montana
Legislature

Performance Audit

Workers' Compensation Insurance Premium Review

Montana State Fund

January 2014

Legislative Audit
Division

13P-05

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Performance Audits

Performance audits conducted by the Legislative Audit Division are designed to assess state government operations. From the audit work, a determination is made as to whether agencies and programs are accomplishing their purposes, and whether they can do so with greater efficiency and economy.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Members of the performance audit staff hold degrees in disciplines appropriate to the audit process.

Performance audits are performed at the request of the Legislative Audit Committee which is a bicameral and bipartisan standing committee of the Montana Legislature. The committee consists of six members of the Senate and six members of the House of Representatives.

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January 2014

The Legislative Audit Committee
of the Montana State Legislature:

This is our performance audit of Workers' Compensation Insurance Premium Review managed by Montana State Fund (MSF) and MSF's Board of Directors.

This report provides the Legislature information regarding MSF's process for calculating workers' compensation insurance premiums, applying dividends and other premium returns, and the effects of House Bill 334, passed by the 2011 Legislature, on policyholder premiums as well as MSF's incentive programs. This report includes recommendations for strengthening controls regarding calculations and premium returns to better ensure consistency, accuracy, and equity among MSF's policyholders. A written response from MSF is included at the end of the report.

We wish to express our appreciation to MSF personnel for their cooperation and assistance during the audit.

Respectfully submitted,

/s/ Tori Hunthausen

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	Richard Duane, Vice President, Human Resources	
	Richard Root, Vice President, Insurance Operations	
	Peter Strauss, Vice President, Insurance Operations Support	
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State Fund Board of Directors	Elizabeth Best, Chair	2015
	Joe Brenneman	2015
	Wayne Dykstra	2015
	Bruce Mihelish	2017
	Richard Miltenberger	2017
	Lynda Moss	2017
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Montana Legislative Audit Division

Performance Audit
Workers' Compensation Insurance Premium Review
Montana State Fund

January 2014 | 13P-05 | Report Summary

Montana State Fund issued approximately 26,000 policies which totaled $158.5 million in final premiums for policy year 2013; Montana State Fund could strengthen its controls and clearly document policyholders' premium calculations and premium returns to help ensure consistency, accuracy, and equity among policyholders.

Context

Montana State Fund (MSF) is a nonprofit, independent public corporation that is the guaranteed market for workers' compensation insurance. The MSF Board of Directors (board), comprised of seven members appointed by the Governor, is responsible for oversight of MSF. In addition to oversight, the board reviews and approves factors included in the premium calculations, premium discounts, and premium returns.

In policy year 2013, MSF issued over 26,000 policies totaling $158.5 million in final premiums. Small businesses are the majority of MSF's policyholders; however, medium and large businesses make up the majority of total premium dollars.

In 2011, the Montana Legislature passed House Bill 334 (HB 334), which made several significant changes to workers' compensation premiums and claims management. This bill was expected to reduce workers' compensation premiums paid by employers and reduce the cost of claims.

Results

Audit work examined the factors included in the premium calculations, discounts, and premium returns as well as the overall effects of HB 334 on policyholder premiums and incentive programs. While this work determined MSF generally calculates policyholders premiums and premium returns correctly, there were some exceptions. Strengthening controls and clearly documenting decisions regarding the premium calculations and returns will ensure consistency, accuracy, and equity.

Manual premium is the premium amount calculated before any discounts and/or adjustments are applied to a policy. Audit work reviewed the factors included in MSF's manual premium calculation and determined MSF correctly applies many of the factors approved by the board. However, controls could be strengthened over rate tier assignments to help ensure equitable treatment of policyholders.

The manual premium can be modified to recognize circumstances unique to individual policyholders. Based on audit work, we conclude that many of the modifiers were applied accurately to policies. This includes

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employers liability, medical deductible, and volume discounts. We were also able to conclude MSF accurately calculates the modified standard premium based on factors input on the policy holder system. Recommendations include establishing additional controls over applying the experience modifier to policyholders, strengthening controls over the construction industry credit application process, and strengthening controls over scheduled rating.

MSF operates several computer systems to calculate premium amounts, underwrite policies, and analyze policyholder data. Audit work identified needed improvements in this area including strengthening controls over the computer program used to underwrite policies to better ensure scheduled rating factors are properly documented.

MSF has programs that offer premium returns to qualified policyholders if losses are managed and kept low. Premiums can be returned to policyholders through dividends, retrospectively rated plans, and group plans. While audit work determined MSF issued and applied dividends accurately, MSF could strengthen policies and procedures over retrospectively rated and group business plans.

Premium amounts paid by policyholders were expected to decrease with the passage of HB 334, which was effective July 1, 2012. Audit work reviewed effects of this change on premiums paid by policyholders and incentive programs for private insurance agents and MSF employees. Audit work determined MSF implemented HB 334 changes related to premium calculations as approved by the board and made reasonable adjustments to its incentive programs following the implementation of HB 334 for factors relating to earned premium.

Recommendation Concurrence	
Concur	7
Partially Concur	1
Do Not Concur	0

Source: Agency audit response included in final report.

For a complete copy of the report (13P-05) or for further information, contact the Legislative Audit Division at 406-444-3122; e-mail to lad@mt.gov; or check the web site at http://leg.mt.gov/audit
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Chapter I – Introduction

Introduction

Montana State Fund (MSF) is a nonprofit, independent public corporation that provides workers' compensation insurance to employers to cover wage-loss and medical benefits of employees with work-related injuries or disease. Management and control is vested solely in the seven member Board of Directors (board) appointed by the Governor. The board is responsible for, among other duties, approving various factors included in the premium amounts calculated for policyholders.

Montana law, with a few exceptions, requires employers to obtain workers' compensation insurance. Employers have three options when purchasing this insurance in Montana. An employer may develop a self-insurance program either individually or by joining with other employers in their industry, purchase from a private company, or purchase from MSF. Unlike private insurance companies, MSF serves as the guaranteed market, so it cannot refuse to insure employers.

Montana State Fund Premiums

MSF is required by law to charge premiums that are neither more nor less than self-supporting. The long-term nature of the liabilities associated with workers' compensation insurance can make it difficult to ensure that premiums are sufficient to cover the obligation to pay claims and other costs as they become due without creating excess equity. MSF offers premium return programs, such as dividends, that assist with excess equity when losses are lower than expected.

MSF issued approximately 26,000 policies in policy year 2013 totaling $158.5 million in final premiums. Small businesses paying under $5,000 in annual premiums were approximately 78 percent of MSF's policyholders and comprised 16.4 percent of MSF's total premium dollars. Additionally, large policyholders paying over $50,000 in premiums annually were approximately 1.7 percent of MSF's policyholders and comprised 40.8 percent of MSF's total premium dollars. For calendar year 2012, according to Department of Labor and Industry's annual report, MSF held 57 percent of the premium market share in Montana, not including self-insured plans.

House Bill 334

During the 2011 session, the Legislature enacted several significant changes to Montana's workers' compensation insurance system. Various interest groups were involved with reforming workers' compensation including private workers' compensation insurers, medical providers, MSF, and national rating organizations. The Montana Legislature passed House Bill 334 (HB 334) to address workers' compensation insurance costs, streamline the treatment process, and add programs to help injured employees stay at work or return to work. The passage of HB 334 was expected to decrease workers' compensation loss costs by approximately 22 percent. The Legislative Audit Committee prioritized a performance audit of workers' compensation insurance.

Audit Objectives

Based on our assessment of MSF, we developed three audit objectives:

1. Determine whether Montana State Fund calculates policyholders' premiums and discounts using consistent methodology and in accordance with state law; board and MSF policy; and, administrative rules.
2. Determine whether premium returns are applied to individual policyholders equitably and in accordance with state law; board and MSF policy; and, administrative rules.
3. Determine whether HB 334 and Montana State Fund's subsequent changes to premium calculations affected policyholder premiums and subsequently Montana State Fund's incentive programs.

Audit Scope

The audit scope focused on policyholders' premium calculations, discounts, and returns. The scope of our audit examined premium calculations for policy year 2013 and the most recent year for the payouts of premium returns, which included policy years 2010 and 2011. We also analyzed the effects of HB 334 and subsequent changes by reviewing changes in the premium calculation for policy years 2009 through 2013. Since the effects of HB 334 on workers' compensation claims will not be fully seen for at least five years after the implementation of HB 334, our audit focused on premiums. Therefore, data related to workers' compensation claims, streamlined treatment processes, and stay at work and return to work programs were outside of the scope of this audit.

Audit Methodologies

To address audit objectives we conducted the following audit work:

- Conducted interviews with MSF management and staff.
- Evaluated compliance with state law, administrative rule, board policy, and MSF policy and procedures.
- Reviewed actuarial reports developed by MSF's consulting actuary and the State Auditors Office's consulting actuary.
- Attended MSF board meetings and reviewed board materials.
- Conducted random samples and reviewed documentation related to factors included in the premium and discount calculations.

- Analyzed premiums returned to policyholders and supporting documentation.
- Analyzed HB 334 and examined the effects on policyholder premiums using data analytics.
- Conducted information systems assurance work over MSF's Policy Holder and Insurance Intelligence Systems.
- Interviewed Department of Labor and Industry and State Auditor's Office staff.

Report Contents

The remainder of the report includes additional background and presents audit findings, conclusions, and recommendations in the following areas:

- Chapter II provides additional information on workers' compensation and premium calculations.
- Chapter III examines MSF's factors that are part of the manual premium calculation.
- Chapter IV examines modifications to the manual premium such as the experience modification factor, construction credit, scheduled rating, and volume discount.
- Chapter V examines premium returns and dividends.
- Chapter VI examines the effects of HB 334 and subsequent changes to policyholder premiums and MSF's incentive payments.

CHAPTER II - BACKGROUND

Introduction

Montana's workers' compensation insurance system establishes Montana State Fund (MSF) as the guaranteed market insurer. While MSF competes with private insurance companies and functions similarly to a private insurer, MSF cannot refuse to provide coverage to an employer. Additionally, state government agencies, excluding the Montana University System, are required to use MSF to provide workers' compensation insurance. MSF generally follows the same process for assessing premiums as private insurance companies. The following sections outline, in general, how all workers' compensation insurers calculate policyholder premiums.

Workers' Compensation Premium Calculation

Factors used to calculate policyholders' premiums are established each year to provide insurance companies with sufficient resources to pay the costs for benefits to injured workers. Since policies written in any given year could generate claims for many decades, premiums collected in that policy year must be sufficient to pay for indemnity (wage loss) and medical benefits to injured workers.

Manual Premium Calculation

The initial premium amount calculated before any other discounts or adjustments are applied is referred to as manual premium. The following sections discuss the various factors used to calculate manual premium including loss costs by class code, the insurer's loss cost multiplier, and the policyholders' payroll.

Loss Costs- Loss costs are the actual claim expenses and do not include general expenses such as overhead, taxes, or profit. Typically, each state annually adopts an advisory organization's recommended loss costs, such as the National Council on Compensation Insurance (NCCI) advisory loss cost filing. When recommending workers' compensation insurance loss costs in a specific state, NCCI collects data from individual insurers in the state and analyzes industry trends. The Insurance Commissioner will then approve or disapprove NCCI's recommended loss costs, by work classification, for use by workers' compensation insurers doing business in the state. Montana's advisory loss costs are filed with the State Auditor's Office and are approved or disapproved by the Insurance Commissioner.

When NCCI develops loss costs, they are issued by industry classification and broken into specific job classifications (class codes) and are expressed as a rate per $100 payroll by class code. The following table shows an example of how loss costs would be applied to an excavating company with staff out in the field as well as clerical staff in the office. The table is broken out by class code and NCCI's advisory loss costs effective July 1, 2012.

Table 1
Examples of National Council on Compensation Insurance's Advisory Loss Costs

Class Code	Description	NCCI Advisory Loss Costs (per $100 of payroll)
8810	Clerical	$0.50
6217	Excavating and Grading of Land and Drivers	$9.31
4000	Sand, Gravel, Clay, Shale Digging/Dredging and Drivers	$7.83

Source: Compiled by Legislative Audit Division using the National Council on Compensation Insurance's advisory loss costs effective July 1, 2012.

As shown in the table, riskier job classifications such as excavating and grading of land are charged a higher rate per $100 of payroll than less risky job classifications such as clerical work.

Loss Cost Multiplier-Each workers' compensation insurer develops its own loss cost multipliers (LCM). This component is based on each insurer's unique operating expenses, taxes, and profit provision. While all insurers start with the same base loss cost published by NCCI, the insurer's individual LCM will vary. This means the premiums paid by policyholders will be different from one insurance company to the next. Using our example class codes, the following table details how each company's LCM would affect loss costs.

Table 2
Examples of Loss Cost Multiplier Effects on the National Council on Compensation Insurance's Advisory Loss Costs

Class Code	Description	NCCI Advisory Loss Costs	Company A (LCM=.90)	Company B (LCM=1.10)
8810	Clerical	$0.50	$0.45	$0.55
6217	Excavating and Grading of Land and Drivers	$9.31	$8.38	$10.24
4000	Sand, Gravel, Clay, Shale Digging/Dredging and Drivers	$7.83	$7.05	$8.61

Source: Compiled by Legislative Audit Division.

As shown in Table 2, Company A's LCM decreased NCCI advisory loss costs and Company B's LCM increased NCCI advisory loss costs. This means Company A will charge the policyholder less than Company B. Private insurers are required to file their LCM with the state's regulating agency. The State Auditor's Office is the regulating agency for private insurers in Montana. The Board of Directors (board) reviews and approves LCM's each policy year for MSF.

Policyholder Payroll-To calculate a policyholder's premium, employers' payroll must be broken out by class code. Since employers can only estimate the amount of payroll they anticipate during the upcoming year, premiums are based upon estimated payrolls. The estimated payroll can either be higher or lower than actual payroll. However, the premium is adjusted as either the employer reports actual payroll and/or an insurer audits an employer's payroll.

Using the example class codes, the following table depicts how a policyholders' payroll, NCCI's loss costs, and an insurer's filed LCM are applied in calculating manual premium for a policyholder. It is important to note that loss costs are filed based on every $100 in payroll. Additionally, the LCM is applied consistently across the class codes.

Table 3

Examples of Manual Premium Calculation

Class Code	Description	Payroll	(A) Payroll $100	(B) NCCI Advisory Loss Costs	(C) Loss Cost Multiplier	Premium (A) X (B) X (C)
8810	Clerical	$45,000	$450	$0.50	1.1	$ 247.50
6217	Excavating and Grading of Land and Drivers	$240,000	$2,400	$9.31	1.1	$24,578.40
4000	Sand, Gravel, Clay, Shale Digging/ Dredging and Drivers	$120,000	$1,200	$7.83	1.1	$10,335.60
Total Manual Premium						**$ 35,161.50**

Source: Compiled by Legislative Audit Division.

Modifiers to Manual Premium

While manual premium is the starting point for premium calculation, modifiers to manual premium tailor this value to an individual employer's circumstances. For example, the employer may have a better-than-average safety record, which would represent less risk to an insurer. Specific modifiers discussed in the following sections include experience modification factors, scheduled rating factors, and volume discounts.

Experience Modification Factors-Experience modification factors are determined by NCCI. The experience modification factor is calculated by NCCI by comparing a policyholder's business loss experience with the expected loss experience of all other businesses in that class code. NCCI determines which employers based on the state's established premium threshold should be experience rated. Using the information from past examples, the following table details how an experience modification factor less than one and an experience modification factor greater than one effects a policyholder's premium.

Table 4
Examples of Effects of Experience Modification Factor

	Policyholder 1	Policyholder 2
(A) Manual Premium	$35,161.50	$35,161.50
(B) NCCI Experience Modification Factor	0.93	1.3
(C) Change in Premium (A * (B-1))	($2,461.31)	$10,548.45
Standard Premium (A+C)	$32,700.19	$45,709.95

Source: Compiled by Legislative Audit Division.

As illustrated in Table 4, if a policyholder was assigned an experience modification factor of .93, it would decrease a policyholder's premium, whereas a factor of 1.3 would increase a policyholder's premium.

Scheduled Rating Factors-While experience modification factors are based on loss experience, scheduled rating is judgmental in nature and allows an insurers' underwriter to acknowledge special characteristics not reflected in an employer's experience. Characteristics resulting in a scheduled rating factor generally relate to the employer implementing or not implementing specific mechanisms to reduce the risk of injury. Examples of these characteristics include, but are not limited to, personal protective equipment being provided and used, safety officer on staff, written safety program, and ongoing safety training. Following our prior example with the 1.3 experience modification factor, the following table details how a scheduled rating factor effects a policyholder's premium.

Table 5
Effects of Scheduled Rating Factors on Premium

	Policyholder 1	Policyholder 2
(A) Standard Premium	$45,709.95	$45,709.95
(B) Scheduled Rating Factor	0.95	1.05
(C) Change in Premium (A * (B-1))	($2,285.50)	$2,285.50
Modified Standard Premium (A + C)	$43,424.45	$47,995.45

Source: Compiled by Legislative Audit Division.

As shown in Table 5, if a policyholder received a 5 percent scheduled rating credit (.95 scheduled rating factor) for having a safety officer on staff the policyholder's premium would decrease. However, if the policyholder received a 5 percent debit (1.05 scheduled rating factor) for poor safety management, it would increase the policyholder's premium. Private insurers are required to file their scheduled rating plan with the state's regulating agency.

Volume Discounts-Insurers typically provide for volume discounts that acknowledge some expenses of issuing workers compensation policies are fixed dollar amounts. For large policies, these expenses represent a smaller percentage of the policyholder's premium and therefore can be reduced. The annual premium discount amounts and the percentage of discount varies between insurers; however, the discount is generally no more than 15 percent. Private insurers are required to file their volume discount table with the state's regulating agency. MSF's volume discount program is approved by the board.

Terrorism/Catastrophe Premium

The terrorism/catastrophe premium as extended through the Terrorism Risk Insurance Program Reauthorization Act (TRIPRA) of 2007 began after September 11, 2001. It is a federal program and requires participation by all workers' compensation insurers. Insurers must charge each policyholder at a rate of $.02 per $100 of payroll. The funds collected from this charge would be used should significant acts of terrorism or a catastrophic event occur.

Expense Constant

Insurers charge a fixed, flat expense to every policyholder. This charge applies to the final premium developed for the policy and recognizes common administrative costs associated with issuing and administering a policy. Therefore, the same amount is applied to each policyholder and does not vary based on the amount of premium.

Other Factors

Insurers provide for a number of other adjustments and/or programs. For example, if a policyholder belongs to a certain industry group, they may receive an additional premium discount as a member benefit.

Summary of Premium Calculation

The following table summarizes the discussion to illustrate how a premium amount is calculated using the excavating company example.

Table 6

Workers' Compensation Premium Calculation

Manual						
Class Code	**Description**	**Payroll**	**(A) Payroll/ $100**	**(B) NCCI Advisory**	**(C) Loss Cost Multiplier**	**Premium (A)x(B)x(C)**
8810	Clerical	$45,000	$450.00	$0.50	1.1	$ 24.50
6217	Excavating and Grading of Land and Drivers	$240,000	$2,400	$9.31	1.1	24,578.40
4000	Sand, Gravel, Clay, Shale Digging/Dredging and Drivers	$120,000	$1,200	$7.83	1.1	10,335.60
Total Manual premium						**$ 35,161.50**
Modifiers to Manual Premium	**Assigned Factor**				**Change in Premium**	**Premium Amount**
Experience Modification Factor	1.3 (determined by NCCI				$10,548.45	
Standard Premium						**$45,709.95**
Scheduled Rating Factor	5% Credit (determined by insurer's underwriter)				($2,285.50)	
Modified Standard Premium						**$43,424.45**
Volume Discount	5% Credit on Premium Over $12,000 (based on specific insurer's criteria)				($1,571.22)	
Earned Premium						**$41,853.23**
Terrorism/Catastrophe Premium	$.02 per $100 of payroll (outlined in TRIPRA)				$81.00	
Expense Constant	$150 (based on specific insurer's criteria)				$150.00	
Final Premium						**$42,084.23**

Source: Compiled by the Legislative Audit Division.

During the audit, we examined the factors adopted for policy year 2013 by MSF's board and MSF's application of these factors to individual policyholders. We conducted testing to ensure MSF offers fair and equitable treatment to its policyholders as well as adheres to state law, administrative rule, board policy, and MSF's internal policies. Chapter III examines factors specific to the manual premium calculation and Chapter IV examines factors used to modify manual premium.

MSF offers specific programs in which a policyholder may receive a return on premiums paid in a previous policy year. We conducted testing over MSF's premium return programs to ensure compliance with state law, administrative rule, and related policy. Results of this work are presented in Chapter V. We also examined the impacts of House Bill 334 (HB 334) on MSF's premium calculation and subsequently MSF's incentive programs. Results of audit work related to the effects of premium calculation changes subsequent to HB 334 are presented in Chapter VI.

CHAPTER III – Montana State Fund's Manual Premium Calculation

Introduction

Manual premium is the initial premium calculated before any other discounts and/or adjustments are applied to a workers' compensation insurance policy. One of the audit objectives was to determine whether Montana State Fund (MSF) calculates policyholders' premiums using consistent methodology in accordance with state law, administrative rules, policy established by the Board of Directors (board), and MSF's policy. This chapter discusses how MSF calculates policyholders' manual premium and presents results of our audit work.

Overview of MSF's Manual Premium Calculation

Manual premium is calculated using loss costs by class code, the insurer's loss cost multiplier (LCM), and the policyholders' payroll. The following sections will further detail MSF's manual premium calculation.

MSF Adopts NCCI's Advisory Loss Costs With Few Exceptions

As required by §39-71-2316(e), MCA, MSF belongs to a licensed workers' compensation rating organization, which is the National Council on Compensation Insurance (NCCI). Administrative rules governing MSF's manual rate calculation require:

1. The advisory or rating organization (NCCI) loss costs used by the board to be the latest filed or prior filed loss costs.
2. MSF staff conduct an analysis of the adequacy of NCCI's filed loss costs by classification. Staff shall present the conclusion of this analysis to the board along with recommendations, if any, to establish loss costs for classification which differ from NCCI's loss costs.
3. For classifications used by MSF, but not part of NCCI's loss costs, MSF staff must develop a loss cost. These loss costs must be certified by MSF's consulting actuary and approved by the board.

MSF generally establishes premiums based on NCCI's loss costs. Currently, the use of the latest filed NCCI loss costs as the basis for MSF rates is under standing approval and is therefore deemed to be approved unless a board member requests that the item be placed on the agenda for board action. While MSF generally accepts NCCI's loss costs, for policy year 2013, MSF proposed and the board adopted four class code deviations from NCCI. These class code deviations include:

- Coal Mining Surface and Driver (53 percent decrease when compared to NCCI's loss costs).
- Log Hauling – All Employees and Drivers (15 percent increase when compared to NCCI's loss costs).
- Stable, Breeding Farms/Riding (31 percent decrease when compared to NCCI's loss costs).
- Hotel/Motel/Dude Ranch/Commissary (16 percent increase when compared to NCCI's loss costs).

Additionally, MSF proposed and the board adopted loss costs for 14 special class codes for which NCCI does not file a loss cost and are unique to MSF. These class codes fell into two general categories:

- Combined code for agricultural producers to eliminate the need to segregate payroll between crops and cattle operations.
- State agencies and municipal governmental entities for ease of payroll reporting.

The loss cost exceptions were reviewed by MSF's consulting actuary who provided a certification that they result in rates that are neither excessive, inadequate, nor unfairly discriminatory.

MSF Adopted New Rate Tier Model for Policy Year 2013

Each workers' compensation insurer develops its own LCM. The LCM is based on each insurer's unique operating expenses, taxes, profit provision, and book of business. Private insurers generally have multiple subsidiary underwriting companies to provide underwriters with pricing flexibility. Therefore, a private insurer will have one LCM for each of its underwriting companies. To allow MSF pricing flexibility similar to private insurers, §39-71-2330, MCA, states the board may implement multiple rating tiers. Therefore, similar to how a private insurer establishes one LCM for each of its underwriting companies, MSF establishes an LCM for each of its five rating tiers.

Administrative rules governing MSF state, upon approval of the board, MSF must establish multiple rating tiers to be applied to all rates with assignment of individual policies to a tier based on factors as approved by the board. At its April 2012 board meeting MSF presented a change in its multiple rating tier process for policy year 2013. The proposed change was based on three years of research and development and MSF working with its consulting actuary. Prior to policy year 2013, the basic structure of the tiered rating process had been in place since fiscal year 2003 and is referred to as Tiered Rating 1.0.

According to MSF, Tiered Rating 1.0, assigned policyholder rate tiers based on whether or not the account was experience rated. If the policyholder was not experience rated, the rate tier assignment was based on a combination of claim incidence and longevity with MSF. MSF believed new statistical modeling tools could improve equity among its policyholders and proposed implementation of Tiered Rating 2.0. MSF's consulting actuary provided a certification letter stating that Tiered Rating 2.0 results in rates that are neither excessive, inadequate, nor unfairly discriminatory. The board unanimously passed the motion to implement Tiered Rating 2.0.

MSF's consulting actuary develops an LCM analysis to assist MSF management and the board in determining LCMs for the underwriting year. While the consulting actuary's analysis included low, central, and high loss projections, the board unanimously approved the central loss projection for policy year 2013. Table 7 illustrates LCMs adopted by the board for each rate tier for policy year 2013.

Table 7
Montana State Fund's Loss Cost Multipliers for Tiered Rating 2.0
Policy Year 2013

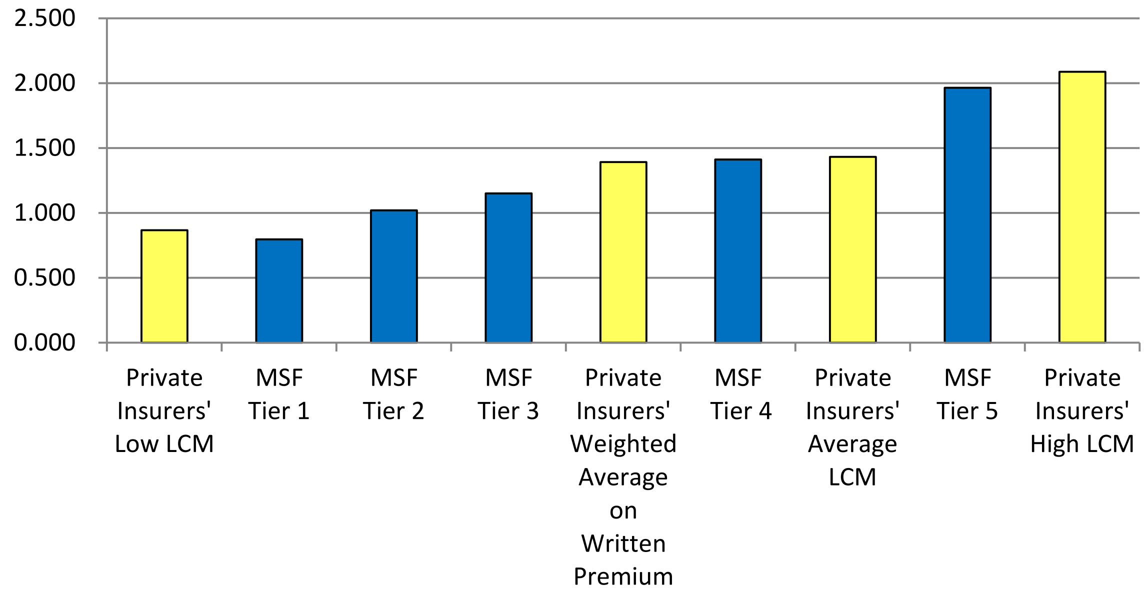
Rate Tier	Board Approved LCM
Tier 1	0.796
Tier 2	1.02
Tier 3	1.15
Tier 4	1.411
Tier 5	1.965

Source: Montana State Fund's Board of Directors meeting minutes, April 27, 2012.

Audit Analysis of MSF's LCMs

Since private insurers are required to file LCMs with the State Auditor's Office, as part of our audit work we reviewed private insurers' LCMs. We conducted an analysis of LCMs to identify whether MSF's LCMs align to some extent with private insurance carriers that write premium in Montana. The following figure shows MSF's LCM for each of its five rate tiers for policy year 2013 as well as the statistics for private insurers that had written premium in Montana for policy year 2012.

Figure 1
Loss Cost Multipliers
MSF (2013) and Montana Private Insurers' Filed LCMs
July 1, 2013



Source: Montana State Fund's Board of Directors meeting minutes and State Auditor's Office data for private insurers.

As illustrated in Figure 1, MSF's Tier 1 LCM is slightly lower than the lowest private insurance company's LCM. The LCM applied to Tier 5 is not higher than the highest private insurance company's LCM. The LCMs used by MSF align similarly to the range of LCMs used by private workers' compensation insurers in Montana. Additionally, the weighted average for private insurers LCMs is comparable to MSF's LCM assigned to Tier 4. Comparative analysis identified no large discrepancies between MSF's and private insurers' LCMs. Additionally, MSF's board approved MSF's LCMs for policy year 2013 as required by administrative rule.

Conclusion

We conclude Montana State Fund's Board of Directors reviewed and approved loss costs and loss cost multipliers in accordance with state law and administrative rules.

Analysis of MSF's Policyholder Rate Tier Assignment

While the loss costs per $100 of payroll are the same for each rating tier, the LCM applied to each rate tier increases or decreases loss costs. Table 8 illustrates the effects of rate tier assignment on policyholder manual premiums.

Table 8
Effects of Rate Tier Assignment on Manual Premium

Rate Tier	Total for Each Class Code Payroll/$100 * NCCI Advisory Loss Costs	MSF Board Approved LCM for PY13	Manual Premium
1	$31,965.00	0.796	$25,444.14
2		1.020	$32,604.30
3		1.150	$36,759.75
4		1.411	$45,102.62
5		1.965	$62,811.23

Source: Compiled by Legislative Audit Division from National Council on Compensation Insurance's loss costs and Montana State Fund's Board approved lost cost multipliers for policy year 2013.

As illustrated in the table, if the policyholder was assigned rate tier 2, their manual premiums would be $32,604. However, if MSF assigned the policyholder rate tier 5, the policyholders' manual premium would almost double to $62,811. The rate tier assignment can have a significant effect on the manual premium assigned to a policyholder. Therefore, we conducted an analysis of MSF's policyholders' rate tier assignment to ensure MSF was assigning rate tiers based on MSF's board approved criterion. The following sections discuss the results of our analysis.

Board Reviewed and Approved Tiered Rating 2.0 Based on Specific Criterion

MSF's board approved Tiered Rating 2.0 for policy year 2013. Based on the board's approval, a policyholder's tier assignment is based on six factors related to their experience and account size. The Final Tier Factor is mathematically derived by multiplying the policyholder's assigned factors together. According to MSF's underwriting guide, the Final Tier Factor determines the rate tier assigned to a policyholder.

Audit Work Determined MSF Adjusts Assigned Policyholder Rate Tiers

To conduct our analysis, we extracted a report from MSF's policy data. Based on this report, there were a total of 25,914 policies issued in policy year 2013. We then analyzed the rate tier assigned to each policyholder by MSF. Based on this review, we identified a total of 229 policyholders that had their rate tier changed by MSF staff following the final rate tier calculation. For these 229 policyholders, nearly 90 percent received a rate tier assignment lower than the final rate tier calculation, decreasing total premiums for these policyholders approximately $1.1 million. The other 10 percent received a rate tier assignment higher than the final rate tier calculation, increasing total premiums for these policyholders by $103,371.

When this was presented to MSF, management indicated a procedure was created for policy year 2013 for new business. While the policy and procedure was not included in MSF's underwriting guide, the procedure established the following criteria:

- Overrides are applicable to policy year 2013 new business only.
- Account size must be in excess of $12,000 to be eligible for override.
- Only historical frequency and months claim free may be considered.

Additionally, documentation procedures state the rate tier calculator worksheet must be used to enter this information, the recalculation worksheet must be included in the electronic file, and a note explaining a tier change occurred is required.

We conducted a random judgmental sample of 30 policyholders out of the 229 policies to determine if the override was applied to a new business as required by MSF's procedure for rate tier overrides. Audit work identified some policies with rate tier changes were not new business as required by MSF's procedures.

Further discussions with MSF management indicated there are other circumstances that occur in which a rate tier change would be warranted. These include a policy being combined with another policy (common ownership), a small policy lapse occurred that affected the rate tier factors, the sale of the business, or an experience modification factor revision. However, MSF has not established specific policy or documented procedures addressing these circumstances. Based on this information we identified 53 percent of the policies we reviewed met MSF's written or unwritten policy for rate tier overrides. However, for the remaining 47 percent of policies we reviewed, the reason for the rate tier change was either not clear (13 percent) or not supported by MSF's management description of allowable rate tier changes (34 percent). Specific examples noted in MSF's files include:

- "One loss driving tier placement, moving to Tier 4."
- "The rate tier was calculated correctly, but it was decided to change the rate tier based on the prior history."
- "Due to experience and longevity."

Additionally, only 50 percent of the policies we reviewed in our random sample had a rate tier calculator worksheet included in the electronic file as required by policy. Since this documentation was not included in the file, we could not identify which factors were changed to warrant the change in rate tier assignment.

Controls Over Rate Tier Changes Could Be Improved

Further discussions with MSF management indicated when MSF changed its tier rating structure to Tiered Rating 2.0, there were unintended consequences for some policyholders, but these changes were never meant to be punitive or cause undue hardship for policyholders. Additionally, MSF states Administrative Rule 2.55.311, which is approved and adopted by the Board, allows for rate tier changes to occur. While Administrative Rule 2.55.311 does allow policyholders to be placed in a higher or lower rated tier, it does not limit the circumstances in which MSF could apply a rate tier change. The broad discretion given to underwriters to change rate tier assignments under the administrative rules contrasts with the narrow and specific circumstances identified by MSF management as necessitating such changes. Although the rules undoubtedly provide MSF underwriters with flexibility, there are legitimate concerns regarding balancing this flexibility with equitable treatment of policyholders.

One example of how an insurer could approach the issue of rate tier assignments can be identified for Colorado's guaranteed workers' compensation insurer, where underwriters do not have the ability to determine the role, or weighting, the risk factors have in the rate tier consideration. Underwriters also do not have the ability to override or move policies into different tiers. Doing so, according to Colorado, would violate numerous filings with the Department of Insurance and would be considered a discriminatory practice. In addition, Colorado's approach is not individualized to specific risks but rather looks at the aggregate performance of credible risk pools, and individual tier movement impacts the integrity of its tier structure. Although the approach taken in Colorado may not be appropriate for MSF, it illustrates the importance of tier rating assignments and providing for strong controls over the process.

As discussed previously, rate tier assignment can significantly impact the manual premium paid by a policyholder. While MSF is working with its actuaries and indicates the tiered rating process will continue to be adjusted and refined as additional research is conducted, we believe MSF should work with its board to review and clarify previous Administrative Rules to ensure it aligns with the intention of Tiered Rating 2.0. Additionally, MSF should clarify its underwriting policy and procedures regarding rate tier changes to better ensure directives of its board are met and equitable treatment to policyholders occurs.

Recommendation #1

We recommend Montana State Fund:

A. *Comply with existing policy regarding documentation of rate tier overrides,*

B. *Clarify underwriting policy and procedures regarding rate tier overrides,*

C. *Develop policy and procedures to ensure rate tier overrides are applied equitably across policy holders, and*

D. *Work with the Board of Directors to determine whether revisions to Administrative Rule 2.55.311 are necessary to ensure equitable treatment to policy holders.*

CHAPTER IV – Montana State Fund's Modifiers to the Manual Premium

Introduction

While manual premium is the starting point for premium calculation, modifiers tailor the manual premium to an individual employers' circumstances. Montana State Fund (MSF), as well as private insurers have various adjustments and/or programs that can either increase or decrease policyholders' manual premium. One of the audit objectives was to determine whether MSF calculates policyholders' premiums and discounts using consistent methodology and in accordance with state law; board and MSF policy; and administrative rules. This chapter discusses various modifiers MSF uses to calculate a policyholder's overall premium and presents results of our audit work. In addition, MSF uses several computer systems to assist with administering policyholder accounts and premium payments. Results of our audit testing of these systems is also discussed.

Standard Premium Calculation

The standard premium is calculated when the experience modification factor is applied to the manual premium. However, MSF has two additional factors that apply to the standard premium. These factors are the employer's liability and the medical deductible discount factor. Audit work completed to review these factors as well as the experience modification factor are discussed in the following sections.

Employer's Liability

Administrative Rule 2.55.328 permits MSF, upon approval of the MSF's board of Directors (board), to provide employer's liability insurance as part of the workers' compensation policy. The National Council on Compensation Insurance (NCCI) publishes the available limits of liability and minimum premiums for use by workers' compensation insurers. Employer's liability insurance is intended to protect an employer from legal liability arising out of employee injury for limited situations when an employee may have a tort claim outside of the Workers' Compensation System. While the basic employer's liability insurance is included in all MSF policies, the board also approved increased limits of employer's liability to be made available at an additional charge. Therefore, if the employer elects to have increased coverage, a charge is added to the manual premium. For policy year 2013 we identified 3,599 policyholders elected to increase their limits of liability with an average increase to premium of approximately $700.

Medical Deductible Discount

Administrative Rule 2.55.402 permits the medical deductible program. The program is an optional policy program in which policyholders are able to lower their premium if they pay a portion of the medical costs of each claim filed in a policy year. Similar to health insurance, the policyholder is responsible for medical costs until the deductible is fulfilled. For policy year 2013, 11 policyholders elected to participate in the medical deductible program which resulted in an average $900 decrease in their premium.

Experience Modification Factor

Administrative Rule 2.55.401 states that an experience modification factor is based on the formula of an advisory or rating organization and that MSF shall use the methods used by the workers' compensation advisory organization to identify a qualified insured and determine the insured's experience modification factor. As discussed in Chapter II, experience modification factors are determined by NCCI. Therefore, regardless of whether a policy is written by MSF or another private insurance company, the policy is assigned the same experience modification factor. Based on our review of experience modification factors, approximately 25 percent of MSF's policyholders are experience rated. Experience modification factors assigned to MSF's policyholders for policy year 2013 ranged from .61 to 3.5 with 70 percent of experience rated policyholders receiving an experience modification factor that decreased their manual premium.

Audit Analysis of Standard Premium

While employer's liability and the medical deductible discount modify manual premium, the experience modification factor generally has a more significant impact on manual premium. Therefore, we analyzed policy year 2013 data for all MSF policyholders to identify if there were any anomalies in premium calculation when the experience modification was applied. For example, if a policy experience modification factor was less than one, we would expect to see the manual premium decrease and vice versa.

Based on this analysis, we identified 367 policies that did not meet this criterion. However, after reviewing a sample of these policies, we determined all policyholders in the sample had mid-year changes to their experience modification factor that aligned with the premium calculation. Therefore, we were able to obtain reasonable assurance that MSF's policyholders' premium is modified appropriately based on employer's liability, medical deductible discount, and experience modification factor data located on MSF's policy holder system.

CONCLUSION

We conclude Montana State Fund calculates standard premium based on factors input on the policy holder system.

Audit Analysis of Experience Modification Factor

While we conclude MSF accurately applies the standard premium based on factors input on the policy holder system, we conducted an additional analysis to ensure NCCI's assigned experience modification factors were entered into the policy holder system accurately by MSF staff.

To determine whether MSF accurately applied NCCI's assigned experience rating factors to policyholders we examined a random sample of 47 policyholders that were experience rated for policy year 2013 and a random sample of 47 policyholders that were not experience rated for policy year 2013. Therefore, we sampled a total of 94 policyholders.

Experience Modification Factor Affects Both the Assigned Rate Tier and Premium Calculation

The experience modification factor can potentially affect MSF's policyholders premiums in two ways. First, the experience modification factor is used to establish a policyholders' assigned rate tier (the assigned rate tier ultimately affects the loss cost multiplier (LCM) applied to a policyholder's manual premium calculation). Secondly, the experience modification factor is applied to manual premium to calculate the policyholder's standard premium. Since both determinations have a significant impact on a policyholder's premium, it is important MSF assigns the correct experience modification factor to policyholders.

Since the experience modification factor affects both the rate tier assignment and the standard premium calculation, we tested whether MSF applied the correct experience modification factor for both determinations. According to MSF's underwriting guide, the first experience modifier in effect for the policy period should be applied when calculating rate tiers. Therefore, we tested the experience modification factor used to calculate the rate tier for our sample of 94 policyholders. Our review identified MSF did not apply the first experience modifier in effect for the policy period when calculating the rate tier for five of the 94 sampled policies. Since rate tier assignment affects the manual premium calculation, if the correct experience modification factor is not used when determining the rate tier, policyholders could be charged improper premium amounts.

We then tested whether MSF applied the correct experience modification factor to the manual premium when calculating policyholders' standard premium. For our sample of 94 policyholders we determined MSF applied the correct experience modification factor when calculating standard premium.

Audit Work Determined Improvements to Experience Modification Factor Assignment Needed

As described in MSF's underwriting guide, rate tiers are established 60 days prior to the policy renewal date. Therefore, when MSF captures the experience modification factor for rate tier calculation, in some cases, the first experience modifier for the policy period was not captured. In these cases, it was generally due to MSF receiving NCCI's experience modification factor letter subsequent to the rate tier being calculated. MSF currently does not have a control in place to identify these policyholders.

Based on our analysis, the majority of policyholders' experience modification factors were accurately assigned to establish rate tiers. However, to ensure all policyholders' rate tiers are accurately assigned, MSF should establish additional controls over its experience modification factor assignment when calculating rate tiers. By doing so, MSF would have better assurance that policyholders' premium is accurately calculated.

Recommendation #2

We recommend Montana State Fund comply with policy by establishing additional controls to ensure the first experience modifier for a policy period is applied when calculating policyholder rate tiers.

Audit Analysis of Modified Standard Premium

Modified standard premium is calculated when the scheduled rating factor is applied to the standard premium. In addition to the scheduled rating factor, MSF also applies a construction industry credit factor. Both of these factors will be discussed further in the following sections, but the major factor in the calculation change between the standard premium and the modified standard premium is the scheduled rating factor. Therefore, we analyzed policy year 2013 data to ensure the standard premium is accurately increased and/or decreased based on the factors input on the policy holder system.

To conduct this analysis, we reviewed policy year 2013 data to identify if any policyholders realized an increase in premium for policy year 2013 from standard premium to modified standard premium. If this occurred, the policy should have received a scheduled rating factor that debited their policy (scheduled rating factor greater than 1). Based on this analysis, we determined all policyholders with an increase between standard premium and modified standard premium had a scheduled rating factor debiting their policy.

We then analyzed the policy year 2013 data to determine if any policyholders realized a decrease in premium for policy year 2013 from standard premium to modified standard premium. If this occurred, the policy should have received a scheduled rating factor that credited their policy (scheduled rating factor less than 1). Based on this analysis, we identified six policyholders with a decrease in premium between the standard premium and the modified standard premium that had a scheduled rating factor debiting their policy. However, additional work revealed these policyholders had a construction credit applied that offset the scheduled rating factor. While both the construction credit and the scheduled rating factors are discussed further in the following sections, we determined policyholders' modified standard premium is accurately increased or decreased based on the factors entered into the policy holder system.

Conclusion

We conclude Montana State Fund accurately calculates the modified standard premium based on factors input on the policy holder system.

Construction Industry Premium Credit Program

The construction industry premium credit program was developed, in part, to recognize the premium inequity that can occur in the construction industry. This industry has a large range of wages paid by employers in which some employers are paying higher wages and others paying lower wages. Because premiums are based on payroll, employers paying higher wages paid higher premiums; however, the higher premium does not necessarily correspond to higher risk. Therefore, a credit is offered to employers paying wages that are higher than the weekly wages for class codes in the construction industry.

Administrative Rule 2.55.327A requires MSF to offer a program for employers in the construction industry paying wages 1.168 times or more of the state's average weekly wage. This average is determined by the Department of Labor and Industry each fiscal year. In policy year 2013, there were 4,277 policyholders eligible to apply for the construction premium credit based on eligible construction class codes. There were 667 policyholders that applied for and received the credit. The standard premium for these policyholders totaled $14.9 million and credits totaled $1.2 million. For policy year 2013, the average construction premium credit was approximately 8 percent of the standard premium.

NCCI and the Construction Premium Credit Program

For policy year 2013, MSF's board adopted its own construction industry premium credit program rather than adopting the Construction Credit Premium Adjustment Program developed by NCCI. MSF determined that NCCI's construction credit was not transparent enough. Additionally, the program could only be administered by NCCI at the cost of $25 per application. MSF has made the formula for the credit available to the public and administers the program.

Application Process

MSF sends policyholders with eligible construction class codes a Construction Industry Premium Credit Application three months prior to the policyholders' renewal. In order to qualify for the construction premium credit in policy year 2013, the average hourly wage was required to be over $18.95 and at least 50 percent of the policyholders' manual premium was required to be attributable to one or more of the eligible construction class codes. Administrative Rule 2.55.327A(2)(b) states policyholders must "apply for the premium credit program and submit the completed and signed application form by the stated due date on the application form." MSF policy allows for an additional seven-day grace period to receive the applications.

Audit Analysis of the Construction Premium Credit Program

To test compliance with administrative rule and MSF policy, we reviewed a statistical sample of 47 policyholders eligible for the construction premium credit program based on eligible construction class codes. Testing showed six percent of the sampled policyholder applications were incorrectly screened for eligibility.

- One application was erroneously denied for being received after the due date. The application was due October 4, 2012, and MSF received the application September 19, 2012. This policyholder did not receive a 24.56 percent credit.
- One application was initially erroneously denied for being received after the due date. The application was due October 31, 2012, and was received that day. This application was later accepted because the policyholder called MSF. If this policyholder had not contacted MSF, they would not have received a 7.53 percent credit.

- One application was correctly denied because it was received after the due date. The application was due August 1, 2012 and was received via fax on August 10, 2012. This application was later accepted because the "employer called very upset." According to administrative rule 2.55.327A(2)(b) and MSF policy, this policyholder should not have received a 22.43 percent credit.

Discussions with MSF management indicate the construction premium credit applications are received by customer service specialists and the information is entered into the system. These applications are received by MSF at the same time other documents related to policy renewal are being received, such as payroll reports. The manual processing of a high volume of paperwork may have led to errors when applying the credit.

Controls Over Eligibility Screening Could Be Improved

MSF could strengthen controls around its application process to help ensure applications are correctly screened for eligibility. For example, supervisory staff could review denied applications to ensure they were not erroneously denied. Additionally, supervisory staff could review disputed applications. By strengthening controls over the application process, MSF could ensure compliance with Administrative Rules and MSF Policy and that the construction premium credit is correctly applied to policyholders.

Recommendation #3

We recommend Montana State Fund:

A. *Strengthen controls over its Construction Industry Premium Credit Application process, and*

B. *Comply with Administrative Rule 2.55.327A(2)(b) and Montana State Fund policy by only accepting construction premium credit applications if they are submitted by the stated due date.*

Scheduled Rating Factor

Scheduled rating factors allow for insurers to increase or decrease a policyholder's premium for conditions unique to the employer (e.g. automated work environment, safety officer on staff, etc.). While scheduled rating factors are not available in all states, in Montana, the State Auditor's Office allows private insurers the ability to increase or decrease premiums by no more than plus or minus 40 percent through scheduled rating.

Administrative Rule 2.55.406 states MSF may modify the premium for an insured to acknowledge characteristics of the business that are not reflected in its experience. Such characteristics may include but are not limited to the condition of the insured's premises and work sites, peculiarities of classification, medical facilities, safety devices, employees, and management. Additionally, Administrative Rule 2.55.406 states all scheduled rating debit and credit modifiers shall be based on evidence contained in the file of MSF at the time the scheduled rating modifier is applied.

MSF's underwriting guide aligns with administrative rules and further states that the factor must be substantiated using the scheduled rating worksheet and must be entered into the Risk Evaluation Tool. The Risk Evaluation Tool is a computer application, outside of the policy holder system, in which underwriters can apply scheduled rating factors to a policy. Once the underwriter applies and issues the quote, the scheduled rating factor is applied in the policy holder system.

MSF is not limited to scheduled rating factors greater than plus or minus 40 percent. However, MSF's underwriting guide establishes authority levels within MSF. These include:

- Underwriter – up to a 25 percent credit or a 100 percent debit.
- Business Unit Director (BUD) – 25 to 50 percent credit or greater than a 100 percent debit.
- Vice President of Operations – greater than a 50 percent credit or greater than a 200 percent debit.
- Underwriting Services Leader – consult on greater than 50 percent credit or greater than 100 percent debit.

MSF's Application of Scheduled Rating Factors

As part of the audit, we examined MSF's use of scheduled rating factors and compliance with related administrative rules and policy. We extracted all of MSF's policyholders with an assigned scheduled rating factor applied to their policy. For policy year 2013, approximately 3.5 percent of 25,914 policyholders were scheduled rated. For these policyholders, 27 percent received a scheduled rating factor greater than 1, increasing their premium an average of $11,000 and 73 percent received a scheduled rating factor less than 1, decreasing their premium an average of $6,700.

Since private insurers can not apply a scheduled rating factor greater than plus or minus 40 percent, we identified all of MSF's policyholders with a scheduled rating factor greater than plus or minus 40 percent. For policy year 2013, MSF wrote two policies that received greater than plus or minus 40 percent scheduled rating factor.

One policy received a 48 percent debit, increasing their premium by $33,849 and the other received a 76 percent debit increasing their premium by $17,446. We further reviewed MSF's file documentation regarding the applied scheduled rating factors and determined MSF followed its policy regarding these policies.

Audit Analysis of Scheduled Rating Factors

For the remaining scheduled rating factors that were 40 percent or less, we conducted a random statistical sample of 47 policies. Similar to our review of policies with greater than 40 percent, we reviewed MSF's file documentation regarding the applied scheduled rating factors to ensure the underwriter had documented the scheduled rating factor in the risk evaluation tool, notes substantiated the rating factor being applied, and MSF's authority levels were followed. Based on our analysis we identified:

- 3 policyholders received over a 25 percent credit; however, we did not identify documentation showing review and/or approval from a BUD had occurred.
- 1 policyholder did not have a scheduled rating worksheet in their file as required by MSF policy.

The following table shows the scheduled rating factor applied, the percentage increase or decrease, and the amount in which it changed premium for these four policyholders.

Table 9

Effect of Scheduled Rating on Premiums

Policyholder	Scheduled Rating Factor	Percent Increase or Decrease	Effect on Premium
1	0.7	-0.30	$ (37,388)
2	0.7	-0.30	(84,623)
3	0.7	-0.30	(153,703)
4	0.9	-0.10	(875)
Total Adjustments			**$ (276,589)**

Source: Compiled by Legislative Audit Division using Montana State Fund's policyholder data for policy year 2013.

As can be seen in the table, scheduled rating can have a significant impact on the premium a policyholder pays. Based on our review it is unclear whether the appropriate authority level (as defined by MSF policy) reviewed and/or approved the applied scheduled rating factor.

Improvements to MSF's Policy for Scheduled Rating Factors Needed

While policy states the authority levels for scheduled rating debits and credits, it does not clearly state how the authority should be documented. MSF management expressed underwriters use their judgment when underwriting accounts and therefore management would not have any more knowledge about the policy than the underwriter. Since MSF has established specific authority levels within its policy related to schedule rating and scheduled rating can significantly effect a policyholders' premium, documentation should exist to support supervisory review. By clarifying policy, MSF will be better able to ensure policy has been met and equitable treatment of its policyholders occurs.

RECOMMENDATION #4

We recommend Montana State Fund:

A. *Comply with policy that requires documentation of scheduled rating factors, and*

B. *Clarify policy regarding what is required in documenting supervisory review and approval.*

Volume Discount

Administrative Rule 2.55.403 allows MSF to establish a volume discount based on premium volume. Most insurance companies offer a volume discount to recognize the fixed costs for larger policyholders are relatively the same as for small policyholders so larger policyholders' premiums can be reduced. The MSF board adopted a volume discount program for policy year 2012 which is detailed in the following table.

Table 10
Montana State Fund's Volume Discount Program

Premium Threshold	Discount Percentage	Number of Policyholders	Discount Amount	Average Discount
$0–$12,000	0%	23,795	$0	$0
$12,001–$150,000	5%	2,243	$2,161,842	$964
$150,001–$750,000	7%	93	$1,325,898	$14,257
>$750,000	9%	8	$1,163,667	$145,458

Source: Compiled by Legislative Audit Division from Montana State Fund's Board of Directors May 20, 2011 meeting minutes and Montana State Fund's policyholder data for policy year 2012.

During the audit, we tested compliance with administrative rule and board policy for applying volume discounts in policy year 2012. We examined 26,139 policyholders of which 2,344 policyholders received a volume discount. Our review determined the volume discount for policyholders that received it was calculated correctly and policyholders that did not receive the discount were correctly excluded based on the criteria established by the board.

CONCLUSION

We conclude Montana State Fund is applying volume discounts in accordance with administrative rules and policy established by the Board of Directors.

MSF's Systems Used to Assist In the Calculation of Premiums

To assist in the administration of policyholder accounts and premium payments, MSF maintains and operates a computer system called the Policy Holder System (PHS). Additionally, in 2006 MSF sought to obtain an overall business intelligence solution that would provide a single, integrated view of its policyholder data. According to MSF, it needed an application for its staff to track trends and anomalies related to pricing, policy retention, and other operational activities. To carry out this functionality, MSF's Insurance Intelligence (II) system went into production in 2009. PHS data is extracted, transformed, and loaded into MSF's II system on a recurring basis.

Audit Work Reviewed MSF's Extract, Transform, and Load Process

Since MSF's business users use and rely on the II system to analyze policyholder data we reviewed MSF's process used to extract, transform, and load (ETL) PHS data to the II system. During the audit, we examined this process to ensure accuracy of data on the II system. Based on our review, we determined MSF currently has mappings of the ETL processes. Mappings are technical drawings and spreadsheets. However, MSF does not have detailed policy and procedures on how to perform the process. This makes it difficult for MSF staff to decipher what tasks should be conducted when the ETL process takes place.

MSF currently has written procedures for other IT processes but not for the ETL process. Additionally, industry standards establish the basis for documenting the procedures of applications processes. These standards maintain system documentation should be completed prior to implementation to ensure:

- Users are aware of their new responsibilities prior to implementation.
- Adequate reference material is available to users, operations personnel and programmers, including:
    - ◊ User manuals, which may include business rules and processing, balancing and reconciliation procedures, input processing, error correction procedures, and a summary of system output and disposition.
    - ◊ Operations manuals, which may include abend procedures, backup schedules, batch schedules, interface listing and procedures, on-call lists, and escalation procedures.
    - ◊ Programmer manuals, which may include listing and descriptions of programs, screen layouts, and file/database descriptions.

Controls Over the Extract, Transform, and Load Process Could Be Improved

Since MSF does not currently have detailed policy and procedures regarding the ETL process, it relies on its staffs' institutional knowledge. Institutional knowledge may not be consistent over time and can lead to deviations in how processes are completed. Written procedures of the ETL process would provide documentation for both nontechnical and technical users. Additionally, written documentation would decrease potential errors that could occur in the process, provide guidance on how to resolve system problems if encountered, and enable critical processing to continue.

MSF staff continue to work on the data architecture of the II system and therefore, developing written procedures for the ETL process has not been prioritized. By implementing written procedures documenting the ETL process, MSF would be better able to ensure MSF's employees can perform their responsibilities and data used by MSF's business users is accurate.

Recommendation #5

We recommend Montana State Fund develop written procedures for the Extract, Transform, and Load (ETL) process.

Risk Evaluation Tool Used to Apply Scheduled Rating Factors

As stated earlier, MSF staff utilize a computer application referred to as the Risk Evaluation Tool. The Risk Evaluation Tool is an electronic application outside of PHS used to apply scheduled rating factors to policies. MSF staff can currently use the risk evaluation tool to issue and adjust the scheduled rating factor, changing the final premium calculation. The Risk Evaluation Tool is also used to document underwriter's notes regarding an underwritten policy.

Review of the Risk Evaluation Tool

During audit work, we reviewed MSF's Risk Evaluation Tool and identified while the Risk Evaluation Tool documents the underwriting process and records when and how a policy was underwritten, all staff including underwriters, the underwriting lead supervisor, and customer service specialists currently have access to issue and adjust a policyholder's scheduled rating factor. Additionally, MSF staff can currently bypass the scheduled rating notes function in the Risk Evaluation Tool.

According to MSF staff when the Risk Evaluation Tool was initially developed, it was developed to replace a decentralized documentation process (e.g. hard-copy documentation located at each underwriter's desk). By establishing the Risk Evaluation Tool, MSF was able to provide a centralized documentation process that could be easily accessed by management. When the tool was initially developed, access controls were not a priority.

As discussed above, MSF's underwriting guide requires underwriters to provide documentation that supports the applied scheduled rating factor. This documentation is housed in the Risk Evaluation Tool. Additionally, industry standards maintain an organization should employ the concept of least privilege. This allows only authorized access for users (and processes acting on behalf of users) which are necessary to accomplish assigned tasks.

Controls Over the Risk Evaluation Tool Could Be Improved

As discussed in the previous sections, scheduled rating can significantly affect a policyholder's premium. Since MSF's Risk Evaluation Tool can currently be accessed and updated by staff other than underwriters, MSF staff without authority can issue and apply scheduled rating to a policy. By implementing access controls to its Risk Evaluation Tool, MSF will be better able to ensure only users with the authority level to issue underwritten policies are applying scheduled rating factors. Additionally, one policyholder out of our random sample of 47 did not have a risk evaluation worksheet supporting the scheduled rating factor. Therefore, by requiring the scheduled rating note field include documentation, MSF would be better able to ensure documentation for scheduled rating factors is included in the Risk Evaluation Tool.

RECOMMENDATION #6

We recommend Montana State Fund strengthen controls over the risk evaluation tool to ensure:

A. *Application of scheduled rating factors is restricted to staff assigned the authority, and*

B. *Notes are mandatory and included in the risk evaluation tool for policies with a scheduled rating factor.*

CHAPTER V – Montana State Fund's Premium Returns

Introduction

Montana State Fund (MSF) offers premium returns to qualified policyholders through retrospectively rated plans, group business plans, and dividends. One of the audit objectives was to determine whether premium returns were applied to individual policyholders equitably and in accordance with state law, administrative rules, and policy established by the Board of Directors (board) and MSF. This chapter presents the results of our audit work.

Retrospectively Rated Plans

Retrospectively Rated Plans allow policyholders to retain some of the risks associated with workers' compensation insurance so they can potentially pay a lower premium than the premiums paid by traditional workers' compensation plans that guarantee the coverage of the cost of claims. A policyholder may receive a premium return if losses are managed and kept low or pay additional premiums if the losses are high. Premium returns are calculated by evaluating losses, typically 18, 24, or 36 months after the start of the policy year.

Board Reviewed and Approved Retrospectively Rated Plan Factors

Administrative Rule 2.55.408 allows MSF to offer retrospective rating plans. To qualify for participation in a plan the employer or group shall:

- Be selected by MSF pursuant to criteria established by the board, and be provided a written proposal for a MSF retrospective rating plan.
- Execute an agreement with MSF.
- Have an annual estimated employer or group earned premium that equals or exceeds an amount determined by the board.

Many factors approved by the board are established as ranges to allow MSF underwriters and policyholders to determine the level of risk each is willing to accept. In addition to the factors approved by the board, underwriters must determine other factors such as the expected future losses based on the prior loss history. All of these factors are compiled in the retrospective rating model to determine the premium returns or additional premiums due once losses are evaluated.

Analysis Identified Controls Could be Strengthened

We reviewed policy year 2011 retrospectively rated plans because this was the most recent year with premium returns. Ten policies were retrospectively rated in policy year 2011. The written premium for these plans totaled $4.6 million. Seven policyholders received premium returns that totaled $737,181 and three policyholders were required to pay additional premiums totaling $138,141. The following table provides details on the premium returns and additional premiums paid by policyholders.

Table 11

Premium Changes for Retrospectively Rated Plans

Policyholder	Premium Returns (Additional Premium Paid)	Loss Ratio	Return Ratio
1	$89,869	0%	55%
2	$4,071	3%	35%
3	$71,478	7%	37%
4	$25,333	14%	25%
5	$245,919	15%	39%
6	$208,225	24%	22%
7	$22,288	29%	5%
8	($43,063)	36%	-16%
9	($8,169)	43%	-1%
10	($86,909)	110%	-30%

Source: Compiled by Legislative Audit Division using Montana State Fund's policyholder data for policy year 2011.

As shown in the table, the premiums returned and additional premiums paid generally align with policyholders' losses. They do not align fully with the losses because there are many factors included in the calculation that depend on the risk MSF and the policyholders' are willing to accept.

When conducting our analysis of retrospectively rated plans, we identified one out of the ten policies included a factor not approved by the board. The calculated retrospective premium return for this policyholder was $89,868. While the board allows the President to adjust this specific factor to take into consideration costs not generally included in the factor, we were unable to determine if the President approved this adjustment. Additionally, because MSF lacked sufficient documentation, we were unable to determine the dollar effect on the amount of premium returned. However, we were able to determine if the factor approved by the board was used instead of the adjusted factor, the retrospective premium return would have decreased.

While conducting our analysis, we also identified five of ten retrospectively rated policies did not have complete documentation on the factors used by the underwriters. There are several worksheets in the retrospective rating model. These worksheets include important information regarding the factors used by the underwriters but were not included in the documentation.

Clear Guidelines for Documenting Retrospectively Rated Plans Needed

Many factors must be judgmentally determined by underwriters when developing retrospectively rated plans. While the board provides guidance by approving factors, many of these factors are a range of values and other factors require underwriter judgment. Management indicated the expectation was this documentation should have been included; however, there is no policy for documentation requirements.

Without clear documentation on the factors used, it is difficult to determine how the plans were calculated and allow for management review of these plans. By strengthening its controls, MSF would be better able to ensure that retrospectively rated plans are accurately calculated and comply with board policy.

Recommendation #7

We recommend Montana State Fund establish procedures for documenting retrospectively rated plans and obtaining approval from the President/CEO.

Group Business Plans

Group business plans are typically formed by an agreement between group associations and MSF. All group plans have established business rules that policyholders must meet to be included in the group. This criterion can include items such as eligible loss ratios, eligible experience modification factors, eligible class codes, safety requirements, or exclusive agents. Group business plans are similar to retrospectively rated plans because there is an evaluation of losses to determine if premiums can be returned; however, unlike retrospectively rated plans, there are no additional premiums due for group business plans that have losses that are greater than expected.

Premium Returns for Group Business Plans

Group business plans have an evaluation period at a specified time after the end of an accident year. At this time the group's premiums and losses are examined. If the group meets the criteria established in the group contract, the premium return available for the group is calculated. The premium return for the group is then divided between individual policyholders based on individual premiums paid and losses. If an individual policyholder within the group has higher losses, they may not receive a premium return even though the group as a whole qualified.

Table 12

Montana State Fund's Group Business Plans

Group Business Plans	Number of Policyholders
Agricultural	471
Auto Dealers	88
Construction Industry	368
Food Distributors	87
Independent Businesses	1,256
Small Businesses	917
State Agencies	36
Timber Industry	195

Source: Compiled by Legislative Audit Division using Montana State Fund's policyholder data for policy year 2011.

We reviewed policy year 2011 group business plans because this was the most recent premium returns for these plans. Table 12 provides examples of group business plans at MSF during policy year 2011.

There were two groups that received premium returns in policy year 2011. The Montana Small Business Group received premium returns totaling \$363,047 and State Agencies received premium returns totaling \$263,542.

Analysis of Group Business Plans

We reviewed contracts and business rules for group business plans. Four out of the six contracts reviewed did not clearly establish if policyholders should be evaluated on eligibility requirements upon renewal or whether MSF or the association was responsible for performing the evaluation. Two of the group contracts have clear criteria outlined in their contracts with MSF including:

- Establishing who is responsible for determining eligibility requirements for policyholders upon renewal.
- Defining eligibility requirements that apply during policy renewal.
- Establishing guidelines for the distribution of premium returns among policyholders.

Our review examined group business plans to determine if any policyholders did not meet criteria established by the group business rules and found:

- Two policyholders did not qualify based on eligibility requirements specific to class codes for one group.
- Fifteen policyholders did not qualify based on eligibility requirements specific to experience modification factors for three of the groups.

According to MSF staff, group business rules are agreed upon with the group associations' board. MSF evaluates policyholders in accordance with the criteria established in the group business rules at the time a policyholder submits an application to join a group. Some groups have chosen to eliminate policyholders that no longer meet the eligibility requirements on renewal, while other groups have chosen to not eliminate these members. However, based on the lack of clear guidelines on eligibility requirements upon renewal for group plans, we were unable to determine if policyholders that no longer meet eligibility requirements should be included or excluded from the group plans.

If members do not meet eligibility requirements of the groups subsequent to their initial application, their actions have the potential to cause other members of the group to not receive premium returns or receive decreased premium returns. Many of the eligibility requirements for group plans are factors that reflect the safety record of a policyholder. Policyholders that no longer meet the eligibility requirements may have a higher potential to have losses that exclude the entire group from receiving a premium return.

Responsibility for Eligibility Screening Should Be Clarified

While management indicated groups have elected whether or not to continue to reevaluate their membership, there are no clear policies or procedures. By clarifying policy and procedures on group business plans regarding responsibilities in reviewing eligibility requirements of members, MSF can better ensure that the group business plans are working as intended.

Recommendation #8

We recommend Montana State Fund clarify policies and procedures for group business plans to establish responsibilities regarding reviewing eligibility requirements upon renewal.

Dividends

Since workers' compensation claims are difficult to estimate because of their long-term nature, it can be difficult to establish premiums that are neither more nor less than self-supporting. If equity increases to a level that exceeds the estimated cost of covering claims, dividends are one method MSF can use to maintain their nonprofit status. Section 39-71-2316(1)(h), MCA, allows MSF to "declare dividends if there is an excess of assets over liabilities. However, dividends may not be paid until adequate actuarially determined reserves are set aside."

Determination of Dividends

During the November 16, 2012 board meeting, the board approved a declaration of dividends of approximately $10 million for policyholders in policy year 2010 after considering the review completed by the contracted actuary. Dividends were calculated for individual policyholders by using the amount of premiums paid and the loss ratio of a policyholder provided the policyholder had at least six months of continuous coverage. The following table provides details on the dividends paid to policyholders for policy year 2010.

Table 13
Dividends Declared for Policyholders in Policy Year 2010

Premium Threshold	Policyholders	Total Dividends	Average Dividend
$0–$2,000	15,143	$668,091	$44
$2,001–$4,000	4,205	$726,042	$173
$4,001–$6,000	2,173	$656,080	$302
$6,001–$9,000	1,726	$765,458	$443
$9,001–$13,000	1,210	$807,899	$668
$13,001–$18,000	847	$793,877	$937
$18,001–$25,000	600	$751,643	$1,253
$25,001–$35,000	409	$706,253	$1,727
$35,001–$50,000	304	$756,699	$2,489
$50,001–$70,000	179	$630,306	$3,521
$70,001–$100,000	153	$777,877	$5,084
$100,001–$150,000	93	$582,084	$6,259
$150,001–$300,000	75	$655,037	$8,734
$300,000–$1,000,000	24	$466,352	$19,431
Greater than $1,000,000	5	$261,513	$52,303

Source: Compiled by Legislative Audit Division using Montana State Fund's policyholder data for policy year 2010.

We examined MSF's methods for issuing dividends to ensure state law, administrative rule, and MSF board directives were followed. We reviewed 27,146 policyholders in policy year 2010. Of these policies, 23,884 policyholders (88 percent) received dividends. We reviewed the loss ratio and calculated dividends based on the dividend table approved by the board and found that dividends were calculated correctly.

Conclusion

Montana State Fund issued dividends in accordance with state law, administrative rule, and Board of Directors policy.

CHAPTER VI – Effects of HB 334 on Policyholder Premiums and MSF's Incentives

Introduction

During the 2011 Legislative Session, the Legislature enacted several changes to Montana's workers' compensation system by passing House Bill 334 (HB 334). As a result of these legislative changes, workers' compensation loss costs were expected to decrease approximately 22 percent. One of our objectives was to determine whether HB 334 and Montana State Fund's (MSF) subsequent changes to premium calculations affected policyholder premiums and subsequently MSF's incentive programs. This chapter defines how MSF's application of these changes affected overall premiums and presents the results of our audit work.

Effects of HB 334 Changes on MSF's Premiums

HB 334 was passed with an implementation date of July 1, 2011. As discussed in Chapter III, the National Council on Compensation Insurance (NCCI) develops advisory loss costs for Montana insurers, including MSF. Loss costs are claim expenses and do not include general expenses such as overhead, taxes, or profit. NCCI had initially filed a loss cost reduction of 5.6 percent on average for fiscal year 2012. Following the passage of HB 334, NCCI issued a second filing that resulted in a combined reduction on average loss costs of 26.7 percent. Since it is an average loss cost reduction, some class codes received more and others received less than a 26.7 percent reduction.

MSF's Board Adopted NCCI's Loss Costs

While MSF must adopt NCCI's loss costs, under administrative rules, the board has the option to use the latest NCCI filing or to revert back to the previous year's filing if the loss cost filing is known to be defective. As discussed earlier, NCCI loss costs are on standing approval and therefore, unless the board chooses to do otherwise, no action is needed by the board to adopt NCCI's latest loss cost filing. Therefore, MSF adopted NCCI loss cost filing as amended on April 25, 2011. This filing included the combined reduction of average loss costs of 26.7 percent.

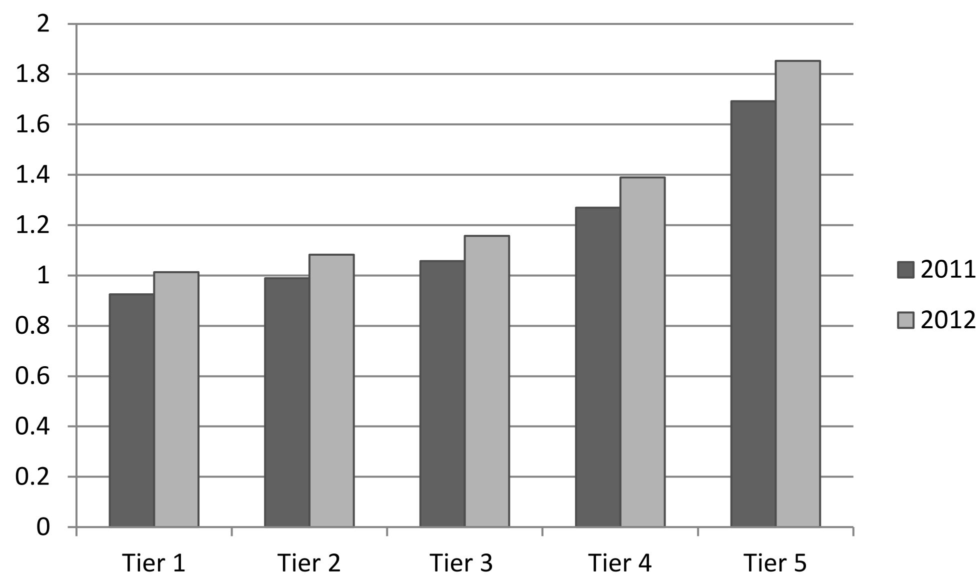
MSF's Board Adopted Overall Decrease for Class Code Deviations

MSF has special class codes for which NCCI does not file loss costs and are unique to MSF. These class codes fall into the two categories of a combined code for agricultural producers, and state agencies and municipal government entities. For the 13 class codes related to state agencies and municipal government, MSF's board, on May 20, 2011, approved loss cost decreases ranging from 15.5 percent to 33 percent. For the agricultural combined code, the board approved a loss cost decrease of 32.4 percent.

MSF's Board Adopted Loss Cost Multipliers

While NCCI's loss costs, as well as MSF's special class code loss costs decreased, MSF's loss cost multipliers (LCMs) for policy year 2012 increased. The LCM is based on each insurers' unique operating expenses, taxes, and profit provision. The following table shows policy year 2011 LCMs as compared to 2012 LCMs.

Figure 2
Montana State Fund's Board Approved Loss Cost Multipliers
Policy Years 2011-2012



Source: Compiled by the Legislative Audit Division Using Montana State Fund's Board of Director's meeting minutes.

While NCCI loss costs decreased (on average) for policyholders in policy year 2012, the LCMs (if the policyholder was in the same rate tier for both years) increased. Using our example from Chapter III – with an assignment of rate tier 3, the manual rate for a policyholder in policy year 2011 and policy 2012 would have been as follows:

Table 14

Example Manual Premium Calculation

Policy Year 2011 and Policy Year 2012

Business Class Codes				2011 Manual Premium Calculation			2012 Manual Premium Calculation		
Class Code	**Description**	**Payroll**	**(A) Payroll/$100**	**(B) NCCI Advisory Loss Costs**	**(C) MSF Loss Cost Multiplier**	**Premium (A) X (B) X (C)**	**(B) NCCI Advisory Loss Costs**	**(C) MSF Loss Cost Multiplier**	**Premium (A) X (B) X (C)**
8810	Clerical	$45,000	$450	$0.66	1.057	$313.93	$0.48	1.157	$249.91
6217	Excavating and Grading of Land and Drivers	$240,000	$2,400	$13.96	1.057	$35,413.73	$9.95	1.157	$27,629.16
4000	Sand, Gravel, Clay, Shale Digging/ Dredging and Drivers	$120,000	$1,200	$11.27	1.057	$14,294.87	$8.35	1.157	$11,593.14
Total Manual Premium						$50,022.53			$39,472.21

Source: Compiled by Legislative Audit Division using Montana State Fund's Board of Directors approved National Council on Compensation Insurance's Loss Costs and the lost cost multiplier for rate tier 3 in the corresponding policy year.

As illustrated in Table 14, while NCCI loss costs decreased an average of 27.3 percent for this specific policyholder, MSF's LCM increased 9.5 percent. The overall percentage of change for this specific policyholder's manual premium from policy year 2011 to 2012 was a 21.1 percent decrease.

Audit Analysis of MSF's Mid-Year Rate Adjustments

To be consistent with NCCI loss costs filing impacting policies on accounts renewing after July 1, 2011, MSF management requested a mid-year rate adjustment effective July 1, 2011. The board approved a pro-rated 20 percent decrease to rates on policies with an effective date of July 1, 2010, through June 30, 2011.

To determine whether policyholders in policy year 2011 with an effective date after July 1, 2010, received a mid-year rate adjustment, we reviewed policyholder data. Based on this review we identified, 19,172 policyholders out of 26,549 (72 percent) with written premium in policy year 2011 received a 20 percent reduction to their premium, while the remaining 28 percent did not. We further examined the policy data for the policyholders that did not receive a mid-year rate adjustment and found:

- 6,115 of these policyholders renewed their policies on July 1, 2011, and therefore would not qualify for a 20 percent reduction.
- 1,262 policyholders cancelled their policy with MSF on or prior to July 1, 2011, and therefore would not have qualified for the 20 percent reduction.

MSF's Implementation of HB 334 Effects on Manual Premium

Since MSF, with the approval of the board, implemented HB 334 changes through its adoption of NCCI's loss costs and the loss cost multiplier as discussed previously, we analyzed the written manual premium changes between policy year 2011 and 2012. Based on our analysis, we identified 20,729 policyholders with policies effective in both 2011 and 2012. For these policies, our analysis determined:

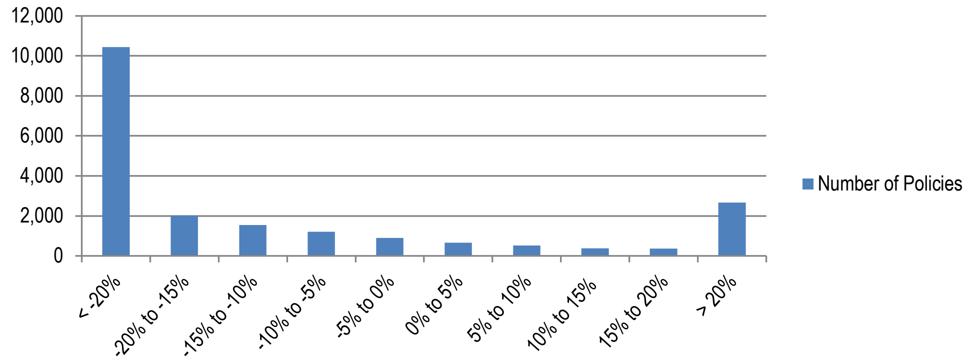
- 78 percent of these policyholders' manual premium decreased or stayed the same.
- 22 percent of these policyholders' manual premium increased.

The following figure details the number of policies by ranges for the percentage of increase or decrease in policyholder premiums.

Figure 3

Policyholders Percentage of Premium Changes

Policyholders with Written Manual Premium in Policy Years 2011 and 2012



Source: Compiled by Legislative Audit Division from Montana State Fund's policyholder data for policy years 2011 and 2012.

As can been seen in the figure, most policyholders received a premium decrease greater than 20 percent, while 13 percent of the policyholders experienced over a 20 percent increase. We reviewed policy data for the policyholders that experienced an increase and identified 98 percent of these policyholders increased their payroll between policy years 2011 and 2012. Other factors that may have increased a policyholder's premium include changes to class codes and/or a rate tier change. Based on the information presented above, we have reasonable assurance that MSF implemented HB 334 changes related to premium calculations, subsequently decreasing over 78 percent of its policyholders, with policies effective in both policy year 2011 and 2012, manual premiums for policy year 2012.

Conclusion

We conclude Montana State Fund implemented House Bill 334 changes related to premium calculations as approved by the Board of Directors.

MSF's Implementation of Tiered Rating 2.0 Effects on Manual Premium

MSF implemented Tiered Rating 2.0 for policy year 2013. Since the new tiered rating process generally only affects manual premium, we analyzed the manual premium changes between policy years 2012 and 2013. Based on our analysis, we identified 20,817 policyholders had manual premium in both 2012 and 2013. For these policies, our analysis showed:

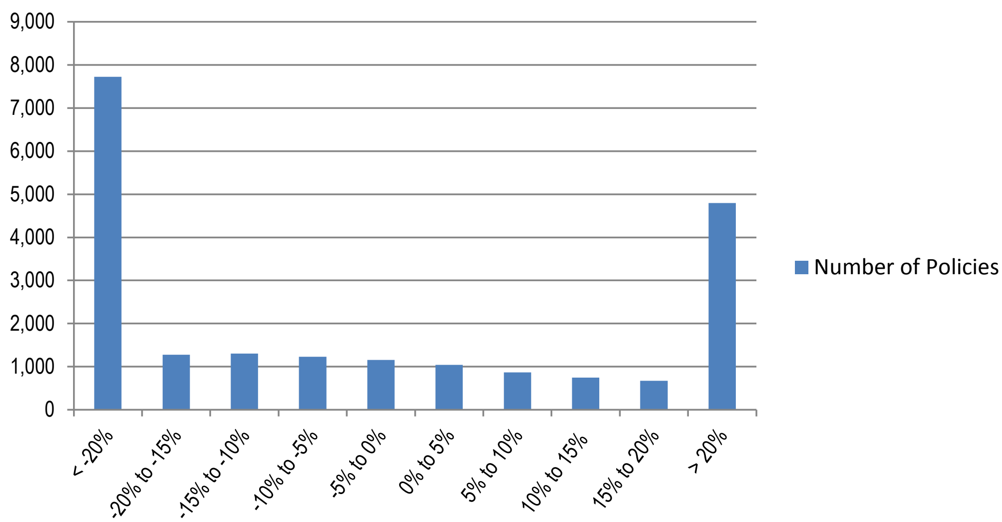
- 62 percent of these policyholders' manual premium decreased or stayed the same.
- 38 percent of these policyholders' manual premium increased.

The following figure details the number of policies by ranges for the percentage of increase or decrease in policyholder manual premiums.

Figure 4

Policyholders Percentage of Premium Changes

Policyholders with Written Manual Premium in Policy Years 2012 and 2013



Source: Compiled by Legislative Audit Division from Montana State Fund's policyholder data for policy year 2012 and 2013.

As can been seen in Figure 4, 37 percent of policyholders experienced a manual premium decrease greater than 20 percent, while 23 percent of the policyholders experienced an increase greater than 20 percent. We further reviewed policyholder data for these policyholders that experienced an increase in manual premium and identified 84 percent of the policyholders increased their payroll between policy years 2012 and 2013. For the other 16 percent of policyholders that received a premium increase, other factors exist that may have increased manual premiums, including changes to class codes and/or a rate tier changes.

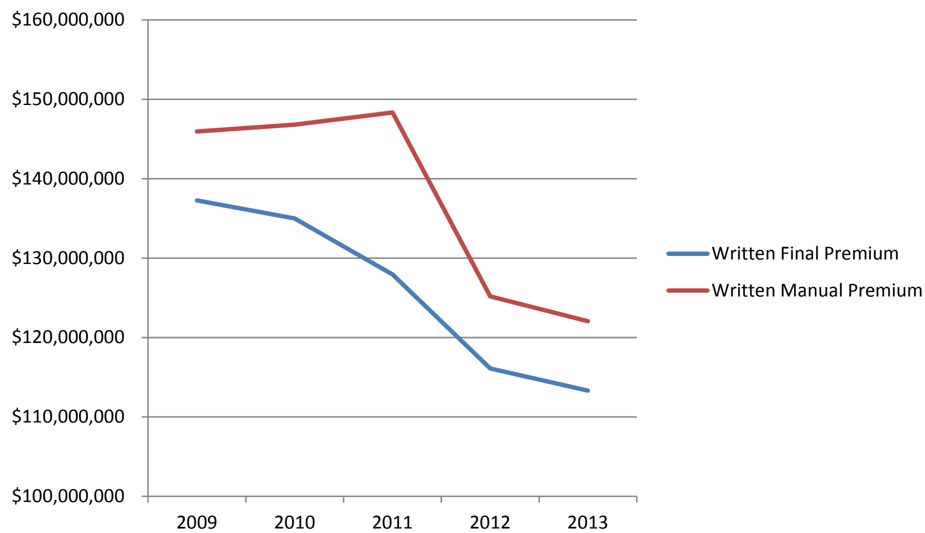
Overall Premium Trends

While various factors affect the premium assessed to a policyholder, we obtained a general understanding of how premiums changed for MSF policyholders between 2009 and 2013. To complete this analysis we extracted policyholders that had policies effective in each year between 2009 through 2013. Since we only included policyholders with policies in each of the years, a total of 17,175 policyholders were included. This analysis reviewed written manual premium and written final premium for these specific policyholders. The following figure shows the overall results of our analysis.

Figure 5

Overall Trends in Montana State Fund's Written and Manual Premium

Policyholders with Written Premium in Policy Years 2009-2013



Source: Compiled by Legislative Audit Division using Montana State Fund's policyholder data.

As depicted in the figure, in aggregate, most policyholders experienced a decrease in written premiums since 2009, with a marked decrease beginning in policy year 2012. However, as presented in the figure, in policy year 2011 a more significant difference between written final and written manual exists. This difference generally represents MSF's mid-year policy adjustment related to HB 334. Since the mid-year adjustment was applied through scheduled rating, the adjustment affected the final premium; however, manual premium was not affected. Additionally, NCCI loss cost decreases related to HB 334 were approved by the board for policy year 2012 which relates to the marked decrease in premiums in policy year 2012.

MSF's Incentive Plans Following HB 334 Implementation

Since components of MSF's incentive programs are based on premiums, we conducted audit work to determine how HB 334 and MSF's subsequent changes to premium calculations affected MSF's incentive programs. MSF offers two types of incentive programs, one for private insurance agents and the other to MSF employees. These programs are discussed in the next section.

MSF's Private Insurance Agent Commissions

MSF issues policies directly and through private insurance agents. Section 39-71-2316, MCA, allows MSF to contract with private insurance agents with the approval of the board. MSF offers both base and incentive commissions related to MSF policyholders represented by private insurance agents. While all agents may submit applications of insurance to MSF, not all receive commissions. According to MSF, an insurance agent must have a "producer appointment" agreement with MSF to earn commissions. MSF indicated it expects appointed producers to bring value and therefore has established selection criterion for appointments. For policy year 2013, 31 private agencies issued 45 percent of MSF's policies.

Our review of MSF's private agent commission and incentive plans for policy year 2011, 2012, and 2013 determined base commissions to insurance agents are directly and proportionately related to earned annual premiums and as such will decrease when premium revenue decreases. MSF's agent plans, for fiscal year 2011, 2012, and 2013 remained unchanged with private agents earning 5 percent commission for policies with an earned annual premium of $5,000 or less or 8 percent commission for policies with an earned annual premium greater than $5,000. Commissions paid by MSF each fiscal year are as follows:

- Fiscal year 2011 - $9.3 million
- Fiscal year 2012- $8.2 million
- Fiscal year 2013- $8.6 million

When MSF's overall premiums decreased in fiscal year 2012 due to HB 334, private insurance agents' commissions also decreased. Additionally, between fiscal year 2012 and 2013 MSF's overall premiums increased and therefore the amount of commissions MSF paid to private insurance agents also increased.

MSF's Private Insurance Agent Incentive Plan

MSF states private insurance agents have a critical role in meeting its strategic business plans and therefore developed a program of incentives designed to reward supporting agencies for superior results in profitability and retention of quality business. We reviewed MSF's incentive plan for 2011, 2012, and 2013 to identify whether changes to MSF's incentive plan were made as a result of HB 334 and subsequent premium changes.

When HB 334 was implemented in fiscal year 2012, there were no changes to the private insurance agent incentive plan. Incentive payouts were $725,785 for fiscal year 2011 and $374,729 for fiscal year 2012. The reduction in incentive payouts was partly due to a large producer not meeting MSF's criteria regarding losses on its book of business.

We determined MSF updated its incentive plan for fiscal year 2013 in response to HB 334. For fiscal year 2013, producers were required to have at least $250,000 in written premium at the end of the plan-year to qualify for the incentive. This was an increase from fiscal years 2011 and 2012 minimum written premium of $100,000. Additionally, MSF adjusted the loss ratio table used to calculate the incentive payment. We reviewed the table and determined these changes generally made it more difficult for an agent achieving the same results as fiscal year 2012 to receive the same level of incentive in fiscal year 2013. According to MSF, this allowed the incentive plan to balance the rate impacts of HB 334 while still allowing MSF to pay an incentive. Since MSF's incentive payouts for fiscal year 2013 will be paid in February 2014, it is currently unknown how these changes affected the overall incentive payouts.

Employee Incentive Programs

MSF has designed an incentive plan for three different groups including the President/CEO, executive team, and major operating areas of the company. The plan was designed to establish common goals between all levels of operations and to provide employees the opportunity to share in MSF's success. Incentives payments are made to MSF employees for attainment of predefined success measures adopted by MSF's board. If these predetermined goals are met at the end of the year, MSF pays incentives to its employees. The specific amount of employee incentives paid is determined using a weighted formula.

Audit Analysis of Factors Used to Calculate Incentive Payments

To assess whether HB 334 and subsequent changes affected MSF's incentive programs, we reviewed the factors established in MSF's incentive plans for fiscal years 2011, 2012, and 2013. For each of the three fiscal years, MSF used its net operating income as its initial success measure. Net operating income represents MSF's bottom line profits. MSF establishes three goal levels of achievement with the payout increasing for each level. These levels are referred to as threshold, target, and outstanding. Since the net operating income threshold must be reached before any incentive payments are considered we reviewed and determined MSF increased its net operating income threshold each fiscal year.

Since specific measures are established for each of the groups, we reviewed changes in these factors to determine if significant changes occurred. We identified the threshold for net earned premium decreased from $153.9 million in 2011 to $132.9 million in

2012. Other changes included a loss ratio threshold decrease of 6.9 percent and an expense ratio threshold increase of 4.5 percent. Based on our review of these changes, it appears MSF took into consideration the effects of HB 334 when developing incentive measures. We further reviewed the measures established in fiscal years 2012 and 2013 and noted the net operating income threshold increased by 63 percent from $24.0 to $39.2 million. Based on incentive targets, this means MSF will need to grow its business to attain incentive payments in fiscal year 2013.

Audit Review of Incentive Payouts

MSF staff receive payments as a percentage of their total eligible salary and the amount of incentive increases in line with the three levels (threshold, target, or outstanding). The percentage of total salary is different for all three groups and higher levels of responsibility are rewarded with higher percentages. During audit work we reviewed the incentive plans for fiscal years 2011 through 2013 to determine whether payout opportunities changed.

Based on our review, the executive team and employees' percentage of payout remained the same for all fiscal years and the CEO/President's percentage of total salary increased slightly. This increase meant the CEO/President, if all factors stayed the same, would receive higher incentive payments in fiscal years 2012 and 2013 than in 2011.

Incentive payouts are dependent on measures attained and the level of attainment (threshold, target, and outstanding). In fiscal year 2011, while all three groups were eligible to receive incentive payments, both the President/CEO and executive team submitted letters to the board waiving payments in light of the difficult economic conditions in Montana. Therefore, the incentive payout for fiscal year 2011 only included staff incentives and totaled $1.4 million. For fiscal year 2012, the incentive payout was $1.3 million and included the President/CEO, executive team members, and staff incentives. Fiscal year 2013 incentive payouts totaled $1.1 million and included the President/CEO, executive team members, and staff incentives. For fiscal year 2014, under management's advisement, MSF's board terminated the President/CEO, executive team, and MSF staff incentive programs.

Conclusion

We conclude Montana State Fund made reasonable adjustments to its incentive programs following implementation of House Bill 334 for factors relating to earned premium.

MONTANA STATE FUND

STATE FUND RESPONSE

MONTANA STATE FUND

5 South Last Chance Gulch • P.O. Box 4759 • Helena, MT 59604-4759
Customer Service: 1-800-332-6102 or 406-444-6500
Fraud Hotline: 1-800-682-7463 (800-MT-CRIME)

January 2, 2014

Ms. Tori Hunthausen
Legislative Audit Division
Room 160, State Capitol
Helena, MT 59620-1705

Dear Ms. Hunthausen:

I thank the Legislative Audit Division, in particular, Diedra Murray, Katherine Guenther, Lisa Blanford and Greg Olsen, for the opportunity to participate and respond to their report (13P-05) dated January 2014.

The report contains eight (8) recommendations and seven (7) conclusions. Generally, we believe the recommendations address the need to ensure appropriate file documentation of actions taken on underwriting policy files consistent with existing or more clearly stated policies and procedures. MSF provides the following response to the recommendations, only.

Recommendation #1: We recommend Montana State Fund:

A. Comply with existing policy regarding documentation of rate tier overrides,
B. Clarify underwriting policy and procedures regarding rate tier overrides,
C. Develop policy and procedures to ensure rate tier overrides are applied equitably across policy holders, and
D. Work with the Board of Directors to determine whether revisions to Administrative Rule 2.55.311 are necessary to ensure equitable treatment to policy holders.

Response: We concur. The recommendation contains four subparts. Of 25,914 insurance policies issued by MSF during policy year 2013, less than 1% (229) of policies had a rate tier change subsequent to the initial rate tier determination. In a vast majority of rate tier reassignments the rate tier was *lowered.* Nonetheless, 13% of the 229 sampled policies did not have sufficient file documentation to ensure rate tier changes were made in accordance with MSF policies and rules. While rate tier reassignment is a necessary and appropriate business practice to ensure policy rates are adequate, not excessive, and not unfairly discriminatory, we agree that complete and appropriate file documentation is required. MSF will establish an approval process for rate tier over ride. The approval process will designate appropriate levels of authority to specific staff. With this process, we will also confirm documentation of the reasons and reasoning for an appropriate rate tier change is present in the file. MSF will strengthen policy, including any appropriate administrative rule amendments, and procedures in this area as soon as practicable and by June 30, 2014.

Recommendation #2: We recommend Montana State Fund comply with policy by establishing additional controls to ensure the first experience modifier for a policy period is applied when calculating policyholder rate tiers.

Response: We concur. MSF's understanding of the policies found in this situation were an experience modification factor either being applied or removed after the original rate tier calculation had been performed by the policy system. The application/removal of the experience modification factor to the policy was handled appropriately; however, there was no documentation in the file about any impacts to the rate tier which was not changed. This situation will be addressed in MSF's response to Recommendation #1, specifically "if the factors considered in original rate tier assignment change after the initial assignment."

Recommendation #3: We recommend Montana State Fund:

A. Strengthen controls over its Construction Industry Premium Credit Application process, and
B. Comply with Administrative Rule 2.55.327A(2)(b) and Montana State Fund policy by only accepting construction premium credit applications if they are submitted by the stated due date.

Response: We concur. For A., as soon as practicable and by June 30, 2014 MSF will put an application review process in place for the Construction Industry Premium Credit applications that are received. With this process, we will also confirm documentation of the reasons for the program application decision is present in the file. For B., MSF will work to amend ARM 2.55.327A(2)(b) to allow a reasonable grace period after the due date to allow for reasonable mail time.

Recommendation #4: We recommend Montana State Fund:

A. Comply with policy that requires documentation of scheduled rating factors, and
B. Clarify policy regarding what is required in documenting supervisory review and approval.

Response: We concur. For A., as soon as practicable and by June 30, 2014, MSF will establish a scheduled rating review process. The review will be performed by specific staff. With this process, we will also confirm documentation of the reasons for the scheduled rating factor applied to the policy is present in the file. For B, a policy will be established as soon as practicable and by June 30, 2014 to assure supervisory review and approval is properly documented.

Recommendation #5: We recommend Montana State Fund develop written procedures for the Extract, Transform, and Load (ETL) process.

Response: We concur. MSF agrees that written technical documentation for IT staff regarding how the various specific parts of the ETL process fit and work together should be developed. MSF commits to developing this documentation as soon as practicable and by June 30, 2014 and to revisiting it at least annually to make sure it stays current. MSF notes that written procedures currently exist for the specific ETL processes, including backup schedules and emergency plan of action. These processes have been tested.

Recommendation #6: We recommend Montana State Fund strengthen controls over the risk evaluation tool to ensure:

A. Application of scheduled rating factors is restricted to staff assigned the authority, and
B. Notes are mandatory and included in the risk evaluation tool for policies with a scheduled rating factor.

Response: We concur. For A, as soon as practicable and by June 30, 2014 MSF will implement additional controls to ensure application of scheduled rating factors is restricted to staff assigned the authority. For B, MSF will establish policy to assure notes are included in the risk evaluation tool for policies with a scheduled rating factor.

Recommendation #7: We recommend Montana State Fund establish procedures for documenting retrospectively rated plans and obtaining approval from the President/CEO.

Response: We partially concur. MSF concurs with the need for appropriate documentation. As soon as practicable and by June 30, 2014, MSF will establish a retrospectively rated policy documentation procedure to clarify the appropriate documentation to be contained in each file. For policies proposed to have retrospective rate factors other than those specifically approved by the Board of Directors, and within the CEO's authority granted by the Board for these policies, the CEO shall review and approve the factors assigned. MSF does not concur with a requirement for approval by the CEO of every retrospectively rated policy. The CEO will be required to approve changes to the applied expense factors, if they are different than those specifically adopted by the Board.

Recommendation #8: We recommend Montana State Fund clarify policies and procedures for group business plans to establish responsibilities regarding reviewing eligibility requirements upon renewal.

Response: We concur. Policies and procedures will be clarified as soon as practicable and by June 30, 2014 to establish clear responsibilities regarding reviewing eligibility requirements upon renewal.

MSF thanks the Legislative Audit Division for the timeliness, professionalism and quality of the audit recommendations. We look forward to addressing any questions from the Legislative Audit Committee.

Sincerely,

Laurence A. Hubbard
President/CEO