

# **OLD FUND ANALYSIS FISCAL YEAR 2010**

A Report Prepared for the  
**Legislative Finance Committee**

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## INTRODUCTION

Due to significant unfunded liabilities associated with workers' compensation in Montana, the May 1990 Montana Special Legislative Session separated funding and accounts for claims of injuries resulting from accidents occurring before July 1, 1990 (Old Fund) and claims occurring on or after July 1, 1990 (New Fund). The Old Fund was determined to be adequately funded in 1999 when the revenues generated from a payroll tax were deemed to have generated sufficient assets to fund the payments of benefits and administrative costs over the payment period of about 50 years.

However, in recent years the Old Fund is again experiencing significant unfunded liabilities. The state is responsible for the payment of claims and related administrative costs at the time they are due once the current resources are exhausted, estimated in FY 2011. The unfunded liability that began in FY 2004 has continued to increase each year, as resources are depleted and estimated costs increase<sup>1</sup>. According to the financial summary prepared by Montana State Fund management, as of June 30, 2009 the unfunded liability is estimated to be \$45.5 million. The unfunded liability is based on the assumption that the state set aside the assets on July 1, 2010 to pay the claims and to earn investment income over time to pay claims. Claim costs are projected until 2048 when all claims are estimated to be fully paid. However, the current estimated costs to the state's general fund over the life of the Old Fund appear to be significantly higher, a total of \$57.8 million. Figure 1 shows anticipated cost to the general fund each year.

This report discusses:

- Significant increases to the Old Fund estimated unfunded liability since FY 2008, including:
  - Open claims
  - Medical loss reserves
  - Administrative costs
- The reasonableness of assuming a 3.5 percent investment yield
- Higher costs to the general fund in FY 2011 than anticipated by the legislature

Figure 1  
Montana State Fund  
Old Fund General Fund Transfers

FY	Beginning Balance	Total Loss & Expense	Investment Income	General Fund Transfer
2011	8,365,368	12,575,073	72,724	4,136,981
2012		9,250,101		9,250,101
2013		7,290,250		7,290,250
2014		6,169,518		6,169,518
2015		5,084,479		5,084,479
2016		4,020,992		4,020,992
2017		3,098,548		3,098,548
2018		2,226,695		2,226,695
2019		1,719,443		1,719,443
2020		1,330,098		1,330,098
2021		966,402		966,402
2022		841,406		841,406
2023		754,078		754,078
2024		676,465		676,465
2025		649,913		649,913
2026		670,335		670,335
2027		640,759		640,759
2028		691,313		691,313
2029		750,039		750,039
2030		781,536		781,536
2031		809,411		809,411
2032		843,188		843,188
2033		849,840		849,840
2034		806,194		806,194
2035		804,056		804,056
2036		653,013		653,013
2037		492,207		492,207
2038		340,368		340,368
2039		209,283		209,283
2040		70,555		70,555
2041		28,073		28,073
2042		25,095		25,095
2043		22,467		22,467
2044		20,146		20,146
2045		18,089		18,089
2046		16,270		16,270
2047		14,654		14,654
2048		13,219		13,219
Totals	8,365,368	66,223,571	72,724	57,785,479

Source: Montana State Fund  
Based on Tillinghast 6/30/2009 Reserve Analysis  
Assumes 3.5 Percent Annual Investment Yield  
Includes estimated payout for Stevenjord & Schmill

<sup>1</sup> \$23.0 million of Old Fund surplus was transferred to the state's general fund between FY 2003 and FY 2004.

## INCREASED UNFUNDED LIABILITY PROJECTED FOR THE OLD FUND

Montana State Fund (MSF) management calculated the unfunded liability for the Old Fund was \$36.5 million at June 30, 2008. Their estimate for the unfunded liability at June 30, 2009 is \$45.5 million, an increase of \$9.0 million in a year. Figure 2 shows the individual components of the projected increase.

	(in millions)
FY 2008 Unfunded Liability	(\$36.5)
Increased medical loss costs	(4.8)
Decreased indemnity costs	0.5
Decreased annual investment yield	(4.7)
FY 2009 Unfunded Liability	<u>\$45.5</u>

The increase is the result of several factors:

- Open claims above actuarial projections
- Increased projected medical loss reserves
- Increased administrative costs
- Decreased annual investment yield

These factors are discussed in detail below. In addition, estimated cost increases due to present value calculations that increase the unfunded liability over the \$45.5 million amount are discussed.

### Open Claims

When the Old Fund and New Fund were separated there were at least 8,100 claims outstanding in the Old Fund. According to MSF management, an open or active claim reflects benefits, either indemnity or medical, that are currently being paid or are expected to be paid. Claimants can be either injured employees or beneficiaries receiving fatality benefits. Actuarial estimates project Old Fund claim payments until 2048. The estimates include consideration of the age of claimants and the type of claims. A number of the claimants are in their 40s and 50s, which will result in claims payments potentially over the next several decades.

As of June 30, 2009 there were 924 open or active claims in the Old Fund compared to 952 open or active Old Fund claims as of June 30, 2008. This is 36 more open claims than actuarial estimates for this period of 888 open claims. The Old Fund claims are re-opened and closed on a regular basis. 458 Old Fund claims have been open continuously since 7/1/1990 and the remaining 466 claims have been re-opened at least once during the last 19 years.

While actuarial estimates of unpaid losses are not directly impacted by open claims, re-opening claims for additional medical costs can indirectly result in higher estimated medical losses. The medical costs associated with the re-opened claims become part of the cumulative medical payments. Cumulative payments and outstanding case reserves are used by the actuary in the estimates of unpaid loss.

### Increased Medical Loss Reserves

Medical loss reserves are a portion of estimated unpaid claims recorded in the financial statements based on actuarial recommendations. The costs for medical loss costs included in the calculation of the unfunded liability are based on actuarial estimates for FY 2009 and include the \$4.8 million increase discussed above. Actuarial recommendations for unpaid medical loss costs in the Old Fund have increased a total of \$18.1 million since FY 2005.

### Old Fund Administrative Costs

Unpaid claims administrative expenses and Department of Labor and Industry assessments are included as a portion of unpaid claims in the financial statements of the Old Fund, and as such contribute to the unfunded liability. At June 30, 2008 this amount was estimated by the actuary to be \$9.5 million based on 14.8 percent of future loss payments. As medical loss costs increase, the cost of administration expense increases. According to the MSF actuary, claims administration expense has been growing as a percentage of claims payments. As a result, the actuary has selected 14.9 percent of future loss payments as the provision for claims administration expense, an increase of \$624,119 in administrative costs between FY 2010 and FY 2048 when claims are estimated to be fully paid. The increase results in an equal increase in the unfunded liabilities associated with the Old Fund.

## DECREASED ANNUAL INVESTMENT YIELD

Between FY 2008 and FY 2009, the annual investment yield was decreased from 4.5 percent to 3.5 percent. As discussed previously, the impact of the decrease of the discount rate applied to loss reserves resulted in an increase to the unfunded liability of \$4.7 million between FY 2008 and FY 2009.

As stated, at June 30, 2009 MSF management calculates the unfunded liability for the Old Fund to be \$45.5 million, an increase of \$9.0 million since FY 2008 and current statute requires that general fund be transferred to pay claims when all available assets are depleted. As part of its calculation of the unfunded liability, MSF's management includes a reduction of \$12.3 million to the costs of the unpaid claims to bring the costs to their estimated present value as of June 30, 2009. This calculation is based on annual investment yields of 3.5 percent as discussed above. According to MSF's management, present value is included as a part of the calculation of unpaid claims as it is statutorily required by 39-71-2352, MCA. The effect of the present value calculation is to reduce the unfunded liability and hence the estimate of needed general fund transfers from \$57.8 million to \$45.5 million.

The issue with this calculation is that the present value reduction is based on the assumption that the MSF receives the entire \$45.5 million of general fund in FY 2011. General fund transfers to MSF in FY 2011, the first year they occur, were included in the general fund projections at \$760,317, not \$45.5 million. The \$760,317 is to pay claims and administrative expenses incurred and paid in FY 2011. Therefore, since the general fund transferred will be made over time and not all at once, this reduction in liability will not be realized and the total costs will be \$12.3 million higher.

## COSTS TO GENERAL FUND IN FY 2011 \$3.4 MILLION HIGHER THAN BUDGETED BY THE LEGISLATURE

MSF's management calculated at June 30, 2008 that the general fund would need to pay \$760,317 of claims in FY 2011 when it determined loss reserves would be depleted. The general fund transfer of \$760,317 was included in the Legislative Fiscal Division calculation of the general fund balance for the legislature.

Using the reduced annual investment yield and increased medical and claims administration expenses, MSF management calculates at June 30, 2009 that \$4,136,981 in general fund will be needed to pay claims in FY 2011, an increase of \$3.4 million above what was included in the general fund balance projections for the 2011 biennium.

## SUMMARY

At this time, the cost to the state's general fund of the unfunded liability for the Old Fund is estimated by the Legislative Fiscal Division to be \$57.8 million between FY 2011 and FY 2048. This amount includes \$45.5 million for the FY 2009 unfunded liability and \$12.3 million of additional general fund due to the unrealized annual investment yield of 3.5 percent. \$4.1 million in general fund will need to be transferred to the Montana State Fund in FY 2011 to pay costs of benefits and administration. Figure 3 illustrates.

Figure 3  
Montana State Fund  
Estimated General Fund Costs

	(in millions)
FY 2009 Unfunded liability	\$45.50
Additional General Fund Transfers	12.30
Costs to General Fund	<u>\$57.80</u>