Mark Barry, VP Corporate Support
5 South Last Chance Gulch . P.O. Box 4759
Helena, MT 59604-4759
Phone: 406-444-6494 . Fax: 406-444-7796
e-mail: mbarry@montanastatefund.com

MEMORANDUM

DATE: May 11, 2010

TO: Pat Murdo, Legislative Services

FROM: Mark Barry

CC: Laurence Hubbard
Kris Wilkinson

SUBJECT: Summary of Impact of Changes to State Agencies

During the January Economic Affairs Interim Committee, Chairman Keane requested the Health Care and Benefits Division of the Department of Administration determine the costs and benefits of having the flexibility to obtain workers' compensation insurance with any of the three plans and to provide the committee with complete information should they wish to make a decision on changes to state agencies required to insure with Montana State Fund (MSF).

Kris Wilkinson, Legislative Fiscal Analyst requested a brief summary on the impacts of such potential changes to MSF. The request included the following,

- Is there a point where the fixed costs of providing for administration and general overhead costs would require an increase for other policyholders?
- A break-even point, that would or could be reached if the state agency premiums of $18 million plus or minus were no longer available?
- Can you quantify the effect on the rates of the other policyholders?

There are many variables included in the analysis of rate impact given changes to the amount MSF premium reduction of a significant volume such as state

government. The factors and assumptions taken into consideration include but are not limited to the following.

- In our analysis, we assume no changes that would impact the expected loss rate. The expected loss rate is the expected cost of claims as a percent of premium. Since loss trends are variable from year to year, any changes to the expected loss rate may be the result of changes in trends as much as a change in premium volume. These changes would include mix of business types and industry, changes in the economy, changes in general wage trends, changes in medical inflation, changes in medical costs as a result of implementation of treatment guidelines and others.

- Since MSF establishes parameters in setting premium across all sizes of policies and industries through the MSF Tier Rating program, we expect no material change in MSF's loss ratio if MSF did not insure state agencies.
    - The caveat to this would be the potential for adverse development on the remaining open claims of the state agencies as MSF would continue to manage these claims to closure.

- MSF establishes a reinsurance program structure that considers state government offices located in Helena as the single largest concentration of losses in the event of catastrophe. As a result, we expect some savings on our reinsurance program as MSF would not have that concentration in the event potential coverage of a catastrophe event such as an earthquake.

- Impact on loss adjustment or claim management expenses (LAE) to manage the losses as they occur.
    - LAE is variable with the number of claims incurred. Since we would expect fewer losses, we would adjust claim management and other support staff accordingly. However, the reduction to LAE would not be a direct correlation to the reduction of premium. As a result,

MSF would expect an increase to the LAE as a percent of losses incurred even though in dollar terms, there would be a decrease. There is additional explanation on possible reduction of claim management staff later in this document.

- Impact on commissions paid to independent agents.
  - Commissions are a variable cost dependent on the level of premium written and represented by agents. Commissions as a percent of premium would increase however the amount of expense would remain the same.

- MSF has the option to achieve the same level of contribution to policy holder equity with a slight rate increase or could assume no change in rates with a slight decrease in contribution to policy holder equity.
  - MSF would not need to raise additional capital should our book of business be decreased by $18 million. That is as a percent of premium, the contribution to equity does not change. To achieve the same level of contribution to equity, a moderate rate increase of .75% would be required.
  - As an alternative, MSF has the ability to make no rate change and still achieve our long term financial targets.
  - The primary reason for the slight increase is because MSF would not decrease expenses to the same degree or as would be the case with the reduction in premium.

- Investment income on cash flow would decrease. MSF would need to monitor cash flow needs on the remaining open claims. However, since MSF is adequately reserved for the outstanding claims, we do not expect a need to take action on cash flow.

Approximately 40% of MSF operational expenses are fixed. The remaining 60% of operational expenses would be variable and subject to the volume of premium and number of accounts as well as the frequency and severity of

reported claims. Variable expenses would include the loss adjustment expenses incurred in managing claims, agent commissions, travel and training. Our staffing levels are also variable but we assume some minimum level of staffing is required regardless of premium volume. Fixed costs would include the costs of our office location, utilities, as well as the costs MSF is required to pay to the state of Montana for various services such as SABHRS and ITSD. Any operational expenses MSF considers a reduction in expenses with a reduction in premium is from variable expenses as the fixed expenses would remain at the same level and MSF does not have the flexibility of reducing these fixed expenses.

If MSF did not insure state government, our analysis indicates the near term impact on manual rates would be an increase of approximately .75% on remaining customers and their premiums. The average rate per $100 of payroll for non-state agency business insured with MSF is $4.655. an increase would make this rate $4.69 per $100 of payroll. Applying current workload and staffing indicators, we estimate the reduction of expenses would include reducing staffing levels by approximately 9 employees. Keep in mind that the reduction in premium does not immediately result in a reduction in workload for claim examiners. Our estimates of staff reductions include approximately 6 claim examiners that would only be reduced as the remaining open claims are closed. This would occur over a number of years.

If MSF did not increase rates on remaining customers but expected the same level of contribution to equity, our analysis indicates MSF would be required to decrease operational expenses by less than $1 million in addition to the employee reductions noted above. However, as noted above, MSF would still achieve our long range financial goals if MSF made no rate adjustment based on the loss of state agency business.

Over the long term, MSF will achieve our financial goals with or without the state agency premium because we have provided the processes and procedures to assure equitable premium is charged based on the risk of the policy.

However, with a smaller level of premium, there is a greater chance for variability of results from year to year. This may affect the stability of rate level changes that MSF has been able to achieve over the last six years because there is a smaller base of policies and premium over which to spread fixed costs. As MSF has stated, having state agencies insured with MSF provides a stabilizing factor for all businesses insured with MSF.

If the committee has any questions relative to the impact on remaining customers if MSF did not insure state agencies, staff of MSF would be available to address them.