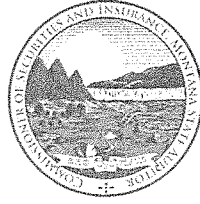


COMMISSIONER OF SECURITIES & INSURANCE

MATTHEW M. ROSENDALE, SR.
COMMISSIONER



OFFICE OF THE MONTANA
STATE AUDITOR

December 8, 2017

CERTIFIED MAIL - RETURN RECEIPT REQUESTED

Laurence Hubbard
President/CEO
Montana State Fund
855 Front Street
Helena, MT 59604

Re: Report of Examination as of December 31, 2016

Dear Mr. Hubbard:

Enclosed please find the report of examination of Montana State Fund, completed by Craig Jackson, CFE on behalf of this office. The examination was made as of December 31, 2016, of the business affairs, records, and financial condition of Montana State Fund. Also enclosed is Order No. I-694 adopting the report of examination. The order requires that each of Montana State Fund's directors file affidavits with the Commissioner of Insurance stating under oath that they have received a copy of the adopted report and the order. The affidavits are to be filed within 30 days of the issuance of the report.

Pursuant to Mont. Code Ann. §33-1-409(4)(a), you have the right to appeal this order. Pursuant to Mont. Code Ann. §33-1-409(5)(a), the contents of the examination report will be held as private and confidential information for a period of 30 days. After 30 days, the report may be opened for public inspection so long as a court of competent jurisdiction has not stayed its publication.

Sincerely,

A handwritten signature in cursive script that reads "Steve Matthews".

Steve Matthews
Chief Financial Examiner

Enclosures

**COMMISSIONER OF SECURITIES AND INSURANCE
MONTANA STATE AUDITOR
STATE OF MONTANA**

IN THE MATTER OF THE REPORT OF THE EXAMINATION OF MONTANA STATE FUND, Respondent.	CASE NO. (I-694) FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER ADOPTING THE EXAMINATION REPORT FOR THE PERIOD ENDING DECEMBER 31, 2016
--	--

Having fully considered the proposed Examination Report of Montana State Fund, dated November 1, 2017, the Commissioner of Securities and Insurance, Montana State Auditor (Commissioner), makes the following findings of fact, conclusions of law, and order adopting the examination report:

FINDINGS OF FACT

1. Craig Jackson, the Examiner representing the office of the Commissioner of Securities and Insurance, Montana State Auditor (CSI), conducted an examination of the affairs, transactions, and records of Montana State Fund and prepared an Examination Report (Report) covering the period from January 1, 2016, through December 31, 2016.
2. On October 23, 2017, the verified written Report was completed and on November 1, 2017, it was served by mail on Montana State Fund, together with a notice giving 30 days to make a written submission or rebuttal with respect to any matters contained in the Report.
3. The Report included three recommendations to Montana State Fund.
4. Per its November 27, 2017 letter to this Office, Montana State Fund does not object to the matters contained in the Report.

CONCLUSIONS OF LAW

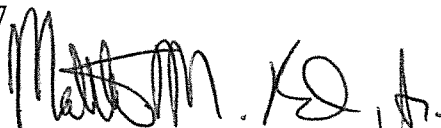
1. The Commissioner has jurisdiction over this matter pursuant to Mont. Code Ann. § 33-1-311, which charges the Commissioner with the duty of administering and enforcing the Montana Insurance Code, and pursuant to sections in Title 33, Chapter 1, Part 4, which govern examination of insurers by the CSI.
2. Pursuant to § 33-1-409, the CSI has authority to issue a final agency determination with respect to this Report.

ORDER

Having carefully and thoroughly reviewed and considered the record in this matter including the Report, relevant examiner work papers, and Montana State Fund's written submissions to the Report, IT IS ORDERED:

1. The Examination Report of Montana State Fund for the period ending December 31, 2016, attached hereto as Exhibit A, is hereby adopted in full.
2. Within 30 days of the mailing of this Order, each of Montana State Fund's directors shall file affidavits with the CSI stating under oath that they have received a copy of the adopted Report and the related Order.
3. Pursuant to Mont. Code Ann. § 33-1-409(5), these Findings of Fact, Conclusions of Law, and Order Adopting the Examination Report for the Period Ending December 31, 2016, and the adopted Examination Report (Exhibit A) will remain confidential for 30 days following the issuance of the same.

DATED this 7th day of December, 2017


MATTHEW M. ROSENDALE, SR.
Commissioner of Securities and Insurance
Montana State Auditor



REPORT OF EXAMINATION

of

MONTANA STATE FUND

NAIC Company Code 15819

of

HELENA, MONTANA

As of

December 31, 2016

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The Honorable Matthew M. Rosendale, Sr.
Office of the Montana State Auditor
Commissioner of Securities and Insurance
Helena, MT 59601

Commissioner:

Pursuant to your instructions an examination has been made of the financial condition and affairs of

MONTANA STATE FUND
HELENA, MONTANA

hereinafter referred to as "MSF" or "Fund". The examination was conducted at the Fund's home office located at 855 Front Street, Helena, Montana. The report of examination is herewith respectfully submitted.

SCOPE OF EXAMINATION

This examination was a full scope examination of the MSF, covering the period from January 1, 2016 to December 31, 2016, with a review of such prior and subsequent transactions as deemed necessary. This was a single state examination.

This examination was conducted in accordance with the risk-focused financial surveillance framework set forth in the National Association of Insurance Commissioners (“NAIC”) Financial Condition Examiners Handbook (“Handbook”). All accounts and activities of the MSF were considered in accordance with the risk-focused examination process, which includes the identification of significant risks, assessing and analyzing those risks, documentation of the analysis results, and the development of recommendations for application of the analysis to ongoing risk-focused financial surveillance monitoring activities. Other fundamental purposes of this examination are the identification and evaluation of significant risks that could cause an insurer’s surplus to be materially misstated, both currently and prospectively, and the conformity of the Fund to the related insurance laws of the State of Montana.

This Report of Examination includes selected financial statement schedules from the Fund’s 2016 Annual Statement filed with the Office of the Montana State Auditor, Commissioner of Securities and Insurance (CSI). This Report of Examination does not attest to the fair presentation of the financial statements presented herein. If, during the course of the examination, an adjustment is identified, the impact of such adjustment will be documented separately following the Fund’s financial statements.

This Report of Examination includes significant findings of fact and general information about the insurer and its financial condition. There may be other items identified during the examination that, due to their nature (e.g., subjective conclusions, proprietary information, etc.), are not included within the examination report but separately communicated to other regulators and/or the Fund.

For the year ended December 31, 2016, workpapers prepared by the Fund's independent auditors, Eide Bailly LLP, relating to its annual statutory audit were reviewed and relied upon to the extent deemed appropriate.

Included in the financial statements to this Report of Examination are actuarially determined estimates of certain reserve liabilities. The reserve estimates reported in the Fund's Annual Statement were supported by a Statement of Actuarial Opinion by an actuary representing the Fund.

COMPANY BACKGROUND

MSF is a nonprofit, independent public corporation established under Title 39, Chapter 71 of the Montana Code Annotated (MCA) for the purpose of allowing an option for employers to insure their liability for workers compensation and occupational disease coverage, and is attached to the State of Montana, Department of Administration for administrative purposes only. The Fund is reported as a component unit in the State's Comprehensive Annual Financial Reports. In the ordinary course of business, the Fund conducts various transactions with State of Montana agencies.

To make the regulation of MSF more like the state's other insurers, the 2015 Montana Legislature passed Senate Bill 123 (SB123) thereby transferring the regulatory oversight of MSF to the CSI. Effective January 1, 2016, MSF evolved from legislative oversight to regulation under Title 33, Montana Insurance Code. This puts MSF substantially in line with other insurance carriers in Montana, and is intended to increase confidence from policyholders and the legislature in the operations of the MSF. Because MSF is the guaranteed market for workers' compensation in Montana and can only be dissolved by an act of the legislature, certain special provisions were included in the law. MSF is exempt from premium tax and is required to maintain a Risk-Based Capital Company Action Level and Regulatory Action Level double that of other insurers in the state. To comply with SB123, MSF converted from a fiscal year ending June 30th to a calendar year ending December 31st. Insurance Department regulation became

effective January 1, 2016, and therefore the year ending December 31, 2016, was the first calendar year reported. A conversion period of July 1, 2015, to December 31, 2015, was used to transition MSF's financial reporting.

The MSF is subject to the oversight of the Legislature, CSI and the Department of Labor and Industry. As of January 1, 2016, MSF must file quarterly and annual financial reports with SAO. The legislative auditor conducts annual financial and compliance audits. In addition, the Legislature has oversight of MSF and is monitored through the Economic Affairs Interim Committee, which appoints two legislative liaisons to attend the State Fund Board of Directors meetings. This committee receives an annual report on MSF's Board approved budget. MSF provides legislators a copy of the annual report every year. The CSI, as the Commissioner of Insurance, has regulatory responsibilities over MSF similar to that of other insurance companies.

Those responsibilities include:

- Market Conduct Examinations
- Financial Examinations
- Solvency and Financial Monitoring
- Rate Review
- Form Approval
- Policyholder Complaint Reporting

Finally, as with all workers' compensation insurers, the Department of Labor and Industry is the regulator for matters related to workers' compensation claims.

Old Fund versus New Fund

Between 1987 and 1993 the Montana Legislature dealt with major issues in the state's workers' compensation system. At the core was an estimated unfunded liability of more than \$500 million in claim benefits due to injured employees.

During the 1980s, workers' compensation insurance premium rates were influenced by the political process rather than by actuarially sound analysis and insurance practices. This remained true even as the cost of claims increased. Because losses far exceeded premiums

collected, the unfunded liability grew at a staggering rate jeopardizing the entire system. In addition, the underpriced market essentially forced private carriers to leave the state because they could not profitably write coverage compared to the insufficient rate levels charged by the original state fund. Their departures meant that Montana businesses had fewer options for their workers' compensation insurance and placed a greater burden on a flawed system in which the state fund experienced a greater amount of unfunded liabilities.

The Legislature convened in a special session in May 1990 and separated the liability into claims occurring before and after July 1, 1990. Claims occurring before this date became known as Old Fund. Any claims after this date became the responsibility of MSF. MSF is reimbursed for the cost of administering the Old Fund claims but has no liability or funding responsibilities. The Old Fund is not subject to regulation by the CSI and is outside the scope of this examination.

The current MSF began operations on July 1, 1990 as an independent public corporation.

COMPANY ORGANIZATION

MSF is a single entity with no affiliates or subsidiary company ownership. MSF is subject to the oversight of the Legislature, CSI and the Department of Labor and Industry.

CORPORATE GOVERNANCE

Corporate governance is the set of processes, customs, policies, laws and institutions affecting the way a corporation is directed, administered or controlled. Management and the Board of Directors ("Board") are the principal players in corporate governance and are tasked with monitoring an organization's risk management activities and with establishing a control environment. The control environment represents an organization's first line of defense to mitigate all risks, including the risks of financial reporting errors.

The Fund's corporate culture appears to emphasize the importance of integrity and ethical behavior, with management setting the tone at the top. There has been little turnover in management or key personnel within the organization.

Based on the current examination review, the Corporate Governance at the MSF is adequate and within regulatory expectations given the structure, size and complexity of the organization. While it appears that the environment in which the Fund operates is conducive to producing accurate and reliable financial reporting, it is worthy to note that the Enterprise Risk Management is still in development and is not mature at the time of the examination. This has led to a more substantive approach to the examination of key financial reporting balances in the examination.

Board of Directors

The MSF board of directors consists of seven members appointed by the Governor of Montana. As per Section 2-15-1019, MCA:

- At least four of the seven members shall represent state fund policyholders and may be employees of state fund policy-holders.
- At least four members of the board shall represent private enterprises.
- One of the seven may be a licensed insurance producer.
- One of the seven members must be a person with executive management experience in an insurance company or an executive level experience in insurance financial accounting.

The directors as of December 31, 2016 are as follows:

Lawrence M. Zanto, Jr., Chairman	Bruce D. Mihelish
Richard S. Miltenberger	Matthew C. Mohr
Lynda B. Moss	Jack E. Owens
Janice S. VanRiper	

Part of the risk surveillance examination approach is to offer suggestions and best practices where needs and risks can be identified. The examination notes that the current board meets all required Montana statutory requirements.

The examination wishes to offer a best practice that is widely accepted by Commissioners around the country. The examination proposes that the make-up of the Fund's Board of Directors also include a "Financial Expert". This person should exhibit the experience, credentials and qualifications of a financial expert to advise and offer opinion on a

wide variety of issues that are faced by all financial institutions. This statement will be carried to the “Comments” section later in this report.

There are no committees of the Board.

Officers

Officers of MSF as of December 31, 2016 are as follows:

Laurence A. Hubbard, President & CEO
Mark C. Barry, CFO
Kevin M. Braun, General Counsel
Richard S. Duane, Jr., VP Human Resources
Denise M. Heigh, VP Insurance Operations Support
Julie A. Jenkinson, VP Insurance Operations
Albert Parisian, Chief Information Officer

Conflicts of Interest

The Fund adheres to the policies and principles promulgated by a Code of Conduct. All employees are required to sign the Code of Conduct prior to employment. Conflict of Interest Disclosure Statements are signed annually by management, but not by Board Members. This item is carried to the comments section of this report.

RELATED PARTY ACTIVITY

MSF is a nonprofit, independent public corporation established under Title 39, Chapter 71 of the Montana Code Annotated (MCA) and is attached to the State of Montana, Department of Administration for administrative purposes only. The Fund is reported as a component unit in the State's Comprehensive Annual Financial Reports. In the ordinary course of business, the Fund conducts various transactions with State of Montana agencies.

The Fund received \$11,428,069 in net premiums from State of Montana agencies for the year ended December 31, 2016. The agencies are policyholders of the Fund. The Fund had \$78,948 payable to various Montana state agencies at December 31, 2016. All payables were paid during January 2017.

By law, the Montana Board of Investments manages the Fund's short and long-term investments. The Montana State Treasury holds the Fund's cash and cash equivalent balances. Additionally, the Fund transacts with various State of Montana agencies in the normal course of business.

TERRITORY AND PLAN OF OPERATION

Territory

MSF is a worker's compensation insurer operating only in Montana.

Plan of Operation

The Montana workers' compensation system gives employers three options for purchasing their insurance:

- Plan 1- Develop a self-insurance program
- Plan 2 – Purchase from a private company
- Plan 3 – Purchase from MSF

In 2016, MSF maintained about 61% of Montana's direct written premium of the insured market (Plan 2 and 3). MSF cannot refuse to insure an employer except when an employer or the employer's principal defaults on an obligation to MSF and the default remains unsatisfied. Private carriers can select the risks they underwrite and can move in and out of the state based on opportunity and profit.

MSF writes policies for which the premiums vary based on loss experience. Future premium adjustments for these retrospective policies are estimated and accrued. The premium adjustments are determined through the review of each individual retrospective rated policy, comparing actual losses with projected future losses, to arrive at the best estimates of return or additional retrospective premiums. For certain large employers, the MSF Board can establish retrospective rating plans for each policy year utilizing the methods and formulas published by the National Council on Compensation Insurance in the Retrospective Rating Manual. The Fund's Board determines the factors, multipliers, ratios, or other formula components for the plan. Group Retrospective Rating plans may also be established by the board. MSF records retrospective premium accruals and receivables as adjustments to earned premium. Return premiums are recorded as liabilities and additional premiums are recorded as assets.

The Fund may offer an insured an optional deductible plan for benefits payable under the Workers' Compensation Act. The Fund's Board can establish deductible plans for each policy year and the factors, multipliers, ratios or other formula components for the plan.

Fidelity Bond

MSF is the named insured on a Fidelity Bond policy with a limit of \$7,500,000 single loss. Coverage was issued by Travelers Indemnity Company of America. The Fund asserts that it has made a risk assessment and has established a reasonable level of insurance coverage and that the coverage meets the needs of an insurance entity of similar size and exposure. Fidelity Bond coverage also meets the NAIC recommended coverage based on risk exposures.

Reinsurance

MSF's primary ceded reinsurers as reported on MSF's annual statement as of December 31, 2016 are Hannover Re (Ireland) Ltd (rated A+ by A.M. Best), XL Re Ltd (rated A by A.M. Best), both of which are considered authorized reinsurers, and Axis Specialty Ltd (rated A+ by A.M. Best), an unauthorized reinsurer. The reinsurance program incorporates contingent commissions, which is based on the experience of the cession program. The risk involved with reinsurance contingent commissions lay primarily in the computation of these commissions, as the loss reserves should reflect the ultimate losses of the program, not just the current case reserves.

The reinsurance program consists of excess of loss contracts that protect against occurrences over stipulated amounts and aggregate stop loss contracts. The excess of loss contracts provides for the following coverage:

Contract Period	Reinsurance Coverage
2016	Workers' compensation accidents of up to \$5M in excess of \$5M. Maximum of \$5M per any one claimant.
	Workers' compensation accidents of up to \$20M in excess of \$10M. Maximum of \$5M per any one claimant.
	Workers' compensation accidents of up to \$70M in excess of \$30M. Maximum of \$5M per any one claimant.

The current aggregate stop loss contract provides coverage based on MSF's premium levels not to exceed 15% of subject net earned premium. In the event reinsurers are unable to meet their obligations under either the excess of loss contracts or aggregate stop loss contract, MSF would remain liable for all losses, as the reinsurance agreements do not discharge MSF from its primary liability to the policyholders.

The Fund also assumes a small piece of reinsurance, primarily from Zurich American Insurance Company. Reinsurance is assumed in connection with provision of coverage to Montana employers with operations in other states.

ACCOUNTS AND RECORDS

General Accounting

Administration of the Fund's business is performed at the Fund's corporate offices located in Helena, Montana.

MSF's primary data center is located in Helena, Montana. The backup location is in Miles City, Montana.

The MSF relies upon the State of Montana to provide many IT services and Internet access. The MSF network connects to the State's network and both organizations maintain firewalls at the interface. The State provides a VPN for remote access. The State will issue new users their Windows login credentials; however, additional rights to network shares and applications within the MSF Organizational Unit (OU) are administered by the MSF IT help desk.

Investments are outsourced to the State of Montana-Board of Investments.

MSF uses the following financially significant applications and vendor products to process its business:

Application(s)	Business Process	Platform	Location
Claims Center Version 8.03	Claims Management	IBM AIX 7.1	Helena, MT
PHS-Policy Handling System	Policy Management	IBM AIX 7.1	Helena, MT
Business Objects Metadata Manager	Data Warehouse	Windows Server 2008	Helena, MT
Host Analytics	Financial Reporting	Externally hosted	Helena, MT

Based on procedures performed in conjunction with the Information Technology (IT) portion of the examination, the IT examiners found the overall IT risk mitigation and control environment to be Effective and the overall risk-based on IT operations to be Low.

Capital and Surplus

Capital adequacy is an important factor in the protection of policyholders and claimants. To measure the minimum capital an insurance company must possess to support its overall business operations, size and risk profile, the National Association of Insurance Commissioners has implemented the Risk-Based Capital (RBC) method of capital measurement. This system requires that a company and its state insurance commissioner take certain corrective actions should the company's capital fall below the minimum amount, as prescribed by the RBC calculation. Because MSF is a quasi-governmental agency, it is at the risk of Legislative action. The CSI considers this a significant risk for the MSF. Accordingly, it is recommended that the board of directors and its legislative liaisons ensure the Montana Legislature is provided with information clearly explaining the following: (1) The Fund's capital is shown on its balance sheet as "Unassigned funds (surplus);" (2) For an insurance company, the terms "unassigned" and "surplus" cannot be interpreted using common definitions of the words, which may lead one to erroneously assume the balance represents excess or unused funds; (3) Pursuant to Title 33, Chapter 2, Part 19 , Montana Code Annotated (MCA), the MSF's capital must remain at a level satisfactory to the requirements of the RBC system and any other tools used by the CSI to assess the financial solvency of an insurance company;

This statement will be carried to the "Comments" section later in this report.

Independent Accountants

The firm of Eide Bailly, LLP was retained by the MSF to perform the statutory basis audit of its financial statements for the year ended December 31, 2016. Eide Bailly concluded that the financial statements presented fairly, in all material respects, the financial position of the MSF at the respective audit dates.

Actuarial Opinion

The reserves for unpaid losses and loss adjustment expenses and related actuarial items as of December 31, 2016, were reviewed by Russell H. Greig, FCAS, MAAA, CFA, Willis Towers Watson, from data presented by Mark Barry, Chief Financial Officer of the Fund. The opinion stated that the amounts carried in the balance sheet on account of the actuarial items identified, were computed in accordance with accepted loss reserving standards and principles, made a reasonable provision in the aggregate for all unpaid loss and loss adjustment expense obligations of the Fund under the terms of its policies and agreements, and met the requirements of the insurance laws of Montana. The identified actuarial items are:

Losses	\$	<u>805,392,247</u>
Loss adjustment expenses	\$	<u>116,139,385</u>

Financial Risk Analysts, LLC (“FRA”) was engaged by the CSI to perform certain actuarial procedures in conjunction with the current examination. Daniel A. Reppert, FCAS, MAAA has represented FRA in this review. Mr. Reppert opines that the actuarial methods used and assumptions made are appropriate for the business written by MSF and are applied in accordance with actuarial principles and standards of practice and with the requirements of Montana law and regulation.

FINANCIAL STATEMENTS

The following financial statements are based on the statutory financial statements filed by the MSF with the CSI for the period ending December 31, 2016.

MONTANA STATE FUND

ASSETS

As of December 31, 2016

	<u>Assets</u>	<u>Nonadmitted Assets</u>	<u>Net Admitted Assets</u>
Bonds	\$ 1,151,130,004	\$	\$ 1,151,130,004
Common stocks	165,474,113		165,474,113
Real Estate, Properties			
occupied by the company	25,585,789		25,585,789
Cash, cash equivalents and short-term investments	35,091,741		35,091,741
Other invested assets	91,394,518		91,394,518
Securities lending reinvested collateral assets	45,360,715		45,360,715
Subtotal cash and invested assets	\$ 1,514,036,880	\$ 0	\$ 1,514,036,880
Investment income due and accrued	9,429,791		9,429,791
Premiums and considerations:			
Uncollected premiums and agents' balances in course collection	9,017,592	473,694	8,543,898
Deferred premiums, agents' balances and installments booked but deferred and not yet due	68,689,600	555,645	68,133,955
Accrued retrospective premiums	133,058	13,306	119,752
Reinsurance:			
Funds held by or deposited with reinsurance companies	278,310		278,310
Other amounts receivable under reinsurance contracts	62,613,491		62,613,491
Electronic data processing equipment and software	1,115,497	230,130	885,367
Furniture and equipment	985,923	985,923	0
Healthcare and other amounts receivable	1,735,423	1,734,626	797 0
Aggregate write-ins for other than invested assets	1,970,192	1,970,192	0

MONTANA STATE FUND
LIABILITIES, SURPLUS AND OTHER FUNDS

	<u>As of December 31, 2016</u>
Losses	\$ 805,392,247
Loss adjustment expenses	116,139,385
Commissions payable, contingent commissions and other similar charges	3,071,226
Other expenses	18,181,304
Unearned Premiums	68,179,913
Dividends, declared and unpaid:	
Policyholders	915,070
Ceded reinsurance premiums payable	75,554
Funds held by company under reinsurance treaties	75,739,328
Amounts withheld or retained by company for account of others	3,674,613
Payable to parent, subsidiaries and affiliates	78,948
Payable for securities lending	45,360,715
Aggregate write-ins for other liabilities	767,479
<i>Total Liabilities</i>	<u>\$ 1,137,575,783</u>
Common capital stock	-
Gross paid in and contributed surplus	-
Unassigned funds (surplus)	526,466,458
<i>Total Capital and Surplus</i>	<u>\$ 526,466,458</u>
<i>Totals</i>	<u>\$ 1,664,042,241</u>

MONTANA STATE FUND
STATEMENT OF REVENUE AND EXPENSES

	For the Year Ending December 31, 2016
UNDERWRITING INCOME:	
Premiums earned	\$ 169,677,071
Deductions:	
Losses incurred	126,265,372
Loss adjustment expenses incurred	20,863,871
Other underwriting expenses incurred	23,900,247
Total underwriting deductions	171,029,490
Net underwriting gain (loss)	\$ (1,352,420)
INVESTMENT INCOME	
Net investment income	\$ 40,475,840
Net realized capital gains (losses)	10,538,407
Net investment income	\$ 51,014,247
OTHER INCOME:	
Net gain (loss) from agents' or premium balances charged off	\$ (337,078)
Aggregate write-ins for miscellaneous income	(3,508,348)
Total other income	\$ (3,845,426)
Net income before dividends to policyholders	\$ 45,816,401
Dividend to policyholders	35,000,685
Net income, after dividends to policyholders, after capital gains tax and before all other federal and foreign income taxes	\$ 10,815,717
<i>Federal and foreign income taxes</i>	\$ 0
<i>Net income</i>	\$ 10,815,717

MONTANA STATE FUND
CAPITAL AND SURPLUS ACCOUNT

	For the Year Ending December 31, 2016
Capital and surplus, prior reporting year	\$ 505,157,612
Net income	\$ 10,815,717
Change in net unrealized capital gains	10,294,827
Change in nonadmitted assets	198,302
Net change in capital and surplus	\$ 21,308,846
Capital and surplus, end of reporting period	\$ 526,466,458

COMMENTS ON FINANCIAL STATEMENTS

The Fund prepares its financial statements on a statutory basis in conformity with the accounting practices prescribed or permitted by the State of Montana. This report does not attest to the fair presentation of the financial statements presented herein. Within the scope of our examination process we did not detect any circumstances or conditions where the Fund's financial statements would need to be materially amended or corrected.

The capital and surplus balances reported by the Fund for the year under examination were in compliance with the minimum requirements for a domestic casualty insurer as set forth in Montana State law. The total adjusted capital reported by the Fund in its filed 2016 Annual Statement is above the required risk-based capital level as required by NAIC guidance and Montana statute.

The Financial Statements and Audited Financial Statements filed by the Fund with the CSI include extensive Notes which assist the reader with understanding and assessing the Fund's Financial Statements.

SUBSEQUENT EVENTS

Subsequent to December 31, 2016, the Fund decided to divest its investment in the TIAA-CREF US Cities Fund LP as identified on its Schedule BA. Sales will take place through 2017 and proceeds of the sale will be used to repurchase similar investments. No impairment of the values in the above referenced invested assets are deemed necessary.

As a public entity, MSF is subject to specific laws such as public open meeting laws, and is constitutionally required to use the Montana Board of Investments (BOI) as the investment manager. The established investment policy managed by the BOI will ultimately make the investment decisions related to proceeds of the asset sale.

COMMENTS

As discussed earlier, the risk-focused surveillance framework set forth by the NAIC is centered upon the identification of prospective risks and the evaluation of controls put in place by the insurer to mitigate those risks. In the course of this examination, three instances were noted in which additional risk mitigation is recommended:

1. The risk that the Board is not adequately staffed to perform its corporate governance role. Within the insurance community, it is a common best practice that the Audit Committee of the Board of Directors include a financial expert, in that they hold an accounting certification (CPA, CFE, etc.) and have previously been employed in a financial oversight role. In this instance, because the entire Board of MSF serves as the audit committee, it is recommended that Board membership include a “financial expert”.

2. The risk that the MSF’s surplus levels or financial solvency could be impacted by the actions of the Montana State Legislature. Currently, Mont. Code Ann. §39-71-2320 provides that money collected by the MSF for claims for injuries may not be used for any other purpose and may not be transferred by the legislature to other funds or used for other programs. In addition, the MSF must include a provision in every policy of insurance that incorporates the prohibition against the transfer of assets by the legislature, Mont. Code Ann. § 39-71-2316. This is a contractual limitation that provides additional protection as the Montana Constitution prohibits the legislature from passing a law that impairs contracts, Article II, Section 31. Other statutes authorizing dividends to policyholders when it is safe to do so, Mont Code Ann. §39-71-2323, and the need for surplus, Mont. Code Ann. §39-71-2330, further address the disposition, constraints and requirements for the MSF’s assets. While the existing statutes address the current risk, they do not mitigate the risk that the legislative body could change the law, especially in

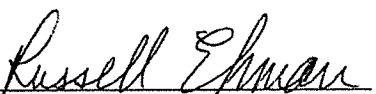
times of economic stress and when some may consider the unassigned funds (surplus) held by MSF to be excessive. It is recommended that the MSF board of directors and its legislative liaisons ensure the Montana Legislature is provided with information clearly explaining the following:

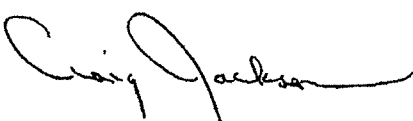
- a. The Fund's capital (net worth / surplus/ assets over liabilities) is shown on its balance sheet as "Unassigned funds (surplus);"
- b. For an insurance company, the terms "unassigned" and "surplus" cannot be interpreted using common definitions, To do so, may lead one to erroneously assume the balance represents excess or unneeded funds;
- c. Pursuant to Title 33, Chapter 2, Part 19 Montana Code Annotated (MCA), the MSF's capital must remain at a level satisfactory to the requirements of the risk based capital (RBC) system and any other tools used by the CSI to assess the financial solvency of an insurance company;

3. The risk that conflicts of interest within the board of directors may not be fully disclosed. Conflict of interest statements are signed annually by MSF management and employees. It is recommended that this practice be extended to board members.

CONCLUSION

The preceding report of examination of the MSF as of December 31, 2016, reflects its financial condition in accordance with the National Association of Insurance Commissioners Accounting Practices and Procedures Manual and any and all prescribed and permitted accounting practices of the Montana Department of Insurance. The examination was assisted by Examiner, Craig P. Jackson, CFE, associated with the firm INS Regulatory Insurance Services, Inc, and attests that the examination was performed in a manner consistent with the standards and procedures required by the CSI and the National Association of Insurance Commissioners Financial Condition Examiners Handbook. Examiner, Kari Leonard, AFE, of the Montana CSI, also participated as a financial examiner on the current examination. Based on my review, to the best of my knowledge, the examination was performed in a manner consistent with those standards and procedures and properly reflects the financial condition of the MSF.


Russell Ehman, CFE
Assistant Chief Examiner


Craig Jackson, CFE
Financial Examiner

CERTIFICATE OF SERVICE

I hereby certify that on the _____ day of December 20178, I have served a true and accurate copy of the foregoing Findings of Fact, Conclusions of Law, and Order Adopting the Examination Report for the period ending December 31, 2016, by U.S. mail, postage prepaid and certified, receipt No. _____ for the following address:

Montana State Fund
855 Front Street
Helena, MT 59604

Office of the Commissioner of
Securities and Insurance,
Montana State Auditor