



Mark C Barry, VP Corporate Support
P.O. Box 4759
Helena, MT 59604-4759
Phone: 406-495-5109
e-mail: mbarry@mt.gov

MEMORANDUM

DATE: February 8, 2018
TO: Economic Affairs Interim Committee, SJR 27 Subcommittee
FROM: Mark C Barry, VP Corporate Support
CC: Pat Murdo, Committee Staff
SUBJECT: **Cost Differentials to Montana State Fund Customers**

We have been asked to identify what we believe are differences in the operational costs MSF incurs currently as being an entity attached to the state of Montana and required to participate in state programs such as the health care and benefits program and other state costs in comparison to costs if MSF were not attached to the state. The analysis is to include any cost additions, such as premium tax and then an estimate on the impact to MSF customers.

While not exhaustive, we have attached a schematic chart to show most of the more significant “touchpoints” MSF has with the state of Montana. These touchpoints include both regulation and services provided to MSF by the state. There are costs associated with these touchpoints that need to be considered in the discussion of cost impact to customers. Generally speaking, if MSF were to transition to a private mutual insurance entity the only touchpoints that would remain would be the State Auditor’s Office as the insurance regulator over MSF and the Department of Labor and Industry as the claim management regulator over MSF. Most of the other touchpoints would be terminated.

To start the discussion, we are making a number of assumptions.

- MSF would transform to a mutual insurance carrier under Title 33.
- MSF would continue to function as the guaranteed market insurance entity for the state of Montana, at least for a period of time.
- MSF would not participate in the guaranty fund as long as MSF serves as the guaranteed market. As the guaranteed market MSF could not be dissolved and as a domestic mutual insurer would have assessable policies to act as the backstop if MSF were to become financially strained.
- MSF would have several years to plan and prepare structural changes to convert to a mutual insurance carrier in order to put in place the needed regulatory filings, systems, and procedures to accommodate the change.
- State agencies may have an option of how to obtain their workers compensation insurance.

Should MSF become a private mutual insurance carrier, there are three “new” costs that would have the largest impacts to MSF and MSF customers. MSF is currently not subject to these costs but would be in some form if MSF were to transition to a private entity. These would be,

- State Premium Tax
- Federal Income Tax
- Property Tax

Premium Tax

Premium tax is assessed annually at 2.75% of applicable direct premium. The premium is reduced for dividends to policyholders. Based on the 2016 premium, we estimate the premium tax expense would be approximately \$3.9 million.

Federal income tax

For purposes of this analysis, we are assuming a federal income tax rate of 21% of net income. This is based on an analysis of financial statements of the Property and Casualty (P&C) industry, the workers compensation composite companies, P&C mutual companies, individual workers compensation writers in Montana and former state funds. The source of this information was AM Best Aggregates and Averages and S&P Global Market Intelligence Platform. The federal tax as a percentage of net income ranged from a low of minus 43.4% to a high of 34.9%. Using an average of 21% as the basis, which also coincides with the revised federal corporate income tax rate, we estimate the federal income tax liability at approximately \$2.1 million on an estimate of \$10.1 million of net income. The amount MSF may pay in federal income taxes depends on planning and preparing MSF to be a taxed entity and also strategic planning necessary for tax advantages. Not the least of these would be to structure MSF investments much differently than currently structured in a tax advantaged format.

Property taxes

In the event MSF became a private mutual insurance company, MSF would be subject to property taxes for the building MSF owns and occupies. Based on our analysis of tax rates of various commercial buildings in Helena, we are assuming property taxes of anywhere from \$200,000 to \$300,000. For this analysis, we use \$200,000 as the estimate.

Costs of Services Provided by State of Montana

Most of the costs MSF pays to the state of Montana for services would be transferred to payment to other entities in the private market place. There are some costs MSF pays to the state that we would no longer pay. For example, we would assume MSF would no longer be subject to the statewide indirect cost allocation, Legislative Audit Division costs, Department of Justice Fraud Prosecution services or the State Auditor required funding for two positions. We estimate, some of the services costs MSF would incur in the private market increase from what is paid to the state and could impact MSF staffing needs. This would include services received from SITSD. We anticipate cost savings in some areas as well. For example, group health insurance costs could be reduced based on information we received from a local school district. However, until there is a decision by the legislature and the administration to transition MSF to become a private entity and MSF begins the process of identifying the sources and costs of these services, the actual cost differences are not fully known. With that in mind, based on MSF's review and analysis, we present the following table as a summary of the cost differentials of the state of Montana provided services.

Services Received from the State of Montana	2018 MSF Budget Amount	Estimated Cost In Private Market
PERS employer contributions	\$1,985,499	\$1,985,499
Group Insurance	3,920,880	2,541,672
Workers Compensation	155,189	155,189
Investment Management	1,156,471	1,156,471
Insurance	539,627	458,683
Payroll Service Fees	63,354	156,000
Financial/Banking Systems (GL, AP, AR, Asset Management, Banking)	116,668	295,000
SITSD	690,402	1,332,946
Other Costs	187,005	194,662
Dept. of Justice Fraud	386,898	-
Funding for CSI positions	223,105	-
Statewide Indirect Cost Allocation	101,830	-
HCBD Work Comp Program Fee	7,058	-
Audit Fees (LAD)	70,000	-
Total Estimated Costs	\$9,603,986	\$8,276,122
Estimated Decrease		(\$1,327,864)

We need to stress that some of the cost estimates in the table above have not changed from the MSF 2018 budget amount. We know that the costs will continue to be incurred from some source but we cannot determine if there is a significant change and so have carried the 2018 budget amount forward. In addition, the additional Financial/Banking Systems costs identified would be the ongoing maintenance costs for those services. We would anticipate obtaining an accounting system to include the modules noted above and estimate the capitalized cost of such a system to be \$2.5 million. Our analysis reflects annual ongoing costs and we are not including one-time implementation costs of conversion.

These cost comparisons are not intended to be a complete identification of the cost differentials but they should serve to indicate where there may be impacts to the policyholders of MSF as a mutual insurance company. Examples not included would be an impact of a state business equipment tax. In addition, we have not included the cost impacts of the 3% management fee identified in SB 4 from the special session of November 2017. We also have not addressed the issue of the employees currently participating in and contributing to PERS. We would expect to have discussion about the options available to address how to treat current employees and further analysis of any estimated funding assumptions. A summary of the cost differential impacts to MSF customers we have identified would be as follows.

Total Expense Increases	
Premium Tax	\$3,900,000
Federal Income Tax	2,121,000
Property Tax	200,000
Additional Services Costs now provided by State	(1,327,864)
Total	\$4,893,136

The most effective way to measure the impact of these cost differentials to customers is to reflect them as an estimated impact on the rate level of MSF. Our estimate of the impact on rates would be an increase of approximately 3% given the analysis of costs above.

As you can see, there would be some significant cost considerations in a transition to a private mutual company, but at the same time there are any number of other factors that impact the rate level, such as increasing or decreasing wage trends, medical cost trends and trends in the cost and frequency of claims. The actual change in the rates to MSF customers may be different from the estimates presented here. However, given these estimates alone, MSF believes the impact is manageable and would continue to allow for a competitive insurance market as well as continue to allow for a cost effective guaranteed market for all businesses.

Attachment