-DRAFT- Pending Committee Approval

Attachments to the minutes are available on this website under “Meeting Notes & Handouts - January 22, 2004 - Handouts”

SENATE BILL 304 STUDY COMMITTEE
January 22, 2004

The fourth Senate Bill 304 Study Committee Meeting was held on January 22, 2004 at the Capitol Building, Helena, Montana.

Committee Members Attending

Senator Royal Johnson
Rep. Dave Lewis
Jacqueline Lenmark
Jack Morgenstern
David Hunter
Senator Bea McCarthy
Rep. Bob Bergren
George Wood
Tom Beck

Others Attending

Don Judge - Teamsters Local 190
Mike Taylor - NCCI
Larry Jones - Liberty Northwest
Carl Schweitzer - American Sub-Contractors Association of Montana
Tom Schneider - MPEA
Eddye McClure - Legislative Services Division
Bob Biskupiak - Payne Financial Group
Bill Stevens - Self
Lorri Chugg - Payne Financial Group
Dave Davidson - Liberty Northwest
Mark Cole - Dick Irvin, Inc.
Michael Harrold - Property Casualty Insurers (PCI)
Aidan Myhre - Gallatin Group
Jason Todhunter - Montana Logging Association
Riley Johnson - NFIB
Herbert Leuprecht - MSF
Jerry Keck - Department of Labor and Industry
Ann Nelson - Employers Insurance Group
Amy Carlson - OBPP
Webb Brown - Montana Chamber
Carl Kochman - Wendt Kochman
Laurence Hubbard - MSF
Nancy Butler - MSF
Layne Kertamus - MSF
Mark Barry - MSF

Matthew Cohn - MSF
Kathy Gowen - MSF

Senator Johnson called the meeting to order at 9:00 a.m. The minutes of the November 7, 2003 meeting were approved as submitted.

Senator Johnson asked if there were any questions about the letter from David Davidson of Liberty Northwest. George Wood stated that the real decision is whether or not the committee believes there should be a state fund, and that he has not heard any convincing information that leads him to believe that anything would be accomplished for the state of Montana by doing away with the State Fund.

Senator Johnson asked for comment from the private insurance companies.

David Davidson, Executive Vice President of Liberty Northwest, stated that he believes the committee is going through the process of gathering information so that it can decide if there is any change to Montana's workers' compensation system that is appropriate. He stated that if government is to interact in a private industry arena, there should be some public purpose for that involvement. Liberty Northwest would like to have that public purpose defined. Mr. Davidson stated that he sees a deteriorating market as far as a competitive marketplace. Liberty Northwest believes that the state of Montana should have a charge stating that it wants to have a healthy, competitive market, with a number of viable insurers. He also distributed a handout (Attachment A - Role of Montana State Fund), which lists the following changes his company would like to see:

1. MSF should clearly define its public purpose.
2. MSF should be fully regulated by the Montana Commissioner of Insurance.
3. MSF should be subject to taxes.
4. MSF should periodically undertake efforts to reduce liabilities through reinsurance agreements.

Representative Lewis asked why removing subsidies to the State Fund would be a benefit to the state of Montana. Mr. Davidson replied that he thinks the social purpose of the State Fund is to provide coverage to those employers who have difficulty obtaining coverage. He advocates that the State Fund not use the benefits of its operation to the benefit of those employers who have alternatives in the voluntary market; but use those benefits to support and assist the less desirable risks. He stated that he is seeing an ever-increasing differential in rating related to risk by the State Fund. He requested that the committee ask what the experience is on minimum premium accounts, and how much money is being lost each year on minimum premium accounts. Ultimately, what would it take for those accounts to be self-sufficient? Mr. Davidson stated the benefit of cost reductions should go to the segment that needs assistance.

Senator Johnson asked Mr. Davidson what percent of Liberty Northwest's business is in smaller business. Mr. Davidson replied that about 20% of Liberty's policies are accounts that generate less than $5,000 in premium. (Attachment B - Number of Workers' Compensation Accounts in Montana) He explained that Liberty predominantly writes medium to large-sized business. Senator McCarthy asked Mr. Davidson if Liberty

Northwest is interested in smaller companies. Mr. Davidson replied this his company focuses on large accounts, and has not yet expanded into small business. Senator McCarthy stated that considering the population areas in Montana, there are basically seven areas that Liberty Northwest would service, whereas all of the outlying areas would be left out. Mr. Davidson replied that this is correct, but there are other companies specializing in smaller risk that would be interested if the market were different. Senator McCarthy stated that her point is that the State Fund is still needed for most of the state. Mr. Davidson replied that the State Fund could function as an assigned risk pool, functioning as it does today, but would be out of the underwriting business. The underwriting risk would be born by all employers in the state in an assigned risk pool. The advantage would be that with an assigned risk pool, pricing would be under the control of the Commissioner of Insurance and the Legislature.

There was discussion about assigned risk pools and the manner in which they operate.

The committee and Mr. Davidson discussed the profitability of Liberty Northwest and Montana State Fund, the payment of premium tax, and MSF's rate relativity.

Jack Morgenstern spoke about the liabilities and impact costs associated with an assigned risk pool. He stated that he does not believe that Montana is able to support a completely private, competitive system at this time. He stated that the committee should work hard to make the playing field as level as possible, while still maintaining the three-way system.

Representative Bergren stated that if Liberty Northwest's proposal could reduce rates for Montana's employers, he would be supportive, but he feels that leveling the playing field or privatizing would raise rates for employers. He is also concerned that there is not enough business in Montana to make insurance companies want to compete. Representative Bergren also stated that he would probably support legislation that would place regulation of the State Fund under the State Auditor.

There was discussion about Senator Johnson's reasons for sponsoring Senate Bill 304. Senator Johnson explained that he had read the minutes of the MSF Board Meeting where a Rabbi Trust was established, and was concerned.

Laurence Hubbard, President/CEO of Montana State Fund explained why rates would be higher with an assigned risk plan. (Attachment C - Why Can Rates Be Higher in Assigned Risk Plans?) Mr. Hubbard stated that the ultimate question is should the government have a social insurance system in place that ensures that Montana's employers and workers are covered? Mr. Hubbard believes that the answer is yes. Mr. Hubbard believes that the three-way system is operating well and is healthy and competitive. National market conditions are not favorable to private insurance companies, but these conditions are not caused by the State Fund. Mr. Hubbard explained that MSF is charged with operating like an insurance company - rates are to be based on sound, actuarial principles. There is a need to recognize that certain classes of business may not pay their fair share. Historically, those classes have been subsidized by other businesses. Mr. Hubbard distributed a document entitled "Policy Count and Premium Volume by Rate Tier and Account Size", (Attachment D) which shows the distribution by three premium segments of MSF's policies for Policy Year 2003 by tier. Mr. Hubbard gave an overview of MSF's tier rating system, and also explained MSF's experience modifier and scheduled rating program. Mr. Hubbard explained that tiers are standard in the workers' compensation market. MSF's tier rating process is actuarially sound and is reviewed by an independent actuary as well as the Legislative Audit Division's actuary. MSF is not able to turn away business; so all accounts must be fairly priced.

There was discussion about MSF's tiered rating system. Mark Barry distributed a handout regarding MSF Premium & Policies by Account Size. (Attachment E) This document reflects active accounts from Policy Year 2003 (when the tiered rating program was started) compared to those same accounts that were also active in 1999, to compare the experience between those two years. Mr. Barry clarified that in 1999, MSF did not have a tiered pricing program.

The committee discussed the state agencies and their placement in the tier rating system, as well as the classification codes of state agencies. Mr. Barry explained that the state agencies are in the tier rating system, but NCCI class codes are not used for state agencies. MSF has specific class code for the state agencies, which are based on loss history, providing state agencies with their own pricing. Mr. Barry also explained that MSF encourages state agencies to utilize safety programs and early return to work programs. Mr. Hubbard explained that MSF has offered a retention plan to state agencies for a number of years. If an agency has a good year, there is an opportunity for the return of their premium. MSF also gives an early return to work credit to state agencies. Mr. Hubbard also explained that the losses of state agencies have been as expected or higher, so MSF has not been in a position to return premium to the agencies. MSF's goal is to reduce the ultimate costs of workers' compensation insurance by encouraging workplace safety.

In response to a request by Jacqueline Lenmark, Mr. Hubbard provided information regarding the number of state agencies in each tier:

There was discussion about how state agencies are underwritten. Mr. Hubbard explained that state agencies are underwritten just as a private business would be. The three largest state agencies (Corrections, Department of Transportation and Department of Public Health and Human Services) drive the experience for all state agencies.

Senator Johnson asked for public comment.

Michael Harrold, of the Property Casualty Insurers Association of America, which is a recently merged property casualty insurance trade association, formerly of the Alliance of American Insurers and the National Association of Independent Insurers, stated that the Association represents over 1,000 companies, and writes approximately 40% of the property casualty insurance in America, and about 39% of the workers' compensation insurance in America. Mr. Harrold thanked the committee for its work, and expressed his trade association's interest in the issue. The Association represents a number of smaller workers' compensation insurers, and is very interested in having a more competitive market with a more level playing field so that some of his association's members could come into the state.

Senator Johnson encouraged Mr. Harrold's companies to participate in future meetings.

Mr. Hubbard stated that the proof of whether or not there is a competitive marketplace in Montana is in the history of Montana since 1990. There were corrections made to the workers' compensation system - the creation of a board of directors, holding MSF to the standard of operating like a domestic mutual insurance company, the setting of adequate rates, and the removal of politics from the ratemaking process - to ensure that MSF operates in a financially sound way, as a non-profit. MSF must make a contribution to surplus to ensure that there is adequate financial strength to pay the cost of claims through all market cycles. MSF has an expense ratio, a percentage of the premium collected, which is necessary to operate MSF. MSF's operating expense percentages are very similar to those of private companies. Mr. Hubbard stated that is the proof that, in the final analysis, MSF does not have an unfair advantage.

The committee recessed for lunch. Mr. Beck and Senator McCarthy were not able to attend the meeting in the afternoon.

Ms. Lenmark asked about the recommendations made by Mr. Davidson, specifically the recommendation that MSF be placed under the regulation of the Insurance Commissioner, and thereby under the same laws and regulations as private companies. She asked Mr. Hubbard what kind of difficulties it would present to MSF to have its rates filed and reviewed in the same way that private companies do. Mr. Hubbard replied that Senate Bill 153 addressed this issue. MSF has been moving, by it's own choice, closer to operating like a private insurance company. Many of MSF's class codes are the same as those used by private companies. In short, MSF could be placed under the regulation of the Insurance Commissioner, although it would take some time to transition. Mr. Hubbard stressed that there would be trade-offs, most significantly, in the ratemaking process. MSF uses NCCI loss costs as a basis for setting rates, with certain exceptions as approved by the Board of Directors. Private companies use NCCI's loss costs, with exceptions that can be demonstrated to the Insurance Department as reasonable. Therefore, there is a vehicle to handle exceptions on a carrier-by-carrier basis. Mr. Hubbard explained that it is the nature of MSF as a guaranteed market that creates the most significant need for exceptions. For example, the Insurance Department can put a carrier into rehabilitation and ultimately liquidation, but if there is no residual market mechanism other than the State Fund, that would create a problem. Mr. Hubbard stated that the inclusion of MSF in the guaranty fund is also an issue. Ms. Lenmark asked how difficult it would be for MSF to convert from its present system to NCCI classification codes. Mr. Hubbard responded that there would be some difficulty, because there are still differences in class codes, but it could be done.

Ms. Lenmark asked Mr. Hubbard if MSF interprets and meets the standard of rates being neither inadequate, excessive nor unfairly discriminatory in the same way that private companies do. Mr. Hubbard responded that he believes that MSF does meet this standard in the same way. MSF's independent actuary also files rates with many private companies as well. Ms. Lenmark asked what kind of problems would be created if MSF had to use the same rating law and file its rates with the Insurance Commissioner? Mr. Hubbard responded that other than the express difference because of having guaranteed market responsibility, he does not see a barrier to using the same regulatory structure for the standards of rate adequacy. Ms. Lenmark asked Mr. Hubbard if he would object if the committee were to make a recommendation to place MSF under the regulation of the Insurance Commissioner. Mr. Hubbard responded that he cannot endorse the recommendation at this time without further research, but if the committee decides to make such a recommendation, Senate Bill 153 could be revisited.

Senator Johnson asked for public comment.

John Youngberg, of the Montana Farm Bureau stated that the Bureau represents Montana agriculture, which makes up approximately 14% of the total policyholders of the State Fund. There are 23,000 farmers in Montana, and approximately 20% of farmers are insured with the State Fund. The average premium is $2,200 per year. Agriculture is also in the high-risk area. He stated that the majority of agriculture is insured with the State Fund, and that he has seen no compelling evidence that a significant change needs to be made. The legislature requires the State Fund to lump livestock and farming agriculture into on class code - something that is not done in other states or by private carriers. If those two classes had to be kept separate, the record keeping would be significant. Mr. Youngberg explained that farmers appreciate that the State Fund does this, and would not want to see it changed. Perhaps some tweaking could be done to make things more competitive, but recognizing that the State Fund has to insure those who can't be insured anywhere else.

David Davidson, Liberty Northwest, stated that he agrees that there are some unique requirements in each state. One reason he recommended that there be a uniform system is so that all participants have the same course of action. He asked why someone that Liberty insures should have to be classified in a different way than someone insured with the State Fund? NCCI can adopt deviations or special classes for any given state, so if there is a special need, the classification system should be changed. Mr. Davidson stated that there is an opportunity to file with the regulator those deviations by company that can be supported.

Bob Biskupiak, Marketing Manager of Payne Financial Group, and President-Elect for Montana Independent Insurance Agents, stated that his responsibility is working with insurance carriers to bring their products to Montana. Over the last several months, he has asked his national carrier representatives the following question: If the workers' compensation delivery system in Montana were to change to something that included an assigned risk pool, would they be interested in doing business in Montana? He stated that the answer has generally been no. Montana simply does not represent enough market share for those companies to make money. In order for a company to provide service, they have to invest a great deal, and there has to be a critical mass on a premium standpoint. Mr. Biskupiak stated that the Bureau endorses the three-way system as it is today, and that he thinks the marketplace is competitive.

Mr. Wood asked if Payne Financial Group writes workers' compensation coverage with MSF and private carriers, and if so, what is the proportion? Mr. Biskupiak responded that approximately 75% of their volume is with MSF, and the remaining portion of the business is with 8 or 9 other carriers. Mr. Wood asked if the private carriers are committed to workers' compensation coverage, or if they are writing it as part of a package. Mr. Biskupiak replied that it is some of both.

Jason Todhunter, of the Montana Logging Association, explained that logging is a high-risk field, and the logging industry needs the State Fund and the three-way system to maintain constant and available coverage.

Carl Schweitzer, of the American Sub-Contractors Association of Montana, spoke about the special committee studying the independent contractor exemption and how it is currently working in Montana. The recent *Wild* decision has thrown the independent contractor exemption into turmoil. The Montana Contractors Compensation Fund has decided that anyone who sub-contracts with them will have to prove they have workers' compensation insurance, or members will be assessed a fee equal to what the contract is worth. Many of these sub-contractors fall into the small business, high-hazard category, with no alternative other than the State Fund. One of the proposals the committee is looking at is requiring all contractors to have workers' compensation insurance. Montana has 30,000 independent contractors with 56% in the construction industry. There is an imbalance between contractors who are paying workers' compensation insurance competing with someone who is not. If workers' compensation insurance were required for independent contractors, they would need a place to go for that coverage.

Mr. Wood asked if the committee feels that the committee's charge is only to consider the sale of the State Fund and the creation of an assigned risk pool, or if the charge is larger. Senator Johnson stated that the committee's charge is to look at all the options, one of which might be selling the State Fund.

Mr. Morgenstern stated that he would like the committee to recommend staying with the three-way system. The committee could possibly tweak the system, but he would not recommend selling the State Fund. He stressed that above all, the committee should keep the ratemaking system from becoming politicized.

Ms. Lenmark stated that she believes the committee must specifically answer the questions about selling the State Fund and creating an assigned risk pool, but then could make changes to the system and still be within the committee's charge.

Representative Lewis made a motion that the committee not pursue the issue of the sale of the State Fund at this time.

Nancy Butler, General Counsel, Montana State Fund, raised the issue that the agenda did not contemplate a final vote on the charges of the bill. She recommended that the committee not take action at this time, but put notice on the agenda of the next meeting that the committee is going to make a decision. Eddye McClure, Legislative Services Division explained that House Bill 94 requires that if a committee is going to take final action on something, that action needs to have been on the agenda. The committee cannot take final action if it was not listed specifically on the agenda.

Representative Lewis withdrew his motion.

There was discussion about the distinction between the New Fund and the Old Fund. Ms. Butler stated that a motion could be set up that clearly delineates the difference between the New Fund and the Old Fund.

Ms. Lenmark stated that she believes the committee needs to have a specific discussion about the Old Fund, separately from the New Fund. She also stated that the committee should consider them and vote on them as separate items.

Senator Johnson suggested that the agenda of the next meeting include discussion of the Old Fund and its possible resolutions.

Senator Johnson recommended that the committee consider Liberty Northwest's fourth recommendation, regarding reducing the liabilities of the State Fund through reinsurance agreements. He also suggested that the committee look at the possibility of issuing an RFP for administration of the Old Fund

There was committee discussion about other possible agenda items for the next meeting. Ms. Lenmark stated that the next agenda should also include some of the items that have been raised as competitive issues.

Mr. Morgenstern stated that the agenda should include the following items:

1. Motion on sale of MSF
2. Governance of the New Fund
3. University Discussion
4. Sale or Transfer of Old Fund
5. Governance of Old Fund - charges paid to administer the Old Fund

The committee discussed the possible transfer of liabilities of the State Fund through reinsurance agreements. Mr. Davidson stated that the State Fund should periodically consider this option, although it must consider the costs of transferring the risk. Mr. Hubbard responded that as part of prudent insurance management, MSF does reinsure a considerable amount of its exposure in order to ensure that MSF's financial position is protected. MSF has not entered into any loss portfolio transfers. Mr. Barry explained that MSF has investigated a loss portfolio transfer for the Old Fund, but did not find much of a market. Mr. Barry stated that there is a possibility to see some gain with the New Fund, but a loss portfolio transfer in the Old Fund could end up costing money. There was also discussion about MSF's reinsurance on the Old Fund and the New Fund.

Mr. Morgenstern asked Mr. Barry if it would be a bad time to sell a portion of the liabilities of the Old Fund. Mr. Barry responded that on a purely financial basis, it is better to structure a deal in a high interest environment. However, there are other considerations.

Senator Johnson asked if there is an industry formula that would tell the committee what percentage is a reasonable percent of potential losses to be reinsured? Mr. Barry responded that MSF has done a survey of other state funds to determine what an appropriate structure for a reinsurance program should be. The survey showed that there is no uniform structure among state funds, but that it depends on what management thinks the risk is. There is no consistent formula. Mr. Davidson agreed that this is left up to individual companies' judgment.

There was discussion about the payment of taxes by MSF. Mr. Morgenstern stated that although MSF is a non-profit organization, there is a need to realize some profit in order to pay dividends, which are the most fundamental incentive for a safe workplace. Furthermore, MSF must charge enough premiums to add to surplus. He believes that the intent of the legislature in directing MSF to not pay taxes is to allow MSF to charge lower premiums, but not to allow predatory pricing.

There was discussion about the transfer of $37 million from surplus to reserves. Mr. Hubbard explained that MSF has an actuarially recommended surplus target for the premium written. At the time the actuary gave MSF the target, MSF was at about $122-124 million in gross earned premium, and the recommendation was to have anywhere from $197 million to $235 million in surplus. MSF also benchmarks off the NAIC reserve to surplus and premium to surplus ratios. MSF's board of directors must determine the pace at which MSF builds in profit to rates in order to grow to the target ratio to maintain financial strength. Because MSF is a mono-line, mono-state carrier, above-average financial strength is targeted.

There was discussion about the process of paying dividends.

Ms. Lenmark commented about the discussion on premium tax. She explained that all insurers, except the State Fund, pay three different taxes - taxes to the state, federal tax, and an assessment to support the subsequent injury fund. Ms. Lenmark stated that one important distinction the committee should understand is that private insurance companies do not pay tax on profit. Private companies pay a 2.75% tax on premiums written, regardless of profit. This tax is noted and added into the expense component when rates are filed with the Insurance Commissioner, but is not part of the loss cost. The concern about competition is that private companies have to add that tax into their rate, while the State Fund does not. Self-insurers add a similar amount into their costs, although they do not deal with premium. Ms. Lemark encouraged the committee to look at the premium tax as an area where the playing field could be adjusted to make things more equitable.

Mr. Morgenstern stated that the premium tax is part of what tilts the playing field one direction, while there are other things that tilt it a different direction. Mr. Morgenstern stated that Senate Bill 153 advocated that given certain concessions, MSF could afford to pay the premium tax. If MSF could purchase some of its resources on the open market, it might be able to pay the premium tax.

Mr. Hubbard suggested that it would be valuable for the committee to look at Senate Bill 153. From MSF's perspective, the premium tax would be a cost of doing business, which would be included in the operating costs as a pass-through in the ratemaking structure. Ms. Lenmark stated that she would not advocate that MSF be required to pay the federal income tax that private insurance companies pay. This should compensate the State Fund for insuring risks that are not insurable by the private market. She encouraged the committee to preserve what some may view as an inequity, because the State Fund is acting as the guaranteed market.

Representative Lewis stated that it would be useful if MSF would do a fiscal note to illustrate the costs associated with being exempt from certain state regulations. He would like to ensure that it would not have an impact on those who pay workers' compensation premiums. Mr. Hubbard agreed to provide information on the relative cost savings at the next meeting.

Ms. Lenmark asked Mr. Hubbard if MSF still supports Senate Bill 153 as currently drafted. Mr. Hubbard stated that MSF would be prepared to present the things that are still relevant and that MSF could support at the next meeting.

Senator Johnson asked Mr. Hunter to explore the burden that would be placed on the Auditor's Office if it were required to regulate MSF. Mr. Hunter agreed to work with Mr. Hubbard to provide this information.

Senator Johnson stated that he would like to see a system that allowed the Governor's Office and the Legislature to have more immediate and closer monitoring of the actions of the State Fund, and asked the committee to think about this issue.

The next meeting was tentatively scheduled for March 25, 2004.

The meeting was adjourned.