MONTANA STATEFUND

Legislative Study Committee Meeting
October 25, 2002

What is “surplus” and why is it needed?

When an insurer reports a surplus, they are not talking about unneeded or excess funds. A surplus is in actuality a contingent liability fund, and is intended to assure that the insurer will be able to fulfill its obligations to policyholders and injured employees.

These funds should only be spent for the purposes for which they were collected. In the insurance business, premiums are established long before the number, severity, duration, or cost of claims can be known. Case and actuarial reserves are established as claims occur, but the ultimate cost of those claims is not known for many years, sometimes taking as long as 35 to 40 years. Catastrophic and/or unanticipated events may also occur which are not covered by annual premiums. Because of this, insurance is quite different from all other goods and services where the price is established after most costs of production and delivery are known.

The tragic events of 9/11 make it painfully clear that catastrophic losses can occur at any time, resulting in significant claims. A responsible insurance carrier needs to be prepared for any eventuality. When reserves are adequate and results are positive, an insurance company can declare a dividend to return unneeded funds to their customers. In the past 4 years, MSF has returned over $28 million to our policyholders, resulting in a positive impact on the Montana economy.

How much surplus is enough?

There are a number of measurements used by insurance companies to determine what constitutes an adequate level of surplus. The Board of Directors based on a review and suggestions from an independent actuarial analysis sets the surplus level for Montana State Fund. The target established for MSF is to achieve a reserves to surplus ratio of 1.5~2. The current ratio for MSF is 2.16, which indicates that surplus will need to be added to in the near term to achieve the target ratio.

Whose money is it?

Surplus funds belong to Montana State Fund to be used solely for the purposes for which they were paid by policyholders.

How do reserves differ from surplus?

Reserves are determined through an actuarial analysis of liabilities that exist from all outstanding claims. Reserves can and will fluctuate over time to reflect changing conditions, medical inflation, and a variety of other factors. The Board of Directors of MSF sets reserves at their October board meeting after reviewing an analysis prepared by an outside independent actuary. For FY02, MSF reserves were set at $346.6 million.

Surplus is a contingent liability fund that is used to generate investment income and be available for unforeseen adverse developments should they arise.

The investment income generated from both surplus and reserves is used to help maintain stable pricing, and provide the means for the Board of Directors to declare a dividend in years when it is appropriate. Taken together, reserves and surplus form the foundation of financially sound and responsible insurance carrier.

What is the impact on Montana State Fund if surplus is taken legislatively for other purposes?

A surplus that is based on sound industry standards helps to stabilize costs to business, thereby fostering regional economic competitiveness for Montana employers. MSF's surplus exists to protect against normal financial variations, loss development and unanticipated events. The investment return on surplus is a key factor in the pricing of insurance policies for businesses in Montana. A taking of the surplus through legislative action would have an immediate impact on pricing to all our customers. There is a direct correlation to the investment income received from surplus, and the ability of an insurer to maintain competitive pricing. Any reduction in surplus translates to an increase in pricing for insured businesses.