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December 22, 2003

The Honorable Royal Johnson
2915 Illinois Street
Billings, Montana 59102

RE: Senate Bill 304 Committee

Dear Senator Johnson:

At the end of the November hearing you asked that we outline important key issues for future examination by the Senate Bill 304 Committee.

We are doing so with two documents. First, please accept this letter as our official recommendation regarding the future issues we believe should be addressed by the Senate Bill 304 Committee. We have attempted to be brief but complete in our recommendations and hope they are helpful.

Second, we have enclosed an additional document by way of background that we hope will provide both historical background and our analysis of the work of the Senate Bill 304 Committee to this point. We hope you will find this perspective to be useful in providing a background against which you can weigh your decision about how to move forward on this important issue.

We respectfully recommend the committee examine the following related issues to determine what it wants in terms of workers' compensation insurance:

1. The State Fund's application of its various advantages--State subsidies in the form of no taxes, no regulation, a captured block of business, offices, etc.

- Evaluate the operation of the State Funds on costs paid by small business in recent years. Under underwriting changes including "tiered rating" the State Fund pursues larger, profitable business while prices charged to small businesses have increased.
- Is this use of state subsidies to attract larger businesses that can obtain coverage in the voluntary market the proper expenditure of these funds?
- Should these funds be used for advertising campaigns?

2. Define what Montana wants for a workers' compensation insurance market.

- Does the state want a healthy completive w.c. insurance market offering the largest complement of competitive choices from many insurers?
- Does the current role of the State Fund contribute to that?
- If the state is going to be in the insurance business, why?
- Summarize past total tax liability paid by Montanans. Evaluate the degree the State Fund's current unregulated status poses possible future tax liability for the state.
- Should all employers and workers in Montana be protected by the insurance code? (State Fund now exempt)

3. Assigned Risk Pool.

- Evaluation of current unilateral assignment by State Fund of who receives what price and service programs.
- Evaluation of cost increases to small business in recent years by state fund.
- Degree to which there is a lack of transparency as to treatment of small businesses (as opposed to full regulation and full transparency of an assigned risk pool).

4. Use of current State subsidies to provide the State Fund as sole servicing insurer of an Assigned Risk Pool.

- Formulate alternative Assigned Risk Pool providing full application of all state/federal subsidies to pool members who do not obtain coverage in the voluntary market with private insurers.

Montana can take steps to restore a healthy competitive workers compensation insurance marketplace. A well-structured system benefits all Montana citizens providing competitive choices for employers who pay the premiums, improved services and reduced disability for injured workers, and elimination of potential future unfounded liabilities that could burden the Montana taxpayers.

If you wish to discuss any issue, please do not hesitate to contact me directly at 503-736-7010. I look forward to working with you to help resolve these important issues.

Sincerely,

David A. Davidson

David A. Davidson
Executive Vice President and Actuary

Enclosure

The Future of the Workers Compensation Marketplace in Montana

An Historical Perspective on The Deliberations of the Senate Bill 304 Committee

By David A. Davidson, Executive Vice President and Actuary, Liberty Northwest

We believe the work of the Senate Bill 304 Committee is an exceptionally important public policy issue of major consequence. It has direct consequence for all Montanans--whether workers or employers, in addition to all other taxpayers. Ultimately this issue is defined by what is in the best interest of Montana. In this respect it directly relates to fundamental governance and not simply a set of insurance issues. <u>Where it ends up is the fundamental question--what is the role of government--is it to operate a competitive business enterprise and if so why and how?</u> In that regard, we believe the issue of the Montana State Fund offers a clear issue of inquiry and is helpful.

The examination for the committee is greatly assisted by the legislation's clear and simple charge:

- Evaluation of the role of the State Fund
- Determination whether sale of the Fund is in the best interest of Montana employees and employers
- Evaluation of the desirability of an assigned risk plan

In this evaluation it is essential to understand the original purpose and subsequent evolution of State Funds to understand how things got to where they are today. This review will hopefully put my November testimony before the Committee in additional context, as well as help provide a background from which the Committee can effectively address recommended future issues.

The Origins of State Funds

- Workers' compensation programs were first created in the U.S. beginning in 1912/1913. They used the European social insurance model (primarily German). Various U.S. states formed monopolistic state social insurance programs. These included both insurance and administration functions within a single state agency. As this type of insurance did not exist prior to this time, the private insurers had no established product.

Changing roles of State Funds

- The obvious benefits from a fully competitive system of workers' compensation insurance drove the effort to break up the monopolies originally created. The old monopolies were split-up and regulatory functions placed with the appropriate state regulatory agency --- insurance regulation to Insurance Divisions and benefit administration regulation to Departments of Labor. From this transition came the hybrid State Funds that exist in a minority of states today, including Montana.

- Some State Funds such as Montana hold on to vestiges of the old State Fund model where major subsidies were provided with little or no regulation but the Fund did not compete for voluntary market business
- As the competitive markets naturally evolved in the various states, the State Funds began changing how they operated. The more aggressive funds sought legislation creating boards of directors to take on the appearance and operation of private insurers. Yet they opposed efforts to have them fully regulated, be required to pay all taxes, or to not have captured blocks of business, etc.
- Even though State Funds such as Montana have sought legislation providing operational autonomy to allow them to act much like a private insurer, they continue to pay no federal or state income taxes, pay no premium taxes or other assessments levied on private insurers. Their employees are covered by State retirement programs. They have their own separate personnel systems and wage structures. Yet they compete for business with private sector companies.
- The resulting untaxed and unregulated insurance entities that evolved over time are a strange arrangement by any standard. The reason is due primarily to the fact these unusual structures evolved slowly over time.
- Some State Funds such as in Montana failed to exercise proper underwriting discipline in the allocation of the state subsidy and pricing. As a result they faced huge unfunded liabilities.
- Legislators often responded with legislation. In Montana this legislation drove a shift in operations at the State Fund from a focus on applying its operational subsidies to primarily benefiting small business to a program of "actuarial fairness" absent any meaningful regulation under the Insurance Code primarily benefiting larger businesses.
- In these instances, the "social fairness" on which the principle of the State Fund concept of providing available and affordable coverage to the most needy employers is gone. In its place is a cruel irony—the small businesses the State Fund was originally created to serve, end up paying more so the State Fund can provide greater benefit and lower costs in the pursuit of larger, more profitable business creating an ever greater competitive disadvantage to small businesses. This has occurred in Montana as well as other states.
- In recent years State Funds gravitated from focusing almost exclusively on the smaller less competitive business market to competing for larger more desirable business. This pursuit of these attractive accounts requires the remaining State Funds to shed"social fairness" in pricing. This begs the question that when the State Fund no longer provides a core social function with the monies it accrues from its many state subsidies, what is its purpose for existence and what will be the effect long term on Montana? This was the concern I tried to review briefly with the Committee at the November hearing when speaking to the issues of the shift of State Fund operations from one of a social function—the shift

from the original purpose of providing "social fairness" pricing for less desirable (small) business to "actuarial fairness" akin to how a private sector company must operate.

- Fully regulated, tax-paying insurers have been driven from states with State Funds operating in this fashion.
- Competitive choices for Montana employers have already declined dramatically. Absent changes, they will disappear. At the same time, services to injured workers deteriorate under such a monopoly.

Mutualization, privatization or sale of State Funds

Due to the factors presented above, more and more states have looked to revisit the role of their State Fund. Given the desire to realize healthy insurance markets over the long term, mutualization, privatization or the sale of State Funds have been selected by some states.

- While these take different forms, all address the conflicts presented by the evolution of State Funds such as Montana.
- Under each of the options, the states realize full, uniform regulation of all insurers with intent to foster healthy competition.
- The benefits are obvious-- healthy, well-regulated markets provide competitive choices for employers while simultaneously providing timely benefits to workers and the reduction of employee disability.
- All taxpayers and workers in the state would be protected by the insurance code. Currently the State Fund, the state's largest insurer, is not subject to the insurance code.
- The large invested reserves required by the nature of workers' compensation claims provides states the opportunity to shed future liabilities and the associated uncertainty of these costs.
- The sale of liabilities to a reinsurer through loss portfolio transfers and other structures is possible. These sales can provide large investment trusts for states due to the fact that these reserves are generally not fully discounted to recognize the true time value of money. This approach simply more correctly recognizes the time value of money.
- The resulting freed-up cash can be used for any public purpose the legislature dictates. This could include a subsidy to all employers or the creation of a rainy-day trust to protect taxpayers from economic fluxuations. Another option could be to subsidize discounts to the involuntary market through the creation of an Assigned Risk Pool.

Assigned Risk Plans

To provide a "sure market" at a fair cost for the involuntary market (most are small businesses) many states have created Assigned Risk Plans.

- The plan insures all applicants. Services such as claim adjustment, loss prevention, etc. are provided by the various private insurers operating in the state.
- The operation of the plan is tightly and uniformly regulated. These rules, regulations and procedures are completely transparent and under the clear control of the legislature.
- By comparison, today the State Fund unilaterally decides who receives the advantages it wields and how much. Small businesses are paying increasingly more. All these decisions are made behind the closed doors of the State Fund. By comparison, all stakeholders participate in the development and administration of Assigned Risk Plan policies and procedures. This was reviewed by Cliff Merritt of NCCI at the November committee hearing.

If the Montana Legislature established an Assigned Risk Plan and the Legislature appointed the Montana State Fund the sole servicing carrier of the plan, it would resolve the concerns prompting passage of Senate Bill 304 and restore a healthy competitive market for employers and workers.

- The plan could be specifically tailored to the specific needs of Montana industries and businesses
- Rates for small business would be determined not by a few, behind closed doors but in an open, transparent and accountable manner
- The State Fund would be realized with its original role and purpose benefiting small, rather than large businesses

The State Fund Today--Summary

- As the largest insurer in the state it is unregulated
- State subsidies include but are not limited to
  - non- payment of state and federal taxes
  - avoiding regulatory costs
  - building/facilities and more
- The State Fund diverts these subsidies from small business and uses these subsidies to pursue larger, more desirable accounts
- The competitive choices for Montana employers has declined and will continue to decline absent changes to State Fund by the legislature
- Services to injured workers will decline and unnecessary disability increase absent necessary changes

Liberty Northwest remains committed to working closely with the Senate Bill 304 Committee in its work to make recommendations to the 2005 Legislative Assembly about how to ensure that Montana's workers compensation insurance system works best for Montana employers, employees and taxpayers.