

Department of Legislative Services
Maryland General Assembly
2012 Session

FISCAL AND POLICY NOTE
Revised

Senate Bill 745

(Senator Middleton, *et al.*)

Finance

Economic Matters

**Injured Workers' Insurance Fund - Conversion to Chesapeake Employers'
Insurance Company**

This emergency bill converts the Injured Workers' Insurance Fund (IWIF), by October 1, 2013, from an independent State entity into a statutorily created, private, nonprofit, nonstock workers' compensation insurer to be named the Chesapeake Employers' Insurance Company. The bill gives current IWIF employees the option to elect to remain State employees of the fund after the conversion; thus, IWIF is required to remain in existence for as long as it continues to have employees.

The bill also requires the Maryland Insurance Administration (MIA) to (1) study whether the company should be subject to specified requirements; and (2) contract with a firm to determine IWIF's fair value. MIA must report the study's findings, as specified by the bill, by October 1, 2012.

Fiscal Summary

State Effect: MIA can use existing resources to conduct the required study. The bill is not expected to materially affect State pension or retiree health benefit liabilities.

IWIF/Company Effect: Expenditures increase by up to \$200,000 between FY 2012 and 2013 to reflect contractual services associated with the required assessment. Expenditures decrease in FY 2014 to reflect savings in pension, health care, and accumulated and sick leave liabilities. This decrease is offset by an increase in expenditures beginning as soon as FY 2013 and no later than FY 2014 due to one-time start-up costs and ongoing expenses associated with converting into a private company. Although additional costs under the bill may exceed savings initially due to one-time expenses, savings are likely to exceed additional costs in future years.

Local Effect: Potential minimal benefit to local governments that are company/IWIF policyholders, to the extent that the bill results in policyholder dividends and/or lower premiums. The likelihood of any such benefit being realized increases in future years. However, most counties are self-insured and, therefore, not directly affected by any changes in the company/IWIF's premiums.

Small Business Effect: Potential minimal benefit to small businesses that are company/IWIF policyholders, to the extent that the bill results in policyholder dividends and/or lower premiums. The likelihood of any such benefit being realized increases in future years.

Analysis

Bill Summary:

Formation of the Company

Effective October 1, 2012, the bill establishes the Chesapeake Employers' Insurance Company as an authorized insurer that may engage only in the business of workers' compensation insurance in accordance with State law. The company may not cancel or refuse to renew or issue a policy except for nonpayment of a premium, failure to provide payroll information, or failure to cooperate in a payroll audit. Before October 1, 2013, the company must take all steps necessary to become a private, nonprofit, nonstock corporation that is subject to – and has the powers, privileges, and immunities granted by – provisions of law applicable to other insurers authorized to write workers' compensation insurance in the State. Beginning on October 1, 2013, the company must serve as the workers' compensation insurer of last resort in the State.

The company is generally regulated in the same manner as other authorized property and casualty insurers and, like other insurers in the State (including IWIF), is a member of the Property and Casualty Insurance Guaranty Corporation (PCIGC). However, the company must continue to set actuarially sound rates in the same manner in which IWIF sets rates, subject to review by the Insurance Commissioner. The company may not be sold, dissolved, or converted into a mutual or stock company and is not, for any purpose, a department, unit, agency, or instrumentality of the State.

The company's board (consisting of nine members appointed by the Governor with the advice and consent of the Senate) is required to adopt rules, bylaws, and procedures for the company. Board members previously appointed to IWIF's board must continue to serve their current terms on the board of the company. The president of IWIF must serve as the president of the company.

The company is subject to requirements, currently applicable to IWIF, related to the use of minority business enterprises for specified brokerage and investment management services. Correspondingly, the company must submit, to the Governor's Office of Minority Affairs, specified reports that are currently submitted by IWIF.

The board of the company may declare a policyholder dividend in the form of a refund or credit, as specified by the bill, with approval from the Insurance Commissioner.

IWIF's Continued Existence

The bill requires IWIF to remain in existence for as long as it continues to have employees and, effective October 1, 2013, makes IWIF an instrumentality of the State. Before October 1, 2013, IWIF must continue to serve as the workers' compensation insurer of last resort for workers' compensation insurance and as a competitive workers' compensation insurer under the same terms and conditions as the fund serves under current law. On and after October 1, 2013, IWIF may not issue new policies or otherwise engage in the business of insurance, although the fund may continue to serve as the third-party administrator for the State under a contract with the State.

Other than assets necessary for IWIF to perform specified duties and IWIF's contract with the State for third-party administration – which may not be transferred or assigned to the company until the fund no longer has any employees – all the functions, powers, duties, assets, real and personal property, accounts, liabilities (including liability for claims arising out of any policy previously issued by the fund), contracts, and obligations of the fund must be irrevocably transferred to the company on October 1, 2013.

Employees of IWIF and Employees of the Company

The bill prohibits IWIF from hiring new employees on or after October 1, 2013, but authorizes IWIF employees to elect to remain employees of the fund and, thus, the State. Such employees may remain in the State retirement system; may not be denied any promotion based on their status as IWIF employees; and are subject to the same laws, terms, and conditions of employment and compensation and benefits that were applicable to IWIF employees before October 1, 2013. IWIF must maintain a payroll and human resources system and is responsible for paying (1) the employer portion of any payroll or other taxes and retirement or pension contributions for IWIF employees; (2) the employee "pick up" contribution (set at 5% of annual earnable compensation); and (3) for any health or other employee benefits that are available to IWIF employees.

IWIF and the Department of Budget and Management must, by December 1, 2012, enter into an agreement establishing the terms, conditions, and schedule for payment by IWIF of the projected costs for the State retiree health benefits of current and former IWIF

employees. IWIF must, by July 1, 2013, begin to pay to the State Employee and Retiree Health and Welfare Benefits Fund an amount sufficient to satisfy these projected costs.

In addition, IWIF must, beginning on or before December 31, 2013, annually pay a withdrawal liability contribution to the State Retirement and Pension System (SRPS), as specified by the bill. IWIF and SRPS must, by July 1, 2013, enter into an agreement specifying the terms and conditions of payment.

If an IWIF employee elects to become an employee of the company, the company must (1) require the employee to make the election in writing; and (2) provide the employee with information that fully discloses the terms of employment and states that the employee's election is voluntary and irrevocable. An employee of the company may *not* elect to be an employee of IWIF.

IWIF employees may be assigned to perform functions of the company under a contract between the company and IWIF. The company and IWIF are required to annually execute an agreement that (1) lists the employees of the fund who have been assigned to perform duties on behalf of the company; (2) identifies the employees who will be utilized by the company and the fund; and (3) specifies that, except with respect to assets necessary for IWIF to perform specified duties, all assets and liabilities of the fund are the assets and liabilities of the company.

Required Studies

MIA must, in consultation with IWIF and the National Council on Compensation Insurance (NCCI), study whether the company should be subject to specified ratemaking requirements – including the requirement for NCCI membership – that apply to other workers' compensation insurers. MIA must report its findings and recommendations to specified committees of the General Assembly by October 1, 2012.

MIA must also contract with an independent consulting firm to conduct a study to determine the fair value of any financial contribution made by the State to IWIF and any financial benefit received by IWIF from the State. In conducting the study, the firm must consult with IWIF, the Insurance Commissioner, and the Secretary of Budget and Management. IWIF is responsible for the cost of the study. MIA is required to report the firm's findings and conclusions to IWIF, the Governor, and specified committees of the General Assembly by October 1, 2012.

If the study concludes that the fair value of IWIF is \$50 million or more, (1) MIA must contract with consultants to conduct a comprehensive assessment of the long-term effect of transferring the fair value to the State on the adequacy of the fund's surplus; and (2) the company owes to the general fund a debt in an amount equal to the fair value less

\$50 million (which reflects the amount to be transferred from IWIF to the general fund under the Budget Reconciliation and Financing Act (BRFA) of 2012 as introduced (SB 152/HB 87) and the amount transferred to the Budget Restoration Fund as passed by the BRFA of 2012 (SB 1301)), less the cost of the study and the assessment. The company must, depending on the adequacy of its surplus and the level of its risk-based capital ratio, pay the debt in installments beginning in fiscal 2014 or over an alternative period of time as agreed by the fund and the Secretary of Budget and Management.

Current Law:

IWIF's Role in the State

IWIF is an independent State entity that is required to serve as a competitive insurer in (and only in) the marketplace for workers' compensation insurance in Maryland. The fund must guarantee the availability of such insurance in the State and serve as the workers' compensation insurer of last resort. IWIF operates as a third-party administrator in the State and is subject to State insurance law provisions related to such entities.

Regulation of IWIF and Rate Making Practices

IWIF is required to submit to the Governor a detailed package of information, including the schedule of premium rates that IWIF will charge for the next calendar year. The board of IWIF, which is appointed by the Governor with the advice and consent of the Senate, is authorized to determine the schedule of premium rates based on the rating system that, in the opinion of the board, (1) most accurately measures the level of hazard for each policyholder on the basis of the number of injuries that occur in the enterprises of the policyholder; (2) encourages the prevention of injuries; and (3) ensures the solvency of IWIF from year to year.

Chapter 336 of 2009 specified that IWIF (1) must operate similarly to an authorized domestic workers' compensation insurer; and (2) is subject to additional regulation by MIA. IWIF is regulated in a manner similar to most other insurers in the State, except that IWIF is not required to pay property, sales, or federal income tax or join (and adhere to the policy forms filed by) NCCI. Chapter 336 also required the Insurance Commissioner to, at least once every five years, study IWIF's ratemaking practices to ensure that the agency produces actuarially sound rates. IWIF's board must adopt a schedule of premium rates in accordance with sound actuarial practices and must ensure that the rates are not excessive, inadequate, or unfairly discriminatory. Chapter 336 also repealed IWIF's authority to declare a dividend for policyholders in the form of a cash refund or credit.

The BRFA of 2011 made IWIF subject to a 2% premium tax that is imposed on all other insurers. The BRFA of 2011 also required a \$4 million transfer from IWIF to the general fund.

The BRFA of 2012 authorizes a \$50 million transfer from IWIF to the Budget Restoration Fund. The Act specifies that this transfer and, based on a valuation study, any additional payments reflecting the value of IWIF's association with the State resolve any claim the State may have to the property or assets of IWIF, except as specified under federal tax law for dissolution of state-sponsored workers' compensation reinsurance organizations.

Employment with IWIF

IWIF's employees are considered State employees and are members of SRPS. However, Chapters 132 and 276 of 2011 specified that IWIF employees are not subject to any State law, regulation, or executive order governing State employee compensation (including furloughs, salary reductions, or any other general fund cost savings measure). That legislation also (1) clarified that IWIF's board is responsible for setting compensation rates for its employees; and (2) repealed a requirement for the board, to the extent practicable, to set compensation rates for IWIF employees in accordance with the State salary plan.

In general, IWIF employees are considered special appointments and may not be removed unless (1) there is cause for removal; (2) written charges are filed; and (3) the employee has an opportunity for an administrative hearing. These conditions do not, however, apply to employees who are laid off due to a lack of work.

Final Disposition of IWIF

A 2011 Opinion of the Attorney General indicates that, to the extent that IWIF has assets in excess of the required reserves and surplus, those assets would belong – upon IWIF's termination – to the State, which created IWIF. If the General Assembly repeals the statute that created IWIF, the fund's assets must be distributed as determined by the General Assembly or as justice requires with regard to existing obligations for compensation.

Chapter 22 of 2002 required IWIF to become, like other insurers in the State, a member of PCIGC. If an insurer in the State becomes insolvent, PCIGC assesses its members to cover claims.

Background: In 26 States and the District of Columbia, private insurers (known as the voluntary market) provide workers' compensation insurance coverage to all employers

except to qualified employers that choose to self-insure; employers who are unable to obtain coverage from the voluntary market may purchase workers' compensation coverage through an "assigned risk" pool of private insurers. In the remaining 24 states (including Maryland), a state workers' compensation insurance fund (such as IWIF) has been statutorily created to provide workers' compensation insurance to employers.

IWIF was established in 1914 as the State Accident Fund (part of the State Industrial Accident Commission) under the Department of Personnel. The fund last received an appropriation from the State (of \$15,000) in 1915; it became a separate agency in 1941 and took its current name in 1990. IWIF writes policies only in Maryland and is the exclusive residual workers' compensation insurer in the State. The fund cannot decline businesses that seek coverage and must adjust rates in response to changing market conditions. In Maryland, IWIF is a major insurer with approximately 380 employees and a 25% share of the market. (In recent years, IWIF's market share has ranged from 34% in 2004 to 21% in 2010.)

IWIF's operations are solely financed by premiums and investments, but its start-up capital and the majority of its plant assets, such as the various parcels of land constituting its current office location in Towson, were provided by the State. IWIF's December 31, 2011 balance sheet includes real estate assets valued at \$9.8 million. However, the State Department of Assessments and Taxation valued IWIF's headquarters property at \$16.4 million in its July 2011 assessment.

IWIF has maintained rate stability with a minimal rate increase of 2.9% in 2012. (IWIF's rates increased 3.5% in 2011 and 2.5% in 2010.)

State Fiscal Effect: The bill requires IWIF to pay to SRPS a withdrawal liability contribution based on the fund's share of the unfunded liability in SRPS, which IWIF estimates to be \$28 million. IWIF advises that it expects to pay SRPS approximately \$1.5 million annually for 25 years. Because this amount represents what IWIF would have contributed to SRPS had IWIF remained in the system, these provisions in the bill are not expected to materially affect SRPS. Similarly, the bill is not anticipated to materially affect the State Employee and Retiree Health and Welfare Benefits Fund.

MIA advises, and Legislative Services concurs, that it can use existing resources to study and report, by October 1, 2012, on whether IWIF should be subject to specified ratemaking requirements.

IWIF/Company Effect: IWIF is responsible for the cost of the assessment of IWIF's fair value and advises that the contractual services for a consulting firm to conduct the assessment are likely to cost up to \$200,000. Thus, expenditures increase by up to

\$200,000 between fiscal 2012 and 2013 to reflect the cost of contractual services associated with the required assessment.

IWIF advises that it currently pays almost \$8.0 million in pension and health care costs for its active employees and that it expects the company to save at least \$3.0 million annually by emulating benefit and leave structures of the private sector (rather than of the State). Legislative Services concurs that the company/IWIF's pension and health care costs are likely to decrease significantly under the bill but advises that these savings are not likely to be fully realized until future years (as IWIF pays off its withdrawal liability contribution to SRPS and as the ratio of IWIF employees to company employees decreases over time). IWIF further advises that, by eliminating the possibility of transfers from the company/IWIF's surplus to the general fund, the bill enhances the company's market position and efficiency.

The decrease in expenditures is offset by an increase in expenditures beginning as soon as fiscal 2013 and no later than fiscal 2014 due to one-time start-up costs and ongoing expenses associated with converting into a private company. IWIF advises that significant one-time costs include legal, accounting, and consulting fees, as well as computer system changes as shown below.

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|--|------------------|
| Computer System Changes | \$390,000 |
| Legal, Accounting, and Consulting Fees | <u>150,000</u> |
| Total One-time Start-up Costs | \$540,000 |

IWIF further advises that significant ongoing costs include sales and property tax, additional insurance, and costs associated with running parallel payroll and human resources systems as shown below.

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|--|------------------|
| Sales Tax | \$420,000 |
| Property Tax | 180,000 |
| Additional Insurance | 125,000 |
| Parallel Payroll and Human Resources Systems | <u>50,000</u> |
| Total Ongoing Costs | \$775,000 |

According to IWIF, these additional expenses are not likely to exceed savings to the company/IWIF under the bill. Legislative Services concurs that ongoing costs are not likely to exceed savings to the company/IWIF in the long term, but advises that costs may exceed savings initially due to significant one-time costs and given that savings are not likely to be fully realized until future years.

Other potential costs to the company/IWIF depend on the results of the required studies and cannot be reliably estimated at this time. For example, if the required study

determines that the company should be required to join NCCI, IWIF advises that fees, reporting costs, and other associated costs are expected to be approximately \$1.4 million annually. Moreover, to the extent that the required study determines that IWIF's fair value exceeds \$50 million, IWIF expenditures increase to reflect payments made to the general fund. However, IWIF advises that any such payments to the general fund are expected to be minimal.

Additional Information

Prior Introductions: None.

Cross File: Although designated as a cross file, HB 1017 (Delegate Davis - Economic Matters) is not identical.

Information Source(s): State Department of Assessments and Taxation, Department of Budget and Management, Governor's Office, Maryland Insurance Administration, Injured Workers' Insurance Fund, Maryland State Treasurer's Office, Workers' Compensation Commission, Department of Legislative Services

Fiscal Note History: First Reader - February 26, 2012
ncs/ljm Revised - Senate Third Reader - April 2, 2012
Revised - Enrolled Bill - May 18, 2012

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