

Memorandum

TO: MAO

FROM: SPJ

DATE: March 14, 2014

RE: *Kentucky Department of Insurance v. Kentucky School Board Insurance Trust Property and Liability Fund, et al.*  
Franklin Circuit Court, Civil Action 13-CI-CI-1282, 13CI-1296, and 13-CI-1297  
Consolidated  
Summary of Testimony Presented at March 12-13 Evidentiary Hearing

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**Opening Statement from the DOI**

The KSBIT Funds became insolvent because of discounted rate premiums, under-reserving and poor claims management. KSBIT originally proposed assessment plans contemplating a novation, which had a price tag of \$70 million. Because KSBIT’s proposed assessment was too high, the Commissioner began working with KEMI on a novation of the Workers’ Compensation Fund. The DOI tried to reach an agreement with KSBIT but KSBIT filed a declaratory judgment action before the petitions for rehabilitation were filed.

**Testimony of Commissioner Clark**

Sharon Clark, Commissioner of the Department of Insurance took office in July of 2008. Soon after, the DOI received the KSBIT financials as of June 2008 in which it was apparent that the KSBIT deficit was growing. The cause of the deficit was discounted premiums, inadequate reserves and liberal claims payment. KSBIT was informed that they had to cure the deficit or face an assessment of its members. The DOI approved of the 2010 deal between KSBIT and KLC, and KLC is still managing the Funds subject to oversight from the Deputy Rehabilitator. Despite the KLC deal, in July 2010 the DOI’s remained concerned that KSBIT premiums were still being discounted. In 2011, KSBIT informed the DOI that it had to pay claims for catastrophic losses. In the Fall of 2012, KSBIT filed an assessment methodology with the DOI and stated that it intended to get out of the insurance business.

KSBIT delayed filing assessment plans until July 2013. The plans filed anticipated a novation for \$72.3 million; comparatively, the DOI plans include a \$48.5 million assessment. KSBIT later filed a runoff assessment plan. The high cost of KSBIT’s novation plan was a result of the bid process that KSBIT undertook. KEMI chose not to submit a bid to KSBIT directly. The DOI did not engage in a bid process to choose KEMI, nor was KSBIT involved in the DOI’s

negotiations with KEMI. KEMI cannot earn a profit on the LPT agreement because by statute it is not a for-profit insurance fund.

### **Testimony of Joe Pope, Deputy Rehabilitator**

Joe Pope is the Deputy Rehabilitator overseeing the rehabilitation of the KSBIT Funds. Pope developed the DOI's assessment plans. He used the audited financial statement deficits and then adjusted those numbers to discount the reserves based on the report of the independent auditing agency of Taylor Walker. The adjusted amount of deficit for the KSBIT Workers' Comp Fund was about \$35 million, which coincides with the payment required by KEMI under the LPT agreement. KEMI will refund any profit it ends up making on the deal. However, there is no mechanism delineated in the LPT agreement by which it will be determined if KEMI will realize a profit.

The deficit is also adjusted to include administrative costs, which the DOI estimates to be \$6 million. These costs include administration of claims until July 1, 2014 when presumably the LPT agreement will be executed and KEMI takes over administration of the WC Fund. It also includes accounting fees, actuarial fees and fees incurred to conduct future audits for the next 7 to 9 years. Any excess money assessed for costs will be refunded to the KSBIT members. However, if not enough is assessed, the KSBIT members would be assessed a second time.

Pope arrived at the \$35 million deficit by using a hindsight reserve analysis conducted by Taylor Walker. The report determines what the Funds' reserves were going back to the 1990s to pinpoint the year in which the Funds moved from having equity to a deficit. Pope determined that the WC Fund first experienced a deficit in 1997; in 1996, the Fund had a \$1 million surplus but by 1997 it had a \$4 million deficit from which the Fund never emerged. Accordingly, the DOI plan assesses members that participated in the WC Fund beginning in 1997, with the exception of 2005 and 2006. In 2005 and 2006, KSBIT actually had a positive cash flow. Therefore, the members that participated in the Funds in those years did not contribute to KSBIT's deficit. The P&L Fund first entered a deficit position in 2007, which is the start date for the P&L Fund assessment plan.

Pope did not analyze whether KSBIT's surplus was eroding before 1997 due to net operating losses. At the point a member leaves a fund, if the fund had a surplus that means that the fund had adequate reserves to pay all estimated potential claims for that member. Future losses sustained by the Fund after the member leaves are what caused the deficit; the future members have spent the assets that should have been available to pay the past member's claims.

Regarding allocation of the assessment to individual KSBIT members, the DOI chose a 60%/40% split: 60% of a district's assessment is based on the earned premiums paid by the district and 40% is based on the district's loss ratio. Loss ratio is calculated based on the percentage of claims paid compared to the premium paid. For the WC Fund, the DOI used a

100% loss ratio to determine when a member's losses are deemed in excess. The 60%/40% split means that those members who contributed more to the losses pay more of the assessment. The P&L Fund assessment is structured the same way, except that the DOI chose an 80% loss ratio to avoid the inequitable result of a small number of districts having to share 40% of the assessment.

Also built into the assessment of the Workers' Compensation Fund is the statutorily required Special Fund assessment. This is basically a tax paid to Kentucky based on premiums. The rate depends on the year the premiums were paid and ranges from 16% to 6.2%. The P&L Fund assessment does not include a Special Fund assessment tax.

Pope did not include a transfer of funds from the Workers' Compensation Funds to the P&L Fund (KSBIT proposes a \$600,000 transfer). KSBIT is a trust managed by KSBA that operates 3 insurance funds that are managed separately. However, in 2003, KSBIT transferred funds from the Property, Liability, and Unemployment funds to a Guaranty Fund and then funneled the money to the Workers' Compensation Fund. There are no documents pertaining to this transfer. There are audited statements that reflect these payments; however, a Legislative Research Commission Report indicates that this money was paid back.

According to Pope, a detailed data sheet explaining each individual school district's assessment can be made available to the districts.

### **Doug Goforth**

KLC engaged Jeffrey Kadison to perform an actuarial analysis to determine KSBIT's deficit. The estimate came back \$2.6 million less than the DOI's estimate for the WC Fund. Kadison also developed KSBIT's assessment methodology, which the DOI initially approved. KSBIT's assessment methodology caps an individual member's liability to 50% of the premiums that member paid over their entire participation in the Funds. The DOI contends that this cap operates to place the excess liability on other school districts that did not incur the losses.

KSBIT's plans assess members that participated in KSBIT in years in which the Funds experienced a net operating loss, without regard to whether the Funds were in a deficit position. Accordingly, it assesses members that participated in the Funds before they experienced a deficit. KSBIT's assessment plans assess members that participated in the Funds through June 30, 2013, despite statements in the plans that the assessment ends in 2012. The P&L Fund assessment starts in 1995 (versus the DOI's plan which starts in 2007), even though claims for property and liability insurance have a much shorter tail compared to workers' compensation claims.

KSBIT bid out to third parties the job of administering KSBIT claims made during rehabilitation of the Funds. The bids came back lower than the administrative costs estimated in the DOI's plans. KSBIT introduced schedules showing that their estimated costs are lower than

the DOI's costs. Its plans also include investment revenue and pay back the loan made to the Workers' Comp Fund from the other KSBIT funds. In Goforth's opinion, the DOI's plans result in large disparities among school districts with similar loss ratios and years of participation in the Funds.

### **Stephen Smith**

Stephen Smith is the CFO of KSBA. He testified that in 2003 KSBIT established a Guaranty Fund into which \$3.1 million from the Property, Liability and Unemployment Funds were transferred. In 2004, these funds were then transferred to the WC Fund. This money was never refunded to the Unemployment Fund and about \$600,000 was not refunded to the P&L Fund (KSBA paid \$600,000 back). However, there is no evidence or written documentation that the transfers were a loan. While the transactions were stated in KSBIT's audits, the funds were not recorded as either assets or liabilities on any of the Funds' financial statements.

### **Jeffrey Kadison**

Jeffrey Kadison is the actuary that KSBIT hired in 2012 to recommend member rates, review reserves and prepare assessment plans. The reserve estimate that he calculated varied from the estimate of Taylor Walker; however, both estimates were in a reasonable range.

Kadison testified that while an assessment is necessary when a self-insurance fund enters into a deficit, the year the deficit occurred is not the appropriate start date for the assessment plans. In 1993 and 1994, the P&L Fund experienced an operating profit; thereafter, the Fund had operating losses. Accordingly, the assessment plans he developed assess members that participated in the Fund starting in 1995 because the revenues collected starting in 1995 were too low to cover the operating costs. In other words, the premiums charged were inadequate to cover the losses experienced. While the Funds were not yet in a deficit position, the inadequate premiums collected in these years eroded the KSBIT surplus. The districts participating in the Funds starting in 1995 benefited from the low premiums that led to the operating losses. For the same reasons, the WC Fund assessment plan developed by KSBIT starts in 1990. Years in which the Funds experienced operating profits are excluded from KSBIT's assessment plans (1997 and 2007 for the P&L Fund and 1995 and 2004-2006 for the WC Fund).

Another difference between the KSBIT plans and the DOI plans is that for the WC Fund, KSBIT used a 100% loss ratio to define when a member's loss was excessive compared to the 80% loss ratio used by the DOI. As discussed above, the KSBIT plans also cap a member's liability at 50% of the premiums paid over the course of their participation in the fund. The excess liability resulting from the cap, which totaled \$470,000, is redistributed by increasing the assessment to all other members.

Kadison testified that the DOI plans result in disparate treatment of members that have similar loss ratios. By starting the assessment at an earlier date, members with similar loss ratios are treated more fairly.

### **Judith Spry**

KSBIT hired Spry to review the DOI and KSBIT assessment plans for purposes of the evidentiary hearing. She testified that members that participated in the KSBIT Funds prior to the DOI's start date for the assessment contributed to the operating losses. The operating losses are what led to the KSBIT deficit. A deficit is simply an accumulation of deficits and surpluses in operations from prior years.

### **School Districts**

A representative from Fayette County School Board addressed the court to support the assessment plans proposed by KSBIT.

I stated for the record that GRREC is not taking a position on behalf of its member districts regarding the assessment methodology. However, I requested that school districts be allowed access to their specific data regarding claims and premiums and how the assessment formula applies to them. Judge Wingate agreed that school districts should be provided access to this information.

### **Judge Wingate**

At the end of the hearing Judge Wingate asked why we could not assess members that participated in the Funds since their inception in 1978. Counsel from DOI and KSBIT agreed that the claims and premium data is insufficient for years prior to 1990.

Judge Wingate provided counsel for KSBIT and the DOI 15 days to submit briefs and then an additional 5 days to file responses. These briefs will address the assessment methodology but not the Surplus Notes issue. Any issues regarding the LPT agreement with KEMI will also be addressed at a later time.