

**1/20/04**

**OVERVIEW:**

**WORKERS'**

**COMP.,**

**AHFC, AK**

**STUDENT**

**LOAN CORP.**

**HFIN**

**FILE**

## Workers Compensation Overview

January 20, 2004

### I. MARKET AND MARKET SHARES

A. There are fewer but different workers compensation companies doing business in Alaska today than there have been over the past couple years. There are four work comp companies who wrote business in Alaska who are insolvent today (to discuss later). Alaska National is one major company which remains a stable market for Alaskan businesses and then there are companies who were not particularly active in Alaska in prior years which have growing market shares – AIG, Liberty Mutual, Liberty Northwest are all increasing the business they write in Alaska

### II. ASSIGNED RISK MARKET AND TYPES

A. If coverage is unavailable in traditional, voluntary companies – Provides source of coverage for mandatory workers compensation

B. Approx. 17% of market share

C. 93% are policies with premiums under \$10,000 (2<sup>nd</sup> Q 2003) (92% 2002)

D. Varied types of business

**By Policy Count** – Clerical, Retail Stores, Restaurants, Carpentry – Detached, Physicians

write property and casualty business in Alaska. The purpose of the Association is to "minimize financial loss to claimants or policyholders because of the insolvency of an insurer". Assessments are made to provide funds to pay the claims of insolvent insurers.

B. In July of 2003, Fremont Indemnity Company was declared insolvent by the Los Angeles Superior court and put in liquidation. While Fremont has not actively written workers compensation business for nearly three years, approximately \$60 million in claims and claim reserves remained outstanding in July. When an active insurer in Alaska they wrote approximately 27% of the Alaska premium.

C. The magnitude of the Fremont insolvency far surpasses any prior insolvency and exceeds the resources of the Association, thus creating a substantial cash flow deficit. Additionally, there are three other workers compensation companies which have been declared insolvent and have claims in the Association.

D. When there are insufficient funds in the Association, statute allows the pro-rating of payments. In August, I received a letter from the AIGA that it was their intent to begin pro-rating payments. This is an absolutely an unacceptable action as it would mean that injured workers would receive lower weekly wage checks and that medical care expenses would not be paid in full. The impact on the claimant could be disastrous.

F. The workers compensation obligation is that of the employer who generally then satisfies this obligation with the purchase of a workers compensation insurance policy.

- A. Effective January 1<sup>st</sup>, rate increase of 21.2% average.  
First substantial increase since 1988.  
Still at 1992 rate levels
- B. Decreases for 9 years, 2 years flat, and 5 years with increases
- C. Increases due to increased costs of claims – particularly medical care costs, including large increases in costs of prescription drugs
- D. Over past several years, a decreasing number of claims which indicates safer work places. However, rising costs of those claims that do occur – tended to be masked by fewer claims. The decreasing number of claims has leveled out and but the cost of individual claims continues to increase.
- E. Rate increases will affect many employers across the state. The State of Alaska is self-insured and thus does not pay premiums to insurance companies but rather fund the cost of claims directly. While the rate increase will not directly impact the SOA, the increasing costs of claims certainly does.

## V. AIGA – FUNCTION AND STATUS

- A. Alaska Insurance Guaranty Association formed under statute and whose members are insurance companies who

**By Premium Volume - Carpentry- Detached,  
Restaurant, Nursing & Home Health, Carpentry NOC,  
Outside Guide Services**

E. The current assigned risk plan has been losing money for the past four years. When losses exceed the premiums collected, insurance companies are assessed for the difference. Currently this charge to companies is at 6% of their direct written premium and is the highest such charge in the country. This expense has become a major burden to insurance companies who write business in Alaska.

### III. PROFITABILITY

A. From 1997 to today, the Alaska Loss and expense ratios have exceeded 100% in all but one year. These ranged from 99.9% to 154.3%. The Alaska loss ratio averaged 123.7 for the six year period while the national average loss ratio for this time period was 118.8%

B. For the same time period, the underwriting loss for Alaska workers compensation ranged from a 4.1% to a low of 54.3% in 2000. 2002 saw an improvement but still was a loss of 5.3%.

### IV. RATE INCREASES

When the carrier becomes insolvent, the claims are transferred to the guaranty fund of the State. When there are no funds to continue to pay claims, the obligation for benefits to injured workers will fall back to the employer. Employers who in good faith purchased an insurance policy to meet their workers compensation obligation would now be faced with the cost of benefits for the injured workers. This additional, unanticipated cost could potentially force small businesses to close their doors.

- G. This potential was averted by diligent searches for temporary sources of funds, including loans from the California Office of the Liquidator on the anticipated share of the Fremont estate and an early access distribution from Pennsylvania and the Reliance estate.

In closing, I would emphasize that Alaska needs a healthy workers compensation marketplace. We need a stable environment that is sustainable and that will encourage current companies to continue to do business in Alaska and to attract new markets. A healthy environment depends on adequate rates, a self-funded assigned risk plan, a cooperative regulatory atmosphere and a sound workers compensation system. Bills will be forthcoming in the near future which will seek to address these issues.

# A New Direction



## Protecting Workers' Compensation Insurance and Alaska Businesses

In the 2004 Legislative Session Governor Frank H. Murkowski will introduce two bills to help address a national crisis that has affected workers' compensation insurance in Alaska. The aim of the bills is to protect Alaskan workers and Alaskan businesses.

### **What is workers' compensation insurance and why is it required by the state?**

Workers' compensation insurance was put into place to assure speedy payment of medical bills and lost wages in case of an on-the-job injury. In addition, workers' compensation insurance is considered to be an "exclusive remedy" – meaning the employee gives up the right to file a lawsuit against the employer and in return an employee gets lost wages and medical treatment without having to prove fault. Every state requires this type of insurance because it is in the best interest of both workers and employers.

### **Why is there a problem with workers' compensation insurance in Alaska?**

In July 2003, the Alaska Insurance Guaranty Association learned that California-based Fremont Indemnity Company was declared insolvent by the Los Angeles Superior Court and was put into liquidation. Fremont became one of 41 insurance carriers in California that have either gone into insolvency or voluntarily pulled out of the California market to avoid insolvency after deregulation of the market in 1995. Fremont was a significant writer of workers' compensation insurance in Alaska prior to 2001, when the Alaska Division of Insurance suspended its authority to write insurance coverage. Even though the company had not actively written insurance policies for more than two years, when the company was declared insolvent there were more than \$60 million in claims and claims reserves still outstanding.

### **How did the Fremont failure impact Alaska?**

The Alaska Insurance Guaranty Association is an association formed under Alaska statute whose members are insurance companies with approval to write both property and casualty insurance in Alaska. The association's purpose is to "minimize financial loss to claimants or policyholders because of the insolvency of an insurer." The association pays the claims of insurance companies that are put into liquidation by insurance regulators through assessments. The law places a cap of two percent (2%) on the amount each company is assessed for premiums it writes each year. Currently, the assessment on workers compensation premiums generates about \$4.2 million each year. But because the Fremont insolvency surpassed the magnitude of any prior insurance insolvency in Alaska's history, it exceeded the resources of the Association and created a substantial deficit. Alaska law allows the Alaska Insurance Guaranty Association to pro-rate the amount it pays on claims based on the funds available. But to do so would place a financial burden on workers who filed compensation claims and would also place a burden on businesses that paid for insurance in good faith, thinking their workers would be covered only to find they are themselves responsible for the claims or even worse threats of large lawsuits.

### **How can the state help workers and businesses?**

The Murkowski administration has proposed a four-part approach to help both workers and businesses in this unfortunate situation. The administration's bills include the following provisions: funding measures that will help the Association continue to pay workers' compensation claims; reforms to statutory deposit requirements that should provide an additional source of claims payments in the future; granting authority to the Department of

Labor to meaningfully sanction employers that refuse to buy workers compensation insurance; and restructuring the Workers Compensation Board in a way that will bring quick, fair and consistent resolution of claims. These changes to current law should benefit employers and employees alike.

#### **Was the state to blame for the failure of the insurance company?**

No. Unfortunately, in the last three years there have been 43 property and casualty insurance company insolvencies in the United States. The higher cost of claims has been cited as one reason these companies have failed. Three other workers' compensation insurance companies serving Alaska besides Fremont – Paula Insurance of California, and Reliance and Legion Insurance Companies from Pennsylvania- also failed in this same time frame. However, the administration recognizes that the state must take steps to protect workers and businesses in the future.

#### **Why did the state approve the rate increases businesses must pay for workers' compensation insurance?**

Once every year the rates for workers' compensation insurance are reviewed by a national organization called the National Council on Compensation Insurance. The National Council looks at both historical data on the cost of compensation claims and looks at "trending data" to project forward losses. Since 1988, the last time there was a significant rise in costs to employers, there were actually nine years when the state had rate decreases, two years when rates were flat, and five years when rates were increased. State statutes give the state the authority to approve or modify the rates set by the National Council on Compensation Insurance and require that rates be "neither inadequate, excessive, or unfairly discriminatory." The state does its own analysis of information to insure the rates charged meet the statutory standards. Because of escalating medical costs, the cost of claims has significantly increased and the rates charged did not keep pace, leading to the tough decision to approve the increase in workers' compensation rates charged to employers an average of 21.2 percent. Of the 580 classes of employees, 30 will receive rate decreases while 17 classifications will experience rate increases over 50%. While the administration recognized this would have a significant impact on employers, it would have been irresponsible not to allow insurers to increase rates charged based on the consequences to employers and workers of not having a favorable insurance climate in Alaska.

#### **Why would not raising rates have been irresponsible?**

If the rates charged to Alaskan businesses are not adequate, many insurance companies might refuse to do business in Alaska. Since the law requires workers compensation insurance, failure to have a state climate that attracts a number of insurers actually puts workers and especially small businesses at greater risk. In addition to rate decreases in the mid-1990s, the decade also saw significant price-cutting by insurers in order to attract business. Fremont was one of the major companies that cut prices, a factor leading to its insolvency.

#### **By raising rates are you putting the burden for insurance company problems on local businesses?**

That is exactly why the Murkowski administration is proposing two bills to address workers compensation insurance problems in Alaska. The administration believes that additional legislation is important because it isn't fair to just increase costs to employers. The system needs other modifications to make the workers compensation insurance system work better, and eventually to be able to decrease insurance costs. Besides a proposal to use various methods of funding Guarantee Association costs, the changes proposed include:

- Change the cost of living allowance for out-of-state workers to keep them on parity with in-state workers, thereby decreasing the cost of insurance;
- Increase statutory deposits required from insurance companies;
- Modify and streamline the appeals process to protect the rights of injured workers and their employers.
- Mandate that workers compensation assigned risk pool be self-funding.

#### **Do the Murkowski administration proposed changes go far enough?**

The administration believes that the changes it has proposed to the Legislature address both the short term and the long-term problems of Alaskan workers and businesses. The goal of its proposed legislation is to address the immediate need to continue to pay claims without having to pro-rate benefits to injured workers or assess employers for the costs and to improve the workers compensation environment in Alaska in order to mitigate problems of this magnitude from occurring in the future.

## **Alaska Student Loan Corporation Return of Contributed Assets to State**

Diane Barrans, Executive Officer/Director  
Alaska Student Loan Corporation/Alaska Commission on  
Postsecondary Education

In 2003, the Murkowski Administration communicated its management expectation to all executive staff—that each state governmental unit is to scrutinize its structure and processes with respect to operational efficiency and effectiveness.

The management team for the Alaska Commission on Postsecondary Education (commission or ACPE) and its partner agency, the Alaska Student Loan Corporation (corporation or ASLC) engaged in that process. Subsequently, in July 2003, ASLC board members and management, in consultation with financial advisors, proposed a mechanism through which the state could 1) optimize the use of its financial assets; and 2) continue to effectively administer ACPE/ASLC financial aid programs.

Simply put, the plan is to convert future ASLC cash flow that is in excess of that needed for effective and efficient operation of corporation programs and mission-directed activities into cash today by issuing bonds. The cash is then made available to the State in lump disbursements to be used in funding other State capital needs. The following discussion focuses on the financing plan, as well as ASLC's historical and current contexts, which may be helpful in better understanding how this option is feasible at this time.

### **Financing Mechanics**

In 2004, the corporation intends to issue tax exempt bonds in an amount sufficient to support a \$75 million return of assets payment to the State. The financing, composed of Capital Project Revenue Bonds, will be issued under a closed, single-issue indenture. The corporation will pledge its 2003 consolidation loan portfolio to the indenture as collateral or "security." These loans are of relatively high credit quality with repayment terms of up to fifteen years in length. The repayment stream from those loan assets will be used to pay the principal and interest on the 2004 Capital Project Revenue bonds.

### **Corporation History**

The corporation was created and first issued bonds as a primary funding source for its programs in 1988 pursuant to a master trust indenture (1988 Indenture). At that time, there were no real meaningful performance data for the commission as a servicing agency, or for the loan portfolio as a whole. The corporation itself was a brand-new, untested issuer. Therefore, the corporation's Master Trust

Indenture (the rules within which bonds could be issued, loans made and serviced, etc.), contained a number of extremely conservative and restrictive terms. Bonds were issued under the 1988 Indenture through 2001. The indenture's terms subsequently were proven to be appropriate and prudent as the corporation experienced a number of years of operating with a growing equity deficit. The end result was an equity deficit that eventually totaled \$50 million.

In 1994, program managers initiated an effort to curtail and reverse the negative financial trend. Without action, within the next three years it was likely the loan programs would have been severely curtailed or ended altogether (erosion of assets through annual losses was pushing the corporation to the point where income was insufficient to pay bonds and make new loans, and no additional debt could be issued). Commission managers asked the legislature for the tools and managerial flexibility to operate as an enterprise agency of the State. Authorized changes to the programs included tying interest costs to the actual cost of funds, limiting interest-free borrowing periods, implementing credit reviews to identify applicants with poor credit records, and expanded use of authorized collection levers.

By the late '90s, as a result of these changes, the corporation and its servicing partner, ACPE, began experiencing a gradual, positive reversal of the agency's financial standing. In 1999, performance and finances had improved so markedly, both Moody's and Standard and Poor's raised the credit ratings on the corporation's outstanding bonds from A/A to Aa2/AA. That year, reinforcing its operational identity as an enterprise agency of the State, the corporation's management priorities included providing an annual return to the State on the more than \$300 million in loans and cash it had contributed to the corporation to capitalize its start up. In 2000, at the corporation's behest, the legislature passed a bill that set out the terms under which ASLC would annually return to the State a portion of its net income.

To date, the corporation has met this objective, while also maintaining financial stability and meeting its mission to provide postsecondary education access for Alaskans. As of FY2004, the corporation has returned \$16.45 million to the State.

### **Recent Management Enhancements**

In 2002, the corporation took steps to increase its options for leveraging ASLC assets by creating a new master trust indenture (2002 Indenture). At this juncture, the corporation was a recognized issuer with a strong track record in the bond market and had shown significant financial improvement for six consecutive years, as reported in its audited financial statements and illustrated in the credit rating upgrade. As a result, the limitations appropriate and reasonable within the original 1988 Indenture (particularly the very conservative debt coverage covenant which required trust cash flows document no less than

150% of annual debt service coverage in each year bonds were outstanding), were no longer necessary. Instead, under the 2002 Indenture, with respect to bonds issued within the new trust, the corporation is subject to a more relaxed rating confirmation test.

Over the last two years, the 2002 Indenture has effectively replaced the 1988 Indenture, eliminating the need to issue bonds within the original master indenture. The 2002 Indenture has been the source of funding for AlaskAdvantage™ Loans. Relative to this discussion was the corporation's ability to finance more than \$75 million in consolidation loans. The underlying loans (from the state's legacy program, Alaska Student Loans) were purchased from the 1988 Indenture through the consolidation process. Due to the structure of the 2002 Trust, the corporation was able to satisfy all relevant requirements of that trust without the need to also pledge the consolidation loans. Therefore, these assets are available for use as collateral for the Capital Project Revenue Bonds.

### **Timeline and Market Conditions**

With the 2002 Indenture in place and the debt outstanding under the 1988 Indenture declining, management proposed the following to insure the State's maximal use of assets:

- 1) The corporation issues government obligation bonds under a closed, 2004 Indenture to return approximately \$75 million to the State. These bonds will be issued at fixed rates with a final maturity of 15 years.
- 2) Subsequently, in 2005 and 2006, the corporation will determine its capacity to issue additional bonds with the objective of returning up to a total of \$260 million to the State (inclusive of the 2004 issue). These bonds would be repaid and secured with cash flows remaining after the currently outstanding bonds in the 1988 Trust were called or matured.

Current market conditions are extremely attractive with the rate environment issuers now enjoy. The issuance of government obligations in the manner described above may also provide the corporation with some refunding options in future years when volume cap may be tight for the State.

### **AlaskAdvantage™ Programs Held Harmless**

The corporation has no need to rely on the assets being pledged to the Capital Project Revenue Bonds and is prepared and able to fully meet future loan demand through its normal annual issuance of bonds under the 2002 Indenture.

Additionally, a Board priority since 1999, the corporation has actively identified ways to lower costs for existing customers who borrowed loans in years when

rates had been substantially higher than they are today. Since 2001, an annual rebate has been applied to all outstanding loans with rates of up to 9%, which has the effect of capping interest rates at 8.3%. More significantly, through the ASL Consolidation option in 2003, qualifying borrowers were able to lower their interest rates by as much or more<sup>1</sup> than 3%. Program managers plan to make this option available on an ongoing basis beginning in July 2004, and it will continue to be the primary means through which former borrowers may reduce their financing costs.

### **Estimated Effect on ASLC Dividend**

The corporation expects to continue to operate with modest but stable annual earnings, with a portion of those earnings available as its annual dividend to the State. Under the current dividend formula, absent use of the bonding mechanism described above for the stated purpose, the corporation could expect to return to the State an average of an additional \$700,000 per year over a fifteen-year period as the consolidation loans are repaid. While not an inconsiderable amount of money, clearly the availability of these substantially smaller amounts greatly limits the State's options for asset reinvestment.

### **Summary**

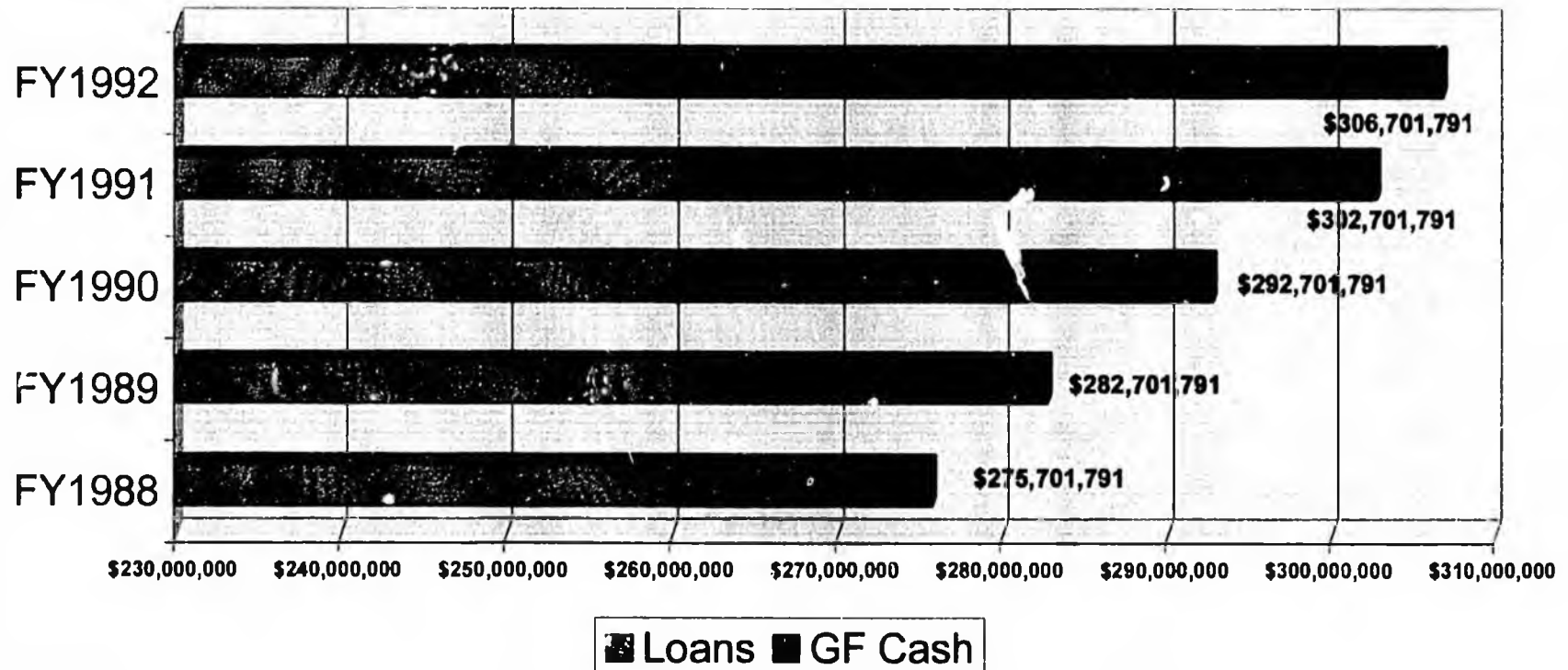
Notwithstanding the plan outlined above, the corporation intends to continue to deliver cost saving options to prior borrowers and to continue offering an annual package of borrower benefits for all qualifying borrowers. Prior to developing this recommended financing option, program managers exercised due diligence, working with the corporation's financial advisors on the feasibility of such a return to the State. Cash flow models were developed to insure the corporation has, *and will continue to have*, the financial capacity to discount loan interest rates and deliver outstanding borrower benefits to our primary customers—Alaska students and the families assisting them. Only after reserving for those ongoing expenses was the issue of capacity for a return of assets to the State (and in what amount) examined.

The corporation has no intention to or interest in abrogating its role in advancing its mission—to support, promote, and provide access to postsecondary education for Alaskans. The objective of this plan is to continue to serve that mission, but to do so in a way that permits ASLC to serve broader State interests through the efficient allocation of financial resources. As an enterprise agency of the State, it is both reasonable and appropriate that ASLC assets be managed in ways that permit benefit not only under the agency's organizational mission and purpose, but also deliver broader purpose benefits to the State.

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<sup>1</sup> Underlying loans being consolidated carry interest rates of 7.8% – 9%. The base interest rate on the 2003 consolidation loan is 5.8%. The application of borrower benefits to qualifying individuals' loans results in rate reductions of .25% to 2.25%.

## Cummulative State Contributions To ASLC



## ASLC Fund Equity by Fiscal Year

