



Steven L. Beshear  
Governor

Terry Holliday, Ph.D.  
Commissioner of Education

EDUCATION AND WORKFORCE DEVELOPMENT CABINET  
DEPARTMENT OF EDUCATION

Capital Plaza Tower • 500 Mero Street • Frankfort Kentucky 40601  
Phone: (502) 564-4770 • [www.education.ky.gov](http://www.education.ky.gov)

February 22, 2013

Mr. Bill Scott, Executive Director  
Kentucky School Boards Association  
260 Democrat Drive  
Frankfort KY 40601

RE: Follow-up Questions to Your Feb. 7 Responses on KSBIT Issues

Dear Bill:

Thank you for your response of February 7, 2013, in which you provided answers to questions I submitted relative to KSBIT. As you know, I continue to receive frequent inquiries from districts and superintendents regarding KSBIT, and thus am writing to pose some follow-up questions. For clarification, I have reproduced my *original questions and your responses in italics*, and the **new follow-up questions in bold**.

1. *"As of January 2010, when management of KSBIT was turned over to KLC, the KSBIT insurance programs were deemed solvent. How in just three years did the deficit become \$28 million?"*

*ANSWER: In January 2010, the Workers' Compensation Fund and the Liability and Property Fund had deficits projected at \$4,480,728 and \$933,063 respectively. KLC loaned the funds \$5.5 million (W.C.) and \$2.5 million (Liability) in the form of surplus notes to address the estimated deficits. This did not eliminate the deficit; rather it addressed the matter from a regulatory perspective. The surplus notes must be repaid at the time of liquidation of the respective pools.*

*Because workers' compensation claims, in particular, have such a long development period, the original loss projections were based on the actuarial assumptions at the time. Actuarial projections are not static; they are adjusted based on the circumstances and additional facts that become available. Effective January 2012, a new actuary was hired by KSBIT to examine the trust's deficits and to recommend rates moving forward. The actuary took a retrospective look at each year back to 1990. As the losses adversely developed, certain adjustments were made to reflect this as well as to provide an accurate estimate of future losses and the amounts needed to pay them. KSBIT management recorded reserves at the actuary's mid-point estimate, rather than at the low-end of the actuarial range used in prior years. Reserve adjustments had the effect of increasing the deficit and resulted in the \$28 million deficit in the current financials.*

**Why did KSBIT hire an actuary in January 2012 if, at that time, the Kentucky League of Cities (KLC) had been providing, by contract, all administrative services for the preceding**



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**two years? Did KSBIT suspect that the actuarial services obtained and provided by KLC were inaccurate? If so, why?**

**To clarify, was the \$8.0 million loan obtained with the understanding that the loan was not sufficient to cover the known deficits?**

**A 10-29-09 *Herald-Leader* story reported that the Department of Insurance had, at that time, been working with KSBIT for over a year to resolve the workers compensation deficit. Was that true? When did KSBIT begin working with the Department of Insurance to address the deficit?**

**The 10-29-09 story also reported that KSBIT had approached KLC in the summer of 2009 about merging. Was that true? If not, when and how were merger discussions initiated?**

**The 10-29-09 story reported that KSBA, in its role as the overseer of KSBIT, advised that the workers compensation deficit was \$4.5 million and the casualty fund deficit was \$900,000. Less than two months later, as reported in the *Herald-Leader* on 12-9-09, \$8 million was advanced, \$5.5 million for the workers comp fund and \$2.5 million for the casualty fund. How did the workers comp and casualty funds lose nearly \$3 million dollars in less than two months?**

**At the time of the takeover by KLC, it was announced that as much as \$500,000 could be saved through joint contracts and economies of scale. What savings were actually realized?**

**Were insurance premiums increased as districts elected to seek insurance coverage elsewhere and the pool of insured shrank?**

**Why, after many years of deficits in the workers compensation fund, was the decision made to record reserves at the mid-point estimate, rather than at the low range as in years past?**

**On June 24, 2005, the *Claims Journal* reported that the KSBIT workers comp fund started a plan of remediation through the Department of Insurance in May 2003, and reported an audited deficit of about \$5 million as of December 31, 2004. The story says that KSBIT was ordered to provide a \$6.5 million letter of credit as additional security for the fund. Please advise how KSBIT failed to remediate a \$5 million deficit that, based on publicly available information, persisted for at least nine (9) years?**

**2. *"It appears from the notes in the current financials that there has been a significant change in the actuarial loss assumptions for the fund for prior years, particularly in the last three or four years. How inaccurate were the loss assumptions that were used in the assessment fund performance?"***

*ANSWER: There were, as noted above, changes in the actuarial assumptions based on the recommendations of a qualified outside actuarial firm. These recommendations were then subjected by KSBIT to outside peer review to test their soundness, given the impact the changes had on the deficit. The management and KSBIT trustees then made certain business decisions including recording reserves for claims at the mid-point of the actuarial range of losses and discontinuing the discounting of reserves (reducing claim reserve liabilities based upon expected future investment income). Prior actuarial assumptions were made by a qualified national actuarial firm and were relied upon by management and the KSBIT board. The issue of whether the prior assumptions were inaccurate or inappropriate is one for experts and has not been determined at this point.*

**What precipitated the change in actuaries and the outside peer review? What event triggered these measures? When were these measures initiated?**

3. *“Prior to 2005, KSBIT had three pools – property, liability, and workers compensation. In determining the amount of a member’s assessment, is participation in each pool being considered independently, or is participation in the property and liability pools being aggregated? Or, is participation in all three areas being aggregated?”*

*ANSWER: While the property and liability pools are reported on a consolidated basis in their audited financial statements, they are still accounted for as separate funds or pools operationally. Members’ assessments are determined on a pool-by-pool basis. There is no deficit in the property pool and therefore no assessment for that pool.*

**No additional questions at this time.**

4. *“In the past KSBIT purchased aggregate or stop-loss coverage as part of the property excess or reinsurance. Did KSBIT purchase such coverage for the policy periods ending 7/1/2012 and 7/1/2013? If so, does the proposed assessment for the policy periods take such stop-loss coverage into consideration? In other words, if a member had heavy losses, but these losses were limited to property only, would that member have any responsibility for the deficit in the property liability fund since KSBIT notes that the deficit relates largely to liability losses.”*

*ANSWER: Yes, KSBIT purchased such coverage for the 2012-13 policy year. However, as stated above, there are no deficits currently in the property pool. In fact, it has a surplus as of June 30, 2012. Any surplus may be distributed to members upon approval of the Commissioner of the Department of Insurance. Accordingly, there will not be an assessment for members’ property losses or policies. Only those members who have liability policies in deficit years will have an assessment for the liability pool. Any stop-loss coverage was applied before determining the losses which are the basis for the assessment.*

**No additional questions at this time.**

5. *“The proposed liquidation of KSBIT is based on a Loss Portfolio Transfer (LPT) that would include a novation with the company performing the LPT agreeing to assume all future liability for the fund--for which a premium would be charged. Don't the actuarial projections and assumptions for the pool – which are a factor in calculating the amount of the deficit – already include amounts for claim development and Incurred But Not Reported (IBNR) claims? If so, isn't this the equivalent of asking the members to fund these potential losses twice?”*

*ANSWER: The Financial Statements of KSBIT do include IBNR projections. Both a novation and a LPT (which are different) include a premium because the insurer is taking on future liability. The LPT is a reinsurance transaction. The novation is the insurer completely replacing KSBIT and assuming the risk of all future claim payments. For assuming this risk, including the risk that claims development will be worse than projected, the insurer requires a premium payment. What the members receive in return is assurance their claims will be paid and that there will not be any future assessments should there continue to be adverse claim development or other factors which result in an unforeseen increase to the deficit. For example, a change in the workers compensation law in the future, as has occurred in the past, could result in unexpected claims payments and an increase in the deficit. The insurer considering the loss portfolio transfer looks at the IBNR projections and amount of claim reserves, and determines how much it will need to pay future claims and assume the risk. This amount then results in the premium to be paid for the novation or LPT. Accordingly, it is not a duplicate payment but rather a payment for someone else to take over administration and the risk of the policies.*

**What alternatives to LPT or novation have been considered? Has consideration been given to a plan under which a trustee may be appointed, who might in turn, through an RFP, retain a third-party administrator?**

6. *“How many companies were approached regarding the LPT and how were they selected?”*

*ANSWER: Twenty-eight carriers were solicited for the LPT and/or novation bids. The market of companies that will offer novations or LPTs is limited. The carriers that were approached were among those known to engage in such transactions and who have the financial strength to be credible for the ability to pay claims for the extended period which will be required for KSBIT's workers compensation pool.*

**How many of the twenty-eight carriers were willing to offer LPT or novation? Who were the twenty-eight carriers?**

7. *“Were the LPT proposals currently under consideration competitively bid? If an agent or broker was used to seek out LPT partners, was this service competitively bid?”*

*ANSWER: Insurance agents were selected to approach the market place on the basis of expertise and knowledge of the KSBIT program. Multiple agents and brokers were involved in the process.*

**Please state whether LPT proposals and the services of agents or brokers were competitively bid. Please identify the agents and brokers and their fees and fee arrangements.**

8. *“KSBIT notes that they believe a transfer of liability is better than putting the program in a run-off status. What is the premium tied to the novation or transfer of liability for the program? How much, if any, in fees or commission will be paid to the agent/broker placing the LPT?”*

*ANSWER: KSBIT does not have the final numbers on a novation, as the carriers are currently doing their due diligence. KSBIT has not made a final decision on novation versus run-off. The trust authorized an outside consultant to advise it on the costs and model for a run-off, while the insurers are completing their due diligence on the novation and finalizing their numbers. Once the information is available on both options, KSBIT will make an informed decision on which approach is in the best interest of the trust and its members. Should the trustees choose the novation route, any agent's commissions will be paid by the insurer selected and included in the overall bid of each insurer in its novation premium cost. A \$100,000 fee was paid by KSBIT to the Underwriters Group to cover the costs of due diligence. If KSBIT goes the novation route, that will be deducted from the winning insurer's bid. If KSBIT does not choose any insurer, it will be applied as a due diligence cost of those responding to the bid request.*

**No additional questions at this time.**

9. *“The alternative to the proposed LPT is to put the program into a “run-off” position and contract with a Third Party Administrator (TPA) to pay claims until their ultimate conclusion. Has a cost comparison between this approach and the proposed LPT been conducted and, if so, what are the results? Also, if the run off option was studied, which TPAs were consulted, how were they selected, and did they have any involvement with or connection to the companies contacted regarding an LPT?”*

*ANSWER: While KSBIT currently believes that shifting all of the risk to a qualified insurer may be the best route for its members, it will not make that decision until after it has all of the information and can compare the pros and cons of a novation to a run-off. As noted in the Answer to Question 8 above, the process is underway to obtain the cost of both options.*

**Will the novation and run-off cost figures be made available? Will those figures be made available before the decision is made, or only afterward?**

**It has been proposed that only a run-off or a novation will resolve the present financial issues. The appointment of a Trustee and the retention, through an RFP, of a third party administrator, would seem to be much more cost effective. Please state whether this option has been considered, and why it was not advanced.**

**Please state whether the KSBIT board has considered whether bonding can be avoided through annual assessments.**

10. *“Are there mechanisms in place for members to contest or appeal the amount of their assessment? Along those lines, what contingencies are in place if members simply refuse to pay their assessment?”*

*ANSWER: There will be a process in place for members to contest their assessments. The first step in this process is KSBIT sending an estimated assessment out to members with all of the backup data. Information on other members' share of the estimated assessment will be available online. KSBIT expects this to go out by the end of the first week in February. Members can study their data and inform KSBIT of any perceived errors. They can also provide comments on the proposed assessment methodology. However, this is an estimate of a future assessment only. The estimated assessment amount, which was chosen at the high end of the assessment, will undoubtedly change depending on the ultimate cost of a novation or runoff. Once the decision has been reached on the actual amount of the assessment, the KSBIT board will vote on the assessment. Then each member's calculated share by pool will be sent to them and posted on line. This is expected to occur later this spring after the KSBIT board has all of the information on its options. At the time of sending out the assessment, members will also be notified of the process for contesting their assessment(s).*

*With respect to the second part of your question, for the benefit of all members, KSBIT will pursue the payment of all assessments. One consequence for a member not paying their assessment in a timely manner will be that the member is not eligible for participation in the bond financing of the assessment. There will also be other penalties including interest for nonpayment and late payment and the costs of collecting the late assessment which are yet to be determined by KSBIT. Any such consequences will be part of the plan submitted for approval to the Kentucky Department of Insurance.*

**Do cost-shifting provisions apply if districts successfully contest their assessment? Or, must districts bear the full cost of contesting, regardless of success?**

11. *“Have KSBIT, KSBA and KLC board members been advised to notify their director and officer insurance carriers regarding potential exposures relative to the deficit position and ultimate dissolution of KSBIT?”*

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*ANSWER: KSBIT, KSBA and KLC routinely notify their insurance carriers whenever any event occurs which might potentially lead to a third party claim regardless of the perceived merit of such claim. Accordingly, such notice was given of the changes in the deficit.*

**A question that I did not raise in my earlier correspondence, but that has been the subject of many comments, regards monies paid by KSBIT to KSBA. From the workers compensation audit, I am aware that, under the January 1, 2010 agreement, KSBA was to endorse, exclusively, the KSBIT funds and to provide other services for a fee equal to one and one-quarter percent of annual gross premiums, not to exceed \$500,000 per year.**

The audit notes that KSBA was paid \$78,206 for 2012 and \$92,284 for 2011. Because the cap of \$500,000 is so dramatically higher than these amounts, I assume that there was some actuarial basis for that cap, and am asking that you provide the amount of yearly payments made to KSBA from 1990 to 2010.

**On February 19, 2013, the *Herald-Leader* reported that KSBA received \$800,000 for management and marketing fees between 2010 and 2013. Please reconcile these figures with those from the audit.**

**Were any funds transferred from KSBIT to KSBA since 1990 that were not accounted for in your answers to the preceding questions?**

**Please identify any services that KSBA provided to districts for which districts were charged a fee between 1990 and 2013, stating the service and the amount charged.**

**The *Herald-Leader* has reported that KSBA received almost \$7.5 million in royalty and management fees since 1997. Is that correct, and what are the annual amounts?**

Thank you for your prompt response to my last letter of inquiry. I look forward to hearing from you regarding these follow-up questions.

Sincerely,



Terry Holliday, Ph.D.

Cc: All Kentucky School District Superintendents