Process for Development of the Reserve Discount Rate

Workers' compensation claims are generally paid over a period of several years. A reserve for compensation is set based on the total of all estimated amounts that will be paid in future years on reported claims and claims incurred but not reported. BWC's practice is to discount the reserve to reflect the time value of money (one dollar of future claims liability can be paid by setting aside less than one dollar today due to expected investment earnings).

BWC has been discounting reserves for at least 30 years. Since 1997, BWC has established a practice to review and evaluate the current discount rate on an annual basis using a documented approach. The approach relies on GASB 10. Prior to FY 2006, BWC performed this evaluation at the time of the actuarial audit. In FY 2006, BWC began its current practice of performing the evaluation in conjunction with the rate making process for private employers. This results in better matching of the ratemaking and reserving processes. The discount rate is utilized for rate making purposes effective July 1. The discount rate is utilized for auditing the reserve for compensation and compensation adjustment expense effective June 30.

Under Ohio Revised Code 4121.121(B)(1) the Administrator has the responsibility to establish a discount rate. Every March, the Administrator presents the discount rate decision to the Board for review, discussion and concurrence.

The business rationale and methodology and guiding principles for the establishment of the discount rate are:

Business Rationale

- The discount rate recognizes the economic benefit of the time value of money. It is an appropriate accounting treatment that recognizes that benefit. However, the discount rate does not create income.
- The discount rate enables the organization to present a prudent picture of its liabilities that is consistent with economic forces and BWC's mission to provide benefits for injured workers at the lowest possible cost while maintaining a solvent state insurance fund.

Methodology and Guiding Principles

- Should use a methodology supported by accounting and actuarial literature, especially the provisions of Governmental Accounting Standards Board (GASB) Statement No. 10 ("Accounting and Financial Reporting for Risk Financing and Related Insurance Issues") and Actuarial Standard of

Practice No. 20 ("Discounting of Property and Casualty Loss and Loss Adjustment Expense Reserves") as approved by the Actuarial Standards Board.
    - GASB 10 requires an examination of past portfolio performance, historical payment patterns and settlement rates
    - Actuarial Standard of Practice #20 requires that explicit provisions for risk accompany reserve discounting and suggests the uncertainty in the timing and amounts of future payments be considered along with historical payment patterns
    - Both standards recommend consideration of a risk-free investment yield
- Should be established with a long term view to reduce volatility in BWC's balance sheet and premiums
- Should not exceed highly probable investment returns over long periods of time
- Should enable management to focus on business enterprise goals
- Should be reviewed annually

The Administrator completes the following steps to establish the discount rate:

1. Meets with the Chief Actuarial Officer, Chief Investment Officer, Chief Fiscal and Planning Officer and other senior executives as appropriate to review reserves, investment returns, and cash flow needs
2. Follows the Actuarial Standard of Practice #20 concerning discounting
3. Follows the Government Accounting Standards Board Statement 10
4. Considers the following questions:
    - Is it consistent with BWC's practice of establishing a conservative discount rate?
    - Is it consistent with industry standards?
    - Is there a decreasing or increasing return on BWC's investment portfolio?
    - Are there changes in BWC's investment strategy?
    - What are the trends of risk free investment yields?
    - Do we anticipate changes in the financial markets?
5. Administrator presents a recommendation and rationale to the Board for review, discussion and concurrence

Discount Rate Assumptions used in actuarial audits and rate indications

Evaluation Date	Discount Rate
12/1991-12/1996	7.00%
12/1997	6.75%
6/1998	6.50%
6/1999	6.25%
6/2000 – 6/2001	6.00%
6/2002	5.80%
6/2003 – 6/2004	5.50%
6/2005 – 6/2006	5.25%
6/2007	5.00%
6/2008	5.00%
6/2009	4.50%

Approved by BWC Board of Directors
February 20, 2009
April 30, 2009

Reserve Discount Rate Recommendation

The Reserve Discount Rate Policy approved by the Board in February 2009 contained a series of steps, listed below, for the Administrator to complete as she considers her recommendation/conclusion. The Administrator recommends a reduction from a 4.5% to a 4% discount rate to be adopted for fiscal year end 2010.

Policy Documentation

The Administrator met with senior executives on March 2, 2010, and followed the Actuarial Standard of Practice #20 and the Government Accounting Standards Board (GASB) Statement 10.

Following BWC Board policy, the Administrator considered the following questions.

- *Is the proposed discount rate consistent with BWC's practice of establishing a conservative discount rate?*

Yes. Table 1 shows a slow yet steady decline in our discount rate that reflects the slow yet steady decline in the yields of "risk free" investments.

TABLE 1

Fiscal Year	Discount Rate (FY)		Fiscal Year	Discount Rate (FY)
1996	7.0		2005	5.50
1997	6.75		2006	5.25
1998	7.00/6.75		2007	5.25
1999	6.50		2008	5.00
2000	6.25		2009	4.50
2001	6.00			
2002	6.00		**Avg.**	
2003	5.80		2005-2009 (5 years)	5.1
2004	5.50		2000 -2009 (10 years)	5.5

- *Is the proposed discount rate consistent with industry standards?*

Yes. Mercer has informed us that many entities select their discount rate based on the yields of a 10 year Treasury and the 10 year "AA" corporate bond.

In their August, 2008 presentation to the Board, Deloitte discussed a 4% "risk-free" discount rate. They compared Ohio's 5% discount rate to discount rates used by West Virginia (3.8%), New York (5%), Canada's monopoly fund (3.3%) and Australia's monopoly fund (6.5%). For FY 2009, the state of Washington used a discount rate of 2.5% for their accident and medical aid fund, and 6.5% for their pension fund.

- *Is there a decreasing or increasing return on BWC's investment portfolio?*

Table 2 indicates State Insurance Fund (SIF) annual returns over a ten year period. While there are year-over-year fluctuations, the five year investment average return is slightly higher than average Treasury yields. BWC returns for the five and ten year period are below corporate bond yields. (See Summary Table). Investment returns should exceed the discount rate. SIF investment returns exceeded the discount rate in just seven of the past ten years.

TABLE 2

Calendar Year	BWC SIF Investment Returns
2000	5.8%
2001	-3.1%
2002	-4.7%
2003	14.4%
2004	7.3%
2005	6.3%
2006	6.3%
2007	6.6%
2008	-2.3%
2009	8.7%
Avg.	
2005-2009	5.12% (5 yr. avg.)
2000-2009	4.53% (10 yr. avg.)

- *Are there changes in BWC's investment strategy?*

The SIF targeted asset class mandate weightings per BWC's Investment Policy Statement were achieved in December 2009. Also please review the attached March 3, 2010 memo from Bruce Dunn.

- *What are the trends of risk free investment yields?*

While the GASB and the Actuarial Standards don't specifically define "risk free" yields, many practitioners in the field use the "AA" corporate bond yield or the 10 year Treasury yield. The trends in these yields are shown below. The five year average yields are consistently lower than the ten year average yields. See Table 3.

TABLE 3

Calendar Year	"AA" Corporate Bonds		Treasuries	
	10-15 years	15+ years	10 year	20 year
2000	7.53	7.83	6.03	6.23
2001	6.47	7.04	5.02	5.63
2002	5.93	6.73	4.61	5.43
2003	4.97	5.84	4.02	4.96
2004	5.15	5.87	4.27	5.05
2005	5.16	5.69	4.29	4.65
2006	5.82	6.07	4.79	4.99
2007	5.89	6.23	4.63	4.91
2008	6.27	6.79	3.67	4.36
2009	6.32	6.33	3.29	4.12
Avg.				
1/05 To 12/09	5.89	6.22	4.13	4.60
1/00 To 12/09	5.95	6.44	4.46	5.03

Bond yields provided are month-end averages for each calendar year.

- *Do we anticipate changes in the financial markets?*

  The following is an excerpt of the March 3, 2010 CIO report to the Administrator.

"Based on the most recently published Mercer Consulting Capital Market Outlook report dated January, 2010, an exercise of calculating expected future rates of return can be made on both the current SIF fixed income portfolio and the current SIF total portfolio with respect to targeted asset mandate weightings per the current investment policy targets for SIF. These asset class mandate weightings were achieved by the BWC investment staff in December 2009 with the completion of certain portfolio transition activities. This asset allocation weighting is broadly a 70% fixed income and 30% equity mix. These calculations reflect the current expected future **twenty-year** rate of return (ROR) assumptions of each asset class Mercer provides in this referenced Capital Market Outlook report relevant to the SIF portfolio. The Mercer twenty-year SIF fixed income portfolio expected average annual future rate of return based simply on the target weights of the current SIF fixed income portfolio asset classes is **5.22%** comprised as follows: 28% long credit bonds @ 6.0% ROR; 17% TIPS @ 4.6% ROR; 15% U.S. Aggregate index bonds @ 4.9% ROR; 9% long U.S. government bonds @ 4.7% ROR and 1% cash @ 3.4% ROR. When the 30% weighted allocation for public equities @ 8.3% ROR are included and added (alternative asset classes ignored for this calculation), the total SIF portfolio expected average annual return increases to **6.15%**. Although these projected theoretical rates of returns are certainly not risk-free, the premise can be made that they can be considered as reasonable expected annual returns over a long period of ten years or more for the current asset allocation targets of the SIF portfolio."

Summary Table

Calendar Year	"AA" Corporate Bonds		Treasuries		BWC SIF* Investment Returns	Discount Rate (applied FY)
	10-15 years	15 + years	10 yr.	20 yr.		
1996	6.93	7.66	6.44	6.82	8.8	7.00
1997**	7.05	7.51	6.35	6.68	19.4	7.00/6.75
1998**	6.39	6.84	5.26	5.72	12.8	6.75/6.50
1999**	7.00	7.27	5.64	6.19	9.9	6.50
2000**	7.53	7.83	6.03	6.23	5.8	6.25
2001**	6.47	7.04	5.02	5.63	-3.1	6.00
2002**	5.93	6.73	4.61	5.43	-4.7	6.00
2003**	4.97	5.84	4.02	4.96	14.4	5.80
2004**	5.15	5.87	4.27	5.05	7.3	5.50
2005**	5.16	5.69	4.29	4.65	6.3	5.50
2006	5.82	6.07	4.79	4.99	6.3	5.25
2007	5.89	6.23	4.63	4.91	6.6	5.25
2008	6.27	6.79	3.67	4.36	-2.3	5.00
2009	6.32	6.33	3.29	4.12	8.7	4.50
Avg.						
1/05 To 12/09	5.89	6.22	4.13	4.60	5.12 (5 yr. avg.)	5.1
1/00 To 12/09	5.95	6.44	4.46	5.03	4.53 (10 yr. avg.)	5.5

* Calendar Year returns for State Insurance Fund only. Specialty Funds not included.
** Dividends rebates paid from SIF to employers

DATE: March 3, 2010

TO: Marsha Ryan, Administrator

FROM: Bruce Dunn, CFA, Chief Investment Officer

SUBJECT: **CIO Discount Rate Setting Comments**
State Insurance Fund
Fiscal Year 2011

[**Introductory Note:** Historical State Insurance Fund portfolio performance and selected bond yield averages over each of the past ten years were recently provided to the Fiscal & Planning Division for the purposes of producing summary information useful for discount rate setting discussions and determination.]

The State Insurance Fund (SIF) portfolio has earned an average per annum total return of **4.53%** over the past ten calendar year period 2000-2009 and **5.12%** over the past five calendar year period 2005-2009. It is interesting to note that the ten-year average annual yield for 10-year maturity Treasuries over the ten-year calendar period 2000-2009 is 4.46% or almost identical to the 4.53% SIF average annual portfolio return over this same most recent ten-year calendar year period. The five-year average annual return of 10-year maturity Treasuries over calendar years 2005-2009 is 4.13% versus the 5.12% SIF average annual portfolio return over this same period. Given this historical information and performance results, the argument can be made to lower the SIF discount rate by ½% to 4.0%. Deloitte Consulting has previously suggested focusing on a 10-year U.S. Treasury yield as the risk-free yield. As a matter of information, the yield of the current market 10-year Treasury note at the time of this writing was 3.62%. Only if one adopts a long-term time frame of ten years can an investor essentially be assured of earning the yield currently available from a 10-year maturity Treasury. If yield levels on 10-year Treasuries at current levels move up even modestly higher (30-40 basis points per year) for several years, then 10-year Treasuries could produce a negative return over that time period. Some investors consider a 3-month Treasury bill to be a true risk-free yield and that instrument is currently yielding an extremely low 0.13% at this time.

Based on the most recently published Mercer Consulting Capital Market Outlook report dated January, 2010, an exercise of calculating expected future rates of return can be made on both the current SIF fixed income portfolio and the current SIF total portfolio with respect to targeted asset mandate weightings per the current investment policy targets for SIF. These asset class mandate weightings were achieved by the BWC investment staff in December 2009 with the completion of certain portfolio transition activities. This asset allocation weighting is broadly a 70% fixed income and 30% equity mix. These calculations reflect the current expected future **twenty-year** rate of return (ROR) assumptions of each asset class Mercer provides in this referenced Capital Market Outlook report relevant to the SIF portfolio. The Mercer twenty-year SIF fixed income portfolio expected average annual future rate of return based simply on the target weights of the current SIF fixed income portfolio asset classes is **5.22%** comprised as follows: 28% long credit bonds @ 6.0% ROR; 17% TIPS @ 4.6% ROR; 15% U.S. Aggregate index bonds @ 4.9% ROR; 9% long U.S. government bonds @ 4.7% ROR and 1% cash at 3.4% ROR. When the 30% weighted allocation for public equities @ 8.3% ROR are included and added (alternative asset classes ignored for this calculation), the total SIF portfolio expected average annual return increases to **6.15%**. Although these projected theoretical rates of returns are certainly not risk-free, the premise can be made that they can be considered as reasonable expected annual returns over a long period of ten years or more for the current asset allocation targets of the SIF portfolio.

Given all of the above historical, current and projected information on yields and portfolio returns, the CIO would support a discount rate reduction to 4.0% from 4.5% for fiscal year 2011. Such a discount rate reduction would be both reflective of the downward trend of the risk-free interest income returns (however defined) available in the U.S. financial markets in recent years as well as the general relatively low yield environment for high quality U.S. government and credit fixed income securities.

MERCER

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Memo

To: BWC Audit Committee
BWC Board of Directors

Date: March 9, 2010

From: Guy M. Cooper
Jordan Nault
Kweku Obed

Subject: Reserve Discount Rate Recommendation

We concur with the Administrator's intent to lower the discount rate from 4.5% to 4.0% beginning July 1, 2010.

This action conforms to two criteria that we consider important in the annual consideration of the discount rate:

1. The discount rate should be set in the low end of the acceptable range of alternatives.
2. The discount rate should be held relatively stable from year to year.

The proposed action is also consistent, in our view, with current and projected bond yield levels and with the professional standards and practices that bear on the setting of a discount rate for insurance company reserves.

Ohio Bureau of Workers' Compensation
Financial Performance Metrics

Introduction

The Monthly Board Financial Reporting Package presents financial results for the current period, projected results, and prior year results. In addition to looking at the raw numbers, ratios are calculated and used to analyze BWC's profitability. These ratios are presented for the current fiscal year to date, projected fiscal year to date, prior fiscal year to date, fiscal year-end forecast, and the last five fiscal year ends.

The ratios enable BWC to benchmark against our peers in the workers' compensation industry. BWC's insurance profitability ratios have been calculated using information contained in BWC's audited financial statements prepared in accordance with generally accepted accounting principles (GAAP). Most private insurance carriers and some state insurance funds prepare financial statements on a statutory accounting basis (SAP). Comparisons of BWC's ratios to industry performance will not be a true apples-to-apples comparison. Major differences will be caused by the following:

- BWC discounts all reserves for compensation and compensation adjustment expenses while most insurance carriers either do not discount their reserves or discount on a very limited basis.
- BWC's investments are reported at fair value, with the change in fair value reported as an unrealized gain or loss in the Statement of Operations. Under SAP bonds are normally reported at amortized cost in the balance sheet, while stocks are reported at values published by the National Association of Insurance Commissioners (NAIC), which are generally fair values, unrealized gains and losses are recognized through a charge to statutory surplus in the balance sheet.
- BWC's exclusive state fund status provides BWC an advantage in that there are no commission, brokerage, or income tax expenses.
- BWC establishes rates at the lowest level possible in order to maintain a solvent State Insurance Fund. This is in contrast to private insurance carriers who must maintain surplus above levels established by state insurance regulators.
- Unlike private insurance carriers, BWC has a separate assessment for administrative costs. The administrative cost assessment is calculated on a pay-as-you-go basis, while liabilities are recognized as incurred. Consequently, the incurred compensation adjustment expenses are not fully funded.

BWC has obtained data from A.M. Best, a widely recognized rating agency dedicated to the insurance industry, from Ward Group, a widely recognized provider of insurance industry benchmarking, best practices and research studies, and from state fund financial statements. BWC utilized data from the state funds in California, New York and Washington, the A.M. Best Composite which consists of groups and companies for which more than 50% of their business is in the workers' compensation line, and six of the largest private workers' compensation carriers.

Ohio Bureau of Workers' Compensation
Financial Performance Metrics

Funding Ratio

Definition: Provides an indication of financial strength and security by evaluating a company's funded assets in relation to its funded liabilities.

For consideration and discussion:

- The funding ratio for four of the six private companies is between 1.5 and 2.0; and
- Two private carriers maintain funding ratios over 2.0 and state funds maintain ratios from 1.0 to 1.5.

Recommendation: Through prudent investments, lowest possible premiums and careful expense management, **the target funding ratio should have a range of 1.15 and 1.35**. This would place Ohio in a comparable position with other state funds.

The proposed funding ratios correlate with the net leverage ratios that follow. It is management's recommendation that a 1.15 Funding Ratio provides enough of a warning indicator that BWC has the potential to see its funded assets fall below its funded liabilities and is also exceeding its Net Leverage guideline of 7:1. On the "high" side, a funding ratio of 1.35 indicates that BWC is possibly approaching a condition where its funded assets could significantly exceed its liabilities and should be concerned with setting the lowest rates possible while ensuring the maintenance of a solvent state fund. The 1.35 tracks well with the Net Leverage guideline of 3.0, which would be considered very strong in the private insurance industry.

Net Leverage Ratio

Definition: Measures a company's exposure to pricing errors and errors in estimating its liabilities in relation to net assets. Premium income and reserves for compensation and compensation adjustment expenses are compared to net assets.

For consideration and discussion:

- Four of the six private carriers had a net leverage ratio of 4.0 or less; and
- State funds maintain net leverage ratios between 4.0 and 8.4.

Recommendation: The target funding ratio range above will produce a net leverage ratio range of 3.40 to 11.90. This assumes the necessary increases in total assets and total funded assets to achieve the indicated funding ratio and what impact those increases would have on the net leverage ratio if liabilities and premiums remain constant. It should be noted that this ratio is significantly impacted by changes in the market value of the portfolio. **As such, the target net leverage ratio should have a range of 3.0 to 7.0**. This would place Ohio in a comparable position with other state funds. (See rationale above under funding ratio.)

Combined Ratio after Policy Holder Dividends

Definition: The combined ratio after policyholder dividends measures a company's overall underwriting profitability. Combined Ratio is the combination of the loss ratio and the expense ratio.

For consideration and discussion:

Ohio (5 year average)	101.4%
Washington (5 year average)	164.6%
California (5 year average)	105.0%
Workers' Comp Composite (5 year average)	105.9%

Recommendation: The insurance industry targets 100% Combined Ratio. BWC being a state agency with a public mission to keep rates at the lowest possible level consistent with maintaining a solvent fund could establish a higher combined ratio that factors investment income into the guideline. **For these reasons, management recommends a guideline for BWC's combined ratio of 110%.**

Net Loss Ratio

Having established our overall performance guideline in the Combined Ratio, we want to establish parameters for the two major components of that Combined Ratio, namely the Net Loss Ratio and the Expense Ratio.

Definition: Net loss ratio measures a company's underlying profitability, or loss experience on its total book of business. Losses and loss adjustment expenses (LAE) are compared to premiums and assessments.

For consideration and discussion:

Ohio (5 year average)[1]	95.8%
Washington (5 year average)	155.1%
California (5 year average)	86.1%
Workers' Comp Composite (5 year average)	79.2%

Recommendation: BWC's five year average noted above reflects an average loss ratio of 78.6% and an average LAE ratio of 16.9%. The net loss ratio was the highest in Fiscal Year 2005. Continued declines have occurred as BWC has stabilized the reserving methodology and reduced the discount rate. This is expected to continue as management reviews the current reserve methodology associated with claims costs and the loss adjustment expenses, as well as the continued decline in the discount rate. Due to our selection of a combined ratio of 110% and our low expense ratio, BWC can tolerate a net loss ratio higher than private industry and higher than 100% of premiums. However, we would be concerned

[1] BWC's 5 year average excludes the $1.9 billion impact of the 2007 adjustment to income related to a statutory change in accounting for the Disabled Workers' Relief Fund.

when our net loss ratio starts to go too far above 100%. **Based on this, management is recommending a target net loss ratio of 102.5%.**

Expense Ratio

The expense ratio measures a company's operational efficiency in underwriting its book of business. We must also remember that expenses are used to manage premiums, losses and investments to achieve an overall performance objective. Many times it is prudent to increase expenses to reduce loss costs thereby reducing total cost of the system.

Definition: The expense ratio measures a company's operational efficiency in underwriting its book of business. Expenses are compared to premiums and assessments.

For consideration and discussion:

Ohio (5 year average)	3.6%
Washington (5 year average)	9.6%
California (5 year average)	18.9%
Workers' Comp Composite (5 year average)	22.9%

Recommendation: The five year average noted above is reflective of BWC's allocation of administrative costs between loss adjustment expenses and other expenses. Evaluation of this allocation in the current fiscal year will result in a lower percentage of costs allocated to LAE and, as a result, an increase in the expense ratio. While our proposed guideline is higher than BWC's current expense ratio, management feels this latitude is appropriate long term to effectively manage the Bureau's total costs with stable to declining rates. **Based on this, management is recommending a target expense ratio of 7.5%.**

Operating Ratio

Definition: The operating ratio measures a company's overall operational profitability from underwriting and investment activities (excluding realized and unrealized investment gains and losses). Total expenses, net of the impact of investment income, are compared to premiums and assessment income.

For consideration and discussion:

Ohio (5 year average)	73.5%
Washington (5 year average)	118.5%
California (5 year average)	85.1%
Workers' Comp Composite (5 year average)	88.2%

Recommendation: The operating ratio is a function of both operating results and investment results. The five-year average investment income ratio at the end of FY 2009 is 27.9%. In the past five years, the investment income ratio has been as high as 38.6% to a low of 18.53%. Two years ago, the five-year average investment income ratio was 16%. BWC has currently completed a transition of the investment portfolio to a new asset allocation. In order to remain conservative in our approach, it is anticipated that the investment income ratio will be approximately 20%. **Based on this, in conjunction with the Combined Ratio guideline of 110%, management is recommending an operating ratio guideline of 90%.**

Net Asset Policy
Ohio Bureau of Workers' Compensation
Board of Directors

BWC requires a prudent level of net assets to protect the fund against financial and operational risks that may threaten the ability to meet future obligations. These financial and operational risks include, but are not limited to, the following:

- Uncertainty in the ultimate amount and timing of future payments on known claims;
- Legislative and court actions that may affect future operations;
- Substantial catastrophic events, either through acts of nature or acts of man;
- Significant market fluctuations resulting in material changes in the valuation of the investment portfolio; and
- Economic factors impacting BWC's ability to collect premiums.

In an effort to maintain a solvent and stable state fund, BWC should maintain a sufficient level of net assets to handle these risks.

Business Rationale

- Adoption of a net asset policy will enable the organization to maintain prudent funded net assets to support the financial strength of the State Insurance Fund and maintain stability in premium costs.
- Adoption of a net asset policy will enable the organization to fulfill the statutory requirements of maintaining a solvent state fund while keeping premiums as low as possible.
- Adoption of a net asset policy with guidelines provides flexibility in decision-making with respect to options such as premium credits or surcharges.

Methodology

- Should use methodology supported by customized metrics to calculate key results used in measuring funding adequacy.
  - Funding Ratio is defined as funded assets divided by funded liabilities (funded assets= cash, investments, and current receivables less deposits and current payables; funded liabilities=reserves for unpaid claims and funded claim expenses, excluding any risk margin, discounted at a rate as approved by the Board of Directors).

- Net Leverage Ratio is premium income plus reserves for compensation and compensation adjustment expense divided by net assets.

Guiding Principles

- Sound fiscal principles would dictate the need to maintain sufficient assets to meet current and future obligations. Therefore, as a matter of policy, the minimum guideline for a funding ratio should never be below 1.00.
- Should reflect the unique characteristics of the Ohio system. We have less stress on premiums and have more flexibility on the level of liabilities than a private carrier. The guidelines also reflect the statutory obligation to maintain a solvent fund with the lowest possible premiums.

The Net Asset policy

- Should incorporate the concept of ranges to be responsive to changes and to maintain a degree of stability in operating results over time.
- Should incorporate appropriate options for premium credits or surcharges, if metrics indicate excessive or inadequate financial reserves.
- Should enable BWC to make limited peer comparisons.
- Should be tailored to each fund where a material amount of a fund's obligations are funded, as opposed to pay-as-you-go (Pay-as-you-go funds include the DWRF I and II, SIEGF and ACF).
- Should include consideration of risks associated with estimates inherent in financial reporting including, but not limited, to medical inflation, discount rate, and portfolio market valuation.

The following steps should be taken when establishing guidelines for the funding ratio and net leverage ratio:

1. The Administrator, with approval from the BWC Board of Directors, should establish guidelines for a Funding Ratio and a Net Leverage Ratio.
2. The guidelines for a Funding Ratio and a Net Leverage Ratio should be monitored as a component of the monthly Enterprise Report (or comparable financial report).
3. Deviations from the established guidelines shall be reported monthly and evaluated at least annually. At least annually, the Administrator, in conjunction with the appropriate senior executives, should prepare a recommendation to address variations from the guidelines.
4. The Administrator shall present these recommendations to the Board of Directors for review and approval.
5. The Board of Directors shall review guidelines for the Funding Ratio and Net Leverage Ratio on an annual basis.

Policy Guidelines

Review Date	Funding Ratio Guideline	Net Leverage Ratio Guideline
July 31, 2009	1.02 to 1.35	3.0:1 to 8.0:1

Historical State Insurance Fund Information*

FY Ended June 30	Net Assets (in millions)	Funding Ratio	Net Leverage Ratio
2000	$6,644,827	1.552	2.1555
2001	$4,643,351	1.373	3.1594
2002	$1,886,585	1.148	8.3538
2003	$417,937	1.029	39.8767
2004	$644,444	1.044	26.4196
2005	$507,491	1.038	34.4908
2006	$1,278,845	1.091	13.5202
2007	$2,080,045	1.144	8.2621
2008	$2,206,923	1.152	7.9323
2009	$2,456,xxx	1.14	8.22
Policy Guidelines			
2010		1.02 to 1.35	3.0:1 to 8.0:1

*Net asset policy with Guidelines adopted by the Board of Directors in July 2009. Data previous to 2009 is for historical purposes only.

Audit Committee: Reviewed and approved July 30, 2009, Ken Haffey, Chair
Board of Directors: Reviewed and approved July 31, 2009, Bill Lhota, Chair

AUDIT COMMITTEE

Fiscal Year 2011 Annual Budget
Executive Summary

Attached is information regarding BWC's proposed Fiscal Year 2011 annual administrative budget. The information reflects proposed funding levels for the Administrative Cost Fund and the Safety & Hygiene Fund. In addition, the information reflects proposed funding levels associated with the Disabled Workers' Relief Fund, the Marine Industry Fund and the Coal Workers' Pneumoconiosis Fund.

BWC is proposing a total budget of $284.7 million for Fiscal Year 2011. This request is approximately $21 million (7%) less than the amount approved for Fiscal Year 2010 and approximately $44 million (13%) less than the appropriation level approved by the Ohio General Assembly.

The budget as proposed includes several major initiatives that began in Fiscal Year 2010 and will continue into Fiscal Year 2011. In addition, there is one major initiative and one capital improvement project that were anticipated to be complete in Fiscal Year 2010 but were delayed. As a result, the majority of the expenses related to these projects will be incurred in Fiscal Year 2011.

BUREAU OF WORKERS' COMPENSATION
PRELIMINARY PROPOSED BUDGET SUMMARY
FISCAL YEAR 2011
In Millions

Funding Sources:

Administrative Cost Fund	$260.0
Safety & Hygiene	24.3
Ancillary Funds	0.4
	$284.7

Expense Description	Fiscal Year 2009 Actual Spending	Fiscal Year 2010 Estimated Spending	Fiscal Year 2011 Preliminary Budget	Percentage Variance FY10 to FY11
Payroll	$190.3	$181.6	$187.9	3.5%
Personal Services	14.0	12.4	12.5	0.8%
William Green Rent	20.5	19.7	19.0	-3.6%
Leases and Term Software Licenses	12.2	11.2	10.1	-9.8%
Software and Equipment Maintenance and Repairs	15.5	14.2	15.0	5.6%
Inter Agency Payments	7.7	9.9	9.6	-3.0%
Communications	3.7	3.2	3.2	0.0%
Supplies and Printing	1.7	1.2	1.3	8.3%
Other Maintenance	3.1	3.3	3.4	3.0%
Equipment	0.1	1.6	1.4	-12.5%
Subtotal	$268.8	$258.3	$263.4	2.0%
Safety Grants and Long Term Care Loans	3.8	2.0	4.0	100.0%
Strategic Projects Examples: Rate Reform HPP Bill Payment Software and Hardware Upgrades	6.6	9.4	14.5	54.3%
Capital Improvements Examples: Elevator Improvement Rooftop Repairs	3.6	0.5	2.8	460.0%
Grand Total	$282.8	$270.2	$284.7	5.4%
		$35.7	$44.1	
		$305.9	$328.8	
		Approved by BWC Board of Directors	Appropriation	

Prepared by: Paula Phillips, Director, Fiscal Operations
Date: April 9, 2010

BUREAU OF WORKERS' COMPENSATION
BUDGET TO ACTUAL COMPARISON
FISCAL YEAR 2010
In Millions

Expense Description	Fiscal Year 2010 Approved Budget	Fiscal Year 2010 Estimated Spending	Variance	Percentage Variance
Payroll	193.7	$181.6	-$12.1	-6.2%
Personal Services	13.4	12.4	-$1.0	-7.5%
William Green Rent	19.9	19.7	-$0.2	-1.0%
Other Rent	12.6	11.2	-$1.4	-11.1%
Software and Equipment Maintenance and Repairs	18.5	14.2	-$4.3	-23.2%
Inter Agency Payments	10.3	9.9	-$0.4	-3.9%
Communications	6.7	3.2	-$3.5	-52.2%
Supplies and Printing	1.6	1.2	-$0.4	-25.0%
Other Maintenance	3.9	3.3	-$0.6	-15.4%
Equipment	3.0	1.6	-$1.4	-46.7%
Subtotal	283.6	$258.3	-$25.3	-8.9%
Safety Grants and Long Term Care Loans	6.0	2.0	-$4.0	-66.7%
Strategic Projects Examples: Rate Reform HPP Bill Payment Software and Hardware Upgrades	14.5	9.4	-$5.1	-35.2%
Capital Improvements Examples: Elevator Improvement Rooftop Repairs	1.8	0.5	-$1.3	-72.2%
Grand Total	$305.9 $22.2	$270.2	-$35.7	-11.7%
	$328.1			

Prepared by: Paula Phillips, Director, Fiscal Operations
Date: April 7, 2010

12-Month Audit Committee Calendar

	Calendar 2010
Date	**April 2010**
4/29/2010	1. Discussion of External Audit
	2. Discount Rate and Financial Metrics (2nd Reading)
	3. FY 2011 Administrative Budget (1st Reading)
	4. Quarterly Litigation Update (Executive Session)
	May 2010
5/27/2010	1. FY 2011 Administrative Budget (2nd Reading)
	2. Internal Audit Charter
	3. Access to Confidential Personal Information Rule 4123-?-? (1st reading)
	4. Metrics Review
	June 2010
6/17/2010	1. Internal Audit QES Review
	2. FY 2011 Audit Plan and Budget
	3. FY 2011 Financial Projections (1st Reading)
	4. External Audit Update
	5. Access to Confidential Personal Information Rule 4123-?-? (2nd reading)
	July 2010
7/28/2010	1. FY 2011 Financial Projections (2nd Reading)
	2. FY 2012/13 Biennial Budget (1st Reading)
	3. Quarterly Litigation Update (Executive Session)
	August 2010
8/26/2010	1. BWC Code of Ethics Review
	2. FY 2012/13 Biennial Budget (2nd Reading)
	3. External Audit Update
	September 2010
9/23/2010	1. Internal Audit QES Review
	2. Inspector General Semi-Annual Report (Executive Session)
Date	**October 2010**
10/21/2010	1. Audit Committee Charter Review (1st Reading)
	2. Quarterly Litigation Update (Executive Session)
Date	**November 2010**
11/18/2010	1. External Audit Update
Date	**December 2010**
12/15/2010	1. Internal Audit QES Review
	2. Office of Budget and Management Update – BWC Staff Transfer

12-Month Audit Committee Calendar

	Calendar 2011
Date	**January 2011**
TBD	1. Annual Disaster Recovery/Business Continuity Plan
	2. External Audit Comments - Update
	3. Quarterly Litigation Update (Executive Session)
Date	**February 2011**
TBD	1. Inspector General Annual Report (Executive Session)
Date	**March 2011**
TBD	1. Internal Audit QES Review
	2. Discount Rate and Financial Metrics (1st Reading)

ADDENDUM INTEROFFICE MEMORANDUM

TO: BOARD OF DIRECTORS

FROM: PEGGY CONCILLA, LEGISLATVIE AFFAIRS

SUBJECT: PENDING BLACK LUNG CLAIMS

DATE: 4/29/2010

Directors,

I received some clarifying information yesterday regarding the number of pending Black Lung applications. The Department of Labor indicated they have 45 applications pending for Ohioans. We now know that number does not take into consideration multiple applications filed by the same person. In Ohio we assign one claim number per person, regardless of how many applications he/she may file. Therefore the accurate number of pending claims, those waiting for approval from the Department of Labor is 23, and not 45 as indicated in my memo of April 26.

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Audit Descriptions

<u>Audit Validation Testing</u>: Validation testing is performed each quarter to ensure outstanding audit observations are resolved adequately and in a timely manner. As part of this process, management provides Internal Audit with updates each quarter regarding the resolution status of the outstanding observations. For observations which management indicates are implemented, we perform testing to validate that action taken is adequate to address the issue identified during the audit. In addition, if there are outstanding audit observations that are in process, but are beyond the target resolution dates, we will meet with management to determine factors delaying resolution. As comments are cleared through this process, they are removed from the list of outstanding comments provided to the Audit Committee.

<u>Data Warehouse Audit (Review performed by OBM)</u>: The data warehouse contains data from multiple systems utilized within BWC. The data from this warehouse is utilized for key operational and strategic decision making. This review will focus on providing assurance regarding data quality control, effectiveness of security management, economy and efficiency of operations, and overall administration of the data warehouse.

<u>Death Benefits Audit</u>: When injured workers expire as the result of a work related injury, their spouse and dependants are entitled to death benefits. This audit will evaluate the adequacy of internal controls over benefit payments, as well as the level of compliance with agency policies and procedures and applicable regulations.

<u>Disability Workers Relief Fund Audit</u>: A special fund that supplements the benefits received by permanently and totally disabled injured workers whose benefits fall below the current cost of living. This audit will evaluate the adequacy of internal controls over the calculation and payment of these benefits, as well as the level of compliance with agency policies.

<u>Employer Rate Adjustments Audit</u>: While the majority of employer rates are established systemically, there are times when manual rate adjustments are required due to various circumstances. This audit will examine the process for performing these adjustments and evaluate the adequacy of internal controls over this process.

<u>External Audit Assistance</u>: Internal Audit provides approximately 1,000 hours of assistance to the external accounting firm during their audit of the BWC financial statements. This assistance reduces audit fees each year by approximately $75,000 - $80,000.

<u>FY 2011 Annual Audit Plan</u>: Activities include meeting with management, BWC Board of Directors, and other parties to obtain suggestions for areas to include in the FY 2011 Internal Audit plan. We assess the relative risk for agency processes and assign a risk score to each of the potential audit areas.

<u>Investment Compliance</u>: This on-going project will involve regular monitoring of compliance with the BWC Investment Policy Statement and/or other applicable rules or regulations. Activities will include receipt and review of daily/monthly compliance reports issued via the compliance rules established within the outsourced investment accounting system. In addition, we will perform periodic testing to assess compliance with the investment policy statement.

Investment Personal Trading Policy: BWC implemented a Personal Trading Policy to provide safeguards against BWC staff utilizing non-public information regarding pending investment transactions for personal gain. This audit will evaluate the adequacy of the existing policy and assess the level of compliance with the policy.

Premium Audit: The Premium Audit department is responsible for verifying the accuracy of employer payroll reporting. This engagement will examine the premium audit process and related controls. The audit will include a review of the premium audit methodology and rationale for audit selection; determining the adequacy of controls to provide assurance that audits are accurate, timely and properly safeguarded and recorded. The project will also assess the level of compliance with policies and procedures and statutory requirements and evaluate the adequacy of quality assurance procedures.

Safety and Hygiene Audit: To assist in lowering employer premiums, a portion of premiums paid by employers is set aside for safety services performed by the Division of Safety and Hygiene. The Division of Safety and Hygiene provides a variety of safety services including technical support, consultation, publications, training classes, research and video libraries, local safety councils, safety grants and an annual convention/tradeshow. This audit will focus on core functions for the division and related controls.

Self Insured Underwriting Unit Audit: The Self-Insured Underwriting unit is responsible for eligibility determinations and processing for employer applications to be self-insured for the workers' compensation benefits or renewals of existing self-insured employers. This project will involve assisting the Self-Insured Underwriting area as they perform a self-assessment of the work processes for granting self-insurance to Ohio employers.

Temporary Total Disability Benefits Audit: BWC pays temporary total disability benefits for lost wages when an injured worker is expected to recover and return to work. It is the largest compensation type paid by the BWC. This audit will examine the related processes for evaluating and issuing determinations on these types of claims, as well as the actual payment of benefits. The focus of the audit will be on compliance with policies and procedures and applicable regulations.

Types of Audits

The Internal Audit Division (IAD) is responsible for the process by which the Bureau reviews and assesses the effectiveness and efficiency of its management control and practices. There are generally five types of projects or reviews performed by IAD. The following is a listing of the types of projects and a brief description of each type of engagement.

Operational Audits (Beginning-to-End Business Process Flow)

This category reviews the principal operational functions of the Bureau. Operational audits are undertaken for the purposes of a high-level overview assessment of compliance, efficiency, economy and effectiveness of management practices and controls associated with these operational functions. They have a strategic focus and are primarily concerned with the achievement of the Bureau's strategic objectives and goals.

Internal Control Reviews/Compliance Audits

Examining and evaluating the effectiveness of the Bureau's system of internal control and the quality of performance in carrying out assigned responsibilities. The primary objectives of the internal control systems are to ensure: the reliability and integrity of information; compliance with policies, plans, procedures, laws, and regulations; safeguarding of assets; economical and efficient use of resources; and accomplishment of established objectives and goals for operations and programs. Compliance audits determine the degree of adherence to policies, procedures and relevant legislative requirements.

Financial Audits

Review of all ancillary functions such as budgeting, financial statements, accounting systems, revenue collection procedures, purchasing operations and payroll. As the procedures covering most of the activities in this category are regulated by laws, external principles or management directive, the purposes of the audit generally relate to the accuracy and integrity of data or compliance with policy. Audits may also be undertaken to assess the efficiency or effectiveness of these activities or the systems or procedures in use.

Consulting

Consulting services are advisory in nature, and are generally performed at the specific request of an engagement client. The nature and scope of the consulting engagement are subject to agreement with the engagement client. Consulting services generally involve two parties: (1) the person or group offering the advice – the internal auditor, and (2) the person or group seeking and receiving the advice – the engagement client.

Special Investigations
Some internal audit activity takes the form of a special investigation. The object of these investigations is to diagnose specific problem areas and establish whether further action or review is necessary.

Ohio | Bureau of Workers' Compensation
30 W. Spring St.
Columbus, OH 43215-2256

Governor **Ted Strickland**
Administrator **Marsha P. Ryan**
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1-800-OHIOBWC

MEMORANDUM
(Attorney-Client Privileged Communication)

TO: Marsha P. Ryan, Administrator
James A. Barnes, General Counsel

FROM: Thomas Sico, Assistant General Counsel

DATE: April 1, 2010

SUBJECT: State Insurance Fund- Can it be used for purposes other than workers' compensation?

The Administrator has asked for a legal opinion as to whether the State Insurance Fund could be used for purposes other than workers' compensation. There are reports that other states are trying to tap into their workers' compensation funds to balance their budgets (see attached article). While nothing is guaranteed (especially since the article states some states are trying raids despite prior court decisions on the subject), Ohio law protects the State Insurance Fund from uses other than uses related to the purposes of the workers' compensation system.

R.C. 4123.30 states that the money deposited into the State Insurance Fund constitutes "a trust fund for the benefit of employers and employees mentioned in sections 4123.01, 4123.03, and 4123.73 of the Revised Code for the payment of compensation, medical services, examinations, recommendations and determinations, nursing and hospital services, medicine, rehabilitation, death benefits, funeral expenses, and like benefits for loss sustained on account of injury, disease, or death provided for by this chapter, and for no other purpose." Of course, the Legislature could amend a statute, so this long-standing statute is not necessarily sacrosanct.

The statute is based, however, on the Ohio Constitution. Article 2, Section 35, states, "For the purpose of providing compensation to workmen and their dependents, for death, injuries or occupational disease, occasioned in the course of such workmen's employment, laws may be passed establishing a state fund to be created by compulsory contribution thereto by employers, and administered by the state, determining the terms and conditions upon which payment shall be made therefrom." The Constitutional provision implies that the State Insurance Fund is to be used for the limited purpose of providing compensation to workers and their dependents.

The case law has been supportive of restricting the use of the SIF for purposes other than those related to workers' compensation. The cases generally rely upon the above Constitutional provision.

In *Corrugated Container Co. v. Dickerson* (1960), 171 Ohio St. 289, the issue before the court was "whether the state can take money which has been set aside for the payment of awards to injured workmen and * * * transfer it to the money comprising the General 293 Revenue Fund of the state." The Court held that the state could not constitutionally effect this diversion of fund proceeds. Transferring

State Insurance Fund proceeds to the state's general revenue fund creates a risk that the proceeds will be applied to purposes wholly unrelated to the workers' compensation system.

In *Thompson v. Indus. Comm.* (1982), 1 Ohio St.3d 244, however, the court distinguished *Corrugated Container*, and held that the transfer of SIF investment income to the Disabled Workers' Relief Fund ("DWRF") did *not* violate the constitutional provision. The court noted that "[t]he General Assembly is afforded substantial discretion to implement a comprehensive workers' compensation program and it is not the function of the judiciary to question the wisdom of the General Assembly's exercise of its permissive powers. * * * [T]o hold otherwise and declare the DWRF program as presently funded and administered unconstitutional makes a cruel mockery of the laudable purpose that the constitutional provision was designed to serve." Note, however, that the DWRF fund has a workers' compensation nexus, an important factor in the court's decision.

In *Northwestern Ohio Bldg. & Constr. Trades Council v. Conrad* (2001), 92 Ohio St. 3d 282, the Court held that the use of premium contributions from the State Insurance Fund for the payment of administrative and performance-incentive fees to MCOs certified by BWC under the HPP does not violate Section 35, Article II of the Ohio Constitution. Again, the distinguishing factor in this decision was the workers' compensation purpose of the use.

Workers' Comp Central
3/1/2010

Fund Raids Date Back More than Three Decades and Are on the Rise

Michael Whiteley, Eastern Bureau Chief

Raids on the surpluses of state-run workers' compensation carriers and second-injury funds date back more than three decades and are on the rise as states face budget deficits stretching into the billions of dollars.

Associations representing both the nation's private insurers and state funds said in interviews last week that no end appears in sight – even in states where courts have previously outlawed such raids.

"Because there's a budget crisis, this situation is going to get worse. It will only be resolved through protracted litigation," said Bruce Wood, associate general counsel and head of workers' compensation for the American Insurance Association (AIA).

Wood wrote Maryland Gov. Martin O'Malley a five-page letter last week warning that the bid to turn the state's Injured Workers' Insurance Fund (IWIF) into a private mutual carrier with a state-appointed board puts carriers and policyholders at risk.
IWIF is backing the plan in response to O'Malley's attempt to take $20 million from its reserves.

The IWIF proposal is pending in the Maryland General Assembly amid attempts to divert it to a special stakeholders' panel and delay a vote on the issue.

Attempts to privatize state-run funds, transfer money from related second injury funds or to sell the carriers outright have triggered lawsuits that are still pending in Arizona, California, Kansas and Oklahoma.

But Wood said none of the lawsuits -- dating back to a 1975 decision by the Oklahoma Supreme Court that the funds of CompSource Oklahoma belong to its policyholders -- have settled the question on a national level.

Insurers are watching the lawsuit filed by the Industrial Commission of Arizona against Gov. Janice Brewer and State Treasurer Dean Martin, because it embraces case law in a variety of other states and has the potential to establish new ground.
AIA has filed as an intervener in the lawsuit, which was filed last April and is now before the Arizona Supreme Court.

The first raids to catch national attention were in New York, where the state made annual withdrawals from the New York State Insurance Fund (NYSIF) through a non-interest loan. News reports estimated total withdrawals of $1.3 billion before stakeholders' outcries halted the withdrawals in the early 1990s.

NYSIF spokesman Bob Lawson said the practice stopped about 20 years ago because the state's governors stopped borrowing from the fund. The annual transfers sparked statewide controversy when NYSIF was forced to raise premiums by 7% to shore up its deficit.

Raids on the New Jersey Second Injury fund prompted lawyers in December to propose a ballot initiative. If approved next November, the referendum would ban raids on all state funds, including the state's Temporary Disability Fund and the Second Injury Fund.

One of the bill's sponsors predicted in a recent interview that the ballot measure will receive overwhelming approval.

Based on the court cases and newspaper reports, issues involving raids on the surpluses and related funds also have included:

- The sale of the assets of Michigan's Accident Fund Insurance Co. of America to Blue Cross Blue Shield of Michigan in 1993. The state auctioned the assets following court rulings that the fund could not be sold outright.
- The transfer of surpluses from Pennsylvania's State Workers' Insurance Fund (SWIF) totaling $432 million in the early 1990s. Lawmakers voted to stop the practice in 1993.
- Repeated transfers from Minnesota's Special Compensation Fund, which pays for second injury fund claims and other funds financed by employer assessments. The transfers occurred in the 1990s and were eventually outlawed, according to a spokesman for SFM, which began as a state-run workers' compensation carrier.
- The pending bid to privatize Colorado's Pinnacol Assurance after Gov. Bill Ritter blocked efforts by lawmakers to take $500 million on the state-run carrier's $700 million in reserves. Pinnacol has offered the state $200 million to make it a more autonomous mutual insurance company.
- Oklahoma legislation that, despite the Supreme Court's 1975 ruling in Moran v. Derryberry, would force the sale of CompSource Oklahoma to the highest bidder by Dec. 31, 2011. State lawmakers have also asked for a court opinion on whether CompSource's assets belong to the state or its policyholders.
- The pending lawsuit, filed by Kansas House Speaker Mike O'Neal on behalf of 18 trade associations, to protest the removal of $5 million from special workers' compensation fee accounts.
- Continuing transfers from the Montana State Fund, which lawmakers split into an old fund and a new fund in the early 2000s to wall-off unfunded liabilities through assessments on both employers and employees.

AIA also listed raids on workers' compensation funds in Texas and Utah as among the instances reported to O'Malley.

Wood said opponents scored a major victory in Oregon, when voters overwhelmingly approved a ballot initiative that prevented the break-up of Saif Corp. in 2004.

"There've been attempts many times over the years to raid the state funds," said Dennis Smith, president of the American Association of

State Compensation Funds (AASCF). "Most of the raids have not been successful."

Smith said the difficulty with developing a uniform policy among the nation's state funds is that they vary widely in structure. Some have converted to private mutual carriers and retained some distance from state-appointed boards of governors.

"We have a saying in the state-fund community," Smith said. "If you've seen one state fund, then you've seen one state fund."