

TESTIMONY BY KALBERT K. YOUNG
DIRECTOR, DEPARTMENT OF BUDGET AND FINANCE
STATE OF HAWAII
TO THE HOUSE COMMITTEE ON FINANCE
ON
HOUSE BILL NO. 1459, H.D. 1

February 22, 2013

RELATING TO INSURANCE

House Bill No. 1459, H.D. 1, establishes a captive insurance company to manage the administration and financing of the current and potential future public employee health benefit obligation of the State and county governments. The bill establishes the Hawaii Employer-Union Health Benefits Trust Fund Captive Insurance Company Fund (the Fund) within the Department of Budget and Finance (B&F) for administrative purposes. The Fund is to consist of contributions, interest, income, dividends, refunds, rate credits, legislative initiatives and other returns, and is held in trust for the exclusive use and benefit of employee-beneficiaries and dependent-beneficiaries.

The bill also establishes a Hawaii Employer-Union Health Benefits Trust Fund Captive Insurance Company Reserve Account (the Account) to be placed within the B&F for administrative purposes. The Account's balance is initially set at \$1.5 billion and is to be used as a reserve against the Fund's future cost of providing health and other benefits for retired public employees and their beneficiaries. Each public employer is responsible for a proportionate share of the initial balance and has five years to make its required contributions. If the Account's balance falls below \$1.5 billion, public employers are required to make additional proportionate share contributions until the Account's balance meets or exceeds \$1.5 billion.

The bill further establishes a Hawaii Employer-Union Health Benefits Trust Fund Captive Insurance Company Minimum Capital and Surplus Account (the Surplus Account) to be placed within the B&F for administrative purposes. The Surplus Account is to be used to hold the minimum capital and surplus amounts established by the Insurance Commissioner for captive insurance companies. Each public employer is to make a contribution to the Surplus Account as determined by the captive insurance company Board.

The provisions under House Bill No. 1459, H.D. 1, relating to definitions and types of plans and benefits appear to generally follow existing provisions under Chapter 87A, HRS. The major differences (aside from provisions to adapt the Employer-Union Trust Fund (EUTF) to a captive insurance concept) are in the makeup and voting of the governing Board of Trustees, and the power and duties of the Administrator. This bill adds a county representative to the captive insurance company Board and gives the county representative a separate vote - currently, the EUTF trustees vote in blocs with the five public employer EUTF trustees having one vote and the five public union EUTF trustees having one vote. This bill also gives the captive insurance company's Administrator broad authority over certain operational aspects of the company - currently, these powers rest with the EUTF Board.

B&F is open to exploring various avenues to improve the cost effectiveness of delivering public employee and retiree health benefits and to address the State's unfunded other post-employment benefits (OPEB) liabilities. However, questions remain as to how House Bill No. 1459, H.D. 1, will accomplish reducing the State's unfunded liability under the requirements of Government Accounting Standards Board (GASB) 43 and 45.

It is unclear if the captive insurance company will reduce current benefits costs. Being the largest employer group in the State, the EUTF has significant bargaining power in negotiating with Hawaii's health insurance carriers. All of the EUTF plans are group experience rated and very favorable interest and return of excess reserves provisions are in place in the EUTF contracts. There is always room for improvement, but it isn't readily apparent how a captive insurance company with all the additional insurance regulatory requirements could be more cost effective. Additional information and data will need to be collected in order to appropriately analyze the State's employee risk pool. The business question of whether to establish a captive insurance program versus a more common and traditional model of paying for third-party insurance is a business decision where organizations must weigh how much risk they are willing to assume, the likelihood of increase costs or savings, and quality of insurance. While this bill does not ensure that financial objectives can be achieved, we do recognize that it does advance the discussion of the future viability of the EUTF.

House Bill No. 1459, H.D. 1, is also unclear as to how a captive insurance company would directly impact the State's unfunded OPEB liability. The introduction of the bill (page 4, lines 9-11) states "[e]stablishing a reserve account to accumulate ten percent of the unfunded liabilities . . . will have the effect of fully funding the liabilities." The total State and county unfunded OPEB liability (as of July 1, 2012) is \$16.3 billion of which the State's liability is \$13.6 billion. The bill does not address how a \$1.5 billion reserve would satisfy a \$16.3 billion obligation. Regardless of the model of insurance structures, the State will still need to comply with the GASB provisions in order to meet the growing liability in the State's financial statements. As of June 30, 2012, the State's position of net assets is \$1.3 billion, down from

\$5.0 billion since implementation of GASB 43 and 45. This is of serious concern as the State's financial statements are one of the key financial material bond investors and rating agencies use to gauge the fiscal health of the State. The EUTF actuaries and the State's auditors would have to agree that partially funding a reserve or captive insurance fund in the near-term would satisfy a larger long-term financial liability.

Regarding public employer contributions towards the captive insurance company's initial reserve account amount of \$1.5 billion, it should be noted that the State will bear the lion's share of the funding responsibility. The State has 70,114 active and retiree plan subscribers out of the EUTF's total plan subscribers of 92,906, or a little over 75% of the total. Hence, the State's share of the \$1.5 billion based on "proportional share" would be approximately \$1.125 billion (\$1.5 billion times 75%). This amount would have to be paid over to the captive insurance company by July 1, 2019 (initial balance requirement is to be met within five years from the effective date of the bill which is July 1, 2014). Again, the State would want to ensure that such a contribution could be attributed towards reducing its long-term OPEB liabilities and that such reduction would be reflected on its financial statements and audits in accordance with GASB requirements.

It should be pointed out that one of the premises of this bill, as stated in the introduction (page 3, lines 8-13), is that ". . . a captive insurance company will address the necessary premium contributions for public employee health benefits because there would be a commitment from the board of directors, composed of members from the public employers and employees, to fund the employees' health benefits going forward." This is not accurate because the creation of a captive insurance company in and of itself does not assure any funding for health benefits

going forward. Funding of active and retiree health benefits, as well as other types of appropriations, are the sole purview of the Legislature and the respective county councils.

Finally, B&F has concerns with the bill's two changes to the current governance structure of the EUTF. One concern is that the addition of a third, county vote on the captive insurance company's Board gives the appointed county representative the swing vote. This would give the counties disproportionate representation when their active and retiree subscribers amount to less than 25% of the total EUTF subscribers (and costs and OPEB liabilities). The other concern is the authority being granted to the captive insurance company Administrator. The captive insurance company Board is the body with fiduciary responsibility for the captive insurance company and the Board should have the appropriate powers and authority (and can delegate certain powers to the Administrator as deemed appropriate) to operate and manage the captive insurance company.

The department is open to continued discussion on ways to reduce the overall cost trends of providing health insurance coverage for its 70,000+ active and retired employees, and we look forward to working with the Legislature on this issue.



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TO THE HOUSE COMMITTEE ON FINANCE

TWENTY-SEVENTH LEGISLATURE
Regular Session of 2013

AGENDA #3
Friday, February 22, 2013
3 p.m.

WRITTEN TESTIMONY ONLY

TESTIMONY ON HOUSE BILL NO. 1459, H.D. 1 – RELATING TO INSURANCE.

TO THE HONORABLE SYLVIA LUKE, CHAIR, AND MEMBERS OF THE COMMITTEES:

My name is Gordon Ito, State Insurance Commissioner ("Commissioner"), testifying on behalf of the Department of Commerce and Consumer Affairs ("Department"). The Department takes no position on this bill and submits comments limited to aspects of the bill dealing with insurance regulation.

The purpose of this bill is to more effectively manage the administration and financing of the current and potential future employee health benefit obligations of the State and county governments by creating the Hawaii Employer-Union Health Benefits Trust Fund Captive Insurance Company ("Captive") as a reciprocal captive insurance company under article 19, chapter 431, Hawaii Revised Statutes ("HRS")("Article 19").

While the Department finds that this is a creative way to address the growth of unfunded liabilities for public employee health benefits, we have concerns that the Captive is being formed without a feasibility study and that the provisions of the bill may be contrary to regulatory requirements applicable to captive insurance companies.

The following highlights some of our concerns:

1. No Feasibility Study: All prospective captive owners are required to submit a feasibility study when filing their captive applications. The feasibility study includes, among other things, the general purpose and main objectives of the captive, how the captive will be capitalized, its net limits and retentions, basis for determining rates, projected premium growth, and its pro forma balance sheet. In most cases, captive owners prepare the feasibility study as part of the process of selecting a captive domicile and determining the purposes for which they will form a captive.

As the Captive should not be treated any differently from any other captive formed in Hawaii, it would be prudent for the Captive to complete a feasibility study prior to its application to carefully consider its purpose, organizational structure, business plan, plan of operation, and how it intends to achieve its risk financing objectives. The Department cannot approve a captive application from a captive that is not adequately capitalized. The Department cannot support a statutory mandate to form the Captive without a feasibility study that indicates that the Captive is sufficiently capitalized and that the Captive would be in compliance with regulatory requirements under the Hawaii Insurance Code as found in chapter 431, HRS (the "Insurance Code").

2. Captive's Organizational Structure: The structure envisioned for the Captive as a reciprocal insurance company ("reciprocal") is not in compliance with the Insurance Code. Since the Captive would be formed as a reciprocal, HRS § 431:19-106 requires the Captive to be subject to certain HRS provisions governing reciprocals in the Insurance Code.

HRS §431:3-108 defines "reciprocal insurer" as "an unincorporated aggregation of subscribers operating individually and collectively through an attorney-in-fact common to all such persons to provide reciprocal insurance among themselves." HRS §431:4-406 sets forth the duties of the attorney-in-fact ("AIF") to act on behalf of the reciprocal's subscribers' advisory committee ("SAC").

Under HRS §431:4-415, the SAC is an advisory committee that exercises the subscribers' rights and is selected by the reciprocal's subscribers under rules adopted

by the subscribers. Among other things, the SAC is responsible for supervising the reciprocal's finances and operations.

If it is the intent of the Legislature to form the Captive as a reciprocal, the bill should be amended to reflect the proper organizational structure of a reciprocal. Specifically, all references to a Board of Trustees and an Administrator should be removed. Instead, the bill should provide for an organizational structure consisting of the Captive's subscribers, SAC, and AIF.

3. Article 19 Compliance: Section 1-104 of the bill states that if there is a conflict between the bill and the Insurance Code, the Insurance Code is controlling. Notwithstanding this broad statement, there are sections throughout the bill that create ambiguity in the application of the law. For example, in section 2-206 of the bill states that meetings may be scheduled, presumably by the Board of Trustees. This provision creates an ambiguity because HRS §431:19-102(b)(2) requires the governing body of every Hawaii captive to meet at least once a year in Hawaii.

We are concerned that there is no clear statement that none of the regulatory requirements of Article 19 will be preempted by this bill. Some of Article 19's requirements include minimum capital and surplus, investment, examination, financial reporting, and loss reserving requirements. These regulatory safeguards were designed over the years to protect the interests of captive insureds and potential claimants.

4. Exemption from Taxes and Fees: We are concerned that the bill proposes to exempt the Captive from all taxes and fees levied by the State on other insurers in section 1-101(d). As the Captive would still be subject to annual filing and examination requirements as is the case for any other captive, the Department's examiners would be required to expend time to review and examine Captive documents. As such, the Captive should not be treated any differently from any other captive domiciled in Hawaii.

5. Application of Article 15 of Insurance Code: Currently, Insurance Code provisions dealing with Insurer Supervision, Rehabilitation, and Liquidation in article 15 ("Article 15") have limited application to captive insurance companies. We are concerned that the Captive, as envisioned in this bill, would be exempt from Article 15.

Without the regulatory authority available under Article 15, there would be no clear statutory direction to dissolve or rehabilitate the Captive in the case of insolvency. Considering the anticipated size of the Captive, if the Captive were to become insolvent, it would be in the best interests of the insureds, claimants, and the public that Article 15 apply to this bill to protect the interests of affected parties in an efficient and equitable manner.

We thank the Committee for the opportunity to submit testimony on this matter.



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TESTIMONY
OF
AARON S. FUJIOKA
ADMINISTRATOR
STATE PROCUREMENT OFFICE

TO THE
HOUSE COMMITTEE
ON
FINANCE

February 22, 2013

3:00 p.m.

HB 1459, HD 1

RELATING TO INSURANCE.

Chair Luke, Vice-Chair Nishimoto, Vice-Chair Johanson, and committee members, thank you for the opportunity to submit testimony on HB 1459, HD 1. The State Procurement Office's (SPO) comments are limited to SECTION 2 proposing to add a new chapter which includes an exemption from competitive bidding, which is HRS chapter 103D, Hawaii Public Procurement Code (Code), for the board and the administrator of the captive insurance company.

The SPO opposes the amendment in SECTION 2 proposing to exempt the board and the administrator of the Captive Insurance Company from the Code requirements. The Code is the single source of public procurement policy to be applied equally and uniformly, while providing fairness, open competition, a level playing field, government disclosure and transparency in the procurement and contracting process vital to good government.

Public procurement's primary objective is to provide everyone equal opportunity to compete for government contracts, to prevent favoritism, collusion or fraud in awarding of contracts. To legislate that any one entity should be exempt from compliance with HRS chapter 103D conveys a sense of disproportionate equality in the law's application.

We request that SECTION 2, page 13, lines 17 to 19 of the bill be deleted. Thank you.