STATE OF MINNESOTA
DEPARTMENT OF COMMERCE

In the Matter of the Proposed Rules
Governing Political Subdivision
Self-Insurance Pools
Minnesota Rules, Parts 2785.0100
to 2785.1500

STATEMENT OF NEED
AND REASONABLENESS
OF PROPOSED RULES

STATEMENT OF AUTHORITY

Minnesota Statutes, section 65B.48, subdivision 3a, authorizes the Commissioner of Commerce to adopt rules to assure the adequacy of the financing and administration of self-insurance plans for the benefits required by Minnesota Statutes, sections 65B.41 to 65B.71. Political subdivision self-insurance pools are a method for financing and administering these benefits. Minnesota Statutes, section 471.617, subdivision 2, authorizes the Commissioner of Commerce to adopt rules to provide standards for the operation of political subdivision self-insurance pools for any employee health benefits except life benefits. Minnesota Statutes, section 471.982, subdivision 2, authorizes the Commissioner of Commerce to adopt rules to provide standards for the operation of political subdivision self-insurance pools for risks and hazards excluding employee health, life, or disability benefits. Laws of Minnesota, 1983, chapter 290, section 171, provides that a public/private pool including the city of Duluth is subject to the rules adopted under Minnesota Statutes, section 471.982. Because of the many commonalities between political subdivision self-insurance pools of all kinds, these rules are proposed pursuant to each of these authorities. The rules' purpose is to ensure that the financial integrity of

these pools is maintained, and that they are administered competently and equitably. The rules govern the formation, operation, and dissolution of political subdivision self-insurance pools of all kinds.

FACTS ESTABLISHING NEED AND REASONABLENESS

As more specifically stated below, the proposed rules are necessary to insure the solvency and operation of political subdivision self-insurance pools.

Part 2785.0100 Definitions.

Part 2785.0100 defines 20 key words and phrases used in the rules. Most of the meanings are straightforward clarifications of commonly used terms. The following commentary is provided for the minority of definitions with less obvious meanings and necessity.

Subpart 9 defines "financial administrator." It establishes minimum standards of staff and organizational experience for entities to be eligible to administer a pool's funds. The standard of five years experience for the organization and current employment of experienced staff are reasonable criteria for precluding inexperienced organizations from assuming responsibility for a pool's finances. This requirement is necessary, because competent financial management is essential to a pool's stability and financial integrity.

Subpart 15 defines "public/private pool." Specific political subdivisions have been authorized to form workers' compensation pools including private employers. This definition is consistent with the statutory authorizations. No specific political subdivisions are named, to accomodate the possibility of additional authorizations over time.

Subpart 19 defines "sponsoring association." The definition distinguishes broad, multi-service associations such as the League of Minnesota Cities, the Association of Minnesota Counties, or the Minnesota School Boards Association, from associations formed primarily to sponsor insurance or self-insurance programs. This distinction is necessary because the rules accomodate the role of broad, multi-service associations in pool development. However, associations formed primarily to sponsor pools would not be considered to have a comparably objective and long-term interest in a pool's success, nor would they have a special basis for promoting pool development.

Part 2785.0200 Purpose.

Part 2785.0200 describes the rules' purpose. This part is necessary to describe the rules' regulatory intent as a guide to the rules' users. The statement of purpose is consistent with the statutory authorities.

Part 2785.0300 Scope.

Part 2785.0300 describes the rules' scope in terms of the entities and organizations that are directly affected. This part is necessary to identify the entities with rights and responsibilities under the rules as a guide to the rules' users.

Part 2785.0400 ByLaws.

Part 2785.0400 states minimum requirements for the content of a pool's bylaws, and procedures for adoption and change of the bylaws.

Subpart 1 specifies the content requirements. The requirements range from basic matters such as the pool's name, to important procedural issues such as the method for distributing dividends. It is necessary and reasonable that a pool decide in advance how important matters are to be resolved, such as membership rights, the relative powers of the various governing parties, access to money, and similar issues. Statements concerning these matters are necessary to the regulator to obtain a complete picture of the pool's method of governance. They are also necessary to enable prospective pool members to ascertain their rights and responsibilities within the pool's structure. Failure to clarify these important matters in advance could harm a pool's stability, because "mid-stream" decisions would be likely to harm some members' interests while benefitting others'. One of the principal elements of a pool's stability and financial integrity is the presence of long-term members. Maintenance of long-term members is enhanced by settling potentially divisive issues before they can disrupt a pool's unity.

Subpart 2 contains the requirements for adopting and changing the bylaws. It is necessary and reasonable that authority over the bylaws reside solely with the pool membership or with a representative board, because the membership is ultimately responsible for the pool's financial integrity. Under part 2785.1400, subpart 3, and part 2785.1500, subpart 6, a pool's members may be assessed to maintain the pool's financial integrity. Accordingly, although the pool's contractors play a major role in day-to-day administration, final responsibility for the pool's solvency and governance must reside with the membership or the board.

Part 2785.0500 Board.

Part 2785.0500 states minimum requirements for the structure and duties of a pool's board of trustees.

Subpart 1 contains the requirements concerning board structure. The most important requirement is that the board members be officials or employees of the members participating in the pool. This is a necessary and reasonable requirement because the pool's members are ultimately responsible for the pool's financial integrity. The pool's contractors, such as the service company, financial administrator, or stop-loss insurer, could have conflicts of interest in serving on the pool's board. A sponsoring association may appoint board members provided a majority of the board represent members other than the sponsoring association. The requirement that the board meet at least four times annually is necessary and reasonable to guarantee that the board will keep appraised of the pool's status, notwithstanding that day-to-day operations may be delegated to the contractors.

Subpart 2 defines the board's overall rights and responsibilities, and states the board's minimum responsibilities. Because the board represents the membership, and because the membership is assessable in the event the pool's financial integrity deteriorates, it is reasonable that the board is responsible for the pool's operation. It is specifically necessary to define the board's minimum responsibilities, lest a board abdicate its responsibilities to the service company or other contractors. This subpart establishes the basis for a pool's contractors reporting to the board, and bringing major decisions and policy issues to the board for its approval.

Part 2785.0600 Application.

Part 2785.0600 establishes the procedures for submission and review of applications for licensure as a political subdivision self-insurance pool.

Subpart 1 defines the initial application procedure. The basic 60 day period established for application review is reasonable and necessary to permit a thorough and orderly staff analysis. A shorter period could result in application rejections solely on the basis of inadequate time for analysis.

Subpart 2 requires pools in existence when the rules are adopted to submit an initial application by July 1, 1985. It is necessary for all pools, old and new, to operate under the same rules, since all pools face the same kinds of issues. However, it is reasonable to permit prior existing pools a transition period, so any changes they may choose or be required to make can be implemented without unnecessary disruption to existing programs.

Subpart 3 defines the renewal application procedure. It is a reasonable convenience that renewal applications consist of the pool's annual status report, since the report contains most of the same information as the initial application. This streamlines the renewal procedure.

Subpart 4 requires that two or more existing pools proposing to merge must assume all obligations of the prior pools. This requirement is necessary to guarantee continuity of coverage to pool members and their employees.

Subpart 5 establishes the period of licensure, and the criteria for approving or disapproving political subdivision self-insurance pool applications. The approval criteria are reasonable, consisting of adherence to the various rules and statutes governing such pools. No further criteria are necessary.

Part 2785.0700 Ending self-insurance, runoff period, and pool dissolution.

Part 2785.0700 establishes the procedures that apply at the end of a pool's life-cycle.

Subpart 1 states how a pool may voluntarily end its self-insurance authority. The three major requirements are that ending self-insurance coincide with the end of the fund year, that the commissioner is notified, and that a pool cannot end self-insurance when less than 45 days remain in a fund year. These requirements are reasonable and necessary to protect the continuity of coverage for pool members and their employees, and to allow members time to arrange alternative coverage.

Subpart 2 establishes standards for the revocation of a pool's self-insurance authority. The revocation standards parallel the criteria for evaluation of a pool's application for self-insurance authority. An additional standard is added concerning a deterioration of a pool's financial integrity. This standard is necessary and reasonable because notwithstanding the various financial safeguards built into the rules, it is possible that a pool's overall financial situation could deteriorate before any specific rules violation could be ascertained. In such circumstances, it would be necessary for the commissioner to be able to act before a pool's situation worsened to a point where it could not conduct an orderly runoff period.

Subpart 3 requires a pool to continue to exist after its self-insurance authority is ended to handle its "runoff" obligations, both regulatory and regarding coverage. This requirement is necessary, because of the time-delayed nature of coverage obligations.

Subpart 4 establishes standards and procedures for a pool's final dissolution. In order to dissolve, a pool must demonstrate that it has no further outstanding liabilities, or that it has contracted with an insurance company to assume all outstanding liabilities. These requirements are necessary to preserve the coverage rights of covered employees, lest a pool dissolve prematurely with open claims remaining.

Part 2785.0800 Administration.

Part 2785.0800 establishes requirements concerning a pool's operations and administration.

Subpart 1 requires pools to contract with a service company for handling most day-to-day operations. It is necessary and reasonable that a service company be assigned responsibility for daily operations, since they must demonstrate expertise and financial integrity to be licensed. Because joint self-insurance pools are not insurance companies, many of the services customarily provided by insurers must be secured from another source.

Subpart 2 requires pools to contract with a financial administrator for handling investments and for other financial services. The financial administrator cannot be affiliated with the service company. Because joint self-insurance pools are not insurance companies, financial services must be secured from an outside source. The minimum requirements for financial administrators are contained in the definition, part 2785.0100, subpart 9. It is reasonable that responsibility for financial services and daily operations is segregated, because service companies are not licensed on the basis of financial expertise. Segregation also reduces the potential for a single contractor assuming near-total control over a pool. Since the service company is likely to be respon-

sible for a pool's underwriting and marketing, conflicts of interest could arise if the service company had full access to a pool's reserves. A service company is not at financial risk, unlike an insurer.

Subpart 3 requires a pool to maintain all records necessary to verify its reports to the commissioner. This requirement is necessary and reasonable for prudent operation, as a basis for financial audits and examinations, and in the event of pool dissolution to provide a basis for allocating remaining assets.

Part 2785.0900 Membership.

Part 2785.0900 establishes procedures for joining a pool, leaving a pool, and monitoring membership size.

Subpart 1 limits pool membership to political subdivisions of Minnesota, although private employers may join public/private pools subject to the standards of subpart 3. These criteria are consistent with the authorizing statutes. There is no need for a more restrictive membership standard, such as limiting pools to homogenous types of political subdivisions (such as counties only). The underwriting criteria standard is reasonable and necessary to maintaining a pool's financial integrity. If a pool could not reject employers with poor loss experience, it may eventually be unable to sustain itself.

Subpart 2 states that membership is not effective until the prospective member signs a membership agreement, which must disclose the possibility of assessment. This requirement is reasonable and necessary because pool membership is likely to be marketed like insurance, but differs from conventional insurance in the possibility of assessment. If employers are not made aware of

this possibility, and do not acknowledge their responsibilities under the rules upon joining the pool, it would be difficult to levy an assessment should that become necessary.

Subpart 3 places several requirements on public/private pool membership. Private employer membership is limited to Minnesota domiciled employers located within 40 miles of a political subdivision member. The Minnesota domicile requirement is necessary because public/private pools represent a new self-insurance concept not recognized by other states. It is not the rules' intent to permit an inter-state or nationwide self-insurance pool anchored by Minnesota political subdivisions, nor would other states acknowledge the legitimacy of such a multi-state entity. The 40-mile requirement is necessary to limit private membership to employers in the locality or region of the political subdivision. Public/private pools are authorized to enable political subdivisions to cooperate in handling liabilities they have in common with private employers, with whom they also share common interests in regional development and welfare. Public/private pools are not intended as mechanisms for political subdivisions to enter the commercial insurance business state wide, underwriting diverse employers with no connection to the political subdivision, and without benefit to local citizens.

Finally, subpart 3 also requires private members of a public/private pool to maintain a surety bond conditioned on the employer's paying all premiums, assessments, and penalties when due. Such security is required by the authorizing statute. The requirement is comparable to the bonding required of private workers' compensation and auto self-insurers. Such requirements are reasonable and necessary, because the stability and longevity of private businesses is significantly less than that of political subdivisions.

Subpart 4 requires employers to give at least 30 days notice before leaving a pool, and prohibits withdrawal unless a minimum membership term has been served and any outstanding debts to the pool have been paid. Subpart 4 also requires the pool to notify the commissioner if a member's withdrawal would cause the pool to fall below the minimum annual premium requirement. The minimum membership term is necessary to preserving a pool's stability. Unlike an insurance company, a joint self-insurance pool has no capital, surplus, or investors to provide a cushion in the event of poor loss experience. As such, pools are particularly vulnerable to a rapid loss of members, because the members constitute pools' primary base of financial support. The minimum membership term requires new members to establish a basic commitment to the pool exceeding the commitment to a commercial insurance policy.

Subpart 5 requires a pool to review its members at least annually to determine whether any warrant expulsion. This requirement is necessary for the same reason that use of underwriting criteria is specifically sanctioned. A pool must be able to protect itself against members with extraordinarily poor loss experience, members that do not pay their debts, or members failing to meet other reasonable membership criteria.

Subpart 6 states that after self-insurance authority is ended, pool membership is frozen. This requirement is necessary to guarantee that the members at the time of self-insurance ending will remain available to sustain the pool while it fulfills its runoff responsibilities. The requirement also precludes any new members from joining should it appear likely that assets will remain upon pool dissolution.

Part 2785.1000 Coverage.

Part 2785.1000 establishes standards for a pool's coverage documents, and procedural requirements for initiating coverages.

Subpart 1 requires that pools self-insuring employee benefit coverage or workers' compensation coverage provide no other type of coverage. This requirement is necessary because these coverages' pay-out patterns and financial requirements differ markedly from most other coverages. The rules provide different standards for these types of pools as appropriate to their respective characteristics. Separate treatment is also warranted by the fact that employee health benefit pools are authorized by a separate statute. A separate pool requirement is also reasonable, considering that of the five pools already formed to self-insure employee health benefits or workers' compensation, each is a segregated pool providing one coverage only.

Subpart 2 imposes on a pool's coverage content, administration, rates, underwriting, and related matters, the same requirements that apply to comparable insurance policies provided by licensed insurance companies. These requirements are necessary and reasonable to guarantee a "level playing field" in the marketing of insurance policies and self-insurance pool memberships. These requirements are also reasonable in that they tie directly into the long-established and refined procedures and requirements applicable to policies of insurance. These include requirements concerning clarity of language, continuation and conversion coverage, mandated benefits, employee notice, and related matters. The purpose of the statutes authorizing political subdivision self-insurance pools is to permit formation of alternative, mutually beneficial financial arrangements for providing coverages that political subdivisions

require. The purpose was not to exempt such alternative arrangements from the basic coverage requirements applicable to comparable insurance, or to make such an exemption the basis for the alternative's attractiveness.

Subpart 3 requires pools to apply the same underwriting standards to all members. This requirement is necessary to guarantee equitable treatment. Specifically, this prohibits a pool from applying inconsistent underwriting standards for marketing purposes.

Subpart 4 states that a pool retains indefinitely the responsibilities associated with coverage previously in force. That is, a pool cannot avoid its responsibilities to covered members or their employees through ending self-insurance authority, expelling a member from the pool, or ceasing to offer a particular coverage. This requirement is necessary to guarantee the integrity of coverage provided through a pool.

Part 2785.1100 Premiums, cash flow, and dividends.

Part 2785.1100 establishes standards and procedures for premiums paid to a pool and dividends paid from a pool.

Subpart 1 establishes minimum annual premium volumes for pools. This is required by statute for most types of political subdivision self-insurance pools, and is reasonable for all types. The basic requirement is $300,000. Although there is no magic point at which a pool becomes sufficiently large to be self-sustaining, $300,000 is in the range where for many types of coverage a group becomes "self-rating." That is, sufficient spread of risk exists within the pool for the groups's losses to be relatively stable from year to year. Private workers' compensation self-insurance pools are also required to maintain a premium volume of at least $300,000 per year. Subpart 1 permits a pool or

prospective pool to apply for a lesser annual premium requirement, if the lesser volume would not compromise the pool's financial integrity. This is a reasonable provision for two reasons. First, a pool may obtain high levels of stop-loss insurance, establish a surplus, or otherwise secure financial safeguards beyond the minimum requirements of the rules. Second, a pool may only provide coverage that is limited in scope and potential liability. In either case, a lesser premium volume may be sufficient to maintain financial integrity.

Subpart 2 requires a pool to monitor its premium volume, to report to the commissioner if volume approaches the minimum, and to end self-insurance authority or submit a plan for increasing volume if the annualized volume falls below the minimum. These requirements are necessary for enforcement of the minimum annual premium requirement. It provides the commissioner an early-warning system if a pool's premium is declining significantly. But the 90-day grace period preserves some flexibility for a pool to restore compliance, particularly if non-compliance is readily correctable. It is not in the regulator's interest to revoke a pool's self-insurance authority on the basis of a readily correctable condition, provided the condition is corrected, and provided the overall financial integrity of the pool is not impaired.

Subpart 3 describes two primary methods by which a pool may protect itself from cash-flow difficulties, through establishing a surplus, or through obtaining a funds-advancement commitment from the pool's stop-loss insurer. Although these arrangements are not required, they are considered under subpart 4 if a prospective pool applies for a reduction in the new pool deposit premium requirement. Such arrangements would also be considered in other circumstances where a pool's overall financial integrity is at issue. A pool's premium levels and reserving should be adequate to prevent cash-flow difficulties. However, in

extraordinary circumstances such as very poor loss experience, investment losses, or difficulties in collecting money owed the pool, difficulties could still arise.

Subpart 4 requires prospective pools to submit evidence that their initial premium payments have been made. The subpart also requires new pool members to make an initial premium payment equal to at least 50 percent of the first year's premium (25 percent for employee health benefit pools), with the remainder in equal installments at equal intervals. Pools may apply for a reduction of this requirement, showing what other arrangements exist for paying large claims promptly during the first year of operation. This requirement is necessary because new pools are not required to have any surplus at start-up (unlike an insurance company), nor would they have any reserves at start-up. Although it is not expected, the occurrence of large losses are just as likely early in a pool's existence as at any other time. A pool is most vulnerable to large losses in its first year, before loss reserves of any size have been established. A pool must be able to sustain a large loss at any time, without the necessity of immediate recourse to member assessments. That is, a pool must have some inherent resiliency. The simplest method of establishing such resiliency in a pool's first year is to require that that year's premium payments be accelerated. That provides a cushion of cash for handling large claims, a function filled by loss reserves in later years. If a pool has made other arrangements for handling cash-flow difficulties, as mentioned under subpart 3, it is reasonable to relax the accelerated payment requirement. A lesser "down-payment" requirement applies to employee health benefit pools because for such pools claims tend to be smaller and more numerous, and large claims are unlikely to require as rapid a pay-out as property/casualty claims.

Subpart 5 requires premium to be calculated on a fund year basis; permits installment payments if paid before premium is earned; requires prompt collection of delinquencies; and requires delinquent employers to pay collection costs. These requirements are reasonable and necessary to guarantee a pool's prudent and conscientious operation and protection of its financial integrity.

Subpart 6 permits a pool to pay a dividend only if the dividend would not cause the pool to have an overall deficit, if the pool does not have any outstanding loans and, in the case of workers' compensation pools, if a one year loss-development period is completed. The deficit requirement is self-explanatory: if a dividend would cause or worsen a deficit, it cannot be consistent with preservation of the pool's financial integrity. Furthermore, if a pool has obtained a loan ("stop-loss advancement") from its stop-loss insurer due to financial difficulties, it is reasonable that the loan be repaid before members receive any benefits from good loss experience. Finally, it is reasonable that workers' compensation pools allow a one-year loss development period to elapse before paying a dividend, because the long pay-out period for workers' compensation makes accurate judgements of outstanding losses difficult until the years' experience is somewhat "seasoned." This requirement is less restrictive than the requirement applicable to private workers' compensation self-insurance pools, which may pay-out only 50% of a year's surplus after a one-year wait. The waiting requirement is necessary to prevent a pool from paying dividends based on a premature judgement of recent loss experience. Many insurance companies have consistently underestimated their Minnesota workers' compensation loss experience, despite efforts to be accurate. Although political subdivisions' taxing authority is an important component of a pool's financial integrity, member assessments are potentially disruptive to a pool's unity and membership continuity (also important for financial integrity). Accordingly,

the restriction on workers' compensation pool dividend pay-outs is not unduly constraining, because it preserves member assessments as a last rather than a first resort in the event of poor loss experience.

Part 2785.1200 Reserves.

Part 2785.1200 requires pools to establish reserves for losses, unearned premiums, and potential stop-loss insurance liability. The standards require prudence and conservatism in setting reserve amounts, with precise accounting instructions contained in the financial statement forms. The establishment of conservative reserves is reasonable and necessary to maintenance of a pool's financial integrity. Reserves are fundamental to the operation of an insurance entity. Failure to establish reserves, or setting reserves too low, may cause a pool to overestimate its financial resources or operating success. A pool may not realize it is in financial trouble until it is too late.

Part 2785.1300 Stop-loss insurance.

Part 2785.1300 establishes standards and requirements for a pool's stop-loss insurance policies.

Subpart 1 states that a pool may purchase stop-loss insurance for indemnification of a portion of its losses. The commissioner must be notified if stop-loss insurance required by subpart 2 is terminated or modified, and of the pool's corrective action. It is reasonable that a pool be permitted to secure stop-loss insurance, and most will in fact do so. Stop-loss insurance is required for workers' compensation pools by statute through the Workers' Compensation Reinsurance Association. In cases where stop-loss insurance is

required by subpart 2, it is necessary for the commissioner to be notified if the stop-loss insurance is cancelled or otherwise modified causing a violation. Such changes could pose a danger to a pool's financial integrity, for the reasons stated in the next paragraph.

Subpart 2 restricts the amount of liability a pool may retain on any one incident to ten percent of its annual premium volume, plus 20 percent of its surplus (except employee health benefit pools). This requirement is necessary to prevent a pool from being wiped out by one or several large losses. The requirement is comparable to, but considerably less restrictive than the requirement applicable to insurance companies. Insurers are not allowed to insure any risk for more than ten percent of their surplus. Annual premium is a much larger number than surplus. (Insurers are also restricted in how much business they can write overall in relation to surplus. Political subdivision self-insurance pools have no comparable requirements.) The requirement is less restrictive for political subdivision self-insurance pools because of their members' ability to tax. Notwithstanding this, however, some limit must exist on the amount a pool may insure to preserve its financial integrity. The ten percent of premium volume and 20 percent of surplus formula makes allowances for both size and surplus (if any), such that even a small volume pool could insure a greater amount by building up a surplus. A pool could also insure more by obtaining stop-loss insurance for any liability in excess of its permitted retention. This is also possible for workers' compensation pools, which may purchase stop-loss insurance below the WCRA's lower retention limit.

Subpart 2 also requires employee health benefit pools to purchase individual excess stop-loss insurance with liability limits no higher than $50,000 per person per year. This is twice as high an amount as required for private employee health benefit pools under Minnesota Statutes, chapter 62H, in

deference to political subdivisions' taxing capacity. This requirement is in place of the annual premium volume and surplus formula applicable to other pools, since employee health benefit pools have a special stop-loss requirement in Minnesota Statutes, section 471.617. The $50,000 standard gives meaning to that requirement, which is open-ended in the statute. A stop-loss insurance requirement without some limit is not meaningful.

Subpart 3 prohibits a pool or its members from making an arrangement with the stop-loss insurer whereby the liability assumed by the stop-loss insurer under subpart 2 is returned to the pool or its members. This prohibition is reasonable and necessary to prevent a "fronting" arrangement, whereby an insurer agrees to provide the appearance of insurance, although in fact liability is passed back to the original parties. Such an arrangement could harm a pool's financial integrity, by circumventing the purpose of the required stop-loss insurance.

Part 2785.1400 Deficits and assessments.

Part 2785.1400 establishes requirements concerning pool deficits and assessments.

Subpart 1 establishes that pool members are jointly and severally liable for all liabilities and expenses of the pool. Joint liability continues for past members for a certain time, which varies according to the type of pool. Joint and several liability is required by statute for some types of pools, and is appropriate for all. The purpose of joint and several liability is to ensure that a pool constitutes an actual pooling of liabilities and resources. That is, if any member's poor loss experience exceeds the pool's resources, all pool members are obliged to share in paying the loss. This is the essence of a

pool's worth, and is the primary underpinning of a pool's financial integrity. It is necessary to require joint and several liability to continue not just while a ~~pool~~ member remains in the pool, but for a fixed period of time after leaving the pool. Without such a requirement, a strong incentive might exist to leave a pool at the earliest sign of high losses. A member might hope to escape any assessments by getting out while time remained. This could make a pool's stability and financial integrity very vulnerable to the first episode of high losses -- which any pool will experience sooner or later. The period of continuing joint and several liability after leaving a pool corresponds roughly to the period of time ~~by~~ during which the claims incurred while a member was in the pool will "run off." For workers' compensation pools this could easily be ten or more years; for other types of pools it will be less. It is reasonable for a past member's continuing responsibility for a pool's integrity to continue during the period that that member's claims are still outstanding. The financial responsibilities from providing coverage end when claims end, not when coverage ends.

Subpart 2 establishes that joint and several liability is frozen during a pool's runoff period. That is, all current members, and all past members still within the period of continuing liability (as described in subpart 1) at the time a pool's self-insurance authority is ended, remain jointly and severally liable until the pool's final dissolution. This requirement is necessary to guarantee that members will not "drop out" of financial responsibility during the runoff period, potentially leaving few or no members to handle the runoff pool's most long-term cases and dissolution responsibilities. The requirement also removes any incentive to leave a pool if it appears imminent that self-insurance authority will end.

Subpart 3 requires the board to correct a deficit within 90 days after determining that one exists. If the board fails to do so, the commissioner must order an assessment. Various methods of assessment are permitted. The 90-day requirement is contained in the statute authorizing some pools, and is appropriate for all. Failure to correct a deficit is self-evidently harmful to a pool's financial integrity. The alternative methods of assessment are intended to permit flexibility in selecting the method appropriate for each pool, but excluding arbitrariness. The "default" method of assessment if the commissioner is obliged to initiate ~~one~~ an assessment is the most neutral, relying simply on the amount of premium paid by the various members.

Subpart 4 authorizes the board to levy an assessment at any time, if it judges an assessment necessary to forestall a deficit or otherwise to improve the pool's financial strength. There may be times when some preventive medicine could avoid serious financial difficulties. A pool might also wish to increase its surplus as a basis for increasing the amount it can insure (see part 2785.1300, subpart 2), or simply to improve the pool's strength and stability. It is reasonable that a pool's board should have the capacity to initiate such assessments, consistent with its fiduciary responsibility.

Part 2785.1500 Financial integrity.

Part 2785.1500 establishes several requirements affecting various aspects of a pool's financial integrity.

Subpart 1 requires all persons with access to pool funds to be covered by a fidelity bond of at least $300,000. This requirement is reasonable and necessary to protect a pool from losses by dishonesty, robbery, or related causes.

Such coverage is commonly required in commercial transactions involving funds-handling. Under rules governing service companies, fidelity bonds of greater amount must be secured.

Subpart 2 prohibits a pool's assets from being used for purposes other than those for which the pool was established. Specifically, pool assets cannot be commingled with member employer's assets, cannot be loaned, and cannot be considered the property of any other person, except as specifically permitted in the rules. These requirements are reasonable and necessary to guarantee that a pool's assets will be segregated, and that no party will use its affiliation with the pool and access to pool funds for their own ends.

Subpart 3 delineates the sources and uses of funds appropriate for a pool. A pool may expend funds for expenses consistent with its purpose. A pool can obtain funds from the usual sources available to an insurance company, but cannot borrow money except as permitted from the stop-loss insurer, and cannot obtain funds through subrogation of the rights of covered employees. These requirements are reasonable and necessary to circumscribe a pool's financial activity to the activities considered prudent, appropriate, and equitable for insurance entities. This would preclude a pool from engaging in business or transactions unrelated to its self-insurance purposes, and not generally permitted to comparable insurance companies. The restriction on borrowing money is reasonable, because a more appropriate and secure source of funds in times of financial difficulty is through a surplus reserve, through an assessment, or through an aggregate advancement as provided in part 2785.1100, subpart 3, item B. The restriction on the use of subrogation is reasonable, because the same restriction applies to comparable insurance companies.

Subpart 4 permits a pool to establish separate monetary accounts for the use of various contractors, provided their use and size is subject to reasonable controls. This requirement is reasonable and necessary to prevent any contractor other than the financial administrator from having more access than necessary to a pool's funds.

Subpart 5 restricts a pool's investments according to the standards of Minnesota Statutes, section 475.66, as required by statute for some pools and appropriate for all. This subpart also prohibits a pool from investing in securities or debt of its members or contractors. This requirement is reasonable and necessary to prevent conflicts of interest in handling of the pool's funds, and to prevent the possibility of a pool member or contractor defaulting and the pool's investments failing at the same time.

Subpart 6 requires the pool's board to monitor the pool's financial condition, and to take corrective action if necessary. The commissioner is empowered to take corrective action if the board is not doing so when required. ~~Standards are established for how assessments may be levied.~~ In part 2785.0500, subpart 2, the board is assigned fiduciary responsibility for the pool's financial condition. This subpart is a necessary complement to that mandate, stating in detail what the board must do to monitor and maintain the pool's financial integrity. This subpart presumes that financial integrity may be impaired before a deficit occurs. It is further reasonable and necessary that if the board does not take action to maintain the pool's financial integrity, that the commissioner be empowered to order changes to restore the pool's sound financial condition. This power is comparable to the commissioner's power to direct the rehabilitation of a financially impaired insurance company.

Part 2785.1600 Reporting.

Part 2785.1600 establishes various reporting requirements and standards necessary for the commissioner's monitoring of pools' status, operations, and financial integrity.

Subpart 1 requires pools to file annual financial reports, and that the reports be audited by an independent certified public accountant and reviewed by a qualified actuary. This requirement is reasonable and necessary to the commissioner's monitoring of a pool's financial condition. The requirement is also necessary to the proper application of various financial requirements in the rules, particularly the reserving requirements and the requirements that necessitate determining whether a surplus or deficit exists. Comparable but more complex financial reporting requirements exist for insurance companies. As a quasi-insurance entity, it is necessary for joint self-insurance pools to report on a basis similar to insurance entities.

Subpart 2 requires that pools with deteriorating financial integrity, as determined by the commissioner, must file quarterly statements summarizing key data from the full financial statements, and other key operating data such as the current total members. This requirement is reasonable and necessary to the commissioner's monitoring of a pool's stability and financial integrity. Because pools do not have the financial safeguards available to insurance companies, primarily surplus and membership in guaranty associations, it is important for the commissioner to be able to monitor their performance at more frequent intervals than annually if there is reason to believe their financial integrity is deteriorating. By requiring more frequent reports from such pools, it may be possible to correct problems before they fundamentally compromise a

pool's integrity. If the conditions giving rise to the quarterly report requirement no longer exist, it is reasonable that a pool be returned to annual reporting only.

Subpart 3 authorizes the commissioner to order investigations into a pool's finances and operations if warranted by irregularities in a pool's reports. The commissioner may order changes in a pool's operations if warranted by the investigation's findings. This power is reasonable and necessary to allow the commissioner to correct deficiencies in a pool's reserving, accounting, or recordkeeping practices. The commissioner's ability to monitor adequately a pool's financial integrity and compliance with the rules depends on the accuracy of the pool's reports. If there is any possibility that the reports may not be reliable, it is essential that the commissioner be able to investigate and order corrections.

Subpart 4 requires pools to file annual status reports, containing updated information from the initial application. This requirement is reasonable and necessary to monitor a pool's continuing compliance with the rules, and for practical administrative purposes such as maintaining accurate addresses, contact persons, membership lists, etc. The annual status report also serves the function of a renewal application in those years when self-insurance authority expires (see part 2785.0600, subpart 3).

Subpart 5 states that pools' financial statements, status reports, and other reports required by these rules are subject to the same standards as apply to comparable reports required of licensed insurance companies. Various penalties may be levied upon insurance companies if they fail to submit required reports. This requirement is reasonable and necessary as an enforcement tool, to compel timely compliance with reporting requirements. Without such a tool the only recourse for non-compliance available to the commissioner, besides

persuasion, is revocation of self-insurance authority. This is an excessive power to bring to bear on every minor reporting infraction. It is important that the commissioner have some direct enforcement power over a pool besides the ultimate authority over licensure. Reporting is the most common source of compliance problems with other insurance and self-insurance entities, but monetary penalties have proven effective in causing reporting requirements to be taken seriously.

IMPACT ON SMALL BUSINESSES

Qualitative impact.

In drafting these rules, their effect on small businesses has been considered as required by Minnesota Statutes, section 14.115.

Insofar as the rules affect political subdivisions, any effects on small businesses are secondary and relatively minor. The primary effect of these rules on small businesses will be in providing some political subdivisions and small businesses with an additional safe and competitive alternative for financing their workers' compensation liabilities, in the form of public/private pools. As stated in part 2785.0200, the purpose of these rules is to ensure that the financial integrity of pools is maintained, and that they are administered competently and equitably. In general, these are the same objectives as in the regulation of other insurance and group self-insurance entities. Regulation provides consumers a measure of safety and reliability in the marketplace. In this case, small businesses may be the "consumers" of public/private pool membership.

In this sense, the primary effect of the rules about public/private pools is a direct benefit to small businesses: ensuring the safety and reliability of a product small businesses buy. In considering other effects of the rules on small businesses, the importance of maintaining this primary effect and benefit has been weighed against the possible benefits of reducing, simplifying, or eliminating the rules' requirements for small businesses.

As stated in part 2785.0300, the rules affect private Minnesota ~~affect~~ employers that form, join, or leave a self-insurance pool including a political subdivision, and service companies administering plans. Both private employers and service companies may meet the definition of small businesses contained in Minnesota Statutes, section 14.115, subdivision 1.

The major responsibilities of the service company and other pool contractors are outlined in part 2785.0800. Other responsibilities may be assigned to the service company depending on each pool's bylaws and board resolutions. Although the rules assign specific responsibilities to the service company, most requirements apply to the pool as such. It is the service company's role to fulfill operating requirements of the pool, and to conduct its day-to-day activities. This is the business that service companies are in; they are licensed on the basis of their competence in these areas, and they are paid by their clients to do it. For these reasons, it is not appropriate to lessen requirements imposed on the service company or other contractors in the interests of making life easier for small businesses. The operating requirements are intended to ensure a pool's competent and equitable administration, and that its financial integrity is maintained. Service companies are licensed and paid to do this work. If the requirements were lessened or eliminated, it would actually harm service company small businesses by lessening the market for their services.

The only direct responsibilities of private employers that belong to a joint self-insurance pool are contained in part 2785.0900, subparts 2, 3, and 4; part 2785.1100, subpart 5; and part 2785.1400. All other requirements of the rules that affect private employers indirectly are, in fact, requirements of the pool, and would be implemented by the service company or other contractors on the pool's behalf.

Part 2785.0900, subparts 2 and 4, govern private employers' joining and leaving a pool. Subpart 2 states that a member may not join a pool until they have signed an agreement affirming their commitment to comply with the rules and the bylaws. The agreement must also specifically acknowledge the possibility of assessment if necessary to maintain the pool's sound financial condition.

The alternatives to this requirement are to eliminate it, or to allow the agreement to be completed after having joined a pool. These alternatives were considered, but were judged to be contrary to the purpose of the proposed rule. Self-insurance pool membership is fundamentally different from a conventional insurance policy, because members are assessable for pool deficits under certain circumstances. Members also have a much more direct role in a pool's administration than a policyholder has in an insurance company's administration. If a private employer is unaware that assessments are possible, it would be a rude awakening to learn of it first upon being presented with an assessment. The collection of an assessment in the face of such ignorance could be considerably complicated. However, the capacity to assess is a fundamental component of a pool's financial integrity. It would not benefit private employers to hide their major responsibilities from them, particularly for assessments and in pool governance, until after they had already joined. These facts should be understood ahead of time, so the employer can judge whether public/private self-insurance pool membership is appropriate to their needs.

Part 2785.0900, subpart 4, states that a member must notify the pool at least 30 days before withdrawing from the pool. Members also cannot withdraw from a workers' compensation pool until fulfilling a minimum membership term of three complete fund years, and until any outstanding debts had been paid.

The alternatives to these requirements are to eliminate some or all of them, or to establish shorter reporting periods or terms of membership. These alternatives were considered, but were judged to be contrary to the purpose of the proposed rule. The 30-day notice requirement is essential if a pool is to have advance notice that it may be dropping below the statutory minimum annual premium volume. The 30-day period allows a pool sufficient time to seek new members and prevent a violation of the minimum volume requirement, if possible. Longer periods were also considered, but 30 days was judged to be long enough to seek out new members if, indeed, they could be found at all. The minimum term of membership is required by the statute authorizing workers' compensation pools. The minimum membership term prevents excessive membership turnover and thereby preserves pool stability. Finally, the requirement to pay all debts to the pool before ending membership is a basic requirement to enforce the payment of debts and preserve the pool's financial integrity. The only alternative is to permit withdrawal with debts outstanding. However, a pool has more leverage over an employer if they can compel continuing membership if the debt is not paid. Elimination of this requirement would not be in the interests of the pool, nor would it be an appropriate concession to small businesses.

Part 2785.0900, subpart 3, imposes several requirements on public/private pools, including the 40-mile radius requirement, pool termination upon withdrawal of all political subdivisions, and the private employer surety bond requirement. The alternative to the 40-mile radius requirement is either a large radius or no radius. These alternatives were not considered appropriate

to the ~~state's~~ statute's purpose, which is specific to named political subdivisions. That is, in authorizing public/private pools for particular political subdivisions, it is apparent that a benefit was intended to a specific community or region, not to political subdivisions ~~of~~ or private employers statewide. The 40-mile radius limits a public/private pool to the named political subdivision and the surrounding county or counties. If public/private pools are to be offered to private employers in other parts of the state, a broader authorization or additional political subdivisions' authority would have to be legislated.

The alternative to automatically ending a pool's self-insurance authority upon withdrawal of all political subdivision members would be to permit the pool to continue. This alternative was rejected for three reasons. First, this would be inconsistent with the statutory authorization of a specific political subdivision to form a public/private pool. Second, withdrawal of the political subdivision would leave a pool without its most stable and (probably) important member, in view of political subdivisions' taxing authority. And third, separate authorization and rules exist for workers' compensation self-insurance pools for private employers only. Those rules contain requirements appropriate to the differences inherent in such a pool.

The statute authorizing public/private pools requires the pool's bylaws to describe what security private employers must provide to guarantee payment of assessments in case of employer insolvency. The rules mandate that a surety bond be filed with the commissioner equal to a year's premium. The alternative would be to leave the statutory mandate more vague, and to let each pool determine its own arrangement. This was rejected, because a political subdivision's interest in forming a pool may cause it to require only minimal security from private employers. Surety bonds or security deposits of comparable size are

required of other private self-insured employers to protect the pool and/or covered employees. In the interests of uniformity and to insure fulfillment of the statutory mandate, it was judged best that the rules delineate appropriate surety provisions.

Part 2785.1100, subpart 5, states that if a pool must undertake special costs to collect money from a member, the costs are also the member's obligation. This requirement was judged necessary to preserve a pool's financial integrity. Because a pool is not an independent company like an insurer, but consists of its collective members and their pooled funds, defaulting to the pool is a more serious matter than defaulting to a wholly separate for-profit business. This requirement compels all pool members to acknowledge this distinction, which would not occur if the pool were obliged to fund its own recovery costs entirely.

And finally, part 2785.1400, states that all pool members (and some past members) are jointly and severally liable for the pool's liabilities and expenses, and that the commissioner may assess a pool's member employers if necessary to maintain or restore a pool's sound financial condition. This is only one of several options available to the commissioner, none of which would be invoked unless the board had first failed in its responsibility to take corrective action.

The alternative to retaining the assessment possibility is to rely wholly on the other financial safeguards contained in the rules. The most important of these are the reserving requirements, the requirement that rates be adequate, and the various provisions of part 2785.1500 (fidelity bonds, separate accounts, investment restrictions, etc.).

The necessity of each of these requirements was carefully weighed before inclusion in the final proposed rules. It was judged that each requirement, including the assessment possibility, was necessary to insuring the stability and financial integrity of political subdivision self-insurance pools, especially public/private pools. As stated previously, unlike insurance companies, self-insurance pools have no investors who have paid-in capital to finance the venture, or who will bail the company out if loss experience is poor. Pools also do not participate in the collective insurance industry arrangements, such as the guaranty associations, which will assume outstanding claims in the event a company goes bankrupt. These differences make self-insurance pools less financially sound than insurance companies, unless substitute financial guarantees are required.

The requirements concerning reserves, rates, and related matters should be adequate to protect a pool in all but the most extreme circumstances. Nevertheless, there are scenarios that could occur in which these safeguards would prove inadequate, as occasionally happens with insurance companies. In such cases, there must be some other source to turn to, and it is appropriate that that should be the entities responsible for the pool's existence and direction. In this respect, a pool's members have a role much like the investors of a business. The rules contain sufficient safeguards to reduce the possibility of extreme cases of financial hardship arising. But to fulfill their purpose and the statutory mandate, the rules must contain some provision for handling a worst-case scenario. And for that reason, the assessability of the members must be established.

Quantitative impact.

The quantitative impact of the rules on small businesses depends on the efforts put forth to establish and market public/private pools. Although some political subdivisions have been authorized to form such pools, including the city of Duluth, none have yet come forth with proposals. If pools are formed, they could constitute a significant new participant in the competitive environment for workers' compensation. The proposed rules are not expected to constitute an impediment to pool's formation and growth. On the contrary, it is likely that the state oversight of these pools, which the rules represent, would be a major factor favoring these pools' growth. The overall market conditions for workers' compensation insurance are likely to dictate whether public/private pools are an appealing option.

FISCAL IMPACT ON POLITICAL SUBDIVISIONS

As required by Minnesota Statutes, section 14.11, subdivision 1, the agency considered whether the rules would require expenditure of public moneys by local public bodies.

In general, political subdivisions are not required to participate in self-insurance pools. For those political subdivisions not participating in any pool at the time of the rules adoption, there is no expenditure requirement.

Of those pools now in existence, some are exempted from the rules under Minnesota Statutes, section 471.982, subdivision 3 (Laws of Minnesota, 1983, ch. 290, section 170). For the pools thus "grandfathered" in there is also no expenditure requirement.

The only existing pools affected by the rules are the employee health benefit pools sponsored by the League of Minnesota Cities and the Minnesota School Boards Association and the property/casualty pool sponsored by the League of Minnesota Cities and providing auto liability coverage. Part 2785.0600, subpart 2, grants these pools until July 1, 1985 to submit an initial application under the rules. It is intended that in the interim period these pools could prepare an application, and make such adjustments in their bylaws and methods of operation as they considered appropriate or the rules required. Consideration has been given in drafting the rules to avoiding unnecessary changes in existing methods of operation, based on correspondence and discussions with the affected parties.

Although some changes will be necessary, they are relatively minor in comparison to the ongoing costs of operating the pools. The costs associated with these changes will not, in the agency's judgement, approach $100,000 in the first or second year after the rule's adoption. On this basis, a detailed fiscal note was not prepared.

CONCLUSION

For the reasons stated above, the commissioner believes that the proposed rules governing political subdivision self-insurance pools are necessary to ensure that the financial integrity of these pools is maintained, and that they are administered competently and equitably. For the reasons stated above, the commissioner believes that the proposed rules reasonably address that need, and accomodate the interests of small businesses to the extent permitted by the statutory objectives of the proposed rules.