Rate Framework Reform

Paper 2:
Current State Analysis

MARCH 2015

WORKPLACE SAFETY AND INSURANCE BOARD

MESSAGE FROM THE CHAIR AND PRESIDENT & CEO

In recent years, stakeholders, experts and the WSIB have identified a number of fundamental challenges to the WSIB's current classification and premium rate setting approach.

Following the recent engagement with stakeholders, Mr. Douglas Stanley released his final *Pricing Fairness* report, in which he recommends that the WSIB develop an Integrated Rate Framework that would change the way employers are classified and the way premium rates are set.

After a careful review of Stanley's recommendations, consideration of stakeholder perspectives and challenges, the WSIB's own analysis and advice from a team of actuarial experts from the firm Morneau Shepell, the WSIB committed to bring forward a proposed preliminary Rate Framework for discussion with stakeholders.

The WSIB's objectives are to consider reforms that ensure that everyone pays their fair share for workplace coverage, to ensure that there is a reasonable balance between premium rate stability and responsiveness, and to make it easier for stakeholders to understand and engage in the process.

The proposed preliminary Rate Framework described in these technical papers builds upon Stanley's recommendations and proposes a plausible working model – a way forward for the WSIB to distribute the costs of the system in a fair and transparent manner.

Its key features are:

- A simplified, transparent and modernized classification system, aligned to an accepted national standard;
- A fair process that prospectively sets premium rates, reflecting individual employers' claims experience relative to their industry; and
- Considerations for a reasonable transition path to ensure employers can gradually adjust to the new premium rate setting process.

Although the WSIB is proposing a plausible working model, there are a number of options and key questions for further consideration. The WSIB understands that it is only with stakeholders' varied and unique perspectives that it will be able to make informed decisions on the issues currently faced by the system.

The WSIB is thankful for the support and thoughtful engagement of stakeholders in the Rate Framework Reform initiative and looks forward to further opportunities to hear the diverse perspectives as we consider potential reforms to the current approaches for employer classification and premium rate setting.

Yours truly,

Elizabeth Witmer
Chair

I. David Marshall
President & CEO

March 31, 2015

Table of Contents

PAPER 2 | CURRENT STATE ANALYSIS

Background

In September 2010, the WSIB appointed Professor Harry Arthurs to review a number of issues related to the financial situation of the WSIB. Professor Arthurs was assisted by four distinguished advisors from various backgrounds – Maureen Farrow, Buzz Hargrove, John O'Grady and John Tory – and by a small staff seconded from the WSIB. In addition, research support for the review was provided by the Conference Board of Canada and Morneau Shepell, a firm of consulting actuaries.

Arthurs' Report, Funding Fairness, made specific recommendations regarding reforms to the WSIB's premium Rate Framework. This led the WSIB to initiate a comprehensive review of its current classification structure, premium rate setting process and experience rating programs.

This review included a multi-phased Rate Framework Reform Consultation led by Special Advisor, Mr. Douglas Stanley.

Following the consultation, Mr. Douglas Stanley released his final report, Pricing Fairness: A Deliverable Framework for Fairly Allocating WSIB Insurance Costs. In this report he recommends that the WSIB develop an Integrated Rate Framework.

Is Workers' Compensation a Payroll Tax or an Insurance Scheme?

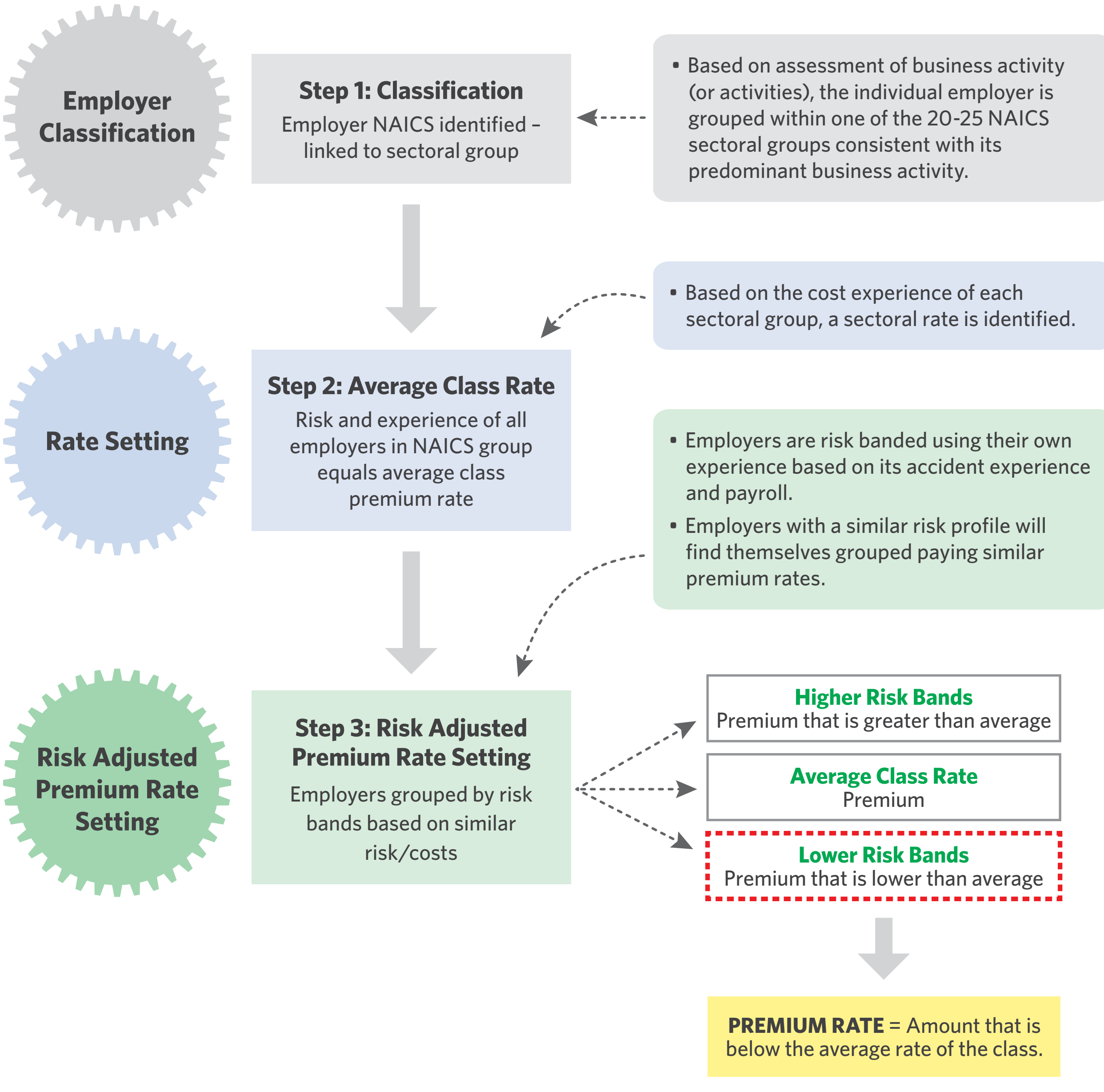
During the Rate Framework Reform Consultation (and in some instances, since workers' compensation has existed in Ontario) certain stakeholders have suggested that workers' compensation is a payroll tax – this is not the case. The WSIB premium rate is an insurance premium which benefits workers and employers. It varies depending upon the injury claims within a specified group of employers.

Workers' compensation, which was established before (and in some respects was the precursor to) social insurance schemes like unemployment insurance, shares certain features with those schemes. Employers that are considered part of the Schedule 1 list of industries must contribute to the insurance fund and this contribution is based on payroll. From this fund, injured workers receive compensation and support, including re-employment and return to work, intended to mitigate the social cost of work-related injuries or illnesses. For this reason, many people refer to it as a "payroll tax".

However, workers' compensation is based on insurance principles similar to those of insurance products in the private market. Employers pay premiums in return for coverage. Premiums are pooled and an employer's premiums can be adjusted to be higher or lower based on the industry or the individual employer's experience. Just like any other insurance scheme, employers may pay a different premium than their competitors, if, for example, their claims experience differs. In addition, there are other examples of mandatory insurance administered by the state or a state agency, such as auto insurance in some Canadian provinces. In these ways, workers' compensation is not the same as a tax-funded social insurance. It is, insurance.

While they have inevitably evolved over time, these features remain a fundamental part of the approach developed by Sir William Meredith in 1913 and they continue to be the essence of workers' compensation schemes in Canadian jurisdictions.

Mr. Stanley recommends an integrated system that includes an improved classification scheme based on the North American Industry Classification System (NAICS), which is very different from the existing approach – it is intended to be simple, transparent and easier to administer. His recommendations include the following highlights:



The Development of a Proposed Preliminary Rate Framework

Figure 1: Rate Framework Reform – Overview

Funding Fairness to Pricing Fairness

Based on the recommendations contained in the *Funding Fairness* report, the WSIB undertook a jurisdictional analysis of best practices related to employer classification and premium rate setting.

Concurrently, Special Advisor, Douglas Stanley led a comprehensive consultation with stakeholders providing an opportunity for discussion on the development of a new Rate Framework.

This culminated in his *Pricing Fairness* report (Feb 2014), which included recommendations to reform current employer classification, premium rate setting and experience rating approaches.

Proposed Preliminary Rate Framework

The WSIB has developed a proposed preliminary Rate Framework, considering the recommendations in the *Pricing Fairness* report and working with Morneau Shepell as external actuarial advisors.

It is a representation of a plausible Rate Framework in line with Stanley's recommendations and the WSIB's own analysis.

A number of options and variations have and could be considered based on further analysis and engagement with stakeholders.

Moving into 2015 and Beyond

Upon describing a proposed preliminary Rate Framework, the WSIB will undertake further stakeholder engagement on a proposed preliminary Rate Framework that will begin in early 2015.

The WSIB will review various options and perspectives as it considers Rate Framework reforms. Recommendations will be developed for consideration by its Board of Directors.

The WSIB is committed to engaging stakeholders in the future to consider the transitional features of any potential Rate Framework reforms.

Since the release of Mr. Douglas Stanley's final report, the WSIB has been working with Morneau Shepell to develop a proposed preliminary Rate Framework that is a workable model with consideration to Mr. Douglas Stanley's fundamental goals and recommendations as outlined in his final report:

The *Pricing Fairness* Fundamental Goals included:

1. A system that collects sufficient funds on an annual basis to pay present and future benefits to injured workers and makes up the inevitable annual gains/losses in a timely and prudent manner (Sufficient and Timely Funding of Benefits);
2. A system that imposes those costs on employers in a fair and equitable manner and strikes a reasonable balance between fair premium rates and collective liability (Fair and Equitable Allocation);
3. A system with clear fundamental goals that is monitored and evaluated against those goals (Monitored Against Fundamental Goals);
4. A system that is responsive to an employer's efforts to reduce workplace injuries but not one that encourages an employer to suppress claims (Reasoned Responsiveness and Flexibility); and

5. A system that is clearly understood by stakeholders, allows stakeholders to engage with confidence, and reduces the administrative burden to both employers and the WSIB (Clear Understanding and Ease of Engagement).

Case for Change

As part of the previous phase of Rate Framework Reform Consultation, the WSIB published a paper entitled, WSIB Classification and Pricing System: The Case for Change (June 2013). This document is a sample collection of real situations and issues brought forward to the WSIB's attention by individual employers or groups of employers in various industries. In addition, it includes concerns and fundamentals as assessed by the WSIB in administering the current classification and premium rate setting approaches. In short, it outlines a case for major change to the WSIB classification structure and the premium rate setting process.

The main issues identified in the paper include:

- Complex and inconsistent classification structure that is no longer relevant due to the changing Ontario economy (i.e. Standard Industrial Classification Codes [SIC]);
- The false assumption that employers undertaking a similar business activity or engaged in the same industry will present a similar risk to the system;
- Increasing divergence between business activity and risk;
- Lack of recognition of employer experience in premium rates, leading to subsidization;
- More rate groups (RGs) have become statistically non-credible; and
- Inadequate experience rating programs that exclude many employers, lead to premium rate instability and perception of negative behaviours.

To read the full document, please see the Case for Change referenced above.

Review of Employer Classification and Experience Rating

Following the release of the Case for Change, Morneau Shepell undertook a further analysis of the WSIB's current classification structure, premium rate setting process, and experience rating programs. The reviews revealed a compelling case for replacing the WSIB's current employer classification structure and experience rating programs. While the WSIB has made some changes to the current system, the analysis further reinforced that a reorganization of the WSIB's current classification structure would be extensive, and may not be sufficient to fix more systemic issues. Additionally, the analysis suggested that the WSIB should consider exploring a prospective experience rating approach for all Schedule 1 employers at the same time.

Rate Group Analysis

To determine whether a more in-depth review might be required and to understand the scope such a review would entail, Morneau Shepell reviewed the current system's RGs and classification units (CUs). In addition to providing insight into the relative "health" of the current scheme, the WSIB wished to better determine whether simply "fixing" the current RGs and CUs (as some stakeholders are suggesting) would address the challenges of the classification structure.

Morneau Shepell conducted an analysis to determine whether each RG had a cost experience sufficiently similar to another RG (or RGs) in its class. If RGs were found to have a similar cost experience, an argument could be made to merge them together, thereby simplifying the WSIB's classification and premium rate setting structure.

For the analysis, Morneau Shepell used insurable earnings and actual claims experience data for each CU, for a six year period (2007-2012), and used a full RG credibility measure of $15 million in actual claim costs over the six year experience period. The rationale for using these parameters was that the size of each RG should be significant enough to enhance claims cost stability and reduce premium rate volatility.

Morneau Shepell then determined whether each of the RGs' experience was significantly different from other RGs in its class by establishing a 75% confidence interval for each RG[1]. Based on the methodology used, their review found that almost 1 in 2 RGs could be considered for a potential RG merger (in some cases, a particular RG could belong in either one or two of the new RGs that would be thus formed). The analysis also highlighted that generally, the classes with a larger number of RGs were more likely to have a higher percentage of RGs flagged for review/potential merger.

Classification Unit Analysis

Beyond bringing RGs together to be able to accurately calculate what the appropriate premium rate should be to ensure the financial sustainability of the compensation system, there are other problems with the existing classification system. There can be significant differences in claims experience among employers that are in the same CU and RG, yet they will pay the same premium rate (before experience rating, noting that there is a significant amount of employers that are not experience rated at all in the current system). To look at this question, Morneau Shepell conducted an analysis of the number of CUs that the WSIB would have to review (and possibly assign to a different RG) because of significant differences in claims experience between the CUs within a RG.

Similarly to the RG analysis, Morneau Shepell used insurable earnings and actual claims experience data for each CU, for a six year period (2007-2012), but used a full CU credibility measure of $10 million in actual claim costs over the six year experience period. For the analysis performed for the WSIB, Morneau Shepell used a similar approach as the one used by some other Canadian jurisdictions to identify potential reclassifications each year.

1 The mid-point of the confidence interval is the average Claims Cost Ratio (CCR) for the rate group (claim costs divided by insurable earnings, for the six year period). Morneau Shepell then defined a range of results where claims experience would be expected to fall 75% of the time.

Adopting the standard approach used by other jurisdictions for their annual classification reviews (75% confidence interval), Morneau Shepell found that 1 in 4 CUs would need to be reviewed for potential RG reclassification[2], equaling 41% of the current insurable base. The CUs that were identified for potential reclassification were distributed throughout the current classification structure – at least 10% of the CUs in each class.

Morneau Shepell's analysis gives more weight to the signals that in the current system, employers may be incentivized to seek a reclassification on an individual basis (or to request a policy change to have their CU as a whole changed from one RG to another RG) in order for their classification to, in their view, better reflect their experience. Reclassifications at the individual employer level or at a group (CU or RG) level are imperfect and at best have been ad hoc solutions to fix problems of the classification system. In this system, some employers feel that they are paying for the poor accident record of other employers in their RG, while others are benefiting based on the good accident record of other employers.

Overall, while the WSIB has made some program changes over the years, the analysis indicates that a significant amount of reorganization of the existing CU and RG structure would be required in order to perform the needed adjustments, in addition to robust on-going maintenance of the current classification structure. The effort this would require would be much more significant and complex than the proposed preliminary Rate Framework approach, which seeks to greatly simplify the employer classification structure.

Previous Review of Experience Rating: Morneau's 2008 Review

Since the introduction of the WSIB's experience rating programs, a number of reviews have been conducted to address issues raised by stakeholders and the WSIB. Small changes have been made over the years, but there has been no major overhaul to date. The challenges with the current experience rating programs have been well documented by a study conducted by Morneau Shepell in 2008, which identified specific issues to be addressed in the current experience rating programs.

- Some stakeholders have raised concerns that it may not be fair to have some costs considered under one program and then other costs included in other programs;
- The complexity of these experience rating programs makes it difficult for most average employers to understand the terminology used in calculating the refund, surcharge or premium rate adjustments. If an employer wants to question and (if needed) revise the data used in the experience rating calculations, it requires them to maintain up to date claims information, and to be conversant in the details of many experience rating programs, especially if they move from one program to another because of their premiums paid; and
- Employers have also expressed that premium rate stability is more important than premium rate responsiveness. With the New Experimental Experience Rating (NEER) and Construction Industry Plan (CAD 7) programs reviewing the historical costs of employers, and then adjusting the premium rate previously remitted the year before (with a refund or surcharge), employers

2 If the WSIB were to proceed with a review that would re-assign CUs as an initial step, this may reduce the number of RGs (identified above) with overlapping cost experience.

have raised concerns that the current experience rating programs do not allow an employer to appropriately budget for potential costs that may arise in surcharge situations. For some employers, this can represent a significant cash flow management issue, further complicated by their accrual accounting practices.

The issue of premium rate stability was also brought up by stakeholders as part of the 2013 Rate Framework Reform discussions. In this review, a number of design issues in the current experience rating programs have led to increased premium rate instability.

These design elements include:

- Transition Between Programs – There is a misalignment of potential rebates and surcharges at the point where an employer moves from Merit Adjusted Premium (MAP) to NEER / CAD 7, and vice versa. Moving from one program to the other can produce materially different premium rate adjustments for the same cost experience;
- Multiplier Effect – Both CAD 7 and NEER have features that lead to significant financial leverage. This means that for each additional dollar in cash claims payments, there can be many dollars of premium impact. This is often referred to as a multiplier effect;
- Limits on Annual Premium Rate Changes – All three WSIB experience programs (MAP, NEER, and CAD 7) have a limit on incentive amounts, but no year-to-year limit on increases. This leads to highly volatile results and a relatively weak incentive to improve for employers with extremely poor experience; and
- Participation Factor – The participation or rating factor is an adjustment applied in the calculation of experience incentives that has the effect of reducing the impact of the incentive for smaller employers that are subject to proportionally larger statistical fluctuations. This factor can have a significant impact on experience rating results.

One of the design issues highlighted above is the "multiplier effect". In the Morneau Shepell review, they provided the following example:

One $2,000 lost time claim for an employer paying $250,000 in premiums can lead to an experience rating adjustment of:

- $52,000 for a CAD 7 employer if the claim lasts more than 7 days (i.e., multiplier effect of 26 times the actual payments); and
- $3,000 for a NEER employer (i.e., 1.5 times the actual payments).

It is clear that one of the unintended consequences of the NEER and CAD 7 programs is that there is a considerable difference in how claim costs are factored into the experience rating calculations and resulting cost variability for employers. Despite numerous program reviews, the reoccurring issues and unintended outcomes highlighted above subsist.

Overall, while the WSIB has made some program changes over the years, the analysis indicates that the adjustments needed to fix the current experience rating programs would be much more significant and complex than introducing the proposed preliminary Rate Framework model.

Previous Review of Classification: WSIB – Construction Sector Working Group

A similar review of the Rate Framework Reform Consultation, specifically the reduction of employer groupings, was undertaken by a stakeholder-WSIB joint working group. In December 2008, the Joint Advisory Implementation (JAIG) Subcommittee – Compliance Registered Working Group (Working Group),[3] released a position paper entitled, *Reduction of Rate Groups in the Construction Sector* [i].

This paper addressed what the group called the 'presenting problem', a problem identified with the current RG structure, which allowed for employers to seek a better premium rate, and the misallocation of payroll, which contributed to revenue leakage (commonly referred to as rate shopping)[4]. The objective of the position paper was to deliver a recommendation to streamline the current RG classification structure, focused specifically on the construction sector.

The Working Group agreed upon guiding principles that would be considered when evaluating options to reduce the number of RGs. These guiding principles included:

- Minimize revenue leakage;
- Easy to understand;
- Create a level playing field;
- Reduce fragmentation of classification system/Reduces Rate Shopping;
- Reduce or eliminate the need for special operations classification;
- Balance commonality of business and commonality of risk;
- Provide a clear distinction between rate groups; and
- Actuarially sound rate structure.

A number of these guiding principles are mirrored in the Key Goals used in the development of the proposed preliminary Rate Framework, which is introduced in Paper 3: The Proposed Preliminary Rate Framework.

When considering how they would reduce the number of RGs, the Working Group reviewed a number of different options. They recommended a hybrid of two models – Sector based (model based on combination of risk and sector based) and Phases of Construction Model, a North American Industry Classification System (NAICS) based classification structure similar to what is being suggested in Paper 3: The Proposed Preliminary Rate Framework.

A number of key challenges were identified in the position paper about implementing the hybrid model. The principle challenge was the extensive reform that would also be needed on the existing experience rating programs. Ultimately, this initiative did not move forward because, at the time, the WSIB was not conducting a simultaneous review of its experience rating programs. Fortunately, the scope of this Rate

---

3 The Working Group was comprised of Council of Ontario Construction Associations, RESCON, Ontario Home Builders Association, Kenaidan Contracting Ltd., Electrical Contractors Association of Ontario, Residential Framing Contractors Association of Metro Toronto, and Sayers and Associates Limited, alongside the WSIB.

4 Rate shopping occurs when stakeholders and industries request to have their placement in a rate group reconsidered in order to lower their WSIB premiums or obtain premiums that are more closely linked to their claims experience.

Framework Reform Consultation includes employer classification, premium rate setting and experience rating.

The Need for Equity in Employer Premium Rates

Further to Morneau Shepell's analysis on the current issues associated with the three experience rating programs, the WSIB assessed the impacts that today's premium rate setting process has had on employers. Specifically, the WSIB evaluated the number of employers who are paying too much or too little, to determine if more equity can be provided among employers. In this regard, the WSIB noted a number of issues that will need to be addressed (beyond the more recent across the board premium rate adjustments).

For a number of years, rather than charging employers a high premium rate that reflected a large new claim costs component due to catastrophic events, the WSIB determined a reasonable amount that the class could bear. The remaining new claim costs for that class were then allocated amongst the other classes, as part of their premium rate.

In essence, in an effort to provide premium rate stability for those poor performing classes, all other classes have been supporting some costs for these classes, with respect to the new claim costs component of the premium rate.

Using the 2014 premium rates as the basis (for comparative purposes) the premium rate that the classes should be paying based on their new claim costs may be quite different from what the classes are currently paying.

Figure 2: Assessment of Employer Premium Rates

Category	Number of Organizations	Percentage of Organizations	Balance in Premiums ($M)
Employers paying the same rate*	30,000	13	-0.27
Employer paying too little	77,000	31	363
Employer paying too much	137,000	56	-369
Total	**244,000**	**100**	**-6**

**Paying a premium rate within a +/- 2% of the 2013 Net premium rate.*

As you will note in the above table, 56% of employers are overpaying by $369M in premiums, and 31% of employers are underpaying by $363M, resulting in classes that are not paying their fair share of new claim costs.

To address this imbalance and move towards a system that is more equitable, the WSIB would need to address the following issues:

- When should the transition to a new Rate Framework start and how long should it take to move employers from their current rate to the premium rate that they should be paying; and
- How should the WSIB receive buy in from those classes that should be seeing premium rate increases and want to delay them, when those classes that are anticipating premium rate decreases would like the WSIB to reduce their premium rates as soon as possible?

This problem is further exacerbated when the off-balance of today's experience rating programs is taken into consideration.

Technical components of these experience rating programs (e.g. claim/firm cost limits, rating factors, etc.) limit the ability to hold employers fully accountable for their costs. These technical components exacerbate the off-balance which is ultimately paid for by all Schedule 1 employers. Not only are employers who participate in experience rating programs funding this off balance, so are employers who aren't included.

This raises fairness concerns because all Schedule 1 employers are required to support a portion of the rebates and premium rate decreases that a smaller group of employers receive within and across industry sectors.

Conclusion

Each of the reviews highlighted in this paper presents stakeholders with a detailed understanding of why change is now required to the WSIB's classification structure, premium rate setting processes, and experience rating programs. Together, they provide a telling story of the challenges faced by employers and workers in understanding the complexity in today's environment, as well as the administration of a system that is fair, predictable and transparent.

With some employers paying too much and other employers paying too little, changes to the existing scheme are necessary in order for the WSIB to charge a fair premium to employers that reflects their claims experience.

As a result, a comprehensive remedy to address the issues highlighted above is required, leading to this engagement with stakeholders beginning with discussion on a proposed preliminary Rate Framework. Papers 3-5 seek to provide stakeholders with a workable solution to today's challenges.

Endnotes

i. JAIG Compliance Registered Working Group, *Position Paper on Reduction of Rate Groups in the Construction Sector: All construction employers, workers and independent operators fully participate in the Workplace Safety and Insurance system*, December 13, 2004.

GLOSSARY

Actuarial Predictability is a process where the WSIB determines the degree to which past claims costs can be relied upon to predict future outcomes and therefore fairly and accurately set premium rates. Also referred to as actuarial credibility.

Class Actual Premium Rate is the premium rate that would be set by the WSIB, taking into consideration risk band limitations, previous year(s) premium rates, as well as the collective experience of all employers in that class.

Class Target Premium Rate is a premium rate based on the valuation of collective liabilities of new claim costs for the employers within a respective class, their allocation of administrative costs, and apportionment of the past claims costs for a particular class.

Employer Actual Premium Rate is an adjusted premium rate that represents how much each employer would pay taking into consideration risk band limitations, previous year(s) premium rates, minimum premium rate, as well as the collective experience of all employers in that class.

Employer Level Premium Rate Adjustment is a process where the Class Target Premium Rate is adjusted for an individual employer based on their risk relative to the Class Target Premium Rate, to arrive at their individual risk band position and corresponding Employer Target and Actual Premium Rates.

Employer Target Premium Rate is an adjusted premium rate that represents how much an employer needs to pay in order to fund their fair share of costs, as well as the collective costs of their class.

Net Premium Rate represents the premium rate, for a class, rate group or individual employer, comprised of the published premium rate combined with any premium adjustments resulting from the existing experience rating programs, as applicable.

Predominant Class is the class that represents the largest percentage of the employer's annual insurable earnings.

Risk Adjusted Premium Rate Setting is a two-step process that includes setting the Class Target Premium Rate and Employer Level Premium Rate Adjustments.

Risk Bands are hierarchical series of divisions within each class. Each division represents a different level of risk where employers would be placed relative to the Class Target Premium Rate. In each class, risk bands are subject to limitations, such as the premium rate of the minimum risk band ($0. 20), and the maximum risk band will not exceed about three times the Class Target Premium Rate. Each risk band represents approximately 5% increments in premium rate.

Risk Disparity is when claims experience or premium rates vary significantly from the average experience of the class.

Risk Profile is a step in determining the allocation of the costs to the system between the classes and/or individual employers, and is based on an employer's (or a class') claims costs relative to their insurable earnings.