

# **WSIB Rate Framework Consultation Discussion Paper**

**Mr. Douglas Stanley**

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# WSIB Rate Framework Discussion Paper

## 1. Introduction

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The purpose of this discussion paper is to engage all interested stakeholders in a dialogue on the core principles behind employer classification, rate setting and experience rating and to consider options for the modernization of the Workplace Safety and Insurance Board (WSIB) Rate Framework. This WSIB Rate Framework consultation is an evolution from the WSIB Funding Review, led by Professor Harry Arthurs. It will build upon the resulting discussion and recommendations outlined in his final report, *Funding Fairness: A Report on Ontario's Workplace Safety and Insurance System*.

This consultation is open to the public. We will accept the views of all interested participants directly online, through written submissions, in direct discussions with stakeholder groups, and at public hearings which will be held across the province. Any and all views are genuinely welcomed and should be submitted in accordance with the instructions at the end of this paper.

**Note: All submissions received through this consultation will be published on the WSIB website.**

### Why and Why Now?

This is not the first time that the WSIB has turned its mind to one or more aspects of the classification, rate setting and experience rating systems. The list includes:

- 1989 Revenue strategy: A Framework for the 1990s and Beyond
- 1998 Consultation Report on the WSIB Funding Policy
- 2008 Recommendations for Experience Rating, Morneau Sobeco
- 2009 Chair Mahoney's Report on Stakeholder Consultations
- 2010 WSIB Funding Review

The conclusion reached in each of these examinations, was that there is something that needed to be fixed. In my assessment of these reviews, the time has passed for asking the question, "*is there a problem?*", and it is now time to move on to, "*how do we fix this problem?*".

This consultation is taking place in the context of the broader discussion about the funding of the WSIB. There is universal recognition in Ontario that the WSIB's unfunded liability (UFL) is an overarching issue. We acknowledge that fixing the classification, rate setting and experience rating systems will not contribute to reducing the UFL. In fact, it is fully intended to be a revenue neutral exercise. However, any effort to reduce the UFL must be based on a strong foundation of a Rate Framework that employers accept as fair and reasonable. It must be transparent, provide clarity on the costs of the system, and how each employer will be paying their 'fair share' of those costs.

While Arthurs' final report, *Funding Fairness*, provides a guide for the WSIB as it moves forward, the WSIB must now work with its stakeholders to make important policy and operational decisions about the design, implementation and operation of a new system.

This consultation will undertake a principled approach to reform. Effective reform of the Rate Framework requires that the WSIB, its stakeholders and partners consider the system as a whole. The reform of employer classification, rate setting and experience rating must be done in tandem to provide all interested parties with a balanced and sustainable system of workers' compensation.

In the introduction to his report in 1913, Sir William Meredith said that under a just law, the risks to workers arising from injuries in the course of their employment should be regarded as risks of the industries and that compensation for those injuries should be paid for by those industries.

In putting this approach into effect, deciding how those industries or employers are going to pay for compensation is answered by the employer classification, rate setting and experience rating policies and programs adopted by workers' compensation boards across the country.

## What is Fairness?

Meredith was very concerned about "fairness". Any classification and rate setting framework for workers' compensation should be measured against guiding principles, including specifically efficiency and fairness. It is key to the success of this consultation and reform, that we focus on the core principles that will guide the necessary changes required to improve Ontario's workers' compensation system for everyone.

This approach to consultation is often referred to as "principle based consultation". What we would like to explore in this paper and the dialogue that follows is what philosopher and Harvard Law Professor John Rawls refers to as "fundamental justice or fairness". What is fair for all the stakeholders in this system, not what is fair for any one stakeholder given their interests and circumstances. In answering the questions that follow in this paper, we ask you to consider "*what is fair?*" and that you set aside the question "*what is fair for me?*" We appreciate that this is sometimes difficult.

As Special Advisor to the Chair of the WSIB, and within the scope of my mandate, I will engage stakeholders across Ontario, in a dialogue prompted by this Paper and later provide advice for the WSIB to consider as it moves towards a new sustainable and predictable framework for employer classification, rate setting and experience rating.

## Issues that this Consultation will not Address

Your views are important, encouraged and most welcome but I ask that you remember that this consultation will focus on Employer Classification, Rate Setting, Experience Rating and related issues. Other concerns about workplace safety and insurance will not be examined at this time.

This consultation will *not* address:

- Matters related to programs with Occupational Health and Safety (OHS) objectives. For any current and/or future programs focusing on prevention and OHS, that mandate was transferred to the Chief Prevention Officer (CPO), operating under the aegis of the Ministry of Labour (MOL) in April 2012. The WSIB is working closely with the CPO/MOL to ensure that any renewed prevention offerings, or newly designed CPO/MOL programs (refer to Section 5 for more information) will be addressed in collaboration to determine the best way to proceed.
- Matters related to methodology associated with the maximum amount of insurable earnings, in particular in construction.
- Matters related to the Benefit Policies Consultation, led by Mr. Jim Thomas, or any other benefit issues generally.

## 2. Setting the Context for Dialogue

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In the fall of 2010, the WSIB commissioned an independent funding review, led by Professor Harry Arthurs, in response to the Auditor General's concerns (as expressed in his *2009 Annual Report*) about the WSIB's multi-billion dollar UFL. His final report titled *Funding Fairness: A Report on Ontario's Workplace Safety and Insurance System*, was publicly released in May 2012. Below, I have identified legislative and regulatory amendments put forth by the Government, either in response to the report, or that impact one or more of its components.

- Legislation (Bill 135) was passed in December 2010, requiring the WSIB to maintain a sufficient insurance fund, and repealed government powers to provide loans or grants and to set policy for the WSIB;
- The prevention mandate was transferred to the Chief Prevention Officer (CPO), under the *Occupational Health and Safety Act* (OHSA), in April 2012;
- A new regulation (under Bill 135) was enacted requiring that the WSIB reach funding sufficiency of 60% in 2017, 80% in 2022 and a full 100% by 2027, and provide a plan towards achieving these targets; and
- A new regulation was enacted increasing benefits to injured workers on partial disability by 0.5% in 2013 and 0.5% in 2014 (consistent with the increases regulated in 2011 and 2012).

The *Funding Fairness* Report forms the fundamental basis for future systemic change of the current classification and rate-setting model for Schedule 1 employers. In particular, Chapter five of the *Report* examines in detail the existing classification and rate setting system, highlights its deficiencies and contains a series of recommendations intended to modernize and update the framework.

In moving forward with this engagement of stakeholders, and my role in leading this discussion, the WSIB is demonstrating that it supports the general proposition in the Arthurs' report that the time for updating and modernizing the classification and corresponding pricing model is long overdue.

### A Set of Guiding Principles

In his report, Meredith said:

There are two main types of compensation laws. By one of them the employer is individually liable for the payment of it, and that is the British system. By the other, which may be called the German system, the liability is not individual but collective, the industries being divided into groups, and the employers in the industries in each group being collectively liable for the payment of the compensation to the workmen employed in those industries - - practically a system of compulsory mutual insurance under the management of the state.

Ontario has both of these systems contained in the Workplace Safety and Insurance Act (WSIA). The system for Schedule 1 employers is compulsory mutual insurance and the system for Schedule 2 employers is individual liability. Our concern in this exercise is the operation of the system that applies to Schedule 1 employers. What we are trying to establish is a set of principles for a system of collective liability that allows for the payment of compensation benefits funded by employers in a manner that is fair to all employers. Meredith recognized that any system of collective liability might result in some employers sharing an unfair burden of accident costs and he introduced into the legislation provisions to guard against that unfairness. Understanding how that works and why a

system of grouping employers together is necessary to achieve fairness requires an understanding of how we use “risk” as a measure, and what it is a measure of.

## What do we Mean When we Talk About Risk?

Meredith’s Report, and the original sections in the legislation that he drafted, speak about “hazards” of particular industries. Meredith speaks about the “hazards of steam and electricity” and the relative hazards of one industry to another. He recognized that some workplaces were more “dangerous” and employment in those workplaces entailed a greater “risk” of injury. This preceded the development of more sophisticated statistical and actuarial analysis. Today, when we speak about “risk” in the workers’ compensation system, we are referring to a real relative factor as opposed to an abstract notion of “hazard”.

When we talk about employers bearing their “fair share” of the costs of the system we often speak of the risk that the employer presents to the system and use the concept of relative risk to apportion the premium responsibility of employers. It is important to realize that “risk”, in these terms is not what comes to mind when we ask the simple question – what is the risk in that employment? When we use risk in the apportionment of the premium costs for workers’ compensation we are using “cost of injuries” as a proxy for risk. However, cost of injuries is only a reliable proxy for risk if an entity is large enough, and has enough cost over time, so that measured results are reasonably stable. Because a relatively small proportion of employers are of sufficient size to have stable cost histories, the measurement of cost often must be done for groups of employers (for example, classification units or rate groups). Within these groups, there may be some employers that have little or no cost while others have high cost levels due to different workplace safety and return-to-work practices, or statistical fluctuations. It is not necessarily unfair to include these employers in the same group if the observed cost levels are unstable and therefore unreliable.

The use of “cost” as a proxy for risk is important when we get to the discussion on experience rating. Arthurs has recommended changing the metric for experience rating.

### Question for Consideration

*Is there some other viable and objective measure of an employer’s relative performance in order to rate their relative contribution to the system?*

## Principles

Reviewing the studies done in Ontario over the last 30 years led to the identification of a set of principles to guide the choices among available options for classification, rate setting and experience rating:

- **Collective Liability:** As a cornerstone of the Meredith Principles, Schedule 1 employers must collectively pay the premiums required each year to maintain the Insurance Fund, which exists to fund all costs and expenses under the WSIA (including claim costs) and other legislated obligations. In exchange, employers are insured and financially protected from legal claims arising from workplace injuries and occupational diseases, as well as random and volatile fluctuations in premiums.

- **Fairness:** The premiums paid by Schedule 1 employers must be well aligned with the costs generated by the same employers, both individually and within their industry group without resulting in excessive financial consequences for any one employer. This insurance equity promotes good health and safety practices, disability management and early return to suitable work.
- **Transparent and Understandable:** Employers must see and understand how their premiums have been set and how and why their premiums have been adjusted based on their own individual experience and the collective experience of their peer group.
- **Financial Security:** The Insurance Fund must have sufficient assets to ensure that injured workers and their survivors, dependants and beneficiaries are reasonably assured that their benefits will be paid when due, as promised.
- **Ease of Administration:** The classification and pricing model must be simple, efficient and effective, to the extent possible, in order to facilitate an employer's ability to meet their reporting and payment obligations.
- **Positive Behaviour:** The pricing system should encourage employers to prevent injuries, improve health and safety in the workplace, return injured workers to sustainable employment while discouraging undesirable negative behaviours such as rate shopping, misallocation/misreporting of claims, claim suppression and non-productive or unsafe return to work.

The challenge and goal, is to identify the principles that should apply in Ontario, to guide the design of a modernized Rate Framework that appropriately balances these principles, with input and insight from all interested stakeholders, in a manner that is effective, efficient and fair.

Consider the above principles as you go through this discussion paper and think about the issues raised by the questions posed and by the options that appear at the end of each of the following three sections.

### 3. Employer Classification

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Meredith rejected the British model of workers' compensation, the pay as you go model, where employers are individually responsible for the cost of the benefits paid out to their employees. It did not provide security of benefits to injured workers nor was it suitable for small employers, who could face financial ruin if they experienced one serious claim. He favoured the collective liability model, which he said was particularly appropriate for Ontario's economy dominated as it was by small business. Today there are 240,000 employers covered by Schedule 1 and Ontario is still characterized by small business. In addition, approximately 20,000 businesses move in and out of the system every year. That turnover rate goes directly to the issue of stability and security of benefit.

Unlike other publicly administered benefit plans such as Employment Insurance (EI) and the Canada Pension Plan (CPP), Ontario's workplace insurance plan has never had a single rate for all employers. This makes WSIB assessments less like a payroll tax and more like an insurance premium. Meredith included in the legislation the concept of dividing industries into "classes" and stated clearly that it was the duty of the Board to not unfairly burden employers in any "class". The original Board was given the authority to "re-arrange the classes" or "add industries to the classes" listed in Schedule 1. The Board was given the clear legislative mandate as follows:

Where in the opinion of the Board the hazard to workmen in any of the industries embraced in a class is less than that in any other or others of such industries, or where for any other reason it is deemed proper to do so, the Board may sub-divide the classes into sub-classes and if that is done the Board shall fix the percentages or proportions of the contributions to the accident fund which are to be payable by the employers in each sub-class.

A proper classification system is essential to ensuring that all businesses pay a reasonable share of injury costs while also adhering to collective liability principles. This will avoid a situation where a small number of costly injuries could have adverse financial consequences on an employer.

#### **Question for Consideration**

*What principles should underlie a classification system that "fairly distributes" the cost of workplace injuries amongst employers?*

In 1989, the WSIB (then the Worker's Compensation Board) released an external consultation document titled, *Revenue Strategy: A Framework for the 1990's and Beyond*. A good part of it dealt with the classification system. It identified some key principles that should underlie any system of employer classification and which are as valid today as they were in 1989. This is what they said:

Classification establishes a suitable assessment premium for the coverage of workplace injuries based on group insurance principles. Ideally, from an insurance viewpoint, employers should be grouped together ("classified") so as to ensure that the workers of all employers within a group are subject to similar risk of workplace injury or disease. However, considerations of various other characteristics of the group and the practicalities of administration suggest that comparability of risk should not be the sole basis for classification decisions.

Classifying employers is fairer to all participants in the system because some industries account for a higher proportion of claims costs than others and should, therefore, pay more to finance the costs of workplace injuries. The purpose of a classification system therefore, is to distribute the costs of accidents more fairly among employers. The goal should be to group employers by similarity of business activity and comparability of risk, in groups that are large enough to ensure sustainable collective liability, with clear rules for distinguishing between different classification groups.

After a series of extensive consultations the Board reformed the classification system in 1993 relying primarily on the Standard Industrial Classification (SIC) as adopted from Statistics Canada. The key objectives were to address stakeholder concerns about premium alignment with claim costs and bolster the collection of claims information at a more detailed level. The end result became the current multi-layered classification scheme with 9 classes, 16 sectors, 219 rate groups and 839 classification units (CUs).

Classification is the first critical step in the group rate-setting process. Employers initially pay premiums based on the accident costs associated with a defined business group, regardless of individual differentials in claim costs within the business group. The initial rate may otherwise be adjusted due to experience rating, risk banding or other initiatives. In theory, if the cost experience of a particular CU deviates from the other CU's over time so that its "risk" is no longer commensurate with the rate group's "risk", the CU should be moved to another rate group with similar cost experience. While such CU moves are possible in principle, the practice over the years has seen rate groups merged primarily for the purpose of ensuring a sustainable collective liability pool.

When the current SIC-based classification model was contemplated, it was recommended as a "point of departure" for the classification of employers, to be used as a classification framework that could be adapted to the needs of the workers' compensation system. Unfortunately, shortly after implementation, the SIC was phased out by Statistics Canada and replaced by the North American Industrial Classification System (NAICS) in 1997. Since then, the model has encountered an increasing number of challenges including:

- **Rate group mergers:** Accurate premium pricing requires large enough groups to produce stable claims cost and injury frequency data. Over time, as smaller rate groups were merged to maintain the integrity of the premium rate-setting process, the number of rate groups fell from 219 to 154 in 2010. Rate group mergers can be problematic from a descriptive and communications perspective because they tend to create non-intuitive mixes of different business activities within a single rate group.
- **Cross subsidization:** As rate groups merge, it has unintended, undesirable consequences because of the decrease in alignment between group premium rates and claim costs. For example, it may create a disincentive among poor performing employers to invest in workplace safety and/or stimulate requests/appeals for re-classification by employers with good claim records in the hopes of moving to a rate group with a lower premium rate.
- **Rate Shopping:** CU's with similar business activities are often grouped together for rate-setting purposes, even though the risk of the grouped CUs may vary widely. Informed employers who fall into this situation sometimes lobby to have their CU, or even more specifically just their own account, moved to another rate group with a more similar risk profile and/or appeal their classification in the hopes of being re-



classified to a CU in a lower paying rate group. This could lead to inconsistency, or a certain level of unfairness, for like employers that were not included in the changes.

These challenges are at least partly due to the fact that the WSIB has not had a systematic process for reviewing its classification scheme and making changes. When mergers did occur to deal with the declining size of rate groups, they resulted in CUs being put together in rate groups that lacked commonality. Having a mix of different business activities within a rate group (which is common in other jurisdictions) is not problematic on its own if employers understand that rate group assignments are driven by CU cost experience and if there is an opportunity for a CU or sub groups of employers to be assigned to a lower rated group, or effective premium rate, if experience improves or to a higher rated group when it deteriorates.

A perception of too much cross subsidization may be a symptom of not having reviewed the classification scheme on a regular basis to ensure that CUs are assigned to the proper rate group. By not having a formal review process, the classification structure loses its effectiveness over time. Similarly, the degree of rate shopping is influenced by the inability of a CU to achieve a lower rate through a bona fide rate group re-assignment. It is also reasonable to group small, similar CUs to form larger/more stable entities. However, most jurisdictions have a formal monitoring process that not only looks at the CU/rate group assignment, but also monitors the grouping of smaller CUs to ensure that this classification decision remains appropriate.

Professor Arthurs observed that as groups become larger they become more heterogeneous in character, embracing employers with a broader spectrum of workplace risks and increasing the scope of cross subsidization. He finds that this cross subsidization gives rise to what he refers to as “controversial consequences”, which include rate shopping (which may lead to increased administrative costs); the “moral hazard” of having some employers subsidize others; and the removal of incentives to improve health and safety.

Arthurs referred to rate shopping as “controversial” because there are segments of the employer community that suggest there is no “rate shopping” in Ontario and any adjustment that takes place through the appeals process is simply getting right what was a mistaken classification. Since the classification of employers depends largely on a description and review of their business activities, there is the prospect for discretion, leading to inconsistent application of the classification scheme. As we stated above, the WSIB has not done any systematic review of rate groups to ensure that there are not CU’s which are no longer appropriate to be in that group based on their cost experience. That has been exacerbated by a rate setting process that did not always allow a CU’s rate to decline, notwithstanding that it should, given its performance relative to other CU’s. Thus, the only legitimate process for relief for that employer who is paying more than its fair share is through a classification appeal. This prompts us to ask:

**Question for Consideration**

*Is rate shopping a problem or is it a symptom of a problem? Does it lead to an inconsistent application of the classification policy?*

Professor Arthurs' two-fold solution to the foregoing problem was:

- Replace the existing system of rate groups with a new system of “sectoral groups” that would be used to set premium rates and organize “accident prevention, safety education and return-to-work/labour market re-entry programs.” (Recommendation 5-1).
- Adopt a clear set of principles governing the creation of rate groups and the assignment of employers which should be reviewed and updated at regular intervals (recommendation 5-2).

#### **Question for Consideration**

*Does the system today still achieve the objective of ensuring employers pay a fair share of injury costs and align premiums to claims costs?*

Adopting the objective of aligning premium costs with risk and acknowledging the principle of fairness, does not lock you into any one classification system. Those principles, however, should be the initial yardstick against which any proposed system of classification is measured. If a classification system meets those objectives, you can start to ask whether there are other desirable features that you can build into the system.

#### **Question for Consideration**

*Can you relate the classification system to the legislative framework? Does it facilitate inter-jurisdictional comparisons? Is it a system that allows for growth and change?*

If the system is going to group or classify employers in certain industries or business activity on the basis of accident costs in those groups, you will want to ensure that the cost differences you are relying on are not just random differences but are “statistically significant differences” in the sense that they provide a stable and reliable base for making future projections. The 1990 report that formed the basis for the present system concluded that “for a workforce the size of Ontario’s, a classification scheme of about 300 rating units appears reasonable. It would permit an appropriate balance between homogeneity and fairness on the one hand, and efficient administration and statistical credibility on the other.” Statistical significance is relative, the larger the group the more injury data you have, which results in more stable and reliable data for making predictions of the future.

The 1990 report went on to explain that a classification system of 300 groups would not result in 300 different assessment rates. They recommended that once rates were calculated at the classification level the classifications would be banded together into a smaller number of categories—they suggested there might be 50 to 100 assessment rate ranges.

This creates the bigger pool for insurance and statistically significant measures. For this to work, however, there must be continuous monitoring of the pool to determine if one of those aggregated classification units is pulling away from the others in terms of its cost experience, and ought to be placed in another rate pool either higher or lower. This is simply a refinement on collective liability and the introduction of processes to fairly distribute the financial burden. The lack of homogeneity that Arthurs commented on should be addressed on an ongoing basis to ensure the objective of aligning premiums to claim costs.

## Discussion and Analysis of Options

The options outlined below are not intended to pre-empt the discussion, but simply to stimulate stakeholder thought and dialogue in an effort to engage all who are interested.

### Employer Classification

As already mentioned, the WSIB's existing classification is based on the SIC codes for business activities. The WSIB has a four-tier classification scheme (CU's, Rate Groups, Sectors, and Classes). While employers are initially assigned to a CU, premium rates are set at the rate group level.

A classification scheme can have a single or multiple tiers. Similarly, employers can be classified based on a single or multiple criteria. For workplace insurance purposes, employers are usually initially classified based on their business activity.

### Potential Options

#### **Option 1** Retain SIC-based classification system (status quo, or with some modification)

Notwithstanding its perceived challenges and pitfalls, the current classification system retains some advantages:

- Large stakeholders, in particular, are familiar with and knowledgeable about the current classification. Therefore, as noted by Professor Arthurs, some stakeholders oppose any significant changes to the current system, especially since systemic changes are expected to have no impact whatsoever on the elimination of the UFL, and that any such changes could seek to achieve fairness by redistributing the risk thereby impacting premium rates.
- The technology, databases and staff knowledge required to maintain, monitor and enforce the current classification/pricing system are already in place. Consequently most of current costs are operational in nature. The WSIB, however, is undergoing significant process and system changes over the next few years.
- The scheme continues to satisfy some of its fundamental objectives including facilitation of setting group premium rates and the collection of health and safety data at a more detailed level.

The negative aspects of the current classification are:

- It lacks public transparency and intelligibility. The WSIB does not always adequately publicly explain how or why select CU's are placed in or transferred to certain rate groups. Nor does it have any policy rules set out in either the *Operational Policy Manual* or *Employer Classification Manual* about such rate group changes.
- The system is viewed by many and in particular small employers, as cumbersome and complex; therefore increasing the possibility of erroneous initial classification and the opportunity for "rate-shopping". While no empirical studies have been completed to support this contention, the estimated 3,500 re-classification decisions per year are often cited as evidence of these incidents.
- It is becoming increasingly irrational from a rate-setting and premium pricing perspective. For example, Class D (manufacturing) has five rate groups with identical premiums of \$3.51. This begs the obvious question – why not just collapse these into a single rate group to improve statistical credibility especially since the cost/risk profiles are presumably virtually identical?

## **Option 2** Move to a NAICS-based classification system

The North American Industry Classification System (NAICS) is a comprehensive supply-side industry classification system developed by the statistical agencies of Canada, Mexico and the United States to cover all production and service-based economic activities. At the highest level of its hierarchical structure, the NAICS divides the economy into twenty 2-digit sectors. These twenty sectors could form the basis of a classification system with fewer rate groups than the current system. This system is used in New Brunswick as the basis for classification (see Appendix A).

A single tier classification scheme based on a two digit NAICS code would have several advantages:

- It should end or significantly reduce rate shopping due to the elimination of overlapping CU business descriptors because employers would be classified based on a broad general descriptor instead of detailed business activities. This should significantly mitigate the opportunity for employers to argue that their business activities fall under another sectoral group.
- Reducing the number of rate groups should increase premium rate stability because the population of each rate group will grow considerably and will contain more divergent claims experience, consistent with the principle of collective liability.
- A new classification based on NAICS would be simpler for everybody to comprehend, administer, maintain and enforce. The NAICS is also updated every five years, ensuring that the classification system captures changing industrial and technological trends, while allowing for comparability with other jurisdictions.

The main drawbacks would be:

- A switch to a NAICS based classification system would require significant capital and human resource investment as the supporting technological systems would have to be overhauled and staff, of course, re-trained in the new methodology. The WSIB, however, is undergoing significant process and system changes over the next few years which should mitigate some of this issue.
- From an actuarial perspective, any decrease in the number of rate groups could erode insurance equity because each rate group would, by necessary extension, consist of more employers with more disparate claims experience, unless this classification approach would be coupled with sound measures to address the variability of risk towards premium rates that are more closely related to the risk of a specific employer, or employer grouping.

## **Option 3** “Made in Ontario” classification system

The third option is to develop a completely new classification model based on business activity, claim costs, injury frequency or any other relevant criteria.

The principle advantage of this approach would be that the new model would be specifically customized for Ontario and its economic activities.

The main drawbacks are:

- This would be the most costly solution, especially given the actuarial and technological resources required to fulfil such an objective.
- Moreover, the process would be time-consuming and perhaps viewed by some as completely unnecessary since viable alternatives already exist in the form of SIC and NAICS.

## 4. Premium Rate Setting

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The foundational principle of rate setting is Professor Arthurs' recommendation 5-5.1:

The first and most obvious principle of cost allocation, to my mind, is that new claims costs (NCCs) should be charged at the time they are incurred to the sectoral group (or rate group) responsible for generating them. As I have indicated elsewhere, I think it would be unwise to depart from this principle on grounds of intergenerational, inter-sectoral or insurance "equity".

Meredith stated the same as a fundamental underlying principle of fairness to avoid intergenerational transfer of financial responsibility for the cost of the system. Consider for a moment the 20,000 new employers that come within Schedule 1 every year.

### Question for Consideration

*Do we still accept the principle that every year employers pay the costs of injuries in that year?*

Meredith's principles of security of benefits and equity in employer funding of the system require that there be an accurate determination of the costs of accidents (present and future costs) in any one year and that the money to fund those costs are raised through an assessment on employer payrolls in that year. Consequently, rate setting should be an actuarial and accounting exercise. However, rate setting precision depends on a number of actuarial assumptions resulting in a range of outcomes—this does not detract from the fact that it is the actuarial rate setting exercise that dictates a rate. Superimposing on this exercise any further subjective decision-making undermines the whole point of the rate setting process. If rates paid by CUs are not allowed to move up or down relative to the average rate in any one year problems will manifest in the classification system. Employers caught in a rate group that should have its rates reduced based on a disciplined rate setting exercise but whose rates are not allowed to fall because of other considerations will seek the only means available to them to reduce their costs. Every year that a disciplined rate setting process is not allowed to work creates more inequity in the system and makes it more and more difficult to show that employers are paying their "fair share".

Generally, the rate-setting process begins with the calculation of a single Schedule 1 rate. Specifically, consistent with the underlying statutory framework which implies a top-down approach, the WSIB sets a Schedule 1 premium rate every year based on its estimate of total annual costs and expenses for the subsequent year.

The Schedule 1 rate is comprised of three separate modules/levies for:

- Costs of new injuries and illnesses
- Administrative costs, including legislated obligations (*Occupational Health and Safety Act*, etc.)
- UFL amortization charge

A notional rate is subsequently computed for each of the nine classes using a similar methodology. These class rates, are, in turn, used to determine the "class cost index" and by extension the new claims costs for each rate group.

The overhead and UFL levies built into a particular rate group's premium rate are both determined with reference to, and commensurate with, the group's projected new claim costs. The three individual premium components – new claim costs, overhead and past claim costs – are subsequently totaled to determine the new rate for the entire rate group, subject to any rate change limits. In short, expected NCC are the main determinant and driver of a particular employer group's premium rate. If that element of the calculation is erroneous, that employer group will not pay its fair share of the NCC or its fair share of the UFL and administrative costs.

Once you have a classification system that allows you to group employers and aggregate their NCCs, and use that to reliably predict future costs of the group, you can start to ask important questions about the degree to which you are going to skew the system towards collective liability or group responsibility.

Arthurs discusses reasons why losses on NCCs in any one year might be assigned to a higher level than the basic rate building unit of employers. Assigning costs higher up the chain reduces volatility because it spreads that loss over the largest number of premium paying employers. He also points out that NCCs are based on an estimate of what the next year's experience is likely to be. He finds that the estimate has been frequently and significantly wrong in the past leading to annual losses that get added to the UFL.

A second fundamental issue, identified by Arthurs, was that having gone through the exercise in year 1 of estimating the NCCs losses, how quickly are those losses recovered in the succeeding years' rate setting exercise. This, he points out, is a matter of balancing principles and objectives. If you want "rate stability" you might amortize them over a longer period of time. If you are concerned about the inter-generational transfer of costs, you would want a shorter period of time.

Although it seems logical that losses in a rate group in any one year should be charged back to that rate group, an equally strong argument can be made to say that the total loss in any one year that arises from whatever cause—lower than expected investment income, a change in industry mix, higher than expected accident frequency or healthcare costs—ought to be charged to the whole system. Again this depends on your appetite for collective liability.

Collective liability of a portion of NCCs is always going to be difficult to sell to employers if they are not satisfied that the initial rate setting amongst the basic rate building units of employers is being done fairly and accurately. If any one of these basic rate building units of employers feels that they are consistently paying more than their fair share because of flaws in the classification or rate setting process, they are going to be reluctant to consider introducing any further collective liability to the system.

In the past WSIB has departed in a significant way from the principle that employers pay on an annual basis the cost to the system in that year. In a "Consultation Report on the WSIB Funding Policy" (February 1998), the WSIB said to stakeholders on page six:

Although it could theoretically be subsumed under the general categories discussed...worthwhile to devote specific attention to one particular source of growth in the unfunded liability viz. the practice of limiting annual premium rate increases for certain rate groups. This has resulted in actual premium rates falling below their target levels, often for extended periods of time. It is estimated that during the decade ending in 1993, this source

alone reduced funding by \$2.8 billion thereby increasing the unfunded liability by the same amount. It has also been (and remains) a prime contributor to the serious funding situation now facing the construction class.

While there may be a persuasive economic and public policy rationale for placing annual limits on rate increases, in order to mitigate the impact on specific firms or industry groups, it might also be argued that this conflicts with the objectives of the funding policy to the extent that it results in underfunding. At stake, in addition, is a fundamental issue of equity: is it fair that other groups should effectively subsidize those whose rates are thereby held below appropriate target levels? On balance, the Board believes that the rates for all groups should consistently adhere to their respective target levels.

This should serve to emphasize the importance of not just having an accurate and disciplined process for premium rate setting, but also a disciplined approach to the results.

### **Questions for Consideration**

*What is your reaction to this comment about a rationale for placing limits on rate increases?*

*To what extent does that infringe on the principle against passing costs to future employers?*

It was this consultation report and rate setting exercise in 1998, which led to a policy decision to abandon the policy of ascribing the UFL to particular classes. This change in the “UFL relief policy” had the effect of moving \$1.5B in liability which had previously been ascribed to the construction industry alone to all Schedule 1 employers. On a go forward basis, the UFL was no longer ascribed to industry classes but was recognized as a shared liability of all Schedule 1 employers. To the extent that ascribing the financial responsibility for the UFL to particular industry classes was an exercise in ensuring an equitable distribution of the costs of the system onto employers, abandoning that policy shifts a burden of establishing equity amongst employers covered by Schedule 1 onto the classification system. Cross subsidization of classes remains a concern and an issue to be resolved through the joint mechanism of classification, rate setting and experience rating.

### **Question for Consideration**

*How should rate setting distribute the cost of the UFL?*

## **The Issue of Rate Responsiveness**

Any discussion of rate setting should include consideration of “rate responsiveness to cost measures”. Generally, larger CUs tend to have more stable cost measures than smaller units, and are therefore considered more statistically reliable. Dealing fairly with the different degrees of reliability of observed cost measures across different sizes of employers, CUs and rate groups is a very challenging aspect of system design. For large rate groups, it would usually be fair to base a premium rate entirely on a measure of cost experience. However, for a small employer it would be unfair to base a premium rate on a measure of cost experience because it may not be statistically reliable and therefore, inherently unstable. Instead, the premium rate would usually be based entirely on a measure of cost experience for the CU or rate group to which the employer has been assigned. There are many possible variations between these two extremes.

## Questions for Consideration

*How important is it that the premium rate be reflective of a rate group's recent cost experience?*

*What kind of rate volatility are employers willing to live with as a trade-off to linking the premium rate to most recent experience?*

## Discussion and Analysis of Options

The options outlined below are not intended to pre-empt the discussion, but simply to stimulate stakeholder thought and dialogue in an effort to engage all who are interested.

### Premium Rate Setting

While the WSIB sets and publicly reports an average rate for all Schedule 1 employers, for reasons of premium pricing fairness, as discussed in the section above, employers carrying on different business activities pay different rates. The WSIB, along with other Canadian jurisdictions, takes the position that premium rates should, to some degree reflect the differential claim costs risk imposed on the workplace insurance system.

### Potential Options

#### **Option 1** Single premium rate

One solution, often advocated by labour organizations, is that the WSIB should adopt a single common premium rate for all Schedule 1 employers, just like other publicly administered insurance plans such as EI and the CPP.

A single premium rate would have several advantages:

- It should virtually end rate shopping.
- Premium rate stability would improve because of the larger experience base associated with the single rate.
- It would be very easy to administer a single rate.

The main drawbacks would be:

- There would be very large changes in rates from the current system to a single rate system.
- For many industries, the single rate would be much higher than the rate in neighbouring jurisdictions. This could result in issues of competitiveness.
- A single premium rate would erode insurance equity very significantly.

#### **Option 2** Set rates at either the class or sector level

Group rates could be set at the class level, just as they were for most of the Board's early history. The key difference is that the number of classes has declined significantly over time from 44 to the current 9, though Arthurs' suggestion of the NAICS could provide the flexibility for anywhere between 20 to 60 employer groupings.



Setting rates at the class or sector level would have several advantages:

- It should reduce rate shopping because there would be fewer rates to choose from.
- Reducing the number of rate groups should increase premium rate stability because the size of each rate group would be larger.

The main drawbacks would be:

- Any decrease in the number of rate groups could erode insurance equity because each rate group would consist of more employers with more disparate claims experience, unless this classification approach would be coupled with sound measures to address the variability of risk towards premium rates that are more closely related to the risk of a specific employer, or employer grouping.

### **Option 3** Set premiums based on both business activity and costs

This is essentially British Columbia's approach to rate-setting (see Appendix A), whereby employers who operate in the same broad industry but with different business activities are banded together based on comparable cost/risk profiles. This concept is commonly known as "risk banding" and these risk bands are the equivalent of rate-groups.

Setting rates based on both business activity and costs would have several advantages:

- It should reduce rate shopping because rates would be more consistent with costs and therefore viewed as more fair.
- The use of both business activity and costs allows for a flexible approach where business activity is used for smaller groups with unreliable cost measures and costs are used for larger groups with reliable cost measures.

The main drawbacks would be:

- The use of both business activity and costs in a rate-banding approach would need to ensure simplicity and ease of understanding as it has the potential to be confusing to stakeholders depending on how it is implemented and communicated.

### **Option 4** Employer-centric rates

This is essentially the approach adopted in Manitoba (see Appendix A). Employers are initially classified by business activity but the premium rates they eventually pay, as they develop more reliable cost profiles, are based on a comparison of their costs to the overall aggregate costs of the system. This approach essentially incorporates/integrates experience rating with initial rate-setting.

Employer-centric rate would have several advantages:

- They have the appearance of being fair because employers, in theory, have rates that are directly linked to their experience.
- Rate-shopping is greatly reduced because the primary driver of the premium rate is cost experience.

The main drawbacks would be:

- A method needs to be determined for establishing the initial rate when an employer first registers or changes business activity.
- Small employers usually have very unstable cost experience that does not provide a reliable cost measure for the purpose of calculating an employer-centric rate. This requires that special methods be developed for smaller employers.
- Running an effective annual monitoring system at the employer level in Ontario may require significant internal resources within the WSIB.

## **Claims Cost Measure for Premium Rate Setting**

Every year the WSIB derives an average premium rate for all Schedule 1 employers based on claim costs (current and past), administrative and legislative expenses. Claims costs include charges for:

- The UFL
- Gains and losses, based on the previous six years of premium rate setting experience by rate group
- Bad debt expenses, determined based on the expected bad debts provision by industry class
- Expected net payout from experience rating and other incentive programs

The WSIB presently relies on the previous six years of claims costs to calculate the average rate per rate group. Other jurisdictions have varying approaches and review periods for their premium setting calculations.

## **Potential Options**

### **Option 1** Consider a longer or shorter measurement period

True costs cannot be known until many years in the future (80 years or more) after the last payment has been made. Since it is impractical to wait that long, cost measurements are usually based on costs to date on a few years of claims. Use of a longer measurement period would theoretically lead to a more stable and reliable measure upon which to base future predictions. However, a longer period of time would include periods from further in the past that might be less relevant for the purpose of making future projections. Furthermore, employers will often argue that costs associated with accidents that occurred many years in the past should not be taken into account in establishing a premium rate. To balance these competing issues, most jurisdictions have settled on measurement periods of three to seven years.

### **Option 2** Apply a per claim limit

A per claims limit is an insurance feature that protects an employer and/or a rate group from adverse impacts associated with a single large claim. It might be applied as a maximum amount for the life of a claim or a maximum amount per year. Introduction of a per claim limit will result in more stable and reliable cost measures.

### **Option 3** Apply a flat amount for fatalities

A flat amount for fatalities is another insurance feature that protects an employer and/or a rate group from adverse impacts associated with the large costs that might result from a single fatality. In addition, it addresses a concern that is often raised about the minimal impact that a low cost fatality can have on an employer's premium rate. Introduction of a flat amount for fatalities will also result in more stable and reliable cost measures.

### **Option 4** Weighting of accident years

When multiple accident years are included in a cost measure, distortions can be caused when they are added together. For example, if five accident years are used, the first year contains five years of payments, whereas the last year contains only one. British Columbia, for example, applies a weight to each accident year for experience rating purposes to generate a more reliable cost measure. Several other jurisdictions make similar adjustments in the cost measures upon which premium rates are based.

## **Statistical Significance**

Premium (or assessment) rates need to be calculated using statistically significant cost measures to ensure that the premiums generated for a particular rate group exhibit acceptable levels of statistical fluctuations. Statistical variation will lead to pluses and minuses for each rate group that should result in near zero so as to not impact on the UFL. Under the WSIB's current model, a rate group's experience is considered to be reliable enough for premium rate calculations if its lost-time claims or insurable earnings exceed pre-determined thresholds over the most recent 5 year period. Specifically:

- Total lost time claims of at least 400; and
- Insurable earnings of at least \$900 million.

Particular attention should be given to methods that could effectively estimate the size of a rate group required to meet defined objectives with respect to the reliability of cost measures for premium rate calculations. This could support the WSIB in determining the appropriate size of rate groups and guide other aspects of the design of the rate framework that are impacted by statistical significance.

## **Rate Stabilization Rules**

Stable and predictable rates should result from good system design. The use of arbitrary limits on rate changes may be an indication of system design problems in rate setting. No legislative obligation exists to place limits on premium rates. However, the WSIB has in recent history imposed rate adjustment limits.

It is relatively common practice to apply stabilization measures to deal with changes in rates that will probably occur when any new rate framework is introduced. It might also be advisable to retain the process for all future revisions or effort to maintain the framework.

## **UFL Apportionment**

The UFL basically measures the monetary difference between future benefits owed to injured workers (i.e. liabilities) and the value of the investments available to pay those benefits (i.e. assets).

In accordance with the WSIB's current top-down approach to rate setting, the UFL charge is first determined for Schedule 1 as a whole and subsequently apportioned to each rate group based on their new claim costs. In short, the higher a rate group's expected new claim costs, the proportionally higher its UFL charge. The opposite is also true. The underlying primary assumptions are: i) rate groups with high expected costs also generated high claim costs in the past which were not sufficiently funded; and ii) the rate groups continue to be largely populated by the same employers who generated the old claim costs.

### **Potential Options**

#### **Option 1** Status quo

The WSIB could continue to apportion the UFL levy amongst rate groups based on expected new claim costs. This is a relatively simple approach and would likely be acceptable to most stakeholders. However, there would likely be some who feel that the approach is not equitable. It might be advisable to have a separate discussion on this issue and proceed with a new framework using the Status Quo approach on the understanding that a different approach would be implemented as soon as practical.

#### **Option 2** Flat/fixed UFL charge/levy

Charge all rate groups, regardless of their business activities and new claim costs, a set amount every year to finance the UFL. In other words, completely abandon apportionment. This is the approach inherent in publicly administered insurance plans with a single uniform premium rate – like CPP and EI – which hold all contributors equally accountable for system legacy costs. This is also a simple approach, but would result in a very large shift of responsibility for the UFL from higher rated groups to lower rated groups.

#### **Option 3** Blended charge/levy

All rate groups would pay a set fixed amount regardless of risk as well as a variable levy (based on past and new claim costs). This is essentially the Arthurs recommendation, where he suggests the following distribution: “5% to individual firms as a flat collective responsibility, charge, 47.5% to industry classes on the basis of their historical contribution to legacy costs and 47.5% on the basis of their current claims record” (p.74). This approach is more complicated than Options 1 and 2, but would likely result in less shifting of responsibility than Option 2.

#### **Option 4** Class level UFL

Charge each class in accordance with its actual contribution to the UFL. This would be complicated and expensive to implement. In addition, it would require a number of allocations of claims costs, expenses, investment income etc. that would require considerable judgment. For example, careful consideration would have to be given to occupational disease claims that may have been reported in a class that is different from the one in which the exposure occurred.

## 5. Experience Rating

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Some form of experience rating has always been a part of the Ontario workers' compensation system and confusion about goals and objectives starts early in the history of experience rating. When Meredith included in the legislation Board powers to "classify employers according to the hazards of the industry" and to apportion the assessment on that basis, he was expressing a crude form of experience rating driven by the classification exercise.

Based on their size and/or industry, employers are included within one of the WSIB's present experience rating programs: Merit Adjusted Premium (MAP), New Experimental Experience Rating Plan (NEER) and Construction Amendment Draft #7 (CAD-7) have been developed through policy by the Board, acting under the authority of the WSIA. Unlike most other jurisdictions, Ontario's experience rating programs are administered separately from the premium rate setting exercise.

Professor Arthurs states in his Report that, on the basis of the statutory language of s. 83-84, the WSIB has authority only for experience rating with a safety incentive objective and suggests that they do not have authority to adjust premiums purely for achieving the objective of "insurance equity". However, information provided to him by the WSIB, confirms that one of their current experience rating programs is aimed strictly at insurance equity. Employers maintain that experience rating is a form of "equity", and a necessary element of any insurance scheme. This is a crucial issue, not just from the legal, administrative authority perspective but also whether it is simply good public policy. If the stated objective of experience rating is modifying employer behavior towards good safety practices and accident reduction, *and only that objective*, then all experience rating may be found to be inadequate. Based on what was presented to him, Arthurs concluded that the current WSIB programs provide an incentive to undesirable employer behavior. Morneau, in their *Background and Analysis Report*, said "with respect to the effectiveness of incentive programs, there is nothing to be gained from a polarized debate on this topic, because there is not enough evidence to draw a conclusion that all interested parties would consider convincing".

As stated above, this confusion over the goals of "experience rating" emerged early in the development of the policy. In 1980, Paul Weiler delivered a report to the then Minister of Labour titled *Reshaping Workers' Compensation for Ontario*. Chapter three of that Report dealt with "Financing Workers' Compensation". The idea of experience rating—also referred to by Weiler as merit rating—was floated by the WSIB just prior to Weiler's inquiry and it formed a large part in his consultation and subsequent Report. Weiler correctly pointed out, in my opinion, that experience rating was simply a further refinement of the concept of an individual employer's assessment being based on risk, the concept that underlies the classification system which results in some grouping of companies paying a higher assessment rate than another grouping.

Weiler said: "An individual experience rating plan can be the instrument through which workers' compensation may be modified towards a fairer allocation of the costs of industrial accidents among employers as a group. Presumably, it will also provide business with a structure of incentives which favour, rather than hinder, investment in accident prevention and vocational rehabilitation." He identifies the clear insurance equity justification for experience rating and only as an aside mentions that it will presumably incent good behavior.

### **Questions for Consideration**

*Could an experience rating plan be an instrument through which workers' compensation may be modified towards a fairer allocation of the costs of industrial accidents among employers as a group?*

*If experience rating is simply a further tweaking of the system to ensure everyone is simply paying their "fair share" should it be integrated into the rate setting process?*

Later in his Report, Weiler identified his three objectives of experience rating, which he noted were sometimes in a state of tension with each other:

First, we must define with some precision the appropriate costs which will be allocated to the individual employer, those which will maximize the incentives toward safety (and not those which will deter hiring and rehabilitation of handicapped workers, for example). Yet, secondly we must not go too far towards eliminating the insurance feature of the workers' compensation system. There is a high element of chance in industrial accidents. Notwithstanding some of the moralistic rhetoric, the program does not assume that it is because the employer is at fault that an injured (and occasionally careless) employee is to be compensated. ... Finally, though, we cannot become too sophisticated in reconciling the conflicting goals of collective insurance and individual responsibility. The system must be kept relatively simple; not just to ease the administrative burden upon the Board but also to keep it comprehensible to the average businessman whose appreciation of the fairness of the financing mechanism we are trying to reinforce.

Here again, Weiler identifies an important aspect of insurance based experience rating—it is morally neutral. From the point of view of equitably distributing the costs of compensation, it makes no difference why one employer has a statistically significant lower accident cost. The employer who contributes relatively less cost to the system pays a lower assessment. In this view of equitable assessment adjustment the emphasis is not so much on motivating good behavior as it is on avoiding an incentive to bad behavior.

### **Question for Consideration**

*Are the three principles (definition of costs, insurance features, simplicity) that Weiler identified above still valid principles to build experience rating on?*

Arthurs also comments on the classification system itself being an effort to introduce an element of fairness in the rating of premium payers. He refers to this as insurance equity operating at the margins of the system, on the unverified assumption that similar business activities generate similar risk.

### **Question for Consideration**

*Is it possible to test that assumption once classifications are established and make further adjustments based on the results?*

In 2008, Morneau Sobeco were asked by the WSIB to conduct a study of its experience rating programs. They found that the incentive programs to be researched could be divided into two broad categories: “insurance-based experience rating programs” and “practice-based incentive programs”. Being clear about what the programs goals are—which of these two categories the program falls into—is essential to the proper management, monitoring and evaluation of the program.

We have been discussing in this section, a distinction between insurance-based experience rating and practice-based incentive programs designed to motivate positive OHS behavior and activities. That distinction rests largely with the policy objectives that drive the particular program. Are they driven by OHS policy objectives or are they driven by an objective to fairly allocate the costs of workers’ compensation to employers?

**Question for Consideration**

*Is it clear which category WSIB’s current programs fall into?*

Earlier in this paper, I commented on legislative changes that impact the issues that Arthurs dealt with in his report. The potentially most significant of those amendments, was the transfer of the OHS/“prevention mandate” to the CPO reporting to the Minister of Labour.

**Question for Consideration**

*What should the WSIB’s focus be going forward?*

Although sections 82-83 remain in the *WSIA*, the strategic responsibility for OHS/prevention has been transferred to the CPO. It is my understanding that over the coming year, the CPO/MOL will be undertaking a review of prevention under Bill 160 of the OHSA. As such, conversations related to elements of the WSIB prevention programs should be addressed as part of the CPO’s broader review of prevention. The WSIB ought to be engaged, at the very least, to ensure that any renewed prevention offerings, or newly designed CPO/MOL programs, will be consistent and remain compatible with WSIB objectives.

In conjunction with their 2008 study, Morneau Sobeco did a best practices review of experience rating. They found that experience rating programs in Canada typically have three important goals:

- To improve equity in the sharing of workers’ compensation costs among employers
- To provide employers with a cost-based incentive to prevent injuries and return injured workers to work as early and as safely as practical.
- To encourage employers to improve prevention and return-to-work practices in order to optimize the cost-based incentive available under the programs.

The 2008 Morneau Sobeco study reviewed the existing WSIB experience rating programs. Morneau’s key conclusions were delivered in a report dated October 28, 2008, a summary of which is as follows:

- The three experience rating programs produced very different results for otherwise similar employers on either side of the \$25,000 MAP threshold. This issue should be addressed as part of the long term considerations in a review of these programs.

- Both CAD-7 and NEER are highly sensitive to claims experience. In both cases there is a “multiplier effect” which means that the impact on experience rating can be greater than the variance in claims costs. This has important implications both for the effectiveness of the programs in motivating desired behaviors and on their potential to result in some undesirable behaviors.
- There are reasons to be concerned about the size of the financial incentive because increased use of the SIEF has caused a smaller portion of the premium to be experienced rated.
- The experience rating programs, because of the way they are designed, provide some low cost opportunities to optimize incentives through efforts that are not necessarily focused on prevention and return to work outcomes.
- There are several other design issues that are not an immediate concern, but which should be carefully examined as part of a longer term review. For example, the WSIB should consider the impact of a fixed amount for fatality claims regardless of the true cost.

The “multiplier effect” of the current programs described above in the second point contributes to “rate instability”.

#### **Question for Consideration**

*Could you design ER programs or features within the rate setting process with an insurance equity objective which avoid the incentives for undesirable behavior that are a feature of the existing programs?*

In a paper submitted to the Funding Review, Nexus Actuarial Consultants provided an analysis of the WSIB’s current classification, rate setting and experience rating programs and outlined the advantages of a new pricing system moving forward. They had this to say in their summary statement on experience rating:

To help correct for some of the inequities of classification and rate setting the WSIB added three experience rating plans. While nominally designed to improve workplace safety, these programs in many cases have become ways to adjust premium rates to “fit” the individual employer.

The design of the three experience rating plans permits volatile changes in individual employer total premiums from one year to the next. Employers can move from their lowest to highest premiums based upon one bad year of claims experience and this incents some employers to bad behaviors as they scramble to reduce the unpredictable rise in their premiums. Because of the immediate and significant increase in premiums as a result of each claim under the experience rating programs, employers are incented to mitigate the consequence, which leads some employers to short term measures such as “claims suppression” and “non-productive return to work” programs. The current experience rating programs do not incents long term improvement when employers are focused on the short term.

Employers are beginning to recognize the unfairness of volatile experience rating surcharges and negative impact that it is having in some industries. ...

The complexities of the experience rating plans have caused increased administration, while the relationship between what an employer’s claims were costing and what premiums they were paying remained unclear. Although multiple classifications and experience rating help, the pooled experience of their rate groups, rather than their own claims experience continue to dominate their premium rates.



To counter such impacts, employers are increasingly asking to have their group of firms separated out into their own rate group. They believe that they are currently being asked to unfairly and inappropriately subsidize other employers in their current rate group who have not taken the necessary actions to both eliminate injuries and provide sustained return to work for their injured workers. ...

The Nexus actuarial report is interesting in that it identifies that one of the objectives of the current plans is to rectify problems that result from the classification system. The issue of “rate shopping” is frequently raised as a current problem. We commented on the issue of “rate shopping” in the section of this paper dealing with the classification system.

#### **Question for Consideration**

*Should experience rating be used to correct deficiencies in classification and rate setting systems?*

There are two other issues with experience rating that must be considered in the design of any new program in conjunction with rate setting. The first is whether the programs should be retrospective (as NEER and CAD-7 are) or prospective in nature. Prospective experience rating adjusts the rate in any one year based on past performance. That past performance can be measured in a variety of ways with different results, achieving different objectives. The second is the impact the programs have on premium revenue, are they revenue neutral?

### **Retrospective or Prospective Experience Rating?**

In February 2010, the then Chair of the WSIB, Steve Mahoney, issued a Report of Stakeholder Consultations. He identified “Key Themes for Further Discussion”, two of which were:

- New Model for premium rate setting
- Examine the benefits of a “prospective” experience rating system

He said in his report that during the consultations there was acknowledgement from a number of employer stakeholders that the current ER programs are outdated and required significant changes to improve their effectiveness. A prospective rating system was one such model that was suggested. The distinction is explained by Morneau as follows:

All premium rate setting models in use in Canada are based on an analysis of past costs. They are therefore by nature retrospective. However, some models are said to be prospective because they adjust future employer premium rates based on these past costs. Only models that adjust past employer premiums are referred to as being retrospective. Both prospective and retrospective models have equity among employers and improved workplace practices as objectives, but the emphasis is different on each.

- Under the retrospective approach, the adjustment for a given accident year is made after the end of the year when actual experience is known. These adjustments are more aligned with an objective of making performance incentives obvious to management.

- Under the prospective approach, the premium rate is adjusted at the beginning of the accident year to reflect recent trends. Prospective models place more emphasis on prevention and are more aligned with an objective of improving equity in premium rate setting.

#### **Question for Consideration**

*Do either of these approaches have a tendency to encourage the undesirable claim suppression behavior identified as problematic by Arthurs?*

One of the principles underlying experience rating systems identified by Weiler was that they should be simple, easy to administer and to comprehend.

#### **Question for Consideration**

Does the current WSIB retrospective system meet those criteria?

### **Revenue Neutrality in Experience Rating**

A morally neutral experienced rating program designed to equitably spread the cost of benefits over the employers responsible for the accidents in the context of the Meredith model of workers compensation must be revenue neutral. At the end of the day, if you are going to achieve security of benefits, you must collect all the premiums the rate setting exercise tells you that you need to collect. The WSIB's current experience rating programs are not revenue neutral. This is exacerbated by the fact that, although rebates are always paid by WSIB, not all surcharges are collected.

In 2008, Morneau reported that:

The incentives under the CAD-7 and NEER programs have grown substantially over the past 10 years. In 1998, total surcharges amounted to \$35 million. However, this figure was unusually low compared to the 1999 figure of \$152 million. By 2007, total surcharges had grown to \$278 million. Refunds in 1998 amounted to \$160 million, and had grown to \$350 million by 2007. From 1998 to 2007, refunds to employers exceeded surcharges by a total of about \$880 million. This figure is about 3% of the premiums collected during that period.

That 3% of premiums not collected is added to the UFL. The WSIB has concluded that this "off-balance" is not subject to effective control and has adversely impacted the WSIB's financial position.

However, it should be noted that a net payout of incentives in a given year might be justified if there has been a substantial improvement in cost experience. The reverse is also true. In fact, a system that provides for net payments to the WSIB when cost experience deteriorates and net payouts when it improves provides the right collective incentive to employers and acts to stabilize the WSIB's funding position. However, it is still important that an experience-rating system be designed so that the net payout is close to zero when experience is stable.

#### **Question for Consideration**

*Is revenue neutrality an important fundamental principle of any experience rating system? Does it have to be applied on an annual basis?*

## Discussion and Analysis of Options

The options outlined below are not intended to pre-empt the issues, but simply to stimulate stakeholder thought and discussion in an effort to engage all who are interested.

### Insurance Equity

Insurance equity, predominantly an actuarial concept, is about premium pricing fairness. To actuaries, insurance equity and fairness are achieved when the premiums paid by an insured/policy-holder are fairly adjusted to more accurately correspond with the insured's expected claims costs and related expenses. Hence, employers with different perceived risk levels should pay different premium rates based on their individual risk profiles, usually empirically reflected using a measure of actual past cost experience.

### Potential Options

#### **Option 1** Continue with current experience rating programs (status quo)

Although this might be the simplest approach, very significant issues were raised in both Arthurs' *Funding Fairness* and Morneau Sobeco's 2008 report, as well as by others, that need to be addressed. In addition, history has shown that multiple attempts to achieve revenue neutrality under these programs have been with only temporary success.

#### **Option 2** Replace experience rating programs with risk bands

Employers with similar claims costs are grouped together and pay the same premium rate. Increasing the number of risk bands enhances insurance equity.

Under risk banding, employers with a sustainable/durable change in their cost/risk profiles will be eventually transferred to another risk band that better matches their new profile. With risk banding, an employer's premium rate is normally prospectively adjusted.

This is a very simple approach, in my opinion, because it would replace all current experience rating systems with a single system. However, there are certain practical difficulties associated with the size of employer required to generate statistically significant cost measures. To deal with this issue, special techniques would need to be implemented to avoid significant changes in premiums purely due to statistical fluctuations.

#### **Option 3** Replace the current experience rating programs with a rate-setting model incorporating both risk banding and experience rating

This is the two-fold approach essentially adopted by British Columbia, where they achieve insurance equity through a combination of both risk banding and experience rating. Specifically, industry groups (essentially composed of a group of employers engaged in similar business activities) are assigned to a risk band consisting of other industry groups with similar cost/risk profiles. Moreover, all employers in BC are experience-rated, potentially resulting in either a maximum prospective premium rate discount adjustment of 50% or maximum premium rate increase of 100%.

It appears to be working successfully in British Columbia, and several other jurisdictions use all or part of the same approach. It is, however, very different from the framework used at the WSIB, so significant system changes would be required to support it.

#### **Option 4** Introduce experience incentive ranges

Experience incentive ranges are in place in Newfoundland and Labrador, the Northwest Territories and Nunavut. Under these programs, each employer is given a low and a high cost measure early in the year. A refund is payable if actual costs are below the low cost measure, and a surcharge is due if actual costs are above the high cost measure.

### **Premium Rate Adjustments**

Employer-specific premium rates can be adjusted in one of two ways - through either a retrospective adjustment or prospective adjustment.

#### **Potential Options**

##### **Option 1** Retrospective premium rate adjustment

The advantages of retrospective adjustment are:

- Visibility – the payment of a surcharge is a separate transaction from the premium rate.
- Retrospective adjustment applies to premiums for the same past period over which costs are measured. This allows the incentive to reflect the cost experience within the year of adjustment.

The primary disadvantage of retrospective adjustment is also its visibility. Although the visibility results in attention from employers, the attention may be focused on optimizing financial rewards as opposed to prevention and return-to-work outcomes.

##### **Option 2** Prospective premium rate adjustment

The main advantages of prospective adjustment are:

- Prospective models place more emphasis on prevention and are more aligned with an objective of improving equity in premium rate setting.
- Prospective adjustments are simpler from an administrative perspective because it would reduce billing and mailing costs. These could be replaced with an electronic adjustment to the employer's premium rate.

The disadvantage of prospective adjustment is that the incentive is incorporated directly into the premium, and it tends to become less visible. As a result, additional effort may be required to ensure that employers understand the linkage between the premium rate and their claim costs.

### **Special Situations – Employers with Limited or No Claim Costs**

Generally, all employers in the same rate group should pay the same premium rate, subject to experience rating adjustments, which can consider employers' claim costs history and frequency. However, three types of employers potentially fall outside of this general rule, at least for experience rating purposes. New and small employers as well as those with limited or no claim costs may not have enough experience to be statistically relevant.

## **Potential Options**

### **Option 1** Status quo

The WSIB could continue to exempt small employers from experience rating. However, the size of employer that would be exempted should be re-examined using the state of the art statistical tools mentioned above. This should result in a fair and objective way of dealing with small employers that most stakeholders would find acceptable.

### **Option 2** Equality

The WSIB could treat small employers like everybody else. This would likely lead to unfair levels of fluctuations in costs for these employers relative to their larger competitors.

### **Option 3** Separate treatment

Treat small employers as a separate group or as a number of separate groups in each rate group and either experience rate or risk-band them separately (as suggested by Arthurs). There may be an advantage to taking this approach because many small employers are more closely associated with other small employers than they are with large employers in their own sector.

### **Option 4** Use sector/industry average as benchmark

When a new employer is registered, the average experience of a representative sample of employers with similar business activities could be used to set the initial premium rate. If the representative sample used is based on business activity, this would not likely be much different than the current system.

## 6. Engaging in the Process / Conclusion

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The discussion and analysis in this Discussion Paper raise a number of important questions about how best to proceed with the design of a new Rate Framework. The high level options summarized herein are not intended to pre-empt the issues but simply to stimulate stakeholder thought and discussion in an effort to engage all who are interested. Other noteworthy options may clearly exist and stakeholders are strongly encouraged to bring them forward.

### How to Participate in the WSIB Rate Framework Consultations

The WSIB Rate Framework will schedule hearings across Ontario where a significant number of presenters indicate an interest in participating. It is anticipated that the hearings will be held in April 2013.

If you are interested in making a presentation at the public hearings, we ask that you pre-register ([Registration Form](#)) by February 20<sup>th</sup>, 2013. Written briefs supporting your presentation should be filed in advance of your presentation. If you wish to appear at a hearing without filing a written submission you may do so. However, depending on the number of people who register to participate, the time allotted for your presentation may be limited.

If you pre-register to participate in the hearings, we will contact you as soon as our plans are firmed up. At that time we will provide you with further information including the date and location of your hearing and the time you have been allocated for your presentation.

Organizations and individuals who do not wish to make a presentation at the public hearings, may contribute to the consultation process by filing a written brief, writing us a letter or sending us an e-mail. All submissions will be posted on the Consultation Secretariat's website.

Comments and submissions received by the Consultation Secretariat that deal with matters outside the scope of the Rate Framework will be noted and forwarded directly to the WSIB.

We encourage you to check our website regularly for updates including hearing dates, locations and filing deadlines. [Consultation Secretariat](#)

Submissions, letters, emails should be sent to: [consultation\\_secretariat@wsib.on.ca](mailto:consultation_secretariat@wsib.on.ca)

If you prefer to contact us by regular mail, our address is:

**Workplace Safety & Insurance Board**  
**Consultation Secretariat**  
**200 Front Street West, 17<sup>th</sup> Floor**  
**Toronto, ON M5V 3J1**