The WCB's Funding Policy:

Recommended Changes to the WCB's Funding Policy & Call for Feedback

A. Introduction/Abstract

The purpose of this discussion paper is to state the Workers' Compensation Board's (WCB's) current Funding Policy and seek input from key stakeholders and customers on recommendations that have come from the 2015 Asset Liability Study and subsequent considerations based on the WCB's analysis.

The WCB will seek stakeholder input until March 1, 2017 at which time the WCB will review recommendations, stakeholder and customer feedback and will then implement updates to its Funding Policy later in 2017.

B. WCB Funding Policy - Current State

The Workers' Compensation Act, 2013 (the Act) requires the WCB to maintain a fully funded status although the extent of the reserves to be held by the WCB is left to the discretion of the Board Members.

In keeping with the legislated funding requirements, the Board has established a Funding Policy wherein it defines acceptable surplus and reserve levels. Surpluses are accumulated in the Injury Fund. The policy requires that the Injury Fund maintain a balance of between 105% and 120% of the benefits liabilities and that reserves for Disaster and Second Injury and Re-employment be held at 3% of the benefits liabilities. The policy also states that where the Injury Fund exceeds 122%, the Board, at its discretion, will return this excess to the employers over a period not exceeding 5 years. If the Injury Fund falls below 103% the Board will add amounts into premium rates such that the Injury Fund returns to the 105% over a period not exceeding 5 years.

The WCB established its first Funding Policy in 1997. At that time, a commitment was made to review and adjust the levels in the various reserves to better reflect actual and anticipated usage of these reserves. Prior to 1997, the funded status of the WCB has fluctuated according to the operating surpluses or deficits of previous fiscal years. This instability in the WCB's funded status was due, in part, to the absence of a Funding Policy.

In 2002 and 2004, the WCB implemented changes to the Funding Policy to incorporate then current actuarial practices and changes in the accounting principles regarding the reporting of investments and investment income.

An Asset Liability Study was conducted in 2006 with the specific intent of taking a comprehensive look at the interaction of the WCB's assets, liabilities, reserves, and Funding Policy. The study presented some recommendations in regards to the target funding levels. After consideration and review of stakeholder feedback, the Board approved the Funding Policy accepting the targeted range estimated for the Injury Fund. Levels of the various reserves were also modified to reflect the environment at the time, while maintaining a fully funded status that was consistent with the statutory requirements of the Act.

The Funding Policy required updates in 2011 to reflect Canada's conversion to International Financial Reporting Standards. These standards were effective for the 2011 financial reporting year. The reporting standards required that the Fair Market Value (FMV) of investments be recognized on the balance sheet. As a result, the WCB recognized unrealized gains and losses on the change in FMV of investment assets as income or loss for the year.

Investment income comes in two forms: realized and unrealized investment income. Realized investment income includes interest and dividends received on investments and gains and losses on the sale of investment assets. Unrealized income/loss are gains and losses in our investment portfolio caused by market value fluctuations on investment assets that have yet to be sold. The current WCB Funding Policy only considers realized investment gains and losses in determining its funded position.

C. Background Information

The WCB, under the *Workers' Compensation Act, 2013*, is legislated to collect premiums annually from employers sufficient enough to cover all costs of injury claims that occur in the respective year. For example, the 2017 premiums charged are intended to cover all of the costs, present and future, associated with the injuries that occur in 2017. The underlying principle is that today's employers ought to fund the cost of today's injuries. The premiums collected for future costs of the injuries incurred in 2017 are invested by the WCB. When the WCB calculates premiums required to cover all costs of 2017 injuries, an estimate of the future investment income to be generated by the invested premiums is part of the premium calculation.

The legislation also requires that the WCB be fully funded at all times, that is, sufficient funds are always on hand to fund all obligations related to all injury claims that are in the system such that current and future benefits are never in jeopardy. The legislation goes on to require the WCB to maintain a reserve fund to prevent employers in future years from being unfairly burdened with costs in those years

relating to injuries that had previously occurred. The amount of these reserves is left to the discretion of the WCB Board of Directors (the Board).

Accordingly, a premium rate is set annually by the Board for the following year based on forecasted claim counts, cost of claims, long term investment returns and payroll. The premium rate is therefore a reflection of the revenue requirements to fund the next year's claims, expressed as a percentage of assessable payroll. For example, in December of 2016, the Board set the average premium rate for the 2017 year at $1.24 per $100 of payroll, intended to fund all of the costs of all of the injuries that are forecasted to occur in 2017. Each industry is assigned its own premium rate based on the expected claims and related costs and payroll activity in that industry.

These premiums are collected each year, with payments due in April and September. However, the costs associated with the injury claims for that year will not be all paid out in that year, they would be spread out over the life of the claim. The premiums therefore are invested in various investments that are expected to earn a return sufficient to pay for the ongoing costs of the claims. This rate of return, or discount rate, is used in the calculation of the premium rates to determine the net present value of the future claim costs. The assumed discount rate set by our actuaries is 5.25%. In other words, the premiums must be invested such that they earn a minimum of 5.25% per year, over the long term.

The WCB has two sources of revenue: the premiums it charges employers and the returns it earns on the investments it holds. When investment returns exceed the required rate of return of 5.25% excess investment earnings are generated which get added into the WCB's surplus. In addition, investment earnings on the surplus and reserves that the WCB holds also add to the excess investment earnings.

The WCB released its 2015 Annual Report for the year ended December 31, 2015. The WCB reported a Comprehensive Loss of $7.5 million and a funded position of 144.7%. The 2015 funded position exceeds the WCB's Funding Policy by 24.7% which equates to a $281.5 million in excess surplus. Subsequent to a consultation period following Annual General Meetings in June 2016 the WCB approved a surplus distribution of the entire $281.5 million surplus to be paid in two installments, July and December of 2016.

Substantially, the entire excess surplus for 2015 is directly related to investment earnings in 2015. The following is a breakdown of the factors that resulted in the 2015 surplus:

- Investment activity caused 22.3% of the 24.7% excess funded position.

- During 2015, the WCB realized investment income of $252.8 million from interest, dividends and investment assets sold during the year.

- A small portion of the $281 million 2015 excess funded position, $25.8 million, was caused by the underwriting profit, premium revenue minus costs, as a result of lower than anticipated claims costs and higher reported payroll.

Changes in accounting and actuarial standards, International Financial Reporting Standards 17 (IFRS 17), will be applicable to the benefits liability in 2021 and are anticipated to increase WCB's benefit liability in the range of $186 million to $224 million per consultant actuaries. These changes will require the WCB to use an annually adjusted discount rate based on a risk-free rate of return when determining the valuation of the benefits liability. This will have a material and significant impact on our funded position in the year of implementation, 2021. The Board directed the establishment of a reserve in 2016 to spread the impact of these changes over the next four years and lessen the impact in 2021 from the change in accounting standards. If no reserves are established, there will be a significant impact on 2021 employer premium rates. Given current estimates, the impact on premium rates could be an increase in excess of 60% in the year the new accounting and actuarial standards are implemented.

D. WCB's 2015 Asset Liability Study Overview

In 2012, the Board reviewed its Investment Policy and asked AON Hewitt, it's Investment Consultant, to provide an asset mix optimization analysis based on various asset classes. The objective of the analysis was to maintain or improve WCB's investment returns and at the same time reduce the volatility of investment returns. The Investment Committee considered various optimization scenarios with respect to the asset mix and approved a revised asset mix in the fall of 2013. The first step towards implementation of the new asset mix was undertaken in 2014 and it is anticipated that the final step will be completed in early 2017.

In 2015, an Asset Liability Study (ALS) was conducted by an external actuary, Eckler Ltd. The purpose of the ALS was to illustrate the financial risks inherent at the WCB and their impact on the long term funding of the Board and on the premiums that could be paid by Saskatchewan employers. The ALS was completed in June of 2015 and resulted in several findings and recommendations with respect to the Funding Policy and related financial activities at the WCB.

- Recent changes to the long term investment policy will have the intended objective of reducing volatility of the portfolio returns while maintaining an expected rate of return equivalent to the previous asset mix. The revised asset allocation was used in projections and does not appear to impact the WCB's ability to fund its obligations into the future.

- Most boards provide for a funding range in their Funding Policy.

- The Canadian WCBs' average of the ranges for funding based on fair market valuation (FMV) assets over liability ratio is 108% to 126%. The lowest lower range limit is 100% and the highest upper range limit is 140%. The median for the lower range is 110% and the median for the higher range limit is 128%.

Eckler made the following 5 recommendations in the ALS:

1) The WCB should review its rate setting model for determination of premium requirements.

2) Considering the current financial situation of the WCB and the amount of unrealized investment gains, the surplus distributions in the future should be made over a shorter period than 5 years.

3) The WCB should determine the percentage of surplus distribution considering its risk tolerance level. (Risk in this context is the risk that the Board will become underfunded requiring a special levy in the premium to return the funding level to a stated minimum.)

4) Eliminate the Disaster and Second injury and Re-employment reserves as the amount of benefit liability includes future costs. To maintain a level of protection against risks and uncertainties for the WCB, the funding range should be increased by 2%, 107% to 122%. The study found that the financial risk of becoming unfunded in the next 10 years due to this change was not materially affected by eliminating the reserves (total 3% of benefit liability) and increasing the funding range by 2%.

5) The WCB should review its Funding Policy and consider the treatment of unrealized gains and losses on investments, as well as the impact of a market related rate of return on the benefit liabilities and claim cost expense. This recommendation considered the impact of the change in accounting rules (IFRS 17) which will see the introduction of market discount rate adjusted for a risk-free rate being applied to determine the benefit liability rather than a discount rate based on long term investment returns. As such, there would be an increase in the volatility of the benefit liability and a corresponding increase in the volatility of the funding percentage per current WCB policy. The accounting changes are anticipated to be applicable in 2021.

E. WCB's 2016 Rate Model Review

In 2016, the WCB contracted an independent external actuary, Eckler, to conduct a rate model review. The review determined that the WCB's rate model should be robust and sustainable, satisfying the needs, goals and expectations of the employers, while being actuarially sound, relatively simple and easy to understand, communicate, and administer. These guiding principles are consistent with the Meredith Principles[1].

Throughout Eckler's review and as noted in their final report, they reinforced the following guiding principles as the basis of the rate model review and subsequent recommendations for enhancement:

- **Fairness (accountability, equity & incentives for prevention):** Premiums paid by current employers should cover the costs of their injured workers during the premium period. This principle covers inter-generational equity (current employers should not be paying for claims costs generated by past employers nor should they be subsidizing the claim costs of future employers) and intra-generational equity (employers that incur injuries should be responsible for the costs associated with those injuries).A fair rate making model encourages workplace safety & effective return to work policies by financially incentivizing employers' positive behaviors.

- **Reactivity:** Industries should expect quick recognition of successful prevention initiatives and claims management practices. It should also be quick to recognize industries with poor safety performance.

- **Collective liability (insurance):** Employers, as a group and those within the same industry, are jointly responsible for all workers' compensation costs. Also, employers should not be excessively punished for unusually costly claims, thus portions of unusually costly claims costs should be shared by all employers.

- **Predictability (rate stability):** Employers should rely on a level of predictability and stability in rates.

- **Transparency (ease of understanding):** Employers should be able to understand the factors that went into setting their premiums, and the WCB should be able to clearly communicate this information to employers.

[1] To review the Meredith Principles, visit www.wcbsask.com.

F. Rate Model Review Recommendations

During the review of the WCB's rate model, Eckler found that the current process for setting employer premium rates is sound. At the Board level, the current rate model works well and it accurately predicts costs and collects required premiums. However, Eckler recommended enhancements to the model to ensure it remained actuarially sound into the future. Eckler recommended several refinements to the Board's rate model as opposed to a complete overhaul to continue to maintain the financial health of the WCB and the confidence of stakeholders.
The Board approved recommended enhancements and in doing so noted that there will be significant impacts in some industry rate codes.

Key recommendations outlined in Eckler's Rate Model Review report, which formed the basis of the Board approved enhancements, [2] included:

- Credibility of Industries - Classification
- Use of Indicators to Predict Costs
- Costly Claim Pooling
- Allocation of Fatality Costs
- Long Term Claims
- Allocation of Administration Costs

[2] To review Eckler's Rate Model Review Report, visit www.wcbsask.com.

G. Future Risks

The goal of the WCB is not to have the lowest premium rates in Canada but rather to ensure security benefits for injured workers and stable and predictable premiums for employers. The 2015 Asset Liability Study outlined the following three risks for the WCB:

1. The funding percentage, according to Funding Policy, falls below an established level and that the fair market value (FMV) asset over liability funded position falls below an established level. Maintenance of a funding percentage based on WCB's current Funding Policy, and FMV assets over liabilities greater than 100% ratio is considered more important than average premium rate minimization.

2. Volatility of premium rates.

3. The investment returns are not sufficient to meet the real rate of return required to fund the future costs associated with current year injuries.

H. WCB Funding Policy – Considerations

As part of this Funding Policy review, the WCB has outlined the following 8 key considerations:

Consideration 1:

Move to FMV of investment assets for purposes of determining the funding percentage. This would result in the discontinuation of the removal of unrealized gains and losses on investments when calculating the funding percentage of the WCB.

As per the Asset Liability Study, volatility of the funded percentage would increase. Simplicity and transparency would improve with a fair market valuation of assets.

Consideration 2:

Determine if adjustments to the funding percentage range, lower and upper limits, requires change.

Other jurisdictions who value assets at FMV for purposes of their funded position generally have a higher range for their Funding Policy. The Canadian WCBs' average ranges for funding based on a FMV assets over liability ratio is 108% to 126%. Saskatchewan and PEI have lower ranges because the funding percentage per policy adjusts the valuation of assets and is less volatile than the FMV asset over liability ratio. The lowest lower range limit is 100% and the highest upper range limit is 140%. The median for the lower range is 110% and the median for the higher range limit is 128%. Saskatchewan with a funding range of 105% to 120%, is within the ranges of other Canadian WCB Boards that provide for a range.

Board	Target	Range
Alberta		114% to 128%
Manitoba		110% to 130%
New Brunswick	110%	
Newfoundland and Labrador	110%	100% to 120%
Northwest Territories and Nunavut [6]	125%	110% to 140%
Prince Edward Island [7]		100% to 110%
Saskatchewan [7]		105% to 120%

[6] In Northwest Territories and Nunavut, the reserves are not considered for determining the range: capital replacement and catastrophe reserves.
[7] For Prince Edward Island and Saskatchewan, the range is based on an adjusted value of assets.

Consideration 3:

Evaluate the length of the time period to pay out excess funded position as a surplus distribution. The current payout period can be up to 5 years. The Asset Liability Study suggested that a payout in a period up to 5 years was too long.

Consideration 4:

Shorten the 5 year time period to rectify a situation where the Board is below the lower funding limit. The current policy provides for up to five years to address a funding short fall. This should be reduced to a shorter time frame to ensure security of benefits.

Consideration 5:

Use a defined formula to determine the amount of excess surplus to distribute in any given year.

A formula would provide certainty and predictability. For example, a possibility would be to consider basing the percentage of excess surplus to distribute to the cost of the WCB insurance to employers. This would take into consideration all available premium discounts or provide for a payout of the entire excess surplus.

Consideration 6:

Maintain the 2% cushion on either side of the funding range. This will ensure that distributions do not occur for small amounts, that is, distributing insignificant low value surplus distribution cheques to employers. The 2% cushion on the lower end of the lower limit allows management to take corrective actions that may rectify the funding shortfall before a special levy is applied to the premium rate to restore funding to the minimum level.

Consideration 7:

Remove the second injury and disaster reserves and increase the funding range by 2% as per Eckler's recommendation. Stakeholders may perceive the increase in the range for the funded position as unnecessary and question the need to increase the funding range.

Consideration 8:

The calculation of the funding percentage should also include the obligation to pay annuities for injured workers.

The Act requires the Board to create a fund for each injured worker who is on benefits for 24 consecutive months. This fund is to be used to purchase an annuity when the injured worker reaches 65 years of age. The total annuity liability at October 31, 2016 exceeded $206 million. The annuity liability is not currently considered in the calculated funding percentage formula (Net Assets removing unrealized gains and losses over the benefit liability). The impact of considering the annuity liability in addition to the benefit liability is an estimated reduction in the funding percentage of 3%.

I. Concluding Remarks and Future Direction

In order for the WCB to comply with legislation and to stay true to the security of benefits principle, it must ensure that sufficient funds are in place to safeguard employers in the future years so they are not unfairly burdened with costs relating to injuries that had previously occurred.

The WCB must provide for stable and predictable premium rates. In order to accomplish these objectives, the WCB is reviewing its Funding Policy by assessing the risks of volatile investment markets and unexpected changes in claims costs.

J. Stakeholder Feedback Solicited

In light of the 8 considerations presented in this discussion paper, the Board is inviting input from you, your organization, and your members.

Please submit your comments to Nancy Anderson by email at nanderson@wcbsask.com before March 1, 2017.

We look forward to receiving your feedback.