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June 15, 2011

Dr. Harry W. Arthurs
Chair
WSIB Funding Review
200 Front Street West
Toronto Ontario

RE: Follow up to WSIB Funding Review Public Consultations

Dear Dr. Arthurs,

At the April 2011 WSIB Funding Review Public Hearings, Ontario Chamber of Commerce (OCC) President Len Crispino emphasized the importance of exploring uncharted new ideas to achieve a workplace safety insurance system that meets the needs of all stakeholders in Ontario's economy. To reiterate:

> The business community understands the need for public protection of injured workers. But by the same token, we can't continue on the current path. We don't see it as an either/or question. It's not about curbing the quality of service but about innovating...As a Chamber, we look at all government expenditures and try to achieve a balanced approach.

Finding innovative solutions to the immense challenges facing the WSIB was also the motivating force behind the OCC's formal submission to the Funding Review, dated March 12, 2011. It is our position that fixing an organization that has grown out of touch with its original mandate, industry best practices, and principles of good governance requires visionary thinking with respect to the key attributes of the system. In particular, achieving a winning model for Ontario is predicated on initiating an open and honest discussion with stakeholders about the design of WSIB's legislative framework, governance structure, administrative policies and procedures, and service-delivery model.

In contrast, the Funding Review's mandate suggests that the Board's unprecedented Unfunded Liability (UFL) can be addressed solely through: reviewing the assumptions of the Board's investment strategy; adjusting premiums; and tinkering with the design of existing programs. With respect to the later, the vast majority of commentators, including the non-aligned experts, agree that the specific initiatives identified in the public consultation paper, including rate groups, experience rating, and occupational disease claims, are largely redistributive in nature, only tangentially related to financial performance, and have little to no bearing on the Board's financial situation.

With respect to premiums, there is zero tolerance for further increases in the private sector. Ontario's average employer premium rate is currently the highest of any jurisdiction in Canada. This is largely due to the huge surcharge attributed to the UFL. Whereas premium rates in BC, Alberta, and Manitoba, which do not have UFLs, are approximately 1.5 times the cost of new injuries, Ontario employers pay approximately 2.5 times the cost of new injuries as a premium. Employers have been forced to absorb the legacy costs of the UFL despite the fact that the rate of accident frequency in Ontario has been steadily declining.

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This leaves the Board's funding policy as the only even mildly credible avenue among those outlined in the consultation paper to deal with the Unfunded Liability. Out of acknowledgement that the Board's investment management strategy and the administration and oversight thereof have an immediate and substantive impact on its financial position, and in the spirit of co-operation with the Review Team, this submission outlines in further detail two proposals which, implemented with the proper oversight and due diligence, could provide the Board with innovative tools to help bring down the UFL.

However, the OCC firmly believes that the only way to safeguard against future increases in the UFL is to address the structural factors that have given rise to the Board's financial instability in the first place. At the Funding Review Technical Consultation, it was revealed that the key system cost drivers stem from:

- Ontario's generous range of legislated benefits (including survivor and old-age benefits)
- A high persistency rate (perpetuated by a mandatory six year lock in)
- A benefits indexation rate of 3.5 percent
- Skyrocketing drug and health care costs

The OCC's members have identified two additional leading issues which contribute to the costs of the system:

- The current governance model/statutory framework allows WSIB policy to be driven by political decision making at the expense of a coherent strategic vision
- The WSIB's organizational culture has a built-in bias towards benefit entitlement, resulting in pre-disposition to approve, rather than objectively and consistently adjudicate, new claims

As the OCC has stated from the outset, strategically repositioning the workplace safety and insurance system to effectively fulfill its mandate requires policy-makers to recognize comprehensive legislative and institutional reform as fundamental components of change. The following discussion is premised on the expectation that, alongside the current review exercise, the WSIB will undertake an open-ended strategic review with the mandate to tackle the hard issues necessary to restore legitimacy and confidence to Ontario's workplace safety and insurance system.

Debt Issuance

Faced with spiraling pension and social security costs, many North American jurisdictions have turned to the issuance of debt reduction bonds on capital markets as a way to manage burgeoning unfunded liabilities. This strategy has the potential to expedite the elimination of the UFL through the introduction of a new net revenue source. The proceeds from the debt issuance would be invested in equities. The assumption is that the return on equities will exceed debt service on the bonds. The potential benefits of this strategy include identifying and paying the full cost of liabilities and reducing the impact of the UFL on the operating budget.

As with any arbitrage practice, significant risks are involved. The main downside of bond issuance is heightened financial risk. Investments must be made in equities, high-yield debt, or highly leveraged portfolios if returns are to exceed borrowing costs. As a result, it could potentially create more volatility that may not be within the WSIB's investment guidelines or risk tolerance parameters. However, experience reveals that such risk is most acute in the short term, and that equities consistently outperform fixed income securities over sufficiently long periods of time (20-30 year market cycles is a common assumption). The success of this strategy is clearly contingent on favourable market conditions and prudent investment decisions.

Other potential issues that may have a bearing on the success of this strategy include:

- Shifts in rate groups and/or labour force demographics
- health care inflation
- pressure for additional benefits
- the loss of flexibility in difficult economic times due to the need to meet payment obligations

In light of the risks, the WSIB must perform a rigorous financial analysis based on current actuarial standards and using qualified experts to determine how the influx of revenue bonds would affect the system's overall asset mix allocation and to determine the optimal timing and size of the bond issue. With respect to asset mix, it is essential that prior to pursuing this strategy the WSIB review its asset mix allocation and investment policies to ensure that monies invested are generating long term sustainable returns without taking on excessive risk. If bond issuance is deemed appropriate, the WSIB must take into account the inverse relationship between size and market risk in determining the exact amount of the issue.

Although there are many risks to take into account, several factors have converged to produce a favourable climate for government borrowing in Ontario. As the government indicated in the 2011 Ontario Budget, low interest rates, strong global investor demand for Canadian-dollar assets, the liquidity of Ontario benchmark bonds, and continuing confidence in Province of Ontario Credit have resulted in the strong performance of Ontario Savings Bonds. As such, there is a strong case to be made for the issuance of WSIB bonds structured in the same way as Government of Ontario bonds and offered semi-annually, when Government of Ontario bonds are not available; issuing debt when interest rates are at historic lows significantly increases the odds of long term sustainable returns from equities to stay ahead of debt service costs.

The 2011 Budget additionally indicated that the average term to maturity of Government of Ontario bonds reflects a preference of domestic investors for relatively long-term maturities. Matched by a UFL amortization schedule of 20-25 years, the ability to issue bonds over a relatively long time horizon would further increase this option's likelihood of success.

Pursuing this policy would require amendments to provincial legislation and regulatory policy. A number of Ontario's peer jurisdictions have enacted enabling legislation for the issuance of bonds to service public sector unfunded liabilities. The list includes California, Florida, Indiana, Massachusetts, New Jersey, New York, Ohio, Oregon, Pennsylvania, West Virginia, and Wisconsin, and is growing. West Virginia offers a particularly interesting case study, as the relevant legislation placed statutory authority for the issuance of workers' compensation

bonds in the arms-length West Virginia Economic Development Authority, while protecting the State of West Virginia from all legal obligations and remedies by bond holders. Adopting similar provisions in Ontario could allow the government to exert the greatest degree of financial discipline on the system, while avoiding any potentially detrimental effect(s) to the provincial Treasury.

In the case of Ontario, adopting this strategy would also require the government to amend the Workplace Safety and Insurance Act (WSIA) to give the WSIB autonomy over both revenue and expenditures (again, once a wholesale governance, operating, and expenditure review has taken place). The legislative amendments would enable the Board to conduct its go-forward operations on a cost-neutral basis, and allow WSIB bonds to be valued as investment grade products. The specific rules of the debt-issuance scheme could then be laid out in ancillary legislation. The applicable legislation should explicitly exempt the provincial government from any fiduciary responsibility to investors, should lay out the total amount of the bonds, and should ensure that the maturation term of the bonds coincides with the UFL amortization schedule. It should also specify the specific features of the bonds, such as interest rate(s), denomination, registration privileges, so on and so forth. In light of the strong performance of Ontario Savings Bonds, it is recommended that WSIB debt reduction bonds be structured in the same fashion as Government of Ontario bonds in this regard.

Although the issuance of bonds holds promise as a strategy to manage the UFL, it should not be viewed as a panacea. As debt issuance is ultimately a bet on equities, there is no guarantee of success. The OCC's position is summed up by the following statement by Financial Executives International from their formal submission to the WSIB Funding Review:

> While we support increased WSIB policy allocations to alternative investment assets, the availability of higher anticipated returns from deployments into infrastructure investments, private equity, foreign securities, and real estate are not without a combination of higher risk and volatility, unique investment management issues, and reduced liquidity. WSIB and the Ontario government should not be surprised [if] adverse short term investment results [occur] in the pursuit of long-term investment programs.

Furthermore, experience suggests that if this option is not pursued alongside a serious effort to address underlying structural tensions, it will simply defer the UFL and the legacy burden on employers to a future date in time. It is therefore imperative that debt issuance be considered as part of a broader strategy for managing the UFL, taking into account the need for a comprehensive overhaul of the system mentioned previously.

Annuitization

A second tool the WSIB has at its disposal to reduce the cumulative UFL burden is the annuitization of vested award benefits. The report of the non-aligned experts notes that indexation for partially disabled workers benefiting from a life pension is a policy issue that has a substantial impact on the UFL. Add to that the outstanding pension obligations arising from the full suite of disabilities covered by the WSIB Rating Schedule, and the impact becomes that much more significant.

The WSIB's pension obligations are incurred as a result of permanent disability awards for injuries taking place prior to January 2, 1990. These benefits are usually awarded for the

lifetime of the worker, most often in the form of monthly payments. The WSIA Tribunal has confirmed that permanent pensions cannot be rescinded even if a worker's condition improves. Like most other benefits and dollar amounts stated in the Act, pensions are increased at the beginning of every year in accordance with indexing factors set out in legislation.

Annuitization has gained increasing attention as an option to address pension plan unfunded liabilities in conformance with accepted actuarial practice. The WSIB would purchase a nonparticipating annuity contract from an insurance company with a strong financial rating for some or all of its pension obligations. The pension proceeds would be converted into a stream of income by the insurance company at a constant or inflation-indexed level ensured to last a life time. The liability assumed by the annuity contract is generally considered to be completely settled by the plan sponsor.

Annuitization can be considered the flipside of debt issuance, as it is relatively expensive when interest rates are low, but becomes an attractive option when discount rates are reasonably high. Due to the competing factors at work, debt issuance and annuity are likely mutually exclusive propositions, unless financial market conditions are such that the interest cost of purchasing annuities is less than the interest cost of debt issuance. If, in the future, market conditions favour the purchase of annuities, this option should be considered, as it replicates many of the benefits of state-sponsored plans - such as scale, cost effectiveness, and the pooling of longevity risk for members - while at the same time allowing participants to benefit from private sector expertise in the areas of administration, investment management, and delivery of pension income.

Apart from the credit risk of the insurance company that will always remain, most other risks are eliminated through the annuity purchase option. However, there are a few factors which must be carefully considered with regards to this strategy. Since the process is typically irreversible, the timing of the purchase is key. If the purchase is made when equity markets are depressed, the negative impact of prevailing interest rates and cash flows from investments will increase the cost of purchasing annuities, which is known as "timing risk". This form of risk can be effectively mitigated by locking in values at various points in time, which would help counteract the effects of market volatility. We would strongly advise the Board not to consider annuitization in the short-term, as the prevailing interest rate is too low to make this a realistic option.

Another potential risk is that of "adverse selection", which arises when individuals are able to freely select into or out of annuities and can further drive up cost. However, automatic annuitization over a large group of employees diminishes the effects of this penalty, as total management and expense ratios for large multi-employer plans are dramatically lower than in the retail private sector.

Although cost is a significant factor, annuities can be very competitively priced. Since this product line tends to be viewed as a commodity, only the most competitive quotes receive business as long as the insurer has a respectable credit rating. However, as the market for annuities in Canada is relatively small it is uncertain whether enough savings could be generated through a large bulk purchase to ensure a competitive price. However, the WSIB

could ensure that it has chosen the least-cost option by sourcing the contract through a competitive tendering process.

On the whole, annuitization offers an attractive potential means to leverage the role of private sector while allowing the WSIB to adhere to the principle of collective responsibility for injured workers.

Thank you as always for the opportunity to provide input. If you have any questions or comments, you may direct your staff to contact Angie Brennand, Vice President Policy and Government Relations, at 416-482-5222 ext. 232 or angiebrennand@occ.on.ca

Yours sincerely,

Len Crispino
President & CEO

ccs: OCC Members