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Fact Sheet:

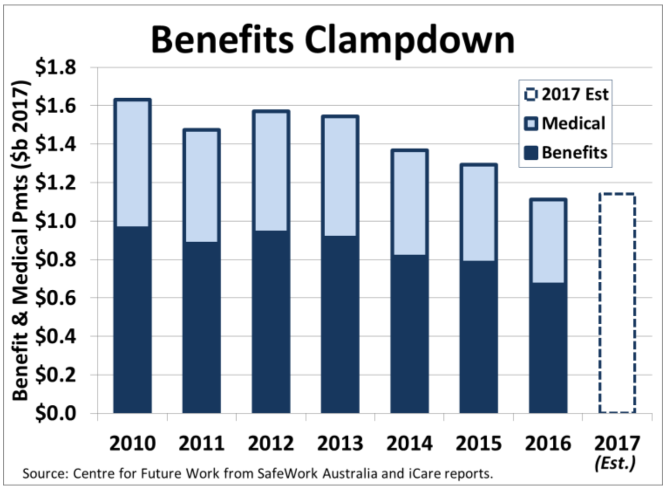
NSW Workers' Compensation Funding

December 4, 2017

The workers' compensation system in New South Wales has been dramatically restructured since the current government was elected in 2011. First, justified by overblown claims of a looming fiscal emergency, benefit levels and eligibility were dramatically reduced – including a harsh new policy that eliminates benefits entirely after a maximum of five years for all but the most seriously injured workers. Some of those cuts are still being implemented; for example, later this month, over 4000 injured workers will have their monthly benefits eliminated (since five years have now expired since the enactment of the new policy).

During the same time, premium rates for private employers have been cut substantially. More recently, in the face of continuing public concern about the plight of injured workers, some of the benefit reductions were partly reversed (with changes implemented in 2015); but the overall level of benefit protection for injured workers in the state is still substantially reduced. In sum, total benefit payouts from the system (adjusted for inflation) have declined by over 30% since 2010.

Now, new financial data released by iCare, the NSW agency that oversees the scheme, confirm that the workers' compensation system has abundant resources with which to fund a full repair of benefits for injured workers. The so-called fiscal emergency of 2011-12 was largely a temporary accounting fiction resulting from the effects of the Global Financial Crisis (which suppressed investment returns and inflated the apparent cost of future liabilities). Now the system has a large and

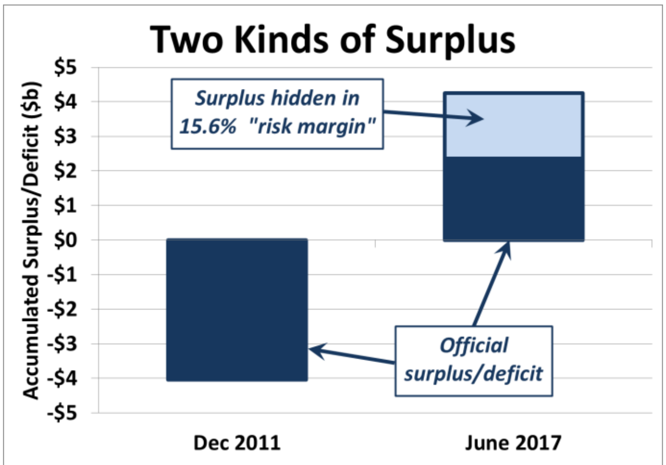


growing surplus, more than adequate to finance significant repairs in benefit levels (including protecting the thousands of injured workers about to be cut off from monthly benefits). Yet managers of the system are intent on continuing to accumulate further surpluses, instead of rebuilding benefits. They are targeting an even larger cushion of surplus finances in coming years. This ultra-cautious financial approach is not necessary in the context of a publicly-run insurance system – but perhaps is part of a longer-run plan to prepare the system for privatisation.

iCare's 2016-17 Financial Results

On November 30, iCare reported its annual financial results for the fiscal year ending June 30, 2017. The insurer continues to report a large accumulated surplus in the Workers Insurance system: equal to $2.4 billion as of June 30. This surplus is somewhat smaller from the year-earlier level, largely because of two one-time adjustments incurred by iCare over the last two years: a $1.06

billion charge to offset the liability effects of the 2015 partial restoration of benefits, and another $1.04 billion charge to reflect the fact that not as many workers will have their benefits cut off under Section 39 (the 5-year cap rule) as the insurer initially expected.[1] Despite absorbing over $2 billion in additional liabilities in just two years, however, the system still maintains a large accumulated surplus. iCare reports that its assets now cover 119% of its adjusted claims and premium liabilities (an internal ratio which the agency uses to evaluate its financial standing).



Source: Centre for Future Work from PWC and iCare reports.

The underlying operations of the system continue to generate strong financial results, even after the partial reinstatement of some benefits in 2015. Despite poor investment earnings in 2016-17 (discussed further below), the scheme generated an underlying net profit of $52 million (after adjusting for the one-time effect of the Section 39 review). Even more important, the core insurance operations generated net cash flow of $415 million: since most of the one-time charges implemented in the past two years reflects an accounting adjustment to future liabilities (not a change in current payouts), on a cash basis the fund has continued to generate significant surpluses. These continuing positive results mean that the accumulated surplus is growing once again.

[1] iCare reports that 16% of the injured workers they originally expected to lose benefits, are in fact being found to exceed the 20% Whole Person Impairment threshold beyond which workers are allowed to retain benefits. This may reflect "additional information" as iCare claims; it also reflects the determined efforts of injured worker advocates to defend the benefits of these seriously injured workers.

<u>Padding the surplus.</u>

iCare's financial position is actually much stronger than indicated by its bottom-line accumulated surplus. The liabilities for future claims payments recorded in its statement include an additional margin, supposedly to adjust for uncertainty in future payouts. Reported liabilities are arbitrarily inflated by a 15.6% "risk margin": giving the insurer extra leeway in case some claims payments in the future are more expensive than expected. This margin adds another $1.9 billion to the actual surplus maintained by the insurer, generating a total surplus in excess of $4 billion.

Inflating The Costs

Actual PV Claims Liabilities	**$12.1 b**
With 15.6% "Risk Margin"	**$14.0 b**
Current Assets (119% Funding Ratio)	**$17.7 b**
Required Assets for 127% Ratio	**$19.2 b**

Source: Centre for Future Work from iCare financial reports.
1. Excess relative to actual PV (present value) liabilities.

The insurer claims that it must maintain an explicit surplus in its balance sheet for prudence: in fact, iCare's Board of Directors plans to increase the funding ratio to a target of 127% in coming years.[2] (At the present level of liabilities, that would require funnelling around $1.5 billion in additional funds into the surplus – and even more in the future.) Yet they have already built in a 15.6% margin into the reported value of liabilities.

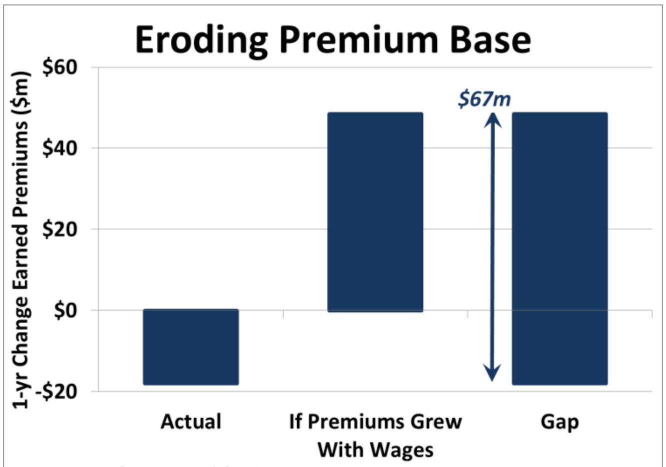
This approach injects a super-sized financial cushion into the scheme's finances – at a very moment when thousands of injured workers are about to be denied benefits altogether. iCare's ultra-conservative financial management policies are likely intended to insulate the fund's continuing surplus funds from demands to restore benefits.

[2] Workers Insurance Scheme (Nominal Insurer) Capital Management Policy, October 2016.

More concerning, they may be setting the stage for the ultimate privatisation of the scheme: the iCare board has indicated explicitly that it is emulating the funding practices of private insurers in escalating its target reserves. As a public insurance agency, backed by the fiscal and policy-making power of the state government (which could adjust premiums and other revenues as needed to maintain the viability of the system), it is not apparent that iCare needs *either* of these large cushions. Yet even as injured workers continue to lose benefits, iCare is moving aggressively to expand its surplus.

Continued erosion of the premium base.

Another concerning aspect of iCare's financial performance is evidence that the base of premium revenue which funds the system continues to shrink. Indeed, the main beneficiary of the major changes enacted since 2011 have been private-sector employers, who have enjoyed significant and ongoing reductions in average effective premiums.



Source: Centre for Future Work from iCare reports.

iCare's earned premium income during 2016-17 fell by another $18 million. This is despite an increase in overall private sector wages during the year (driven by both growing employment and slow increases in average wages). Private-sector compensation in NSW expanded by 2.2 % in fiscal 2016-17. Without a continuing reduction in average effective premiums, therefore, the scheme's revenue base should have expanded by a proportionate amount. If premiums had simply matched the growth in overall payrolls, the revenue stream would have grown by close to $50 million during the year; instead, revenues slipped. The erosion of the effective premium rate thus sapped the system of $67 million in revenue this year alone (see chart). And that does not count the much larger carry-forward impact on revenues of past premium cuts.

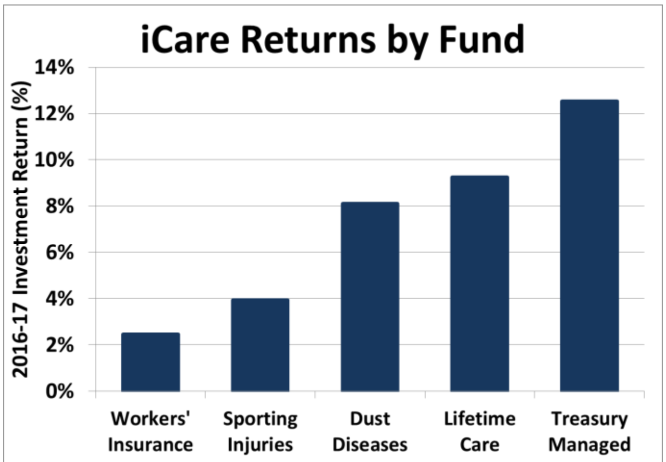
Average workers' compensation premiums have been reduced in NSW by over 40 percent during the past decade; premium reductions have thus passed on to private employers the "savings" from harsh benefit reductions (leaving injured workers and their families to absorb the true cost of these changes). Simply stopping the further erosion of the premium base (let alone reversing past premium cuts) would significantly enhance the scheme's ability to fund better benefits in coming years. The erosion of premiums contradicts the claim that the system "cannot afford" to sustain benefits for the over 4000 workers about to be cut off entirely: to the contrary, both the large surpluses accumulated within the system, and the potential growth in future premium revenue (assuming that premium rates are not cut), provide ample resources with which to fund adequate benefits for all injured workers.

Benefit cuts sustained.

iCare did not include detailed data on benefit payments in its annual report, but there is no doubt the post-2010 decline in benefits has been sustained, despite the scheme's strong financial position. Adjusted for inflation, real workers' compensation payouts (including monthly benefits and medical expenses) have declined by over 30% since 2010. iCare reports only broad data on current claims payments (in its cash flow statement); this data suggest total payments were roughly constant in real terms in 2016-17. (The figure on p.1 of this report illustrates an estimated figure for 2016-17 benefit payouts based on iCare's cash flow report adjusted for inflation.) The "savings" resulting from this dramatic and sustained reduction in benefits underpin the growing surpluses within iCare's balance sheet – as well as the continuing premium reductions captured by employers.

Poor Financial Returns

iCare reported very disappointing results in its Workers Insurance investment fund in 2016-17. This contributed to a narrower net return on its underlying operations. The agency reported an annual return of just 2.46% during the year, less than half the returns generated in previous years, and well below industry benchmarks for this type of asset class. Indeed, the rate of return on iCare's Workers Insurance fund was far lower than the returns posted in the same year on its other investment vehicles (see chart). It is not clear why this particular fund generated such a poor return in a year when financial markets generally performed reasonably well. In its annual report, the agency simply ascribed the poor result to the composition of its portfolio; but this unusually poor performance deserves further scrutiny. In future years, and with changes in investment management practices as required, the return on accumulated assets will certainly improve, providing more resources to fund the repair of benefits.



Source: Centre for Future Work from iCare Annual Report.

Conclusion.

The NSW workers' compensation system has been dramatically scaled back and restructured since 2011. The changes were publicly justified by deficits that were largely the result of temporary factors (investment losses and a steep decline in discount rates) associated with the Global Financial Crisis. Yet those deficits have been rapidly transformed into large and growing surpluses: in part because of better financial market conditions, but also because of dramatic reductions in benefits.

Emerging Fiscal Space

Sources of Fiscal Improvement in Workers' Compensation:

Declining rate of injuries…
…better safety practices and shift to less injury-prone jobs.

Improved investment returns…
…2016-17 return (2.5%) was unusually low and will recover.

Higher discount rates…
…rising interest rates will reduce present value of future claims liabilities.

Even with the modest repair of benefits in 2015, the system continues to generate surpluses that will accumulate further in future years. Yet the administrators of the scheme place more emphasis on sequestering those surpluses in various cushions (boosting target funding ratios, and continuing to apply large "risk margins" in its costings), to insulate them from demands to maintain benefits for injured workers. Contrary to this ultra-cautious management style, the underlying financial parameters of workers' compensation in NSW are in fact improving over time, driven by several positive factors (see table): falling injury rates, investment returns that will increase in future years, and an inevitable increase in discount rates that reduces the apparent cost of future liabilities. At the bottom line, therefore, the argument that NSW somehow cannot "afford" decent benefits for injured workers is not credible. There is no fiscal reason to deny benefits to the thousands of injured workers who are about to lose them.