MORNEAU SHEPELL

NEWS & VIEWS

IN THIS ISSUE

ONTARIO'S 2014 BUDGET

On May 1, 2014, Ontario's Liberal Government released its 2014 Budget (the "Budget"). Given that an election was called in Ontario for June 12, depending on the election results, the Budget proposals might never come to fruition. The Budget's proposed pension initiatives included:

- the introduction of an Ontario Retirement Pension Plan ("ORPP");
- the introduction of an Ontario Pooled Registered Pension Plan ("Ontario PRPP");
- new rules applicable to certain defined benefit plans; and
- consultations for target benefit plans and self-directed retirement savings.

ONTARIO RETIREMENT PENSION PLAN

The Budget proposed to launch the ORPP in 2017, beginning with enrolment of the largest employers. This initiative resulted from the fact that the Ontario government disagreed with the conclusion of the Federal government not to expand the Canada Pension Plan, and would include the following features:

- this plan would be very similar to the CPP and would be publicly administered, at arm's length from the government;
- all Ontario workers would participate, except that those already participating in a comparable workplace pension plan would not be required to enrol in the ORPP;
- benefits would be calculated based on an intended replacement rate of 15% of an individual's earnings, to a maximum annual earnings threshold of $90,000 (increased yearly consistent with CPP maximum earnings threshold increases);

- contributions would be determined to fully fund the new benefits, shared equally between employers and employees, not exceeding 1.9% of earnings each, to the maximum annual earnings threshold, but earnings below a certain threshold would be exempt from contributions (possibly different from the $3,500 exemption under the CPP);
- contribution rates would be phased in over two years;
- annual contributions would be estimated to total approximately $3.5 billion;
- the advantages of this new plan would include benefit predictability by pooling longevity and investment risk, low administration cost, and inflation indexing; it would also be possible in the future to extend this plan to other provinces or combine it with the CPP.

ONTARIO POOLED REGISTERED PENSION PLAN

Another planned pension initiative was the Ontario PRPP, intended to be launched with draft legislation in the fall of 2014. This initiative resulted from the recent consultation, and would include the following features:

- voluntary participation and contributions by employers;
- automatic enrolment of employees where an employer offers an Ontario PRPP, unless an employee chose to opt out within a specified period; and
- low cost administration.

DEFINED BENEFIT PLANS

The three key initiatives relating to defined benefit plans announced in the Budget were (1) reform of certain funding rules, (2) facilitating conversions to jointly sponsored pension plans and (3) enabling asset pooling for broader public sector plans.

The planned reforms to funding rules would include regulations that define the funding level for, and duration of, contribution holidays. Proposed new regulations would set parameters for accelerated funding of benefit improvements in underfunded pension plans. The government also planned to review the current exemption for specified multi-employer pension plans and jointly sponsored pension plans ("JSPPs") not subject to solvency funding requirements from the "solvency concerns" test. In the meantime, the current exemption for specified MEPPs and JSPPs would continue to December 31, 2017.

Further to a previously stated intention in Ontario's 2013 budget, the government planned to introduce amendments to the *Pension Benefits Act* to prescribe the requirements related to the transfer of assets from single-employer pension plans to JSPPs. Amendments would require:

- notice to all plan beneficiaries and trade unions in advance of conversion;
- consent of plan beneficiaries prior to the plan conversion;
- approval of the Superintendent of Financial Services for the conversion; and
- upon conversion, that the same pension be provided to retirees and the equivalent value be provided to current employees.

Also as previously announced, as a result of consultations, the government intended to introduce legislation in the spring of 2015 to establish an asset pooling entity operating at arm's length from the government. Participation of pension plans and qualified organizations would be voluntary; however the government identified the Workplace Safety and Insurance Board and the Ontario Pension Board as "well placed" to be initial participants.

TARGET BENEFIT PLANS

The government planned to engage in consultation with a view to establishing the eligibility conditions, funding rules and governance requirements, for multiple (and, subsequently, single) employer target benefit plans.

SELF-DIRECTED RETIREMENT SAVINGS

The government intended to appoint an expert committee to develop recommendations for the financial planning industry concerning reliance on financial advisors for savings and investment decisions.

ONTARIO PROPOSES CHANGES TO PENSION REGULATIONS

On April 25, 2014, the Ontario government released four proposals for amendments to Regulation 909 (General) (the "Regulation") under the *Pension Benefits Act* (PBA). Those changes had been announced already in past budgets. Given that the Ontario provincial election was called during the consultation period related to the proposals, the status of the amendments cannot be known until after the election. After the election, plan administrators will want to monitor the status of these proposals to ensure that any required changes are implemented on time. An overview of the proposals is outlined below.

1 - STATEMENTS TO FORMER AND RETIRED MEMBERS

Currently, the PBA requires plan administrators to provide statements to active members. The PBA has already been amended to require statements for inactive members, but that is not yet in force because details need to be specified by regulation. Under a proposed change to the Regulation, plan administrators also would be required to provide former and retired members with statements containing prescribed content. The frequency of the statements would be at least once every three years, or within six months of the filing date of the last valuation report, whichever is sooner. Plan administrators would be required to distribute the first statements to retired and former members within twelve months of the date on which the change comes into force.

The Ontario government asked interested stakeholders to comment on whether statements to former and retired members should address the effect of any potential division that may arise from the breakdown of a spousal relationship. Currently administrators are not required to include information about the impact of such settlements in statements.

2 - VARIABLE BENEFIT ACCOUNTS FOR DEFINED CONTRIBUTION PLANS

Currently, defined contribution ("DC") plans transfer money to financial institutions to pay retirement incomes. The PBA has already been amended to allow other payment options, but that is not yet in force because details need to be specified by regulation. Under a proposed change to the Regulation, pension plans with a DC provision would be allowed to offer members the option of having their DC account balances allocated to a variable benefit account held by the plan, from which benefits would be paid on retirement. The amounts payable under a variable benefit account would be the same as from a Life Income Fund under the PBA. DC plan administrators would need to provide annual statements with prescribed information.

3 - STATEMENTS OF INVESTMENT POLICIES AND PROCEDURES (SIPPS)

Proposed changes affecting SIPPs would come into force on January 1, 2015, and would require plan administrators to file SIPPs with the Financial Services Commission of Ontario (FSCO) within 90 days after the changes come into force. In addition, any amendment to a SIPP would have to be filed with FSCO within 90 days. Plan administrators would have to include information in the annual member statements indicating whether environmental, social and governance factors are addressed in their SIPPs. The Superintendent would also be required to make SIPPs available for inspection at FSCO offices and, upon request, to prescribed persons by mail or electronically.

4 - CHANGES TO ACCOUNTING STANDARDS

A proposed change aims to update references to specified terms in the Regulation to reflect updates to the Chartered Professional Accountant (CPA) Canada Handbook (formerly the CICA Handbook). For example, the Regulation will be updated to replace the term "market value" with "fair value" when reporting certain assets and liabilities. Plan administrators will need to ensure that future reports use the appropriate updated requirements and terms. Additional information would also be required with respect to certain types of investments, such as mortgages, repurchase agreements and debt instruments.

REPORT ON (U.S.) PUBLIC PENSION PLAN FUNDING

The Society of Actuaries commissioned an independent expert panel to develop recommendations designed to strengthen funding of public sector pension plans in the U.S. Their report was released in February. The dismal funded status of many state and municipal pension plans in the U.S. has received a great deal of attention since the 2008 financial crisis and the problems have yet to be resolved. The mandate of the panel was to recommend changes to funding, governance and other practices that would enhance the benefit security for plan members. This report includes some observations that may be relevant to public sector plans in Canada.

It is noteworthy that the mandate of the expert panel was defined narrowly. It focussed on funding and did not include recommendations on plan design changes, such as target benefit plans, that would ensure the sustainability of the plans throughout a broad range of economic conditions. However, the panel did note in its recommendations that plans should look into plan changes that enhance flexibility in responding to unexpected experience, a feature that is at the core of target benefit plan design While the panel chose its words carefully, its findings are nevertheless critical of the funding and governance practices in the U.S. Here are some of the major findings:

- The actuarial assumptions have been slow to respond to the changing economic environment. While a nominal valuation interest rate higher than 6% has become rare in Canada, many U.S. public sector plans have continued to use 7.5% to 8%, rates which were more appropriate when risk-free real returns and inflation were much higher than they are today. Even if contributions were made in compliance with the funding recommendations that these high rates produced, the plans would still be in deficit today. The Panel estimates that the long-term rate of return should be closer to 6.4%.
- The Panel considers the current range of funding assumptions and methods to be overly broad.
- The Panel recommends increased risk management and urges the Actuarial Standards Board to develop stronger disclosure and risk measurement standards.
- The Panel suggests 3 principles to frame its recommendations: adequacy of funding, inter-generational equity and cost stability and predictability. These principles are similar to those adopted by other jurisdictions that have or are contemplating pension reform, such as New Brunswick. It recognizes that these principles conflict to some degree and that adequacy of funding should be the primary directive. While unsaid in the report, actual funding practices in too many situations followed none of these principles. The inclination has been to follow the path of least resistance, which involves continuing to make the same benefit promises but not to fund them adequately.

For Canadian readers, the obvious question is whether these problems are just an American phenomenon or whether we have similar problems in Canada. The short answer is that the same challenges do exist but the situation here is much less extreme. In some public plans, the actuarial assumptions are more aggressive than one would typically find in the private sector, but not in the 7.5% range we see in the U.S. In some plans, the contributions were not made in compliance with the actuarial recommendations but the funding shortfalls were less severe than in the U.S. In addition, sponsors of some public sector plans in Canada have been quicker to introduce more flexibility in their pension plan benefits, such as conditional indexing, to reduce the future cost of the plans and to have the plan beneficiaries take a greater share of the cost or of the risk.

Whether the situation in the U.S. is more challenging than in Canada or not is somewhat irrelevant as challenges exist everywhere, only to different degrees. What is more interesting is that actual pension reform or related discussion papers in the U.K., Canada and the U.S. all seem to follow common themes around a principle-based approach to pension funding and design, increased and improved risk management and flexible benefit design to increase the ability to respond to unexpected and unwanted experience.

ALBERTA INTRODUCES AND THEN POSTPONES PENSION BILLS

On April 16, 2014, the Government of Alberta introduced two pieces of pension legislation, Bills 9 and 10. Following public opposition and negotiations with unions, the Government referred them on May 5 to the Standing Committee on Alberta's Economic Future. It is expected to consult with experts and report back to the legislature in October.

BILL 9: PUBLIC SECTOR PENSION CHANGES

As discussed in *News & Views* in October 2013 and March 2014, Bill 9 (the *Public Sector Pension Plans Amendment Act*, 2014) would reform four large public-sector pension plans. Key changes would include the reduction of early retirement subsidies and the removal of guaranteed cost-of-living increases. Rules would also permit three of the plans to move to a jointly-sponsored pension plan structure.

BILL 10: AMENDMENTS TO THE NEW EMPLOYMENT PENSION PLANS ACT

Bill 10, the *Employment Pension (Private Sector) Plans Amendment Act*, 2014, would amend the new *Employment Pension Plans Act*, (the "New EPPA"), which was passed in 2012 (see our *News & Views* of November 2012) but is not yet in force.

Bill 10 makes a number of updates and corrections to the New EPPA. Many of the changes are minor and technical. One key change, however, would permit accrued defined benefits to be converted to target benefits (as is the case with New Brunswick's Shared Risk Plans). The amendment would have to comply with rules that are yet to be prescribed in the regulations.

Furthermore, a new provision would discharge employers from liability when annuities are purchased in respect of defined benefit pensions for deferred members or persons receiving pensions under an ongoing pension plan. The discharge from liability would be subject to the employer complying with certain requirements set out in the regulations.

AS AT APRIL 30, 2014

MARKET INDICES

The following table shows the Morneau Shepell monthly summary of returns from various market indices. It also includes returns from benchmark portfolios used by pension funds.

	RETURNS			
	Monthly	Quarter to date	Year to date	1 year
TSX GROUP/PC BOND INDICES				
DEX Universe Bond	0.5%	0.5%	3.3%	0.2%
DEX 91 Day Treasury Bill	0.1%	0.1%	0.3%	1.0%
DEX Short Term Bond	0.3%	0.3%	1.3%	1.8%
DEX Mid Term Bond	0.6%	0.6%	3.8%	0.5%
DEX Long Term Bond	0.8%	0.8%	6.0%	-2.5%
DEX High Yield Bond	0.9%	0.9%	4.8%	8.0%
DEX Real Return Bond	0.9%	0.9%	7.0%	-7.3%
CANADIAN EQUITY INDICES				
S&P/TSX Composite (Total Return)	2.4%	2.4%	8.6%	21.3%
S&P/TSX Composite Capped	2.4%	2.4%	8.6%	21.3%
S&P/TSX 60 (Total Return)	2.3%	2.3%	8.0%	21.6%
S&P/TSX Completion	2.7%	2.7%	10.5%	20.4%
S&P/TSX Small Cap	4.0%	4.0%	12.2%	25.8%
BMO Small Cap Unweighted	1.2%	1.2%	12.7%	20.1%
BMO Small Cap Weighted	2.6%	2.6%	11.7%	25.0%
U.S. EQUITY INDICES				
S&P 500 (US$)	0.7%	0.7%	2.6%	20.4%
S&P 500 (C$)	-0.1%	-0.1%	5.7%	31.0%
FOREIGN EQUITY INDICES[1]				
MSCI ACWI (C$)	0.4%	0.4%	5.4%	24.8%
MSCI World (C$)	0.4%	0.4%	5.7%	27.2%
MSCI EAFE (C$)	0.9%	0.9%	5.5%	23.7%
MSCI Europe (C$)	1.9%	1.9%	8.1%	33.4%
MSCI Pacific (C$)	-1.3%	-1.3%	0.0%	6.5%
MSCI Emerging Markets (C$)	-0.2%	-0.2%	3.3%	7.5%
OTHER				
Consumer Price Index (Canada, March 2014)	0.6%	1.7%	1.7%	1.5%
Exchange Rate US$/C$	-0.9%	-0.9%	3.0%	8.8%
MORNEAU SHEPELL BENCHMARK PORTFOLIOS[2]				
60% Equity/40% Bonds	1.1%	1.1%	5.5%	14.1%
55% Equity/45% Bonds	1.0%	1.0%	5.4%	12.9%
50% Equity/50% Bonds	1.0%	1.0%	5.2%	11.7%
45% Equity/55% Bonds	0.9%	0.9%	5.0%	10.5%
40% Equity/60% Bonds	0.9%	0.9%	4.8%	9.3%

[1] Returns net of taxes on dividends, except for MSCI Emerging Markets.
[2] The returns are compounded monthly.

ASSET & RISK MANAGEMENT

In **Asset Management**, we provide objective advice on all aspects of asset management for pension funds, including investment policy statements, portfolio manager searches, investment performance measurement and investment strategy.

In **Risk Management**, we provide a structured, comprehensive approach to pension risk management, including implementation of liability-driven investment strategies, advice on allocation of the risk budget within an asset-liability framework and execution of continuous and dynamic processes for risk reduction.

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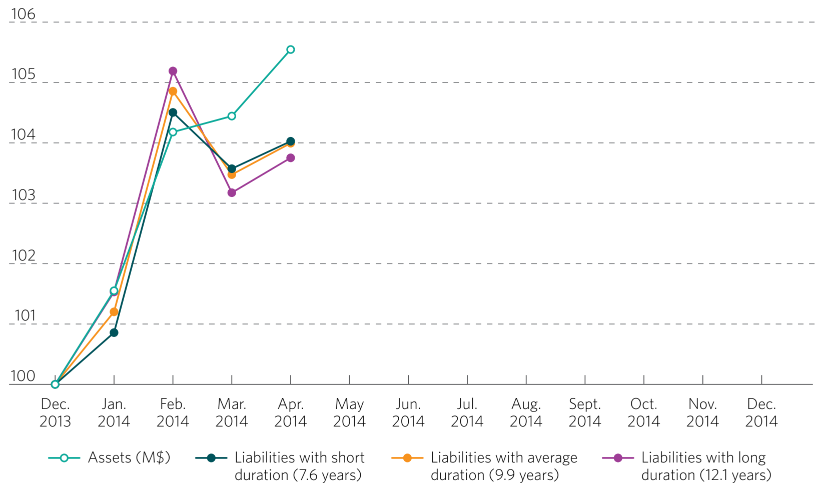
AS AT APRIL 30, 2014

TRACKING THE FUNDED STATUS OF PENSION PLANS

This graph shows the changes in the financial position of a typical defined benefit plan since December 31, 2013. For this illustration, assets and liabilities of the plan were each arbitrarily set at $100 million as at December 31, 2013. This estimate of the solvency liabilities reflects the new CIA guidance published in May 2014 for valuations effective December 31, 2013 or later. Therefore, beginning on December 31, 2013, we present the evolution of liabilities for three groups of retirees, each with a different duration (short, average and long). The following graph shows the impact of past returns on plan assets and the effect of interest rate changes on solvency liabilities.

THE EVOLUTION OF THE FINANCIAL SITUATION OF PENSION PLANS SINCE DECEMBER 31, 2013



In April 2014, Canadian bonds, the Canadian stock market as well as global equity (C$) markets all showed positive returns, which caused assets to increase by 1.1%. Annuity purchase rates decreased while the rates used in the calculation of solvency liabilities remained stable, resulting in a slight increase of 0.5% in solvency liabilities for the average duration plan. The combined effect led to an increase of the solvency ratio.

Since the beginning of the year, driven by strong returns in the Canadian bond market and equity markets the plan's assets increased by 5.5%. Over the same period, the solvency liabilities increased by 3.8% to 4.0% depending on the duration of the group of retirees. The increase in the plan's solvency ratio as at April 30, 2014 depends on the plan's initial ratio, but stands between 0.9% and 1.7%.

Please contact your Morneau Shepell consultant for a customized analysis of your pension plan.

Comments:

1. No consideration has been made for contributions paid to the plan or for benefits paid out of the plan.
2. Solvency liabilities are projected using the rates prescribed by the Canadian Institute of Actuaries for the purpose of determining pension commuted values.
3. This estimate of the solvency reflects the new CIA guidance published in November 2013 for valuations effective September 30, 2013 or later.
4. The underlying typical defined benefit plan is a final average plan with no pension indexing, including active and inactive participants representing 60% and 40% of liabilities, respectively.
5. Assets are shown at full market value. Returns on assets are based on those of the Morneau Shepell benchmark portfolio (60% equities and 40% fixed income). It should be noted that this benchmark portfolio replaced the one that was previously used, which contained 55% of equities and 45% of fixed income.

The table below shows the impact of past returns on plan assets as well as the effect of interest rate changes on solvency liabilities, based on the plan's initial solvency ratio as at December 31, 2013.

INITIAL SOLVENCY RATIO AS AT 12/31/2013	EVOLUTION OF THE SOLVENCY RATIO AS AT 04/30/2014 FOR THREE DIFFERENT GROUPS OF RETIREES		
	SHORT DURATION (7.6 YEARS)	AVERAGE DURATION (9.9 YEARS)	LONG DURATION (12.1 YEARS)
100%	101.5%	101.5%	101.7%
90%	91.3%	91.3%	91.6%
80%	81.2%	81.2%	81.4%
70%	71.0%	71.0%	71.2%
60%	60.9%	60.9%	61.0%

AS AT APRIL 30, 2014

IMPACT ON PENSION EXPENSE UNDER INTERNATIONAL ACCOUNTING

Every year, companies must establish an expense for their defined benefit pension plans.

The graph shows the expense impact for a typical pension plan that starts the year at an arbitrary value of 100 (expense index). The expense is influenced by changes in the discount rate based on high quality corporate and provincial (adjusted) bonds and the median return of pension fund assets.

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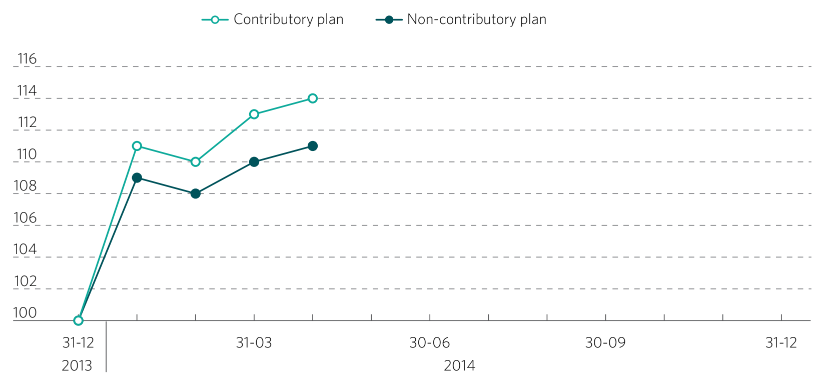
EXPENSE INDEX FROM DECEMBER 31, 2013



(In %)					
Discount rate	4.7	4.3	4.3	4.3	4.3
Return on assets (55% equities)	0.0	1.6	2.4	0.2	1.0

The pension expense has increased by 14% (for a contributory plan) since the beginning of the year, due to the decrease in the discount rate.

The table below shows the discount rates for varying durations and the change since the beginning of the year. A plan's duration generally varies between 10 (mature plan) and 20 (young plan).

DISCOUNT RATE

DURATION	DECEMBER 2013	APRIL 2014	CHANGE IN 2014
11	4.52%	4.06%	-46 bps
14	4.81%	4.34%	-47 bps
17	4.96%	4.52%	-44 bps
20	5.06%	4.63%	-43 bps

Comments:

1. The expense is established as at December 31, 2013, based on the average financial position of the pension plans used in our *2013 Survey of Economic Assumptions in Accounting for Pensions and Other Post-Retirement Benefits* report (i.e. a ratio of assets to obligation value of 83% as at December 31, 2012).
2. The return on assets corresponds to the return on the Morneau Shepell benchmark portfolio (55% equities and 45% fixed income).
3. The actuarial obligation is that of a final average earnings plan, without indexing (two scenarios: with and without employee contributions).

ABOUT US

Morneau Shepell is the largest company in Canada offering human resources consulting and outsourcing services. The Company is the leading provider of Employee and Family Assistance Programs, as well as the largest administrator of pension and benefits plans. Through health and productivity, administrative, and retirement solutions, Morneau Shepell helps clients reduce costs, increase employee productivity, and improve their competitive position. Established in 1966, Morneau Shepell serves more than 5 million plan participants and 21,000 clients, ranging from small businesses to some of the largest corporations and associations in North America. With approximately 3,300 employees in offices across North America, Morneau Shepell provides services to organizations across Canada, in the United States, and around the globe. Morneau Shepell is a publicly traded company on the Toronto Stock Exchange (TSX: MSI).

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