MORNEAU SHEPELL

IN THIS ISSUE

BILL REGARDING QUEBEC'S MUNICIPAL PENSION PLANS

On June 12, 2014, the Quebec government tabled draft legislation to foster the financial health and sustainability of defined benefit pension plans in the municipal sector.

This Bill applies to any pension plan established by a municipal body. It sets out different terms and conditions for service before and after December 31, 2013 and aims to:

For service as of January 1, 2014:

- Ensure an equal sharing (50/50) of the plan costs (current service cost and future deficits attributable to this component). A transition period, ending January 1, 2020, is provided for some plans.
- Foster better risk management for the new component by requiring the creation of a stabilization fund through a stabilization contribution equal to 10% of the current service contribution, shared equally. Moreover, actuarial gains generated in this component will also have to be paid into the stabilization fund.
- Require the elimination of automatic indexation provisions. Limit the current service cost to 18% of payroll (20% for police and firefighters), **including** the stabilization contribution.

For service prior to January 1, 2014:

- Allocate the deficit between active members and retired members in proportion to their respective liabilities.

- For the portion of the deficit attributable to retired members, the employer **may** suspend indexation without requiring the retired members' approval. The remaining deficit must be funded by the employer over a period of 15 years.
- The portion of the deficit attributable to the active members is assumed in equal shares by the members and the employer:
  - Active members' share: regardless of the financial situation, mandatory elimination of automatic indexation provisions. Their residual deficit must be assumed through benefit reductions.
  - Employer's share: funded over a period of 15 years.
  - As well, the parties may agree that the active members' share be reduced, to a minimum of 40%, if other elements of the overall remuneration are amended.
- Any new deficit identified in a subsequent actuarial valuation is to be covered by the employer.

OTHER MEASURES

- Members who started receiving a pension or who applied for a pension between January 1, 2014, and June 12, 2014, are deemed to be retired members as of December 31, 2013.
- Surplus assets can no longer be used to cover employer contributions, except when the tax limits have been reached (125% funded).
- Any additional obligations resulting from an amendment to the plan must be paid in full as of the day following the date of the valuation that establishes their value.

Any changes made to the plan in order to meet the above-mentioned requirements should normally be negotiated by the parties starting February 1, 2015, over a maximum period of 12 months, unless the parties agree agree to extend such period by three or six months.

If the parties have entered into an agreement regarding the pension plan during the three years preceding the legislation's date of assent, negotiations can begin no later than January 1, 2016, based on an actuarial valuation as at December 31, 2014.

CONCLUSION

We note that this Bill has some major implications. It will be interesting to see if the work of the parliamentary commission to be held later this summer will lead to significant changes.

KEY DATES

December 31, 2013	December 31, 2014	January 15, 2015	February 1, 2015	February 1, 2016
Date of the required actuarial valuation	Deadline for filing the valuation	Deadline for sending the invitation to negotiate	Start of the 12-month negotiation period	Arbitration period (6 months)

QUEBEC BUDGET

On June 4, 2014, the Quebec Minister of Finance, Carlos J. Leitão, tabled the province's 2014-2015 Budget. Few measures concerning pension plans and other saving plans have been announced.

It is worth mentioning that the *Taxation Act* will be amended in order to limit the splitting of pension income between spouses to taxpayers who have reached the age of 65 before the end of the year. This measure eliminates an inequity between taxpayers receiving a pension from a registered pension plans and those receiving retirement income from other sources such as an RRSP, RRIF or DPSP.

Until this budget announcement, it was possible to split between spouses income from registered pension plans at any age while the income coming from an RRSP, RRIF or DPSP can only be split from age 65. Starting in 2014, splitting of income from registered pension plans or any other plans will only be permitted if the taxpayer has reached age 65.

This new measure is not harmonized with the federal income splitting rules.

TARGET BENEFIT PLAN FOR REGINA POLICE

The *Pension Benefits Regulations, 1993* in Saskatchewan has been amended to allow new funding rules for The Regina Police Pension Plan (the "Plan"), effective July 1, 2014. The amendment allows the following:

- no new members will be allowed to join the Plan after June 30, 2014;
- benefits under the Plan will cease to accrue for any service after June 30, 2014;
- benefits accrued under the Plan prior to July 1, 2014 will not be changed, and
- the employer will assume sole responsibility for the Plan's liabilities, amortized over a period of 40 years.

Effective July 1, 2014, for future service, all existing Plan members and all new qualifying employees, will join The Target Retirement Income Plan for the Regina Police Services ("TRIP"). The TRIP will include fixed employer and member contribution rates of 8.5% of pay, lifetime and bridge benefits similar to those of the Plan, ad-hoc cost of living adjustments, early retirement provisions based on age and service, pre-determined provisions concerning future surpluses or deficits, a risk management structure and a benefits/funding policy. Pension legislation in Saskatchewan already allows target benefit plans.

TRANSITION IN ACCOUNTING RULES FOR PRIVATE ENTERPRISES AND NOT-FOR-PROFIT ORGANIZATIONS

After three years of discussions on accounting of employee benefit plans for private enterprises and not-for-profit organizations ("NFPOs") in Canada, new accounting rules are being implemented for fiscal years beginning on January 1, 2014 or after. The Accounting Standards Board ("AcSB") adopted Section 3462 in November 2012, with the final standard issued in May 2013. The AcSB also adopted Section 3463 in October 2013, with the final standard issued in December 2013. Private enterprises and NFPOs both apply Section 3462, but Section 3463 is applicable for NFPOs only. For more details, please refer to the *News & Views* of *February 2012*, *December 2012* and *February 2013*.

SUMMARY OF CHANGES

- Removal of deferral mechanisms for gains and losses and past service costs (plan amendments).
- Recognition of the defined benefit liability (asset) in the balance sheet:
    - For private enterprises, "*remeasurements and other items*" are recognized immediately in income, but must be disclosed explicitly.

    - For NFPOs, "*remeasurements and other items*" are recognized and disclosed as a separate component in the statement of changes in net assets.
    - "*Other items*" include past service costs and gains and losses arising from curtailments and settlements.
- Removal of the expected return on plan assets, so that the interest component for plan assets would be based on the actual return for the year (less management fees paid by the plan itself or the plan sponsor).
- Use of either the actuarial valuation for funding purposes or a distinct actuarial valuation for accounting purposes. This constitutes an accounting policy choice by the entity and is applied to all plans.
- The defined benefit obligation must be remeasured at least once every three years (whichever valuation basis is chosen), but may occur more frequently (when a significant event takes place).
- In years between remeasurements, the defined benefit obligation must be rolled forward. Changes in discount rate or employee composition and salaries need not be reflected in the roll-forward.
- The present value of economic benefits for purposes of the limit on the carrying amount of a defined benefit asset is to be calculated using the discount rate for measuring the obligation (instead of the expected rate of return on plan assets).
- The revised standard is applied retrospectively, as per Section 1506 – *Accounting changes*. However, entities that include employee benefit costs in the carrying amount of assets, like inventories or property, plant and equipment, need not restate the carrying amount of those assets.
    - Measurement within a three-month window prior to the balance sheet date is now prohibited, but entities that used an early measurement date obtain some relief in the form of a simplified transition method for retrospective application.

FIVE QUESTIONS TO ADDRESS

For those involved in financial reporting for defined benefit plans of a private enterprise or a not-for-profit organization, here are the five questions that would need to be addressed.

1. How do the new standards impact the financial status of private enterprises and NFPOs?

Entities that chose the "deferral and amortization approach" prior to 2013 could be impacted in many ways:

- Increase (or decrease) in the balance sheet liability, if there is an existing unamortized balance of losses (or gains).
- Increase in the cost for the period, due to the removal of the expected return on plan assets (if the expected rate of return was higher than the discount rate).
- For private enterprises, more volatile costs in future years in the statement of income, due to remeasurements and other items fully recognized in profit or loss. Estimating next year's expense for budgetary purposes becomes a very difficult exercise, as actuarial gains and losses always happen.

2. Which type of valuation basis should the entity use to measure the defined benefit obligation of pension plans that are funded and are subject to an actuarial valuation for funding purposes?

Discount rates used for going-concern valuations are typically higher than those used for accounting valuations, which results in a lower defined benefit cost. In addition, since the going-concern discount rate is based on the expected long-term rate of return of plan assets, minus a margin for conservatism, it is less subject to sudden variations than the accounting discount rate, which is driven by the high quality corporate bond market. Moreover, using the results from an existing actuarial valuation avoids preparing a separate accounting valuation, and thus reduces professional fees.

However, other actuarial assumptions in a funding valuation might include margins for adverse deviations, which would not be the case for best estimate assumptions used in an accounting valuation. Also, for some entities the choice of going-concern assumptions may be subject to external factors (unions, actuary, legislative requirements), while accounting assumptions are determined solely by the employer.

3. If a funding valuation basis is used to determine the accounting obligation of funded pension plans, which type of valuation basis should be used for unfunded plans?

The standard allows an entity to prepare a valuation for an unfunded plan on a basis consistent with a funding valuation, provided that was also the basis chosen for the funded plans. However, the standard does not provide any additional guidance as to how this could be achieved. Therefore, the actuary must use professional judgment to find a way to determine the defined benefit obligation in a manner consistent with a traditional funding valuation. Here are some elements to consider:

- What should be the expected rate of return for the unfunded plan?
- Should all other actuarial assumptions be consistent with those used for pension plans?
- What is the actuarial cost method for a post-retirement benefits plan where the benefits are only vested at retirement?

4. Should the defined benefit obligation be remeasured more often than once every three years?

The standard requires that the defined benefit obligation be remeasured at least once every three years, but it may occur more often, for instance when a significant event takes place (plan amendment, settlement, etc.). This implies that the remeasurement is made at the entity's discretion, provided it meets the 3-year window.

If the funding valuation is chosen as the basis for the defined benefit obligation, should the entity update its results when the 3-year deadline has not been reached yet (for example, when going-concern valuations are required annually)? If the entity decides to forego the remeasurement when a new complete actuarial valuation for funding purposes is already available, would the auditor question the reasons behind this decision?

5. Should the discount rate be updated when rolling forward the defined benefit obligation in years between remeasurements?

One of the big changes in accounting for private enterprises and NFPOs is that a variation in the discount rate does not necessarily constitute grounds to remeasure the defined benefit obligation, even when rolling forward the obligation in a typical accounting valuation. This is quite different from the past practice, where the discount rate was always updated to reflect the latest market rates. The purpose of this is, again, to simplify the reporting process as much as possible. However, the AcSB also indicated that an entity would not be precluded from revising the discount rate, if it chose to do so.

This leads to the question of whether or not the entity can have the luxury of choosing years in which the discount rate is updated and years in which it is not. Even if it appears technically possible according to the standard, external auditors might have a different view on this and might prefer to have a more consistent and systematic accounting policy applied by the entity.

QUEBEC LAUNCHES VOLUNTARY RETIREMENT SAVINGS PLANS

The final version of the *Voluntary Retirement Savings Act* regulations (as well as some changes to the *Supplemental Pension Plans Act* regulations) was published in the *Gazette officielle du Québec* on June 13, 2014. These regulations represent the last legislative milestone required to launch, as planned, VRSPs on July 1st, 2014.

Minor changes were made to the regulations since the draft version was released on March 12 (see the *News and Views* *April 2014* edition); most of these changes are related to VRSP administrator obligations towards the *Autorité des marchés financiers* and the *Régie des rentes du Québec* (RRQ). The following changes will impact employers:

- The contract between employers and administrators must include the contribution remittance method, as well as the consequences in case the employer fails to remit contributions within the prescribed delay.
- Employers will no longer need to provide their employees' salary as part of the enrollment process, but they now must provide their employees' language of communication.

This new version of the regulations also defines some administration fees that could be charged by administrators to members, and provides further guidelines on how information about investment options must be communicated.

The *Autorité des marchés financiers* started issuing VRSP administrator licenses. Those administrators may now submit their VRSP plan text to the RRQ, who is responsible for registering these plans, starting on July 1. Once a plan text is registered by the RRQ, administrators can start marketing their product to Quebec employers and individuals.

Quebec is the second jurisdiction allowing the full deployment of Pooled Registered Pension Plans, following the Federal Government, which implemented its legal framework at the beginning of 2013, applicable to employers in federally controlled sectors, such as banking, communications and transportation. British Columbia, Alberta and Saskatchewan also have PRPP legislation in force, but have not yet finalized their regulations.

AS AT MAY 31, 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
FTSE TMX BOND INDICES[1]				
FTSE TMX Canada Universe Bond	1.2%	1.7%	4.6%	2.9%
FTSE TMX Canada 91 Day Treasury Bill	0.1%	0.1%	0.4%	1.0%
FTSE TMX Canada Short Term Bond	0.3%	0.6%	1.7%	2.5%
FTSE TMX Canada Mid Term Bond	1.2%	1.8%	5.1%	3.6%
FTSE TMX Canada Long Term Bond	2.5%	3.3%	8.6%	2.8%
FTSE TMX Canada High Yield Bond	0.9%	1.8%	5.7%	8.1%
FTSE TMX Canada Real Return Bond	2.9%	3.8%	10.1%	0.0%
CANADIAN EQUITY INDICES				
S&P/TSX Composite (Total Return)	-0.2%	2.3%	8.5%	19.0%
S&P/TSX Composite Capped	-0.2%	2.3%	8.5%	19.0%
S&P/TSX 60 (Total Return)	0.0%	2.3%	8.0%	18.7%
S&P/TSX Completion	-0.7%	2.0%	9.8%	19.7%
S&P/TSX Small Cap	-1.7%	2.2%	10.3%	21.6%
BMO Small Cap Unweighted	-1.7%	-0.5%	10.8%	17.5%
BMO Small Cap Weighted	-1.2%	1.4%	10.4%	21.8%
U.S. EQUITY INDICES				
S&P 500 (US$)	2.3%	3.1%	5.0%	20.4%
S&P 500 (C$)	1.2%	1.1%	7.0%	26.0%
FOREIGN EQUITY INDICES[2]				
MSCI ACWI (C$)	1.0%	1.4%	6.5%	23.1%
MSCI World (C$)	0.9%	1.3%	6.6%	24.9%
MSCI EAFE (C$)	0.5%	1.4%	6.1%	24.0%
MSCI Europe (C$)	-0.2%	1.7%	7.9%	29.4%
MSCI Pacific (C$)	2.1%	0.8%	2.1%	13.8%
MSCI Emerging Markets (C$)	2.4%	2.2%	5.8%	9.9%
OTHER				
Consumer Price Index (Canada, April 2014)	0.3%	0.3%	2.0%	2.0%
Exchange Rate US$/C$	-1.1%	-1.9%	1.9%	4.6%
MORNEAU SHEPELL BENCHMARK PORTFOLIOS[3]				
60% Equity/40% Bonds	0.7%	1.7%	6.3%	14.0%
55% Equity/45% Bonds	0.7%	1.7%	6.1%	13.0%
50% Equity/50% Bonds	0.8%	1.7%	6.0%	12.1%
45% Equity/55% Bonds	0.8%	1.7%	5.8%	11.1%
40% Equity/60% Bonds	0.9%	1.7%	5.7%	10.2%

[1] Indices currently branded as DEX Bond Indices will be transitioned to FTSE TMX Canada.

[2] Returns net of taxes on dividends, except for MSCI Emerging Markets.

[3] 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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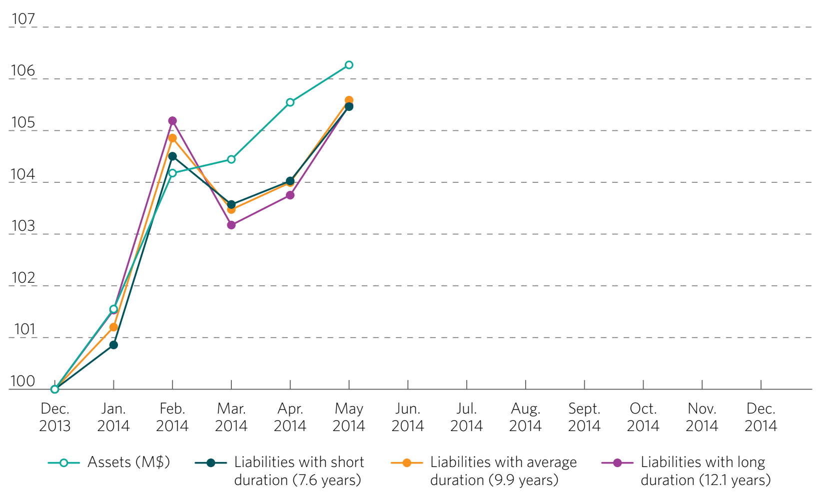
TRACKING THE FUNDED STATUS OF PENSION PLANS

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 May 2014, Canadian bonds and global equity (C$) markets showed positive returns while the Canadian stock market had slightly negative returns, which caused assets to increase by 0.7%. Annuity purchase rates and rates used in the calculation of solvency liabilities decreased, resulting in an increase of 1.5% in solvency liabilities for the average duration plan. The combined effect resulted in a decrease of the solvency ratio.

Since the beginning of the year, driven by strong returns in the Canadian bond and equity markets as well as the global equity (C$) markets the plan's assets increased by 6.3%. The solvency liabilities increased over that same period between 5.5% and 5.6% depending on the duration of the group of retirees. The increase in the plan's solvency ratio as at May 31, 2014 depends on the plan's initial ratio, but stands between 0.4% and 0.8%.

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 May 2014 for valuations effective December 31, 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.

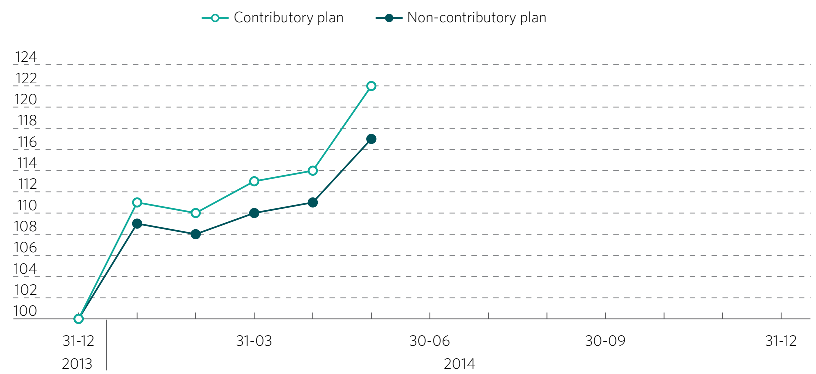
INITIAL SOLVENCY RATIO AS AT 12/31/2013	EVOLUTION OF THE SOLVENCY RATIO AS AT 05/31/2014 FOR THREE DIFFERENT GROUPS OF RETIREES		
	SHORT DURATION (7.6 YEARS)	AVERAGE DURATION (9.9 YEARS)	LONG DURATION (12.1 YEARS)
100%	100.8%	100.6%	100.7%
90%	90.7%	90.6%	90.7%
80%	80.6%	80.5%	80.6%
70%	70.5%	70.5%	70.5%
60%	60.5%	60.4%	60.4%

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.

EXPENSE INDEX FROM DECEMBER 31, 2013



(In %)						
Discount rate	4.7	4.3	4.3	4.3	4.3	4.1
Return on assets (55% equities)	0.0	1.6	2.4	0.2	1.0	0.7

The pension expense has increased by 22% (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	MAY 2014	CHANGE IN 2014
11	4.52%	3.89%	-63 bps
14	4.81%	4.16%	-65 bps
17	4.96%	4.33%	-63 bps
20	5.06%	4.44%	-62 bps

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

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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