MORNEAU SHEPELL

NEWS & VIEWS

IN THIS ISSUE

POOLED REGISTERED PENSION PLANS NOW AVAILABLE TO FEDERALLY REGULATED EMPLOYERS

On December 14, 2012, the federal *Pooled Registered Pension Plans Act* (the "PRPP Act") and the accompanying regulations (the "PRPP Regulations") came into force. The PRPP Act and Regulations only apply to federally-regulated employers and their employees, as well as to self-employed persons and any employees of federally-regulated employers in the Territories, but is the first step in the federal and provincial governments' initiative to implement "pooled registered pension plans" (PRPPs) nation-wide. A PRPP is a large-scale, defined contribution pension plan established and administered by a corporation that is a licensed PRPP administrator. PRPPs are meant to provide a low cost product that can be offered to employees with limited employer involvement.

The PRPP Act requires the federal Office of the Superintendent of Financial Institutions ("OSFI") to regulate PRPPs, just as it regulates registered pension plans under the *Pension Benefits Standards Act* ("PBSA"). PRPPs will also be subject to the federal *Income Tax Act*. OSFI has released a Frequently Asked Questions document and other summary documents on its website.

PARTICIPATION

An employer is not compelled but may choose to offer participation in a PRPP to one or more classes of its employees. All employees of an eligible class (as defined by the employer) must participate in the PRPP, except those who give notice of an objection to participation within 60 days of receiving notice of their membership in the PRPP. Part-time employees in that class must become members after no more than two years of continuous employment. Self-employed individuals and employees whose employer does not participate in the PRPP may also elect to participate in a PRPP, but only such persons who are employed in the Territories may join a federally regulated PRPP.

THE ADMINISTRATOR

The administrator of a PRPP must be licensed by OSFI. To obtain a licence, a would-be administrator must be a corporation, it must submit a five-year business plan addressing its proposed PRPP offerings and it must demonstrate its capabilities to manage a PRPP.

The administrator is responsible for the day-to-day administration of the PRPP. The employer selects the PRPP offered by a particular administrator and may also change the PRPP subject to certain notice requirements. The PRPP Act states that the administrator has the duties of a trustee in respect of PRPP members, and must exercise the degree of care of a reasonably prudent person, taking into account the administrator's business. The PRPP Act also states that the employer is not liable for the actions and omissions of the administrator.

PRPP INVESTMENTS

The administrator selects the PRPP's investments. A PRPP is not required to provide investment choice, but if it does, the investments choices are subject to regulation. The plan may offer up to six investment options of varying degrees of risk and expected return, which would allow a reasonable and prudent person to create a portfolio of investments appropriate for retirement savings.

The administrator must designate a default investment option in case a member does not make an investment choice. The default investment option must be either a balanced fund or a fund tied to the member's age, such as a life-cycle fund.

LOW COST

The PRPP Act requires PRPPs to be provided at a "low cost". The Regulations define "low cost" as costs at or below those incurred by members of defined contribution plans that provide investment options to groups of 500 or more members. The cost must be the same for all members of the PRPP. OSFI's FAQ document states that a corporation applying for a licence to be a PRPP administrator must provide a cost estimate and demonstrate how it intends to meet the low cost requirement. The PRPP Regulations also require significant ongoing disclosure of PRPP costs to members.

CONTRIBUTIONS

PRPP contributions are determined by agreement between the administrator and the employer. An employer is not required to contribute to a PRPP, although it may elect or agree to do so. Member contributions are mandatory at the rate set by the administrator for the first 12 months of plan membership, after which a member may reduce his or her contribution rate to zero. An employer is responsible for paying its own contributions and remitting employee contributions within 30 days from the end of the month, similarly to employer requirements under other pension legislation. Contributions are immediately vested.

INCOME TAX TREATMENT

The *Income Tax Act* generally provides that contributions to a PRPP are included in the RRSP limit applicable to the individual employee. There is therefore no "pension adjustment". As well, like with RRSPs, there is a penalty tax levied on over-contributions. One key advantage to PRPPs is that employer contributions to a PRPP are generally treated in the same way as employer contributions to a DC pension plan. Therefore, unlike amounts paid by an employer to an employee's group RRSP account, employer PRPP contributions are not subject to payroll taxes, such as Canada/Quebec Pension Plan or Employment Insurance contributions.

LOCKING-IN AND PERMITTED TRANSFERS

Member PRPP entitlements are locked-in in the same way that registered pension plan entitlements are locked-in. Upon termination of employment, members may transfer their PRPP entitlement to the same vehicles permitted under the PBSA. As under the PBSA, funds may also be transferred to an insurer for the purchase of a life annuity. The payment of RRIF-type variable benefits from a PRPP account is also permitted.

Exceptions to locking-in exist for members with shortened life expectancy, members with small benefits, members who have ceased to be Canadian residents and in cases of financial hardship.

COMMENTARY

The passage of the PRPP Act and Regulations will have limited significance in itself, in that its scope is limited to federally regulated employment, and employers have no obligation to offer one. It is significant, however, as a model for provinces who are considering adopting legislation to facilitate PRPPs for provincially-regulated employees. Thus far, only Quebec has committed to introduce such legislation in respect of its own version of the PRPP, the Voluntary Retirement Savings Plan.

Whether PRPPs become a viable model for expanding pension coverage remains to be seen. From an employer's point of view, key advantages include the limitations on employer responsibility for plan administration and the exemption from payroll tax on employer contributions. It will be interesting to observe how the requirement for "low cost" plan administration and investment is met. The standardization of investment offerings and the member "opt-out" right are other provisions where PRPPs differ from standard defined contribution pension plans.

NEW BOOK DEFUSES PERCEIVED RETIREMENT CRISIS

There is a widespread perception that Canada is heading toward a retirement crisis. Pension plan coverage in the private sector is low and only a third of taxpayers contribute to an RRSP in a given year. Meanwhile, government pensions may seem insufficient and might even be expected to shrink rather than grow.

Even so, a new book co-authored by Fred Vettese, Chief Actuary and Bill Morneau, Executive Chairman, explains why such fears may be overblown. The book, entitled *The Real Retirement: Why You Could Be Better Off than You Think and How to Make That Happen*, identifies two main reasons why we may well avert a retirement crisis. First, realistic retirement income targets may be lower than we have been led to believe. Second, our sources of retirement income may be greater than we realize, considering various assets many of us have at our disposal.

While retirement planning over the next 20 years may well be more challenging than the last 20, we should be able to weather the changes by working a bit longer. This outcome will not be as bad as it sounds since the extra years of work may involve shorter, more flexible hours as employers try to find ways to retain 60-somethings in the workforce. This may become increasingly important as labour shortages are expected to emerge in the next decade.

The Real Retirement is available in bookstores and online at Chapters-Indigo, Amazon.ca and Apple's iBook store.

TARGET BENEFIT PLANS FOR CERTAIN COMPANIES IN THE PULP AND PAPER SECTOR

On December 6, 2012, the Quebec National Assembly adopted Bill 15, which allows the creation of target benefit pension plans (TBPP) in certain companies in the pulp and paper sector, such as Resolute Forest Products and White Birch Paper. This one-page bill contains very few details, so implementation rules and conditions will be set out in the upcoming regulation. The bill specifies that a TBPP is a pension plan that determines in advance the employer contributions and, if applicable, the employee contributions, or the method of calculating them, and provides that the pension is subject to the plan's financial situation.

The transcript of the Bill's review by the Committee on Labour and the Economy indicated that the White Birch Paper pensions may be improved in the new TBPP, thus decreasing the cutback in retirees' pensions that resulted from the termination of the company's defined benefit pension plan. This improvement would represent a $35 million liability. However, this matter does not seem to be settled.

With respect to Resolute Forest Products, it had already signed an agreement with the unions to establish target benefit pension plans as of the beginning of 2011. The new rules could then affect these plans retroactively, but not earlier than December 31, 2010.

As far as other employers are concerned, they will still have to wait before being able to establish a TBPP. In fact, it appears that the committee that was formed to develop the TBPP rules will now wait for the expert committee on the future of the retirement system, chaired by Alban D'Amours, to table its report. The D'Amours committee's report is expected in the winter of 2013.

NEW BRUNSWICK FINE TUNES SHARED RISK PENSION PLANS

On December 11, 2012, the New Brunswick government announced further proposed amendments to the *Pension Benefits Act* ("PBA") via the introduction of Bill 20. The proposed amendments are designed to clarify the recently introduced shared risk pension plan ("SRPP"). The SRPP model was originally introduced on July 1, 2012, and is similar to a target benefit plan (defined benefit formula, fixed contributions, potential benefit adjustments) but is designed on a more robust risk management and governance model. Some highlights of the proposed amendments are:

CONTRACT AND TRUST LAW

The proposed amendments clarify that a pension plan may be converted to an SRPP and vested benefits may be affected despite any existing contracts or trusts.

POSSIBILITY OF REDUCTION OF VESTED BASE BENEFITS

The Bill proposes to amend the definition of "base benefits" to "vested base benefits". This is to clarify that following a conversion of a pension plan to an SRPP, vested base benefits accrued prior to conversion can be reduced in accordance with the SRPP funding policy. The SRPP model is designed to carefully manage the probability of benefit reductions, however such reductions are possible if the SRPP's financial situation is below the required 100% funded target for two consecutive years.

ENHANCED AND EXPANDED IMMUNITY FOR ADMINISTRATIVE FUNCTIONS

The PBA currently offers immunity to various governmental authorities and plan administrators, and to their officers, directors, and employees who exercise the "care, diligence and skill" of a reasonably prudent person. This immunity provides protection in relation to issues that may arise out of conversion to the SRPP model. The Bill proposes to extend this immunity to a number of new groups and individuals, such as trustees, employers and trade unions, who must also exercise the care, diligence and skill of a reasonably prudent person.

Importantly, the current PBA only provides immunity for actions undertaken pursuant to conversions to SRPPs. The Bill proposes to significantly expand this immunity to any and all actions undertaken pursuant to the PBA, not just SRPP conversions, that are exercised with due care and diligence.

In December of 2012, the City of St. John and its four unions, representing inside workers and outside workers, police and firefighters, all signed a memorandum of understanding to convert to the SRPP model. This is a good indication that the SRPP model is gaining traction and may result in a paradigm shift in pension plans in the future.

NOVA SCOTIA PENSION REGULATIONS

The Nova Scotia Department of Labour and Advanced Education released Draft Regulations on December 7, 2012 which, if approved, will introduce new pension rules in Nova Scotia. The draft Regulations propose, unlike most other provinces, to continue to allow partial pension plan wind-ups. The proposed introduction of advisory committees, consisting of current, former and retired members, provides plan members with avenues to obtain information about their plan.

The draft Regulations also allow employers to offer phased retirement programs and allow defined contribution pension plans to pay variable benefits, both of which are closely aligned with the provisions of the *Income Tax Act*. Clarification is also provided regarding the rules for an employer using a letter of credit with respect to a solvency deficiency.

These December 7, 2012 Regulations are in addition to the draft Regulations that were previously released on December 7, 2011 concerning pension funding. Nova Scotians are now awaiting further information on, and perhaps the proclamation of, the new *Pension Benefits Act* (Bill 96) and these draft Regulations.

On January 3, 2013, the province also announced amendments to the *Pension Benefits Act* which will relax the funding requirements for the defined benefit pension plans of police officers, municipal staff, university professors and staff, non-teaching staff in public schools, and other employees at government-funded agencies. The amendments will provide exemption from solvency deficiency funding, on specified conditions, and extend the time for paying contribution and special payment increases.

TAX AND PENSION CHANGES EFFECTIVE JANUARY 1, 2013

This article summarizes key changes to the *Income Tax Act* (Canada) and *Pension Benefits Act* (Ontario) that became effective January 1, 2013.

INCOME TAX ACT (ITA)

EMPLOYER-PAID CONTRIBUTIONS TO GROUP SICKNESS OR ACCIDENT INSURANCE PLANS

As announced in the 2012 Federal Budget and summarized in our *Special Communiqué*, the ITA was amended to include in an employee's income from employment for a year the amount of an employer's contribution to a group sickness or accident insurance plan to the extent that benefits payable under the plan would not otherwise be taxable in the employee's hands.

This includes employer-paid contributions to plans that pay out lump sums to beneficiaries, such as critical illness insurance plans. Employer contributions to wage-loss replacement plans that pay periodic benefits will continue not to be taxable, as benefits under these plans are generally taxable to a recipient when paid.

The change is applicable to employer contributions made in 2013 as well as to employer contributions paid on or after March 29, 2012 and before 2013, to the extent they relate to coverage in 2013 and beyond.

INCOME-SPLITTING UNDER RETIREMENT COMPENSATION ARRANGEMENTS

The ITA was amended to allow a beneficiary of a "retirement compensation arrangement" (RCA) to split his or her income with a spouse, as is currently permissible with respect to pensions payable from a registered pension plan. The beneficiary must have reached a minimum age of 65 in the year in which the splitting is proposed to occur. This measure applies to 2013 and subsequent taxation years.

REGISTERED DISABILITY SAVINGS PLANS (RDSPs)

Human Resources and Skills Development Canada must now be notified "without delay" of the establishment of an RDSP plan (instead of the previous 60 day deadline). The amendments also require that, when an RDSP is transferred from one issuer to another, notification of the transfer occur "without delay" (instead of the previous 120 day deadline). In some cases, this requirement may be more lenient than the previous strict timelines.

ONTARIO *PENSION BENEFITS ACT* (PBA)

LETTERS OF CREDIT

Pursuant to amendments to the PBA first passed in 2010 and declared in force on January 1, 2013, and the recently filed regulations, Ontario employers may now use one or more letters of credit (LOCs) that meet prescribed criteria to fund up to 15% of a defined benefit plan's solvency liabilities.

For more information, consult our December 2012 *News & Views* article on Ontario's new LOC rules.

MANDATORY ELECTRONIC FILING

Electronic filing is the only method available to submit prescribed filings with the Financial Services Commission of Ontario that are due on or after January 1, 2013. The affected filings are the Annual Information Return, Investment Information Summary, Pension Benefits Guarantee Fund Certificate, Actuarial Information Summary, pension fund financial statements and actuarial valuation reports. The documents must be filed using the Pension Services Portal. For more information, consult our April 2012 *News & Views* article on this announcement.

OUTSTANDING LEGISLATIVE PROVISIONS NOT YET PROCLAIMED IN FORCE

Although many of the Ontario pension reform announcements that were enacted in Bills 120 and 236 have now been enacted, a number have not yet been proclaimed into force. Amendments to the PBA requiring advance notice of all plan amendments (not just "adverse" amendments) have not yet been proclaimed in force.

Requirements that annual statements be sent to former members, retired members and beneficiaries are also not yet in force. Further amendments to the regulations will be required to enact these requirements. There is no indication when these provisions may be proclaimed into force.

AMENDMENTS TO INDIVIDUAL PENSION PLANS

On December 18, 2012, the Canada Revenue Agency (CRA) announced that for the time being it will not require the amendments that it had been seeking for minimum payouts from Individual Pension Plans (IPPs) covering related persons, if a plan is subject to pension standards legislation and the pension regulator has publicly stated that it will refuse such an amendment. In Ontario, the Financial Services Commission (FSCO) had taken the position that based on Ontario's pension legislation, it would not register the amendments CRA had been seeking. Further guidance will be provided by CRA in relation to the filing of such an amendment in due course.

The need for such an amendment stemmed from the 2011 Federal budget, which provided that, commencing in 2012, minimum amounts would be required to be withdrawn each year after the member attains 71 years of age, equal to the greater of the regular annual pension payment and a new minimum amount calculated as if the member's share of IPP assets were held in a Registered Retirement Income Fund (RRIF) (see our April 14, 2011 *News & Views*). Even if an amendment to an IPP is not required by CRA at this time, IPPs with related members who reached age 71 are still required to pay out the required minimum amount and regulatory approval for the payout may be required.

SUPREME COURT RULING ON SURPLUS: AN UNFUNDED GOVERNMENT-SPONSORED PENSION PLAN IS NOT LIKE A PRIVATE PLAN

On December 19, 2012, in a unanimous decision, the highest court of Canada stated that members of the federal public service Plan, the RCMP Plan and the regular force of the Canadian Forces Plan were not entitled to an estimated $30 billion "surplus".

The three plans are administered by the Government of Canada, and each is a contributory, defined benefit plan. The statutes governing the plans established for each one separate "Superannuation Accounts", which records payments into and out of the plan. On April 1, 2000, the *Public Sector Pension Investment Board Act* ("Bill C-78"), which amended the plans and created actual pension funds, came into force.

Consequently, since April 1, 2000, employee and government contributions have been made to the pension funds put in place further to Bill C-78. However, all benefits for pensionable service prior to April 1, 2000, when paid, are charged to the appropriate Superannuation Accounts. Bill C-78 also required the Minister to debit from the Superannuation Accounts certain amounts in excess of specified actuarial surplus ceilings. On the basis of Bill C-78, the government debited over $28 billion directly from the Superannuation Accounts, thereby reducing the actuarial surplus in those accounts.

Various unions and associations filed suit requiring the government to return $28 billion to the plans, plus interest. Essentially, the plaintiffs' position was that the federal Government took pension surplus to pay down the country's deficit. Many arguments were put forward by the plaintiffs but they were all rejected by the Court. Most notably, the Court concluded that:

1. The Superannuation Accounts are legislated records and do not contain assets in which the Plan members have a legal or equitable interest. The plan members' interests are limited to their interest in the defined benefits to which they are entitled under the plans.
2. As the Superannuation Accounts do not contain assets, there was no property in respect of which plan members can have a legal or equitable interest. However, even if the Superannuation Accounts did contain assets, plan members have no proprietary interest in either their contributions or in the government credits under the *Superannuation Acts*.
3. The government, although administrator of the plans, is not subject to a fiduciary obligation in favour of the plan members with respect to the actuarial surplus. The government's duty was to act in the best interests of society as a whole. According to the Court, this is inconsistent with the existence of a fiduciary duty.

The Court referred to its decision in *Schmidt v. Air Products Canada Ltd.* (1994), as the leading statement of the law on pension plan surpluses. The Court reminded the parties that this case established the principle that, in the absence of overriding legislation, the first step to assessing competing claims to the surplus is to determine, in accordance with ordinary principles of trust law, whether the pension fund is impressed with a trust. If it is, all applicable trust principles apply. If, on the other hand, the pension fund is not subject to a trust, entitlement to the surplus is assessed in accordance with the principles of contract interpretation.

The Court also referred to its more recent decisions in *Burke v. Hudson's Bay Co.* (2010), along with *Nolan v. Kerry (Canada) Inc.* (2009) and *Monsanto Canada Inc. v. Ontario (Superintendent of Financial Services)* (2004), which established that entitlement to a pension plan surplus is determined according to the words of the relevant documents, applicable contract and trust principles and statutory provisions.

However, the Court came to the conclusion that because those decisions were rendered in the context of private sector pension plans rather than statutory public sector pension plans, the applicable legal principles are not exactly the same.

Furthermore, it is not clear if the Court would have reached the same conclusion if the plans had been funded through pension funds as are all private pension plans in Canada. Finally, although the Court made distinctions between public and private sectors pension plans, this decision is in line with other recent decisions where the Court has been reluctant to acknowledge proprietary rights to the actuarial surplus of an on-going pension plan and to impose on administrators of pension plans a fiduciary duty with respect to the use of actuarial surplus.

COST REDUCTIONS IN PROVINCIAL DRUG PLANS

NEW GENERIC DRUG PHARMACY AGREEMENT IN BRITISH COLUMBIA

The British Columbia government has announced that new generic drug pricing regulations will come into effect on April 1, 2013. This change will reduce the cost of generic drugs covered under the provincial PharmaCare program to 25% of the brand name price. As of April 1, 2014, the generic cost will be reduced to 20% of the brand name price.

British Columbia first announced generic drug price reductions in July 2010 that came into effect in October 2010. In February 2012, the BC government announced the agreement would end as cost reductions to the provincial PharmaCare program had not met expectations.

While this is positive news for plan sponsors, significant reductions in prescription drug claim costs are not likely. Price reductions are only applicable to drugs covered under the PharmaCare program. The prices of generic drugs not included in the PharmaCare formulary are not impacted, nor are brand name drug prices. As well, in aggregate aging employee populations and the proliferation of biologic and high-cost drugs will lead to increased prescription drug costs for plan sponsors. Taking all of these factors into account, the annual rate of prescription drug claim inflation is expected to increase in the coming years after having stabilized over the most recent few years.

British Columbia's announcement may impact generic drug pricing in Quebec as well, considering that Quebec's drug policy stipulates that the price demanded by the generic drug manufacturers may not exceed the lowest price offered in other Canadian provinces (also referred to as the "trailer clause"). While Ontario announced earlier in 2012 that the price of the top 10 generic drugs would be cut to 20% of the brand name price, British Columbia's reduction to this level in 2014 will apply to a wider range of drugs. Quebec may match this pricing when it takes effect, though there could be changes in other provinces in the interim.

Note that these reductions only apply to generic drug pricing and do not affect mark-up or dispensing fees which also contribute to the final cost.

Now more than ever, plan sponsors should consider implementing a pay-direct drug card if one is not already in place. Doing so enables a myriad of cost control options such as formularies, tiered coinsurance, and restrictions on dispensing fees and mark-up.

QUEBEC ENDS 15-YEAR RULE FOR REIMBURSEMENT OF BRAND NAME DRUGS

Quebec's 2013 budget announced the elimination of the "15-year rule" which required the provincial drug plan to reimburse the brand name drug price even after patents had expired and generic alternatives were available. The rule was introduced in 1994 to encourage pharmaceutical industry investment in the province. No effect is expected for plan sponsors as the change affects only the RAMQ program.

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	-0.1%	0.3%	3.6%	3.6%
DEX 91 Day Treasury Bill	0.1%	0.3%	1.0%	1.0%
DEX Short Term Bond	0.0%	0.3%	2.0%	2.0%
DEX Mid Term Bond	-0.1%	0.4%	4.6%	4.6%
DEX Long Term Bond	-0.3%	0.1%	5.2%	5.2%
DEX High Yield Bond	0.8%	3.5%	14.7%	14.7%
DEX Real Return Bond	-0.8%	0.0%	2.9%	2.9%
CANADIAN EQUITY INDICES				
S&P/TSX Composite (Total Return)	1.9%	1.7%	7.2%	7.2%
S&P/TSX Composite Capped	1.9%	1.7%	7.2%	7.2%
S&P/TSX MegaCap	1.8%	1.5%	5.8%	5.8%
S&P/TSX 60 (Total Return)	1.9%	2.3%	8.1%	8.1%
S&P/TSX Completion	1.9%	0.0%	4.7%	4.7%
S&P/TSX Small Cap	2.4%	-2.0%	-2.2%	-2.2%
BMO Small Cap Unweighted	3.3%	-1.6%	-0.5%	-0.5%
BMO Small Cap Weighted	2.8%	-1.1%	2.5%	2.5%
U.S. EQUITY INDICES				
S&P 500 (US$)	0.9%	-0.4%	16.0%	16.0%
S&P 500 (C$)	1.0%	0.8%	13.5%	13.5%
FOREIGN EQUITY INDICES[1]				
MSCI ACWI (C$)	2.5%	4.1%	13.6%	13.6%
MSCI World (C$)	2.1%	3.7%	13.3%	13.3%
MSCI EAFE (C$)	3.4%	7.8%	14.7%	14.7%
MSCI Europe (C$)	3.1%	8.3%	16.5%	16.5%
MSCI Pacific (C$)	4.4%	7.2%	11.9%	11.9%
MSCI Emerging Markets (C$)	5.1%	6.9%	16.0%	16.0%
OTHER				
Consumer Price Index (Canada, November 2012)	-0.2%	-0.1%	1.4%	0.8%
Exchange Rate US$/C$	0.1%	1.2%	-2.2%	-2.2%
MORNEAU SHEPELL BENCHMARK PORTFOLIOS[2]				
60% Equity/40% Bonds	1.2%	1.7%	7.6%	7.6%
55% Equity/45% Bonds	1.1%	1.6%	7.3%	7.3%
50% Equity/50% Bonds	1.0%	1.5%	6.9%	6.9%
45% Equity/55% Bonds	0.8%	1.4%	6.6%	6.6%
40% Equity/60% Bonds	0.7%	1.3%	6.3%	6.3%

[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.

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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 DECEMBER 31, 2012

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, 2007. For this illustration, assets and liabilities of the plan were each arbitrarily set at $100 million as at December 31, 2007. The 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, 2007

In December 2012, both assets and liabilities rose. Due to positive returns in Canadian and most international equity markets, assets increased by 1.1% to about $116.4 million. Moreover, solvency liabilities increased by 0.7% and ended the year at $159.6 million. Consequently, the solvency deficit decreased by 0.2% during the month and reached $43.2 million.

Assets increased by 7.3% and liabilities increased by 8.9% during 2012. The funded status of this typical pension plan has therefore deteriorated, with the deficit increasing to $5.2 million, prior to application of any employer special contribution to fund the deficit. As at December 31, 2012, the solvency ratio of this pension plan was 72.9% compared to 74.1% as at December 31, 2011. However, taking special contributions into account we could expect an improvement in this typical pension plan's financial situation. So, in 2012, any improvement in funded status has been entirely financed entirely by employer contributions.

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

CANADA BOND YIELDS

	YIELD (CLOSING) DEC. 2011	YIELD (CLOSING) DEC. 2012	CHANGE 2012
Overnight rate target	1.00%	1.00%	0 bp
3 months	0.82%	0.92%	10 bps
2 years	0.95%	1.14%	19 bps
5 years	1.27%	1.38%	11 bps
7 years	1.51%	1.55%	4 bps
10 years	1.94%	1.80%	-14 bps
30 years	2.49%	2.36%	-13 bps

Source: Bank of Canada

Comments:

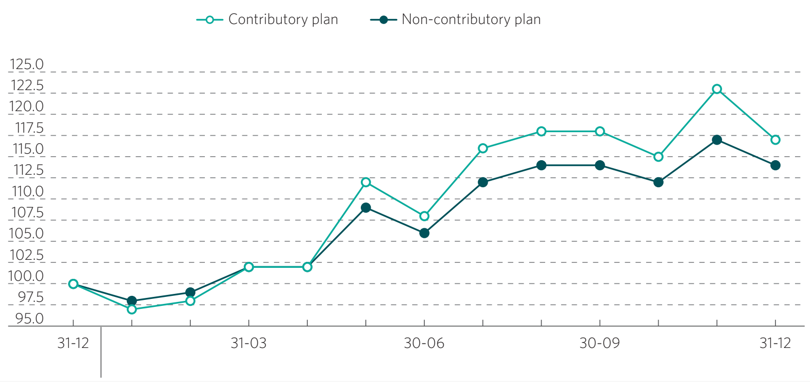
1. No consideration has been made for contributions paid to the plan or for benefits paid out of the plan.
2. Solvency liabilities are projected using the rates prescribed by the Canadian Institute of Actuaries for the purpose of determining pension commuted values. Early application of the 2009 standards is not reflected.
3. The underlying typical defined benefit plan is a final average plan with no pension indexing.
4. Solvency liability calculations take into account revised CIA guidance on the solvency valuation assumptions (annuity proxy).
5. Assets are shown at full market value. Returns on assets are based on those of the Morneau Shepell benchmark portfolio (55% equities and 45% fixed income).

IMPACT ON PENSION EXPENSE UNDER INTERNATIONAL ACCOUNTING

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

The following 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, 2011



(In %)													
Discount rate	4.3	4.2	4.2	4.1	4.2	4.0	4.1	3.8	3.8	3.7	3.8	3.6	3.7
Return on assets (55% equities)	n/a	2.4	1.1	0.1	-0.7	-1.9	1,3	0.4	0.9	1.9	0.5	0.1	1.1

The pension expense has risen by 17% (for a contributory plan) since the beginning of the year due to the decrease in the discount rate since December 31, 2011. However, this month, the discount rate was in fact slightly higher, so the pension expense decreased in December.

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 2011	DECEMBER 2012	CHANGE IN 2012
11	4.16%	3.61%	-55 bps
14	4.39%	3.80%	-59 bps
17	4.51%	3.92%	-59 bps
20	4.58%	4.00%	-58 bps

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

Comments:

1. The discount rates shown reflect the educational note published by the Canadian Institute of Actuaries entitled *Accounting Discount Rate Assumption for Pension and Post-employment Benefit Plans* (September 2011).
2. The expense is established as at December 31, 2011, based on the average financial position of the pension plans used in our *2011 Survey of Economic Assumptions in Accounting for Pensions and Other Post-Retirement Benefits* report (i.e. a ratio of assets to obligation value of 85% as at December 31, 2010). Also, we are assuming that, under the international accounting, the employer elected the exemption at transition with regards to past gains and losses, and that future gains and losses are recognized in other comprehensive income (excluded from expenses shown).
3. The return on assets corresponds to the return on the Morneau Shepell benchmark portfolio (55% equities and 45% fixed income).
4. 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 Canada-based human resource consulting and outsourcing firm focused on pensions, benefits, employee assistance program (EAP) and workplace health management and productivity solutions. We offer business solutions that help our clients reduce costs, increase employee productivity and improve their competitive positions by supporting their employees' financial security, health and well-being.

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Please contact your Morneau Shepell consultant for additional information about this newsletter.