MORNEAU SHEPELL

IN THIS ISSUE

ANNUAL COMPENSATION AND BENEFITS SURVEY HIGHLIGHTS

The results of Morneau Shepell's 31st annual Compensation survey were recently presented to more than 1,000 human resources professionals in seminars from coast to coast. This survey is unique in Canada, capturing trends in pensions, benefits and health management in addition to cash compensation, from 300 organizations counting nearly 3 million employees.

Although on the surface it appears compensation budget increases remain stable, we can expect creativity to attract and retain valuable talent.

CASH COMPENSATION - KEY TRENDS

While the average salary increase budget for 2014 is similar to last year, at 2.6%, the environment is far from stable and the survey revealed important issues. With salary increase budgets still below the level they were prior to the 2008 financial crisis, HR leaders are scrambling to make the most of available financial resources. Here are key survey findings.

- Not surprisingly, the largest salary budget increases are expected in Western and Atlantic Canada, and the lowest in Ontario and Quebec. However, 60% of participants with operations in more than one region (e.g. Alberta and Ontario) forecast salary increase budgets that will be the same in all regions where they hire staff.
- HR leaders are increasingly concerned with the competitiveness of their total compensation offer: 70% indicated that to be a key issue for 2014, compared to only about 45% in prior years.

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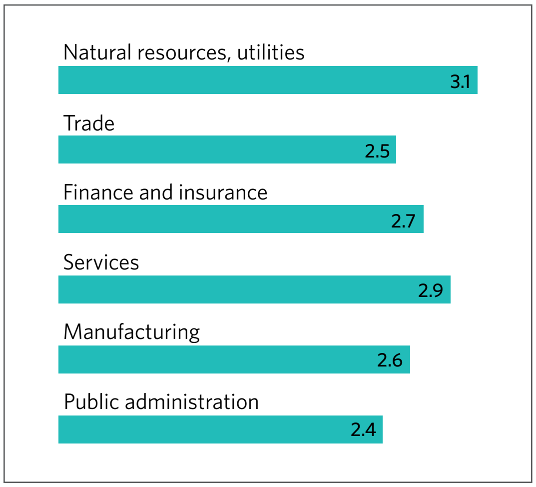
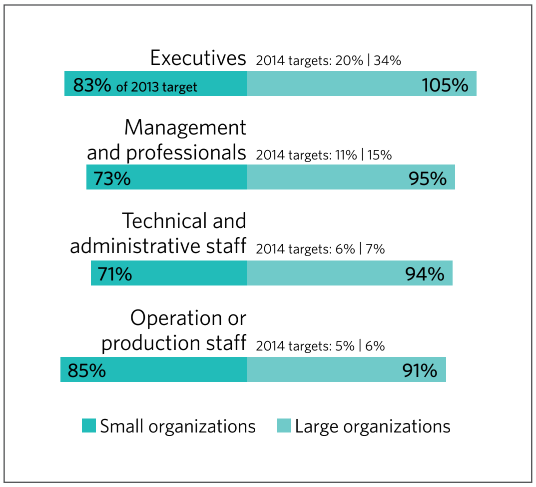
- While very few participants forecast salary freezes for 2014, 20% indicate potential freezes to salary structures (e.g. pay scales or ranges), redirecting most of the new money from long service employees to new hires. Again, this percentage is significantly higher than in prior years. Here is the 2014 average salary adjustment forecast in key industries for management and professionals:



- Over 60% of respondents in large organizations (with annual revenues or budget over $1B) will be awarding top performers twice the average salary increase or more. This means that HR policies and tools in place allow these organizations to reward top performers. In smaller organizations however (annual revenues or budget below $100M), the picture is drastically different, as more than 75% of respondents indicate that they will not differentiate salary increases between top performers and the rest of the workforce. Smaller organizations would be well advised to revamp their salary administration tools to help retain top talent.

- With respect to bonus policies, here are the average survey results for actual payouts as a percentage of 2013 targets, differentiated for small and large organizations and by job categories, along with average 2014 target forecasts:



BENEFITS AND HEALTH MANAGEMENT

Nearly one third of respondents are planning to introduce various initiatives in response to the National Standard for Psychological Health and Safety in the Workplace released earlier this year (see December 2012 *News & Views* for details).

As the issue of mental health in the workplace has grabbed significant attention recently, organizations are planning to address this next year by beginning to train managers and supervisors, so they may be better equipped to cope with these delicate and complex situations. As many as 40% of respondents plan to implement a formal mental health training program (see May 2013 *News & Views* for details on such innovative programs).

Even though nearly 70% of respondents identified health care cost as a key issue for 2014, as many as 25% either improved their health care program in the last couple of years or plan to do so next year. This suggests that employers seek more effective benefit program design to enhance their total compensation package while salary increase budgets are limited.

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PENSIONS

About half of the respondents sponsor defined benefit (DB) pension programs and half sponsor defined contribution (DC) programs.

For DB plan sponsors, the key survey findings are:

- in the private sector, more than half have closed their DB plans to new entrants, with new hires being enrolled in a DC scheme.
- over the last couple of years, more than half of DB sponsors have taken concrete actions to reduce employer pension costs, while over two-thirds of DB sponsors identified pension cost as a key issue for 2014, refocusing from risk management to direct cost management.

While only 5% of DC plan sponsors are planning to increase contributions to cope with the looming retirement savings shortfall, the majority of respondents are strongly advocating financial education for plan members.

A detailed report of the survey results is available (click *here*).

PENSION PLAN RISK TRANSFER - LONGEVITY SWAPS

INTRODUCTION

The costs of defined-benefit pension plans are calculated using numerous assumptions, one of which is the life expectancy of its retirees. Calculating the value of expected future benefit payments based on such an assumption comes with a significant risk – that plan members may live longer than expected. This risk, known as longevity risk, can cause significant increases in pension plan costs. For example, an additional year of payment to a retiree could increase the present value of a pension by approximately 3 to 4 percent. Traditionally, this risk could only be hedged by the purchase of insured annuities, otherwise increases in life expectancy could only be dealt with by increasing plan sponsors' contributions, adjusting member benefits, or hoping for rosier investment markets. New products have been developed which can help mitigate or hedge away this risk. In this article we explore longevity swaps as an instrument for this purpose.

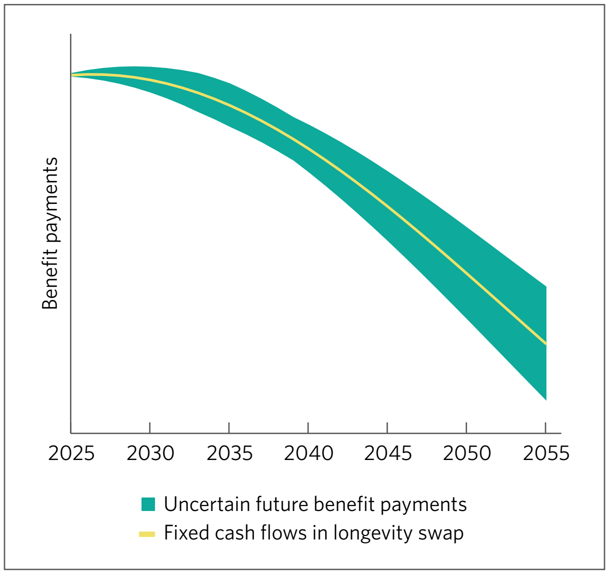
In comparison to annuity buy-outs and buy-ins where interest rate, investment and longevity risk are transferred to a counterparty, longevity swaps allow plans to transfer longevity risk while retaining interest rate and investment risks. This is a new concept in North America, where no plans have yet entered into one of these contracts; but several have been done by pension funds in the UK. One reason that may explain the lack of interest in Canada for longevity risk transfer instruments is that pension plans often use more aggressive mortality rates and discount rates to estimate liabilities.

In August the Office of the Superintendent of Financial Institutions Canada (OFSI) released a draft policy advisory and memorandum providing guidance to plan administrators who are considering entering into such contracts. Also in August, the Joint Forum, a committee in Europe that deals with issues common to the banking, securities and insurance sectors, published a paper on longevity risk transfer. The Joint Forum paper describes the current size and structure of the longevity risk transfer markets around the world and was primarily written to raise awareness on the potential risks associated with longevity risk transfer such as swaps.

LONGEVITY SWAPS

There are two main types of longevity swaps: indemnity-based contracts and index-based contracts. For both, the pension fund administrator makes periodical predetermined premium payments to the counterparty based on the expected benefit payments to the beneficiaries. In return, the counterparty makes payments back to the administrator. For indemnity-based contracts, the counterparty provides the administrator with regular floating payments based on the pension plan's actual mortality experience. Alternatively, for index-based contracts, the payments are based on an agreed upon mortality index. In practice, these sets of payments offset each other and the payment flows are often netted. This method of payment has the advantage of reducing the counterparty risk associated with the contract. Although the administrators could potentially pay more with the contract in place, in order to reflect the group's experience and the counterparty's costs and profits, the plan has more predictable outflows, reducing the volatility of the plan's future benefit payments. This is illustrated in the following graph.

TYPICAL PENSION PLANS FUTURE BENEFIT CASH FLOWS



Pension plans can swap an undefined future benefit payment stream for a known stream through longevity swaps

Entering longevity swap contracts does not come without certain additional risks. The possibility that the counterparty will not be able to fulfill its contractual obligations is an important one to consider, however the risk stems not from the pension payments made to the beneficiaries, but from the additional payments resulting from the beneficiaries living longer than expected, so it would typically be the net payment at risk, not the full payment from one party. The counterparty risk can be mitigated through collateral agreements between both parties in the swap contract. Further, index-based contracts also face basis risk, which comes from the actual mortality experience of the pension plan differing from the index on which the contract is based (i.e. a mismatch when the index is not representative of the plan membership). Other risks to which pension plans may be exposed in entering longevity swaps are rollover risk (risk that the contract expires before the liability) and legal risk.

SPECIAL CONSIDERATIONS

Advantages of a longevity swap contract include the possibility that the longevity risk could be hedged for only a subset of the pension plan population and that the longevity risk could be isolated for a transfer to counterparty. However, entering into longevity swap contracts should not be done without proper due diligence. Several considerations should be made, including the following:

1. **Cost:** Is the cost of the contract going to be more expensive than the increased payments made due to an assumption of the beneficiaries living longer than expected?
2. **Acceptability:** Entering into a longevity swap contract would have to be in the best interest of the beneficiaries and in accordance with the plan's Statement of Investment Policies and Procedures, the *Pension Benefits Standards Act* and the *Pension Benefits Standards Regulations*.
3. **Duration:** It is important to find a balance between contracts that are too short and expire before the life span of the liabilities and contracts that are too long and limit flexibility.
4. **Liquidity:** As there is currently no existing market where longevity swaps are traded, it would be impossible to sell or cancel a longevity swap contract once it has been entered into, unless such a market eventually develops.
5. **Actuarial Valuation Assumptions:** If the beneficiaries of the pension plan eventually die before expected (group experience), the funded position of the plan would be less than what it would be if the contract had not been entered into, since those unexpected experience gains would have been traded against potential experience losses.

OSFI VIEWS AND EXPECTATIONS

OSFI has no objections to a pension plan administrator entering into a longevity swap contract provided that the investment is permissible under the terms of the pension plan and the plan's Statement of Investment Policies and Procedures, and that it complies with the PBSA and the Regulations. Approval from OSFI to enter into such contracts is not required as long as the plan administrators continue to be responsible for making the payments to the beneficiaries, even in the event that a counterparty fails to make the contractual payments to the pension plan. OSFI expects administrators to perform due diligence before entering into such contracts. In particular, administrators should understand the impact of longevity risk on their pension plan, determine whether the longevity swap is worth the cost, and consider the additional risks of entering into such contracts.

Comments may be submitted to OSFI until December 6, 2013.

PUBLIC SECTOR PENSION PLAN CHANGES – ALBERTA

Recently, Canadian governments have been considering changes to their public sector pension plans. This article focuses on the proposed changes for Alberta. On September 16, 2013, the Government of Alberta announced a set of proposed changes to four public sector pension plans: the Local Authorities Pension Plan (LAPP), the Public Service Pension Plan (PSPP), the Management Employees Pension Plan (MEPP) and the Special Forces Pension Plan (SFPP). Together these Alberta plans have approximately 200,000 active members and 120,000 retirees and deferred retirees.

According to the Alberta Government, its proposed changes will preserve accrued benefits, improve benefit security, provide adequate advance notice to plan members and employers, and better control costs. The proposed changes would take effect January 1, 2016, or later, and include the following:

- The MEPP will be closed to new members at the end of 2015, with new managers (newly hired or promoted into management) participating in the PSPP.
- Any time from January 1, 2016, the PSPP, LAPP, and SFPP can become jointly sponsored by the major employee and employer stakeholders of each plan if sponsors reach agreement. They will continue to be jointly funded by employees and employers, who will continue to pay for the cost of new benefits earned as well as paying off any shortfalls over a maximum of 15 years.
- The sponsors will set benefits and funding policies within constraints set by the Government. The constraints will include a cap on total plan costs to protect contributors and taxpayers, and funding requirements to ensure that benefits are properly funded. Another constraint is that the funding of each plan will be split 50-50 between employees and employers.
- Expert boards of trustees, appointed jointly by the sponsors, will ensure that the plans are administered and assets invested in the best interest of plan beneficiaries. The boards of trustees will deal directly with the service providers, Alberta Pensions Services Corporation (APS) and Alberta Investment Management Corporation (AIMCo). Once a jointly sponsored plan is in place, and following a transitional period, the plan's board of trustees will be allowed to choose providers other than AIMCo for investment management and other than APS for administration, subject to their fiduciary responsibilities to plan beneficiaries. It is currently contemplated that this transitional period will be at least five years.
- The new jointly sponsored pension plans will have to be compliant with the *Employment Pension Plans Act*.

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- There will be a moratorium on benefit improvements until January 1, 2021.
- As the SFPP, which covers municipal police, has little funding by the Government, the Government will consult with stakeholders to recommend plan design changes.
- There will be no changes to benefits earned for service before 2016.
- The LAPP, MEPP and PSPP will be ending early retirement subsidies on service after 2015 for retirement before age 65.
- Cost-of living adjustments (COLA) on benefits earned after 2015 in the LAPP, MEPP and PSPP will be “targeted” at 50 per cent of the Alberta inflation rate. Contributions will be set so that there is a high likelihood that the “target” COLA will be paid, but it will no longer be guaranteed. COLAs could be reduced or suspended if the pension plan’s financial status deteriorates, and “catch-up” COLAs could be made later if the plan’s finances improve.
- Those already receiving pensions by the end of 2015 will continue to receive their pensions including COLA covering 60 per cent of Alberta inflation.
- Effective January 1, 2016, benefits will be vested from the first day of plan membership for active members.

The Government of Alberta will be consulting with stakeholders by December 31, 2013 and legislation is expected in the spring of 2014.

Alberta’s announcement seems to follow a certain trend. Jurisdictions, such as New Brunswick, Ontario and the federal government, already have announced some public sector pension reforms. The trend can be expected to continue as other public sector employers across Canada struggle to control pension costs.

AS AT SEPTEMBER 30, 2013

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%	0.1%	-1.6%	-1.3%
DEX 91 Day Treasury Bill	0.1%	0.3%	0.8%	1.1%
DEX Short Term Bond	0.4%	0.7%	1.0%	1.3%
DEX Mid Term Bond	0.8%	0.5%	-1.0%	-0.6%
DEX Long Term Bond	0.6%	-1.1%	-5.9%	-5.8%
DEX High Yield Bond	0.4%	1.6%	3.3%	6.9%
DEX Real Return Bond	-0.2%	-0.5%	-11.4%	-11.4%
CANADIAN EQUITY INDICES				
S&P/TSX Composite (Total Return)	1.4%	6.2%	5.3%	7.1%
S&P/TSX Composite Capped	1.4%	6.2%	5.3%	7.1%
S&P/TSX 60 (Total Return)	1.1%	6.2%	5.2%	7.6%
S&P/TSX Completion	2.2%	6.4%	5.7%	5.7%
S&P/TSX Small Cap	1.7%	8.0%	0.7%	-1.3%
BMO Small Cap Unweighted	-0.5%	8.0%	-4.2%	-5.7%
BMO Small Cap Weighted	0.4%	7.7%	0.7%	-0.4%
U.S. EQUITY INDICES				
S&P 500 (US$)	3.1%	5.2%	19.8%	19.3%
S&P 500 (C$)	0.9%	3.1%	24.1%	25.1%
FOREIGN EQUITY INDICES[1]				
MSCI ACWI (C$)	2.5%	5.1%	18.1%	23.0%
MSCI World (C$)	2.3%	5.4%	21.1%	25.6%
MSCI EAFE (C$)	4.6%	8.7%	19.9%	29.3%
MSCI Europe (C$)	4.4%	10.7%	19.8%	29.8%
MSCI Pacific (C$)	5.1%	5.2%	20.2%	28.8%
MSCI Emerging Markets (C$)	3.8%	3.2%	-1.0%	5.9%
OTHER				
Consumer Price Index (Canada, August 2013)	0.0%	0.1%	1.6%	1.1%
Exchange Rate US$/C$	-2.2%	-2.0%	3.6%	4.8%
MORNEAU SHEPELL BENCHMARK PORTFOLIOS[2]				
60% Equity/40% Bonds	1.3%	3.5%	7.0%	8.9%
55% Equity/45% Bonds	1.2%	3.2%	6.3%	8.0%
50% Equity/50% Bonds	1.2%	2.9%	5.6%	7.2%
45% Equity/55% Bonds	1.1%	2.7%	4.8%	6.3%
40% Equity/60% Bonds	1.0%	2.4%	4.1%	5.4%

[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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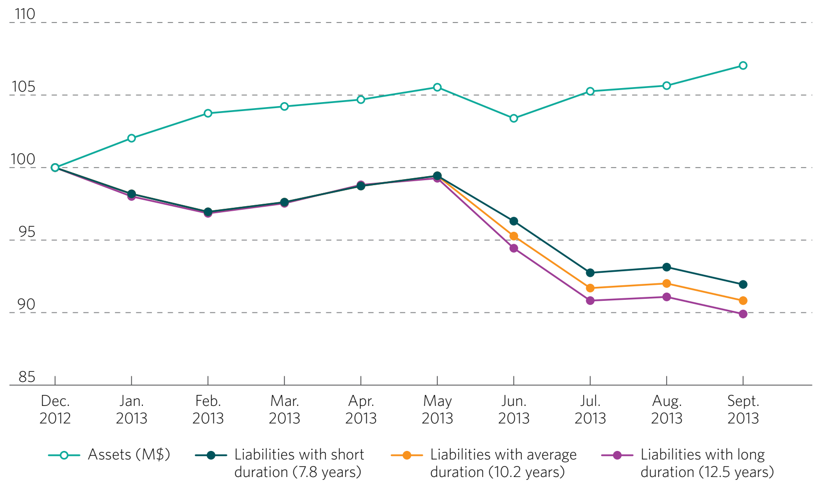
TRACKING THE FUNDED STATUS OF PENSION PLANS

This graph shows the changes in the financial position of a typical defined benefit plan since December 31, 2012. For this illustration, assets and liabilities of the plan were each arbitrarily set at $100 million as at December 31, 2012. This estimate of the solvency liabilities reflects the new CIA guidance published in September 2013 for valuations effective June 30, 2013 or later. Therefore, beginning on June 30, 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, 2012



In September 2013, Canadian bonds and most global equity markets rose which caused assets to increase by 1.3%. Moreover, the effect of an increase in transfer value rates used in the calculation of solvency liabilities caused liabilities to decrease by 1.3%, for the average duration group. The combined effect resulted in an improvement of the solvency ratio.

The table beside shows the impact of past returns on plan assets and the effect of interest rate changes on solvency liabilities, depending on the plan's initial solvency ratio as at December 31, 2012.

Since the beginning of 2013, assets rose by 7.0%, led by excellent returns in global equity markets. Meanwhile, the increase in interest rates caused liabilities to decrease between 8.1% and 10.1%, depending on the duration of the group of retirees. The increase of the solvency ratio up to September 30, 2013 depends on the initial solvency ratio, but stands between 9.9% and 19.1%, which represents a great improvement in the financial situation of pension plans.

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 September 2013 for valuations effective June 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.

INITIAL SOLVENCY RATIO AS AT 12/31/2012	EVOLUTION OF THE SOLVENCY RATIO AS AT 09/30/2013 FOR THREE DIFFERENT GROUPS OF RETIREES		
	SHORT DURATION (7.8 YEARS)	AVERAGE DURATION (10.2 YEARS)	LONG DURATION (12.5 YEARS)
100%	116.4%	117.8%	119.1%
90%	104.8%	106.1%	107.2%
80%	93.1%	94.3%	95.2%
70%	81.5%	82.5%	83.3%
60%	69.9%	70.7%	71.4%

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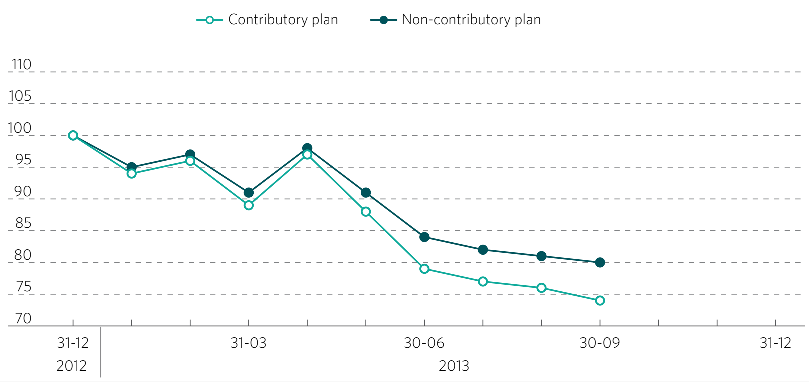
IMPACT ON PENSION EXPENSE UNDER INTERNATIONAL ACCOUNTING

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, 2012



(In %)										
Discount rate	3.7	3.9	3.8	3.9	3.7	4.0	4.4	4.4	4.5	4.5
Return on assets (55% equities)	n/a	1.8	1.6	0.5	0.5	0.6	-2.0	1.7	0.3	1.2

The pension expense has decreased by 26% (for a contributory plan) since the beginning of the year, mainly due to the increase 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 2012	SEPTEMBER 2013	CHANGE IN 2013
11	3.61%	4.33%	72 bps
14	3.80%	4.57%	77 bps
17	3.92%	4.71%	79 bps
20	4.00%	4.80%	80 bps

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

Comments:

1. The expense is established on the basis of the revisions made to IAS 19, applicable on January 1, 2013. The key change concerns the finance cost on plan assets which is now calculated with the discount rate instead of the expected return on plan assets. For more information, please refer to the *News & Views* of July 8, 2011.
2. Please note that 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).
3. The expense is established as at December 31, 2012, based on the average financial position of the pension plans used in our *2012 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, 2011).
4. The return on assets corresponds to the return on the Morneau Shepell benchmark portfolio (55% equities and 45% fixed income).
5. The actuarial obligation is that of a final average earnings plan, without indexing (two scenarios: with and without employee contributions).

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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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