

MERCER'S RESPONSE: PENSION AND BENEFITS ACCOUNTING UPDATE

It's Time to Update Accounting Discount Rates in Canada

Recent changes in the high-quality corporate bond market, notably the downgrading of four long corporate bonds from Aa to A in December 2015 and subsequently the cash tender offer of an issuer's Aa-rated bonds, have created challenges for accounting discount rate models in Canada. As a result, Mercer has updated its accounting discount rate model to adapt to the new Canadian bond environment.

CANADIAN BOND MARKET

The prevailing definition of "high-quality" corporate bonds used for pension and benefits accounting purposes is Aa or Aaa rated. It is generally agreed that there is a deep Canadian market of high quality (i.e. Aa/Aaa rated) corporate bonds overall, due to the number of bonds with short and medium terms to maturity. For maturities beyond 10 years however, only two corporate bonds rated Aa remain. Relying solely on these two bonds to extrapolate the long end of a yield curve can result in discount rate volatility and puts into question the long-term viability of discount rate models that are constructed solely by reference to Aa rated corporate bonds.

UPDATED MERCER MODEL

Given the limited number and volume of the Aa/Aaa corporate bonds with sufficiently long maturities to match pension and non-pension post-retirement benefit payments, the Updated Mercer Model extrapolates an Aa yield to maturity (YTM) curve for longer maturities based on the observed relationship between Aa-rated and A-rated corporate bonds in the medium-term maturity range. This relationship is then transposed

to the universe of A-rated corporate bonds with longer maturities to derive extrapolated Aa-rated corporate bond yields.

A-RATED BOND UNIVERSE

The selection of the appropriate A-rated corporate bond universe is a key element of the extrapolation of the Aa-rated corporate YTM curve under the Updated Mercer Model.

Because the Canadian A-rated corporate bond universe includes bonds issued by entities that are not purely corporate in nature – such as hospitals, universities, airports, etc. – these bonds need to be excluded, along with bonds that have special features such as call features, non-standard cash flow structures or explicit options. After applying these filters, the large number of A-rated corporate bonds that remain are well distributed across all maturities.

As a result, we can expect that the Updated Mercer Model will be more stable due to considerably less reliance on a small number of long-dated bonds.

IMPACT ON DISCOUNT RATES

Based on extensive back testing, discount rates under the Updated Mercer Model are similar to those under the previous Mercer model, with rates being somewhat higher in some months and somewhat lower in others. This is illustrated below for the period since the end of 2012 when the previous Mercer discount rate model became effective.

Currently, discount rates under the Updated Mercer Model are slightly below the previous Mercer Model. Consequently, the impact on financial reporting results of transitioning to the Updated Mercer Model is expected to be modest.

DISCOUNT RATE FOR LIABILITY DURATION OF 15 YEARS

(ROUNDED TO THE NEAREST 5BPS)

| DATE | PREVIOUS MERCER MODEL | UPDATED MERCER MODEL |
|--------------------|-----------------------|----------------------|
| DECEMBER 31, 2012 | 4.35% | 4.25% |
| DECEMBER 31, 2013 | 4.95% | 4.80% |
| DECEMBER 31, 2014 | 4.00% | 4.15% |
| DECEMBER 31, 2015 | 4.15% | 4.25% |
| MARCH 31, 2016 | 3.90% | 3.90% |
| JUNE 30, 2016 | 3.60% | 3.55% |
| SEPTEMBER 30, 2016 | 3.35% | 3.30% |

Mercer's updated discount rate model will become effective on November 30, 2016. However, as part of the transition to the updated model, Mercer will support both models in the period leading up to November 30, 2016.

We will share Mercer's Response to changing legislation, trending public policy as well as federal and provincial budget announcements and keep you abreast of the news that could affect your business. The new format, offering insights from

Mercer's thought leaders, is intended to keep you up to date and ensure you have the most relevant information in a timely manner.

Please note, this new format replaces our Communiques.

Contact your Mercer consultant today to discuss what this means for your organization.



ABOUT MERCER

At Mercer, we make a difference in the lives of more than 110 million people every day by advancing their health, wealth, and careers. We're in the business of creating more secure and rewarding futures for our clients and their employees – whether we're designing affordable health plans, assuring income for retirement or aligning workers with workforce needs. Using analysis and insights as catalysts for change, we anticipate and understand the individual impact of business decisions, now and in the future. We see people's current and future needs through a lens of innovation, and our holistic view, specialized expertise, and deep analytical rigour underpin each and every idea and solution we offer. For more than 70 years, we've turned our insights into actions, enabling people around the globe to live, work, and retire well. At Mercer, we say we *Make Tomorrow, Today*.

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