How Our Canadian Defined Benefit Pension Plan Works

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Air Canada has Defined Benefit Pension Plans which provide retirement benefits for all Canadian unionized and most management employees. Contributions to the plans are made by both employees and the company. They are invested in the financial markets to allow the funds to grow and meet current and future commitments to employees and retirees. To reduce the risk and get better returns on our investments, the funds are made up of a mix of Canadian, U.S. and other foreign stocks and bonds.

This can be summed up in a simple formula – "Assets + Earnings on Invested Assets + Contributions = Future Benefits".

"Assets" simply means the contributions we've already set aside as investments to fund future benefits. As of January 1, 2008 the plans had $11 billion in assets.

"Earnings on invested assets" refers to the investment returns we make on our assets, depending on how the assets are invested and the performance of the stock market the return on the investments will vary.

"Future benefits" is the promise the employer makes to employees in terms of the dollar amounts that will be taken out in future years. The employee contribution amount is fixed by contract but the amount AC contributes can vary greatly depending on the other items in the formula.

This formula and process is overseen by the Office of the Superintendent of Financial Institutions, better known as OSFI. It is an independent agency of the Government of Canada reporting to the Minister of Finance. Among other things OSFI's role is to supervise institutions and pension plans to determine whether they are in sound financial condition and meeting minimum plan funding requirements and whether they are complying with their governing law and supervisory requirements. Or more simply put, they are responsible for ensuring that the system is working properly.

Market fluctuations affect the value of our pension assets. If there is a financial crisis, like we saw in the fall of 2008, the earnings on invested assets may be less than we assumed and assets may fall below the level recommended by actuaries to fund the promised benefits. If that happens, we have to either increase contributions or agree to reduce benefits levels in order for the equation to balance. The latter is not our objective.

In a Defined Benefit Plan, unlike the Defined Contribution Plans, the company bears the burden of making up any shortfall or deficit in order to deliver the promised retirement benefits.

As a result of the financial crisis in the fall of 2008, the value of our assets fell by approximately
approximately 15%. While this was a better performance than many other Canadian Defined Benefit ns,
15%. While this was a better performance than many other Canadian Defined Benefit Plans, this means that our pension deficit is estimated to increase from $1.2 billion last year to $3.2 billion in 2009 (based on certain assumptions and cautions that are described in detail in the financial statements that were released by the company on February 13, 2009). Under current rules, where the deficit would be funded over five years, our pension contribution in 2009 alone is estimated to be $772 million for current and past service (also based on such assumptions and cautions), more than double our contribution last year. And we need to pay this out of available cash resources and do so during a recession.

When our company has to make up a crisis funding contribution it comes from the same revenue that buys our planes, sustains our operating budget and funds our paycheck – the company treasury - which in simple terms is Air Canada’s bank account. Our pension contributions are made in cash which potentially impacts our ability to invest in other things such as new products, tools, our work environment or buying or leasing planes.

The company bank account has to cope with additional contributions on top of the normal business costs. And our ability to function as a ‘going concern’ i.e as a viable business depends on us has money in our bank account.

And in the case of a financial crisis like the current one, the requirement for contributions can increase much more rapidly than the assumptions contemplated because two things happen at the same time:

1. The value of our assets in the pension fund (e.g. stocks and bonds) actually decline so Air Canada needs to make an additional contribution to replenish the value of those assets and
2. The interest rate that must be used to determine the value of benefits promised decreases resulting in an increase of the value of the benefits promised. When the gap between the assets and the liabilities increase, then Air Canada must make additional contributions to bring the formula in balance.