FEBRUARY 2011 – LL764 PENSION COMMITTEE REPORT

The first time most of us ever heard about or thought about pension plan funding was in April 2003 when Air Canada filed for CCAA protection because it defaulted on a required pension funding payment. I know that a great many members still do not fully understand exactly what the hell “Solvency Funding” and “Solvency Funding Ratios” really mean or their implications on the pension plans.

The federal **O**ffice of the **S**uperintendent of **F**inancial **I**nstitutions requires that all federally registered pension plans do a theoretical test of the financial health of the plan every 3 years. They are trying to determine if there is enough money in the plan on the date of the valuation to fully fund all of the pension benefits earned and owing as of that date if the plan was to be hypothetically wound up. If a plan is found to be underfunded then the solvency funding test must be conducted annually until such time as the plan is found to be back in surplus. Air Canada has had to do a solvency funding valuation every year since 2003. But what exactly are the actuaries testing and measuring?

On January 1st of each year, the actuaries take a snapshot of all of the assets and liabilities of the plan. Figuring out the assets is relatively easy. They simply add up the market or cash value of all of the stocks, bonds, securities and any other assets owned by the **M**aster **T**rust **F**und. The more complex part of doing the valuation is totaling up the liabilities. But what are the liabilities of the plan beside the routine administrative costs and fees? It is essential that you understand this concept to understand solvency funding. The major liabilities of the plan relate to the pension benefits owed by the plan. A total dollar value has to be calculated by figuring out the exact pension benefit owed to each and every one of us under the rules of the plan. The actuaries have to do an individual calculation for every single member (active and retired) to determine the dollar value of the pension benefit that we have earned up to the date of the valuation. They calculate your pensionable time, final average earnings and use the benefit formulas of the plan to calculate the total amount owed to you as of that date.

Then they look at what date you would first be eligible to receive a monthly pension under the rules of the plan (i.e. 25 years/80 points/age 65 or already retired). They must then convert that earned benefit into a commuted value. This is the part where the discount (interest) rate comes into play. If the plan was to be wound up the actuaries would have to go into the markets and purchase an annuity for every one of us that would provide the exact same monthly pension benefit on the same date that we would normally be entitled to receive it under the plan rules.

So, knowing the amount of money they will owe you each month, when they will have to start to pay it and the interest rate at which they can invest your money, they then calculate exactly how much money is needed to purchase your annuity to provide that monthly payment. This is your commuted value. The lower the interest rate, the larger the commuted value must be to provide the same monthly pension benefit. It is this part of the solvency funding test that is affected by the long term interest (discount) rate. A 1% change in the discount rate means an approximate 15% change in the total liability amount of any DB pension plan. The Air Canada MTF which holds all of the money for all 11 of Air Canada’s pension plans currently has about $10.6B in assets. That means that a 1% change in the discount rate will increase or decrease the liabilities of the fund by about $1.6B.

The actuaries are currently doing the 2011 valuation by looking at the snapshot data of the MTF as at 1/1/2011. They are now in the process of calculating the assets and liabilities. The last valuation was done on 1/1/2010 and the solvency deficit was $2.73B. That was because the

assets of the MTF were $10.05B and the liabilities were calculated to be $12.78B. That meant that the solvency funding ratio (assets / liabilities) was 78.7% on that date. The valuations are not completed and delivered to the company by the actuaries until June of each year. The 2011 valuation will not be known until June 2011. When you realize that they must calculate approximately 57,000 individual (active and retired members) pension accounts to determine the total liability owed by the MTF you can see why it takes 6 months to complete the valuation.

As the sponsor of the pension plan, Air Canada is responsible to pay for any solvency funding deficit. The normal OSFI rules require the solvency deficit to be paid back in a 5 year period. In 2003 and 2009 Air Canada was given special funding rules by OSFI to extend the amount of time they were allowed to pay back the deficit as well as capping the maximum amount of money they had to pay into the plans each year. To pay down a $2.73B deficit would mean that Air Canada would have to pay $546M each year for the next 5 years as well as their normal yearly current service pension contributions. If the discount rate increased by ½% during that time their required payments would decrease to $396M per year – a significant difference. In 2008 Air Canada paid $456M into our pensions and they paid $389M in 2009. The figure for 2010 is not available yet.

The most important thing to understand about solvency funding is that it only affects the plan if the pension plan was to be wound up. As long as the company is in business and the members and the company make their required contributions the plan is close to fully funded. More importantly, as long as the plan is a going concern, all pensions are paid at 100% of their value.

It is also important to note that throughout both the 2003 and 2009 special funding arrangements Air Canada has made all of their required current service contributions. That means that they are putting in the required amount of money for the pension benefit earned in that year. What they have been given relief on is their past service contributions. This is the amount of money required to pay for the solvency deficit that has accrued because of the prolonged and historic drop in the discount rate since 2001. Up until 2001 when the discount rate started to drop as a result of equity market problems (remember the tech bubble?) and the resultant government interference with interest rates, almost every pension plan in the world was in surplus. Since that time almost every pension plan in the world has gone into a solvency deficit.

So all of this explanation brings us back full circle. The solvency funding deficit does not affect anyone's pension unless the plan is wound up. As long as Air Canada is in business and the plan is a going concern, everyone will continue to receive 100% of their pension. If the company is forced to meet the normal OSFI required payments to pay down the solvency deficit the pension windup might become a self-fulfilling prophecy. A Catch 22 if you will. Because they can't afford to make the payments required to fund a hypothetical windup which is make believe, they may actually be forced to declare bankruptcy and wind up the plan. The OSFI solvency funding rules as currently structured impose a significant risk to Air Canada's long term viability and by extension the pension plans this rule is meant to protect.

It is this single regulatory requirement for which we must find a workable solution that will allow for the long term stability and viability of our pension plans.

I may be contacted at president@iam764.ca with any questions or concerns that you may have.

Please note the change in my email address. It is effective as of January 4th, 2011.

Respectfully Submitted,

Christopher Hiscock
Chairman, LL 764 Pension Committee