

STANDARD
& POOR'S

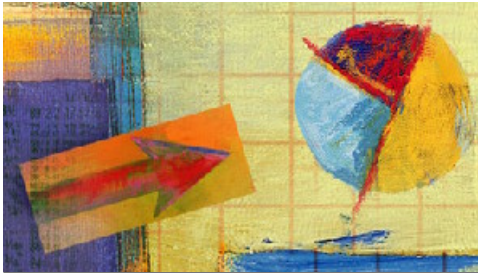
Assessing the Sponsor Covenant

The Institute of Actuaries

1st December 2005

Jim MacLachlan

The McGraw-Hill Companies



Background

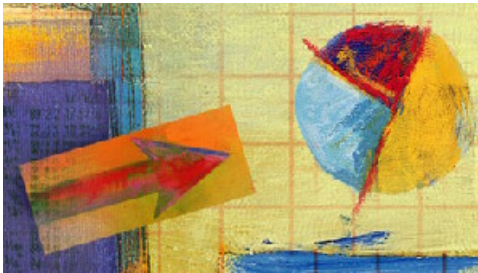
- Schemes in deficit
- Deficits are unsecured loans to sponsor
- Schemes are exposed to default risk

longevity
equity returns
interest rates

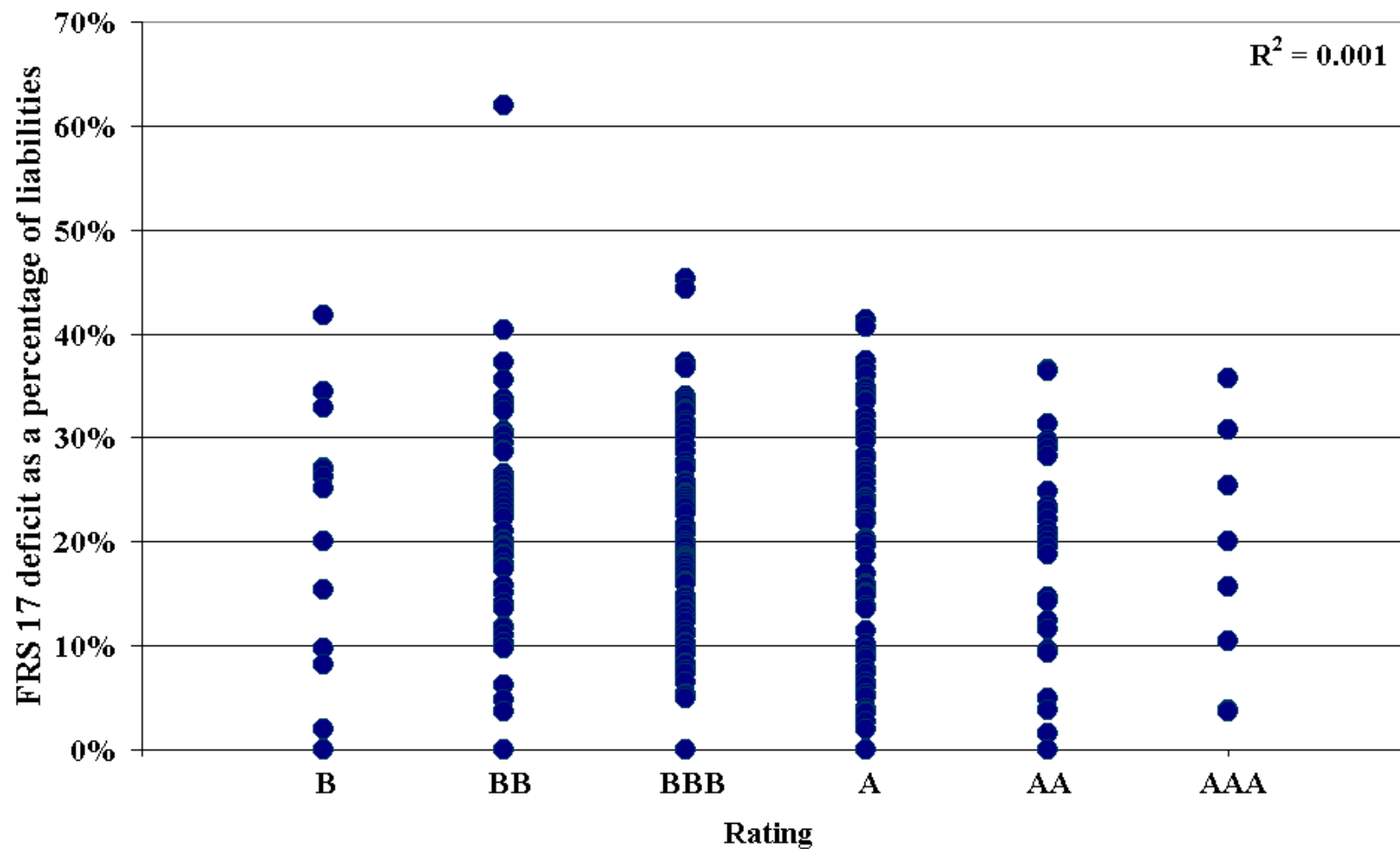
scheme

sponsor

Trustees need to be confident sponsor can fulfil its obligations



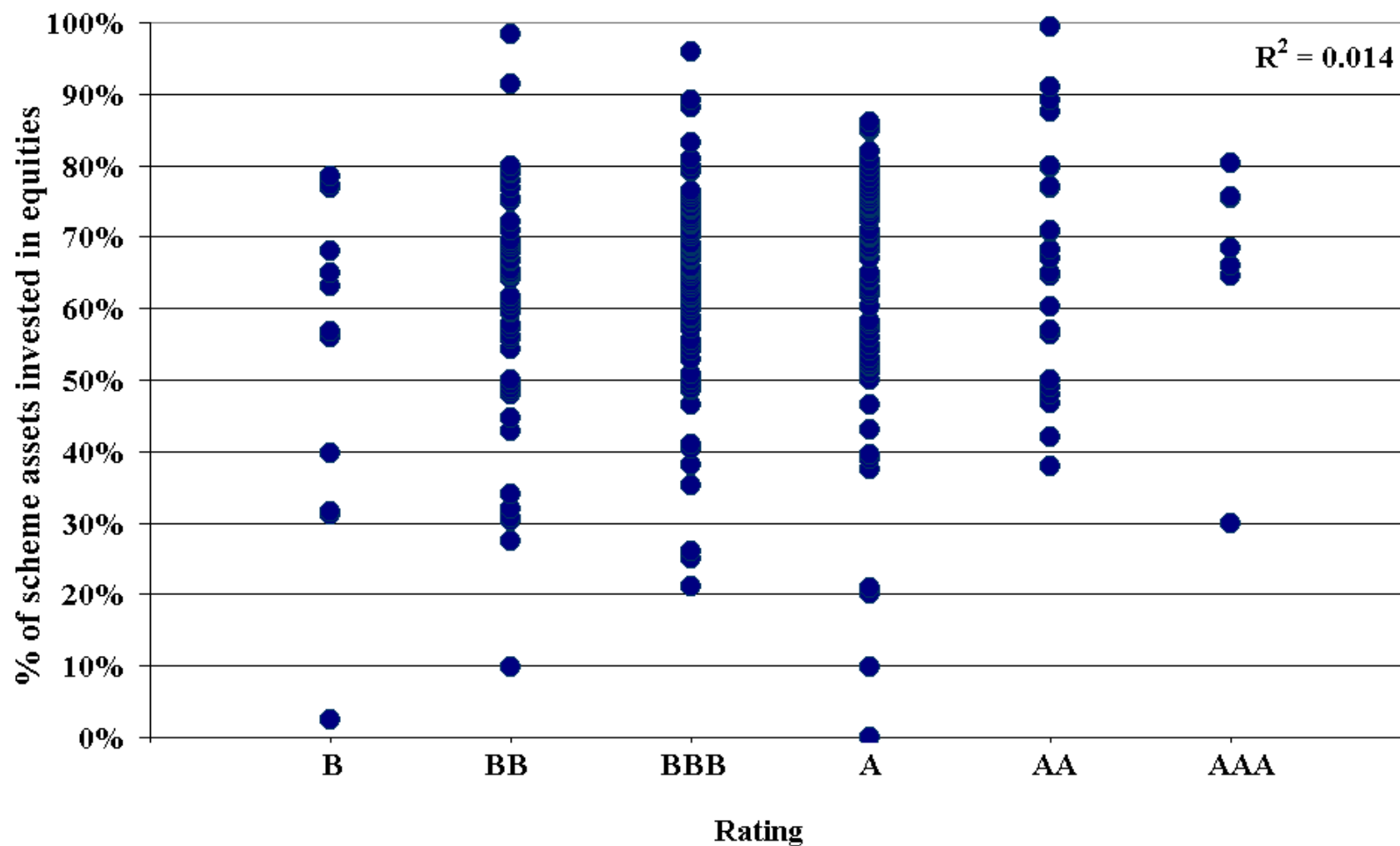
Top 500 UK DB schemes FRS 17 underfunding

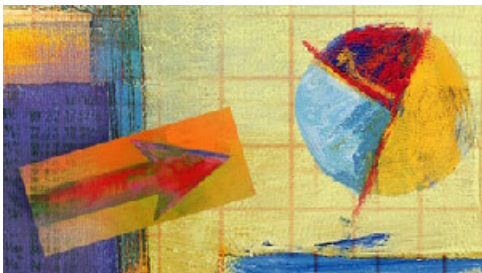




Top 500 UK DB schemes

Equity risk





What are credit ratings ?

The most commonly used measure of a company's financial strength

Coverage

- Interactive ratings (266) mostly listed companies
- Quantitative assessments (350,000) listed, private, subsidiary companies

Credit assessments are available for virtually all UK defined benefit scheme sponsors

low
risk

AAA

AA

A

BBB

BB

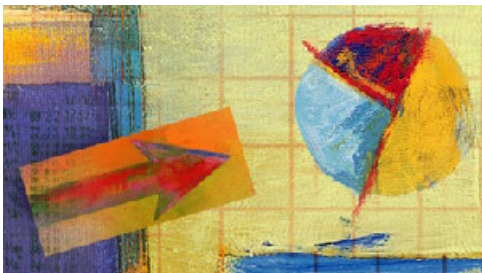
B

CCC

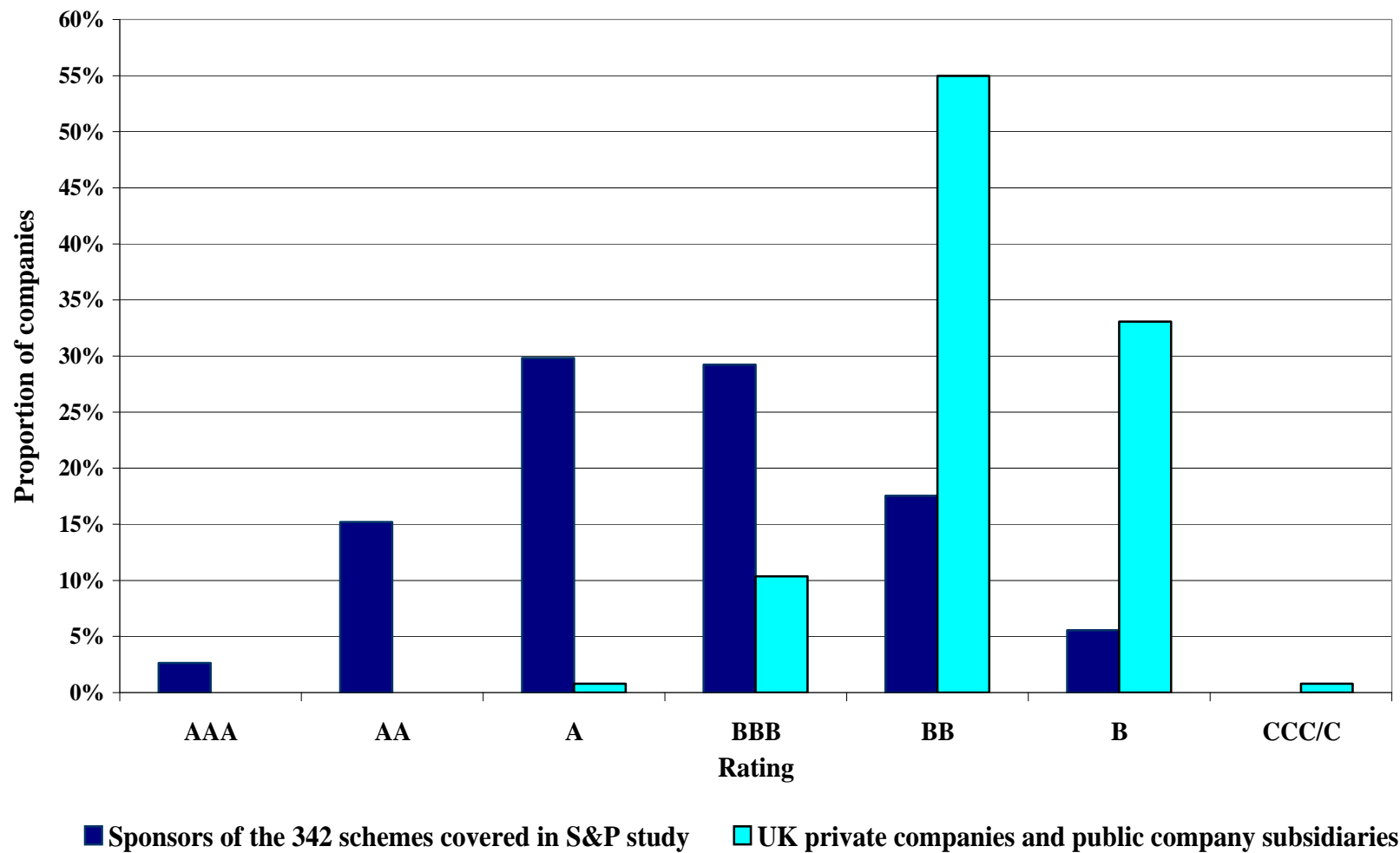
high
risk

investment grade

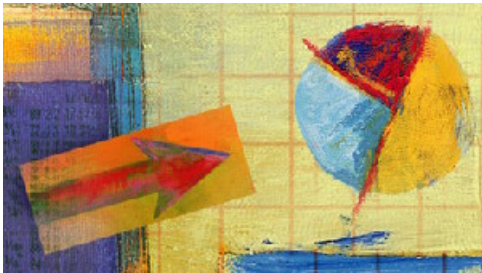
speculative grade



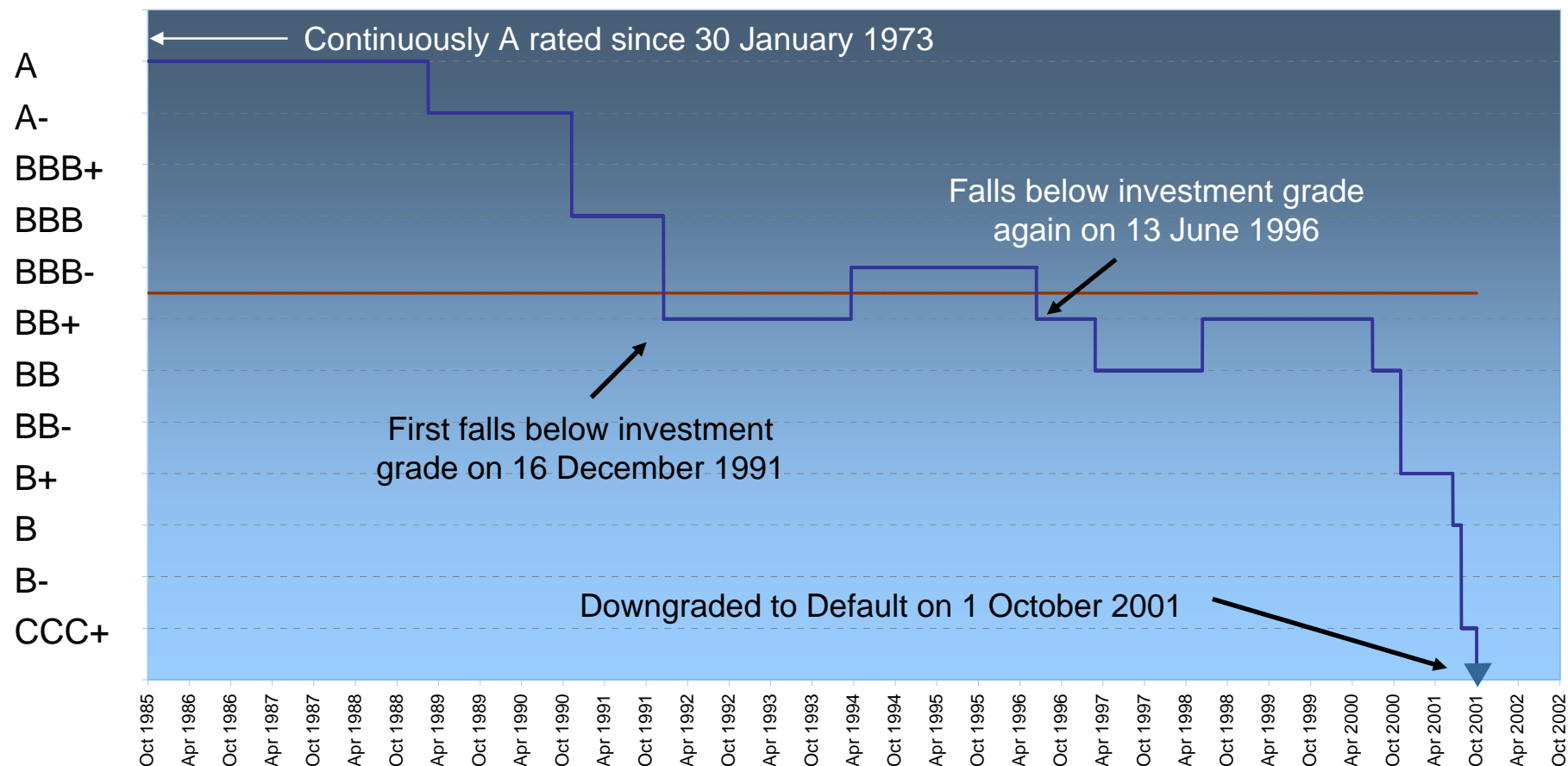
Distribution of ratings



Source: Standard & Poor's



Credit Rating History Federal Mogul (Parent of T&N)



Source: Standard & Poor's



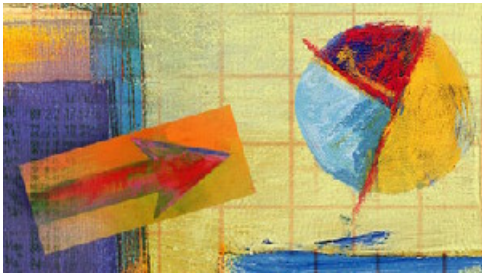
Default

- Credit strength needs to be placed in context
- Default data shows risk of recovery period

Cumulative Default Rates (Percentages)

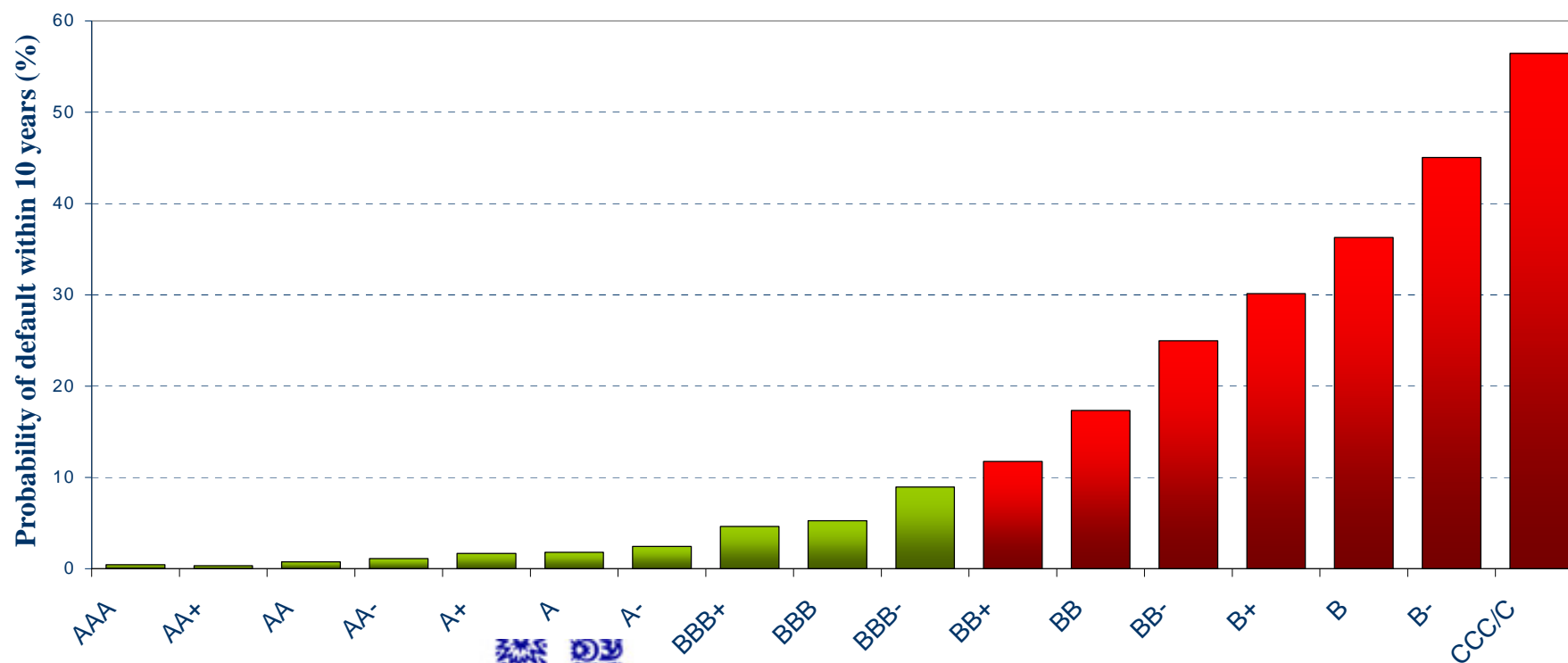
<u>Rating</u>	<u>Y1</u>	<u>Y2</u>	<u>Y3</u>	<u>Y4</u>	<u>Y5</u>	<u>Y6</u>	<u>Y7</u>	<u>Y8</u>	<u>Y9</u>	<u>Y10</u>	<u>Y11</u>	<u>Y12</u>
AAA	0.00	0.00	0.03	0.06	0.10	0.17	0.24	0.36	0.41	0.45	0.45	0.45
AA	0.00	0.00	0.00	0.07	0.15	0.23	0.35	0.50	0.63	0.77	0.88	0.96
A	0.04	0.12	0.17	0.25	0.42	0.65	0.87	1.13	1.41	1.80	2.12	2.29
BBB	0.28	0.62	0.91	1.52	2.17	2.76	3.31	4.01	4.58	5.27	6.04	6.52
BB	0.95	2.99	5.47	7.78	9.98	12.19	13.84	15.31	16.51	17.34	18.26	18.99
B	8.34	16.68	22.60	26.60	29.44	31.88	33.36	34.44	35.40	36.29	37.27	38.32
CCC/C	28.83	37.97	43.52	47.44	50.85	52.13	53.39	54.05	55.56	56.45	57.20	57.99

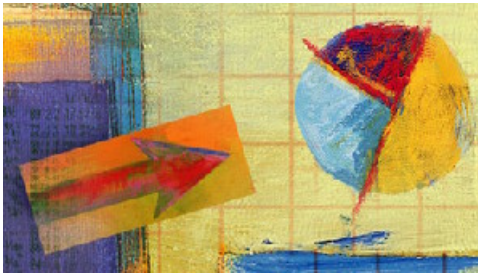
Data Source: Standard & Poor's Risk Solutions
Application: CreditPro® 7.0
Calculation Type: Conditional on Survival



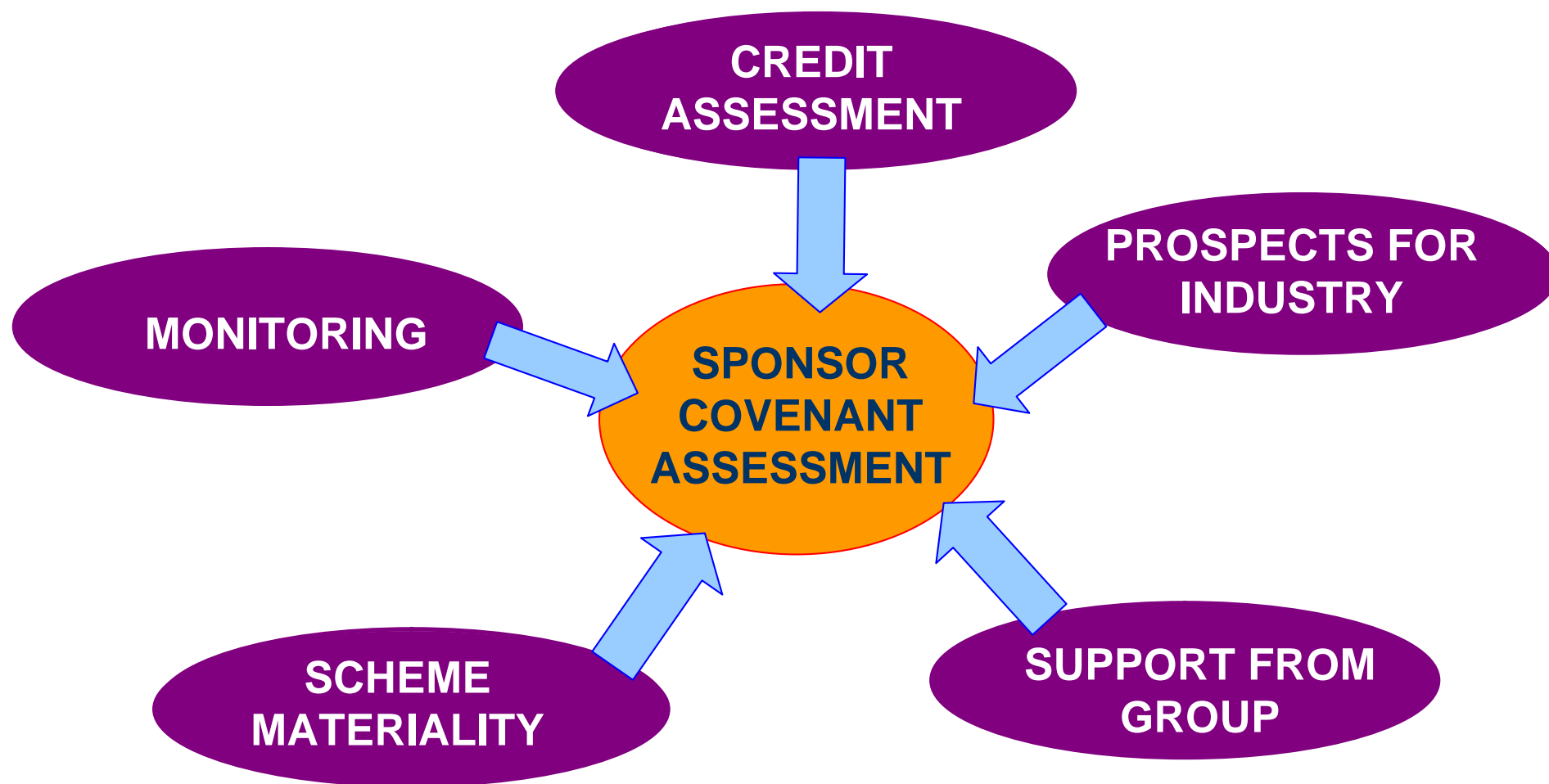
Default

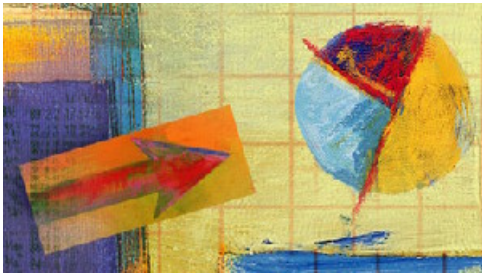
Historic 10 year default rates by rating category (%)



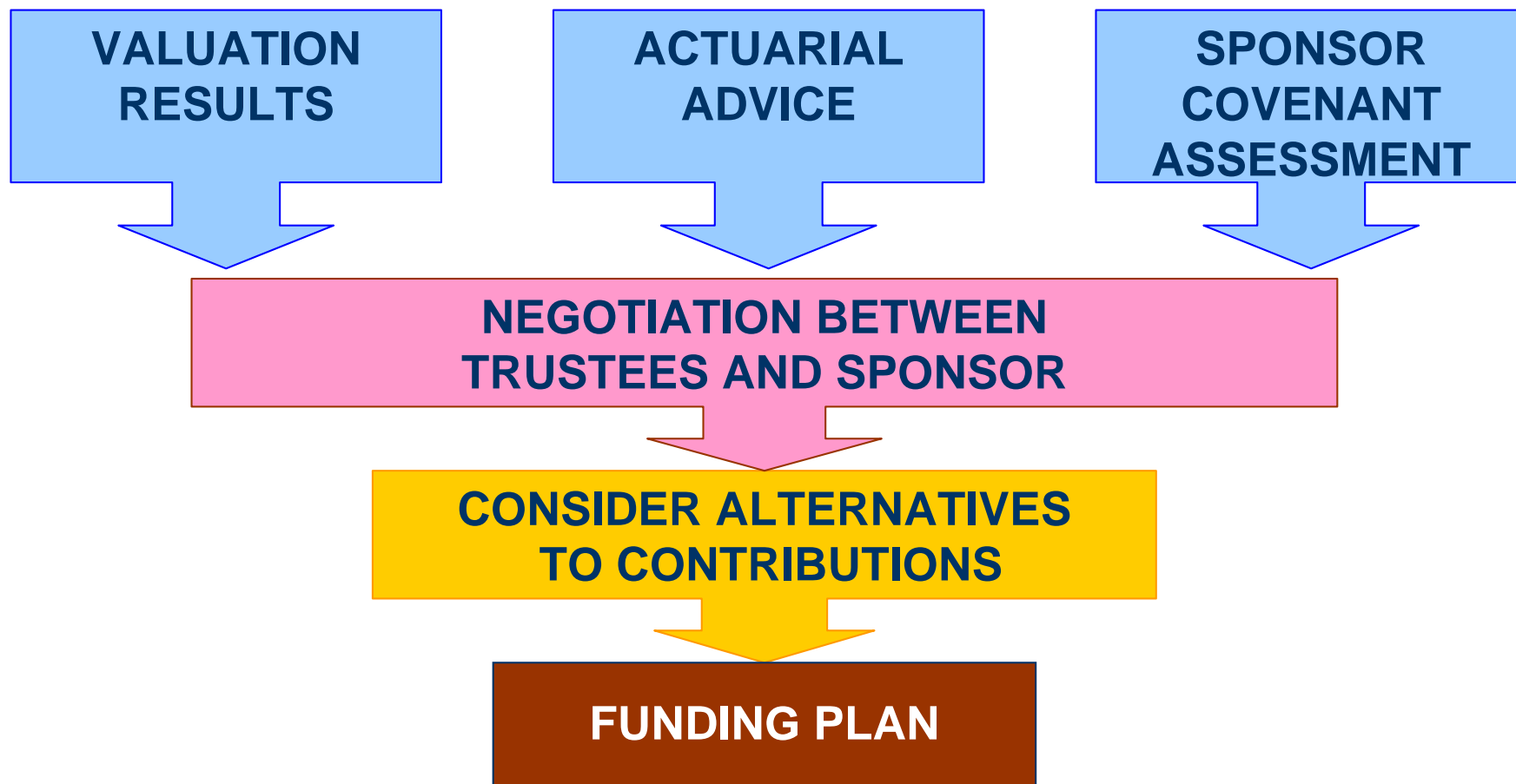


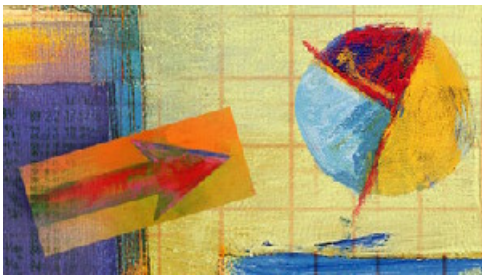
S&P – Sponsor Covenant Assessment





Where does SCA fit in ?



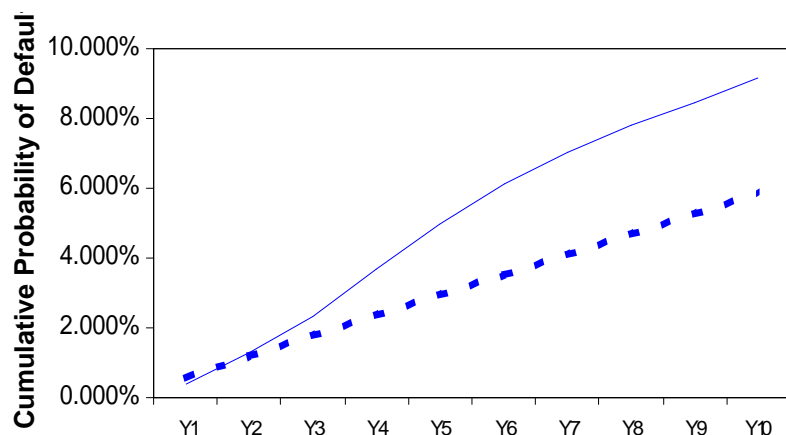


Can PPF risk bands be used to assess covenant?

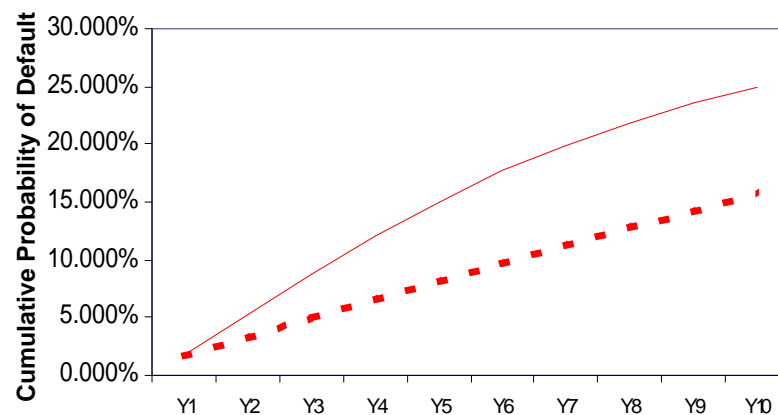
PPF bands inappropriate to assess covenant because:

- One-year horizon too short for most trustees
- Extrapolation from one-year understates risk

BBB- (mid strength)



BB- (weak strength)



- Key event is insolvency for PPF but default for trustees

Using PPF bands to assess covenant may put scheme at risk



SCA Summary of benefits to trustees

- ▶ **Independent** opinion of sponsor covenant
- ▶ Placed in context - can be incorporated into funding plans
- ▶ Compliance with TPR's codes of practice
- ▶ Considers broader picture – industry prospects, materiality
- ▶ 12 month assessment – not 'point in time'
- ▶ Cost effective - **£6,000 to £10,000** (depending on complexity)