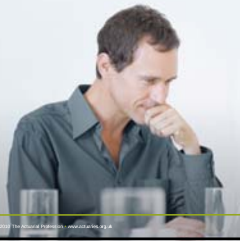
The Actuarial Profession
making financial sense of the future

Pensions & Corporate Finance Seminar
Peter Elwin



Implications of How Analysts Assess Pension Risk

What do equity and credit analysts want to know?

Key questions

- What's the liability?
- What cash might the company have to pay out and when?
- What risks is the company exposed to as a result of the Scheme?

UK-specific issues

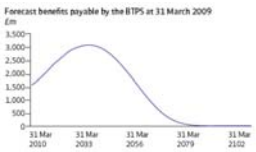
- Funded schemes are more complicated than unfunded ones
- The UK regulatory regime creates additional risks for investors

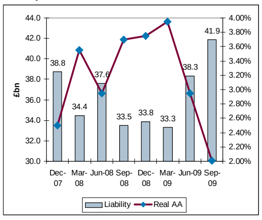
The assets appear easy to understand

- Annual report discloses mix and values
- Supercharged beta?
  - Falling equity markets drive down fund values
  - Deficit grows, driving down the value of the company
- This creates a negative feedback loop…
  - But it works the other way in a rising market
- LDI structures, longevity swaps, etc are harder to understand (disclosure is poor)

The liability is much more difficult

- BT pension - total (undiscounted) cash flows (est): c. £128bn
- 90 year run off
- But discount rate volatility (AA spread) in 2008/9 has made IAS 19 liabilities swing wildly (>25%)





So what do credit and equity analysts do? (Unrewarded complexity)

- Use the (last reported) IAS 19 balance sheet figures
  - Deduct IAS 19 deficits, ignore surpluses
- Credit analysts adjust the P&L or use cash flow figures
- Equity analysts don't always question the P&L
  - Equity risk may be rewarded in earnings-based valuations
- Known unknowns:
  - No disclosure of cashflows, actuarial funding, or buyout liabilities
  - New cash demands are hard to predict
- Funding announcements and contributions agreements matter

What's the result?

- Credit ratings are affected by pension deficits and funding agreements
- Share price reaction is inconsistent - sometimes pensions matter, and sometimes they don't!
  - Asset value changes are expected, liabilities tend to surprise
- Buyout liabilities - the Elephant in the M&A data room
  - Private equity firms, hedge funds and insurance companies take a very different view
- Trustees are an unknown quantity
- Pension deals (buyouts, buy-ins, longevity swaps, contingent assets, etc) are hard for the markets to value

Implications for 2010

- Y/e 09/10 IAS 19 figures - equity beta beaten by other Greeks
- 2009 funding reviews will be ugly
  - Trustees will continue to de-risk their investments
  - The focus on sponsor covenants will increase
- Companies want to reduce pension risk
  - More CFOs will hard-close schemes
  - Longevity swaps = being seen to do something (cheaply)
  - Buy-ins - expect a resurgence
  - Buyouts - will probably remain rare
- M&A will renew the focus on trustees, funding, and tPR powers

Longer term trends

- Equity allocation will continue to reduce (towards 40%?)
- Lack of bonds will force investors to look for alternatives
- Fear of inflation + supply squeeze = cap on rising real yields
- Pension inequalities will create significant HR and political issues
  - Private sector: majority (underfunded) DC vs minority DB
  - Public sector (unfunded) DB

Disclaimer