The Actuarial Profession
making financial sense of the future

Pensions and Corporate Finance Seminar
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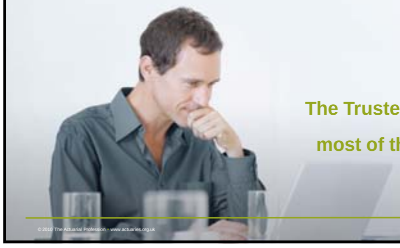


The Trustees' View – making the most of the company covenant

Introductory context

Holding a Trustee mirror to morning session standpoints:

- "The Corporate Finance View"
  - CEOs, FDs and the "equity story"
  - A joint approach to ERM and efficient capital structuring?
- "The Market View"
  - Flagging a deficit
- "The Analyst View"
  - Earnings and growth
  - Credit aspects

Introduction

Themes

- Economic backdrop and corporate challenges
- How companies are responding
- Sponsor covenant risk framework
- Mitigation tool-kit
- Annuity buy-in and buyouts

Economic backdrop and corporate challenges

Impact of the credit crunch on companies:
- More difficulty in refinancing or raising new money
- Higher cost of debt
- Knock-on effect of any credit-downgrade
- Withdrawal of trade credit insurance
- Corporate "zombies"?

Economic backdrop and corporate challenges

Economic factors and responses:
- Reduced revenues
- Margin pressure
- Working capital pressures
  - Slow payment by trade creditors
  - Capital projects deferred
  - Ricks in the upturn - re-stocking

How companies are responding

Typical corporate responses
- Maximising or preserving cash
  - Deferring payments (e.g. suppliers)
  - Raising equity
  - Cutting / freezing dividends
    - Interesting shift in shareholder expectations
- Managing liquidity
  - Extending debt maturities
  - Reviewing financial covenant headroom
  - Protecting the credit rating

How companies are responding

Understanding corporate drivers as the basis for mitigation / recovery plan negotiations:

- *"If we gave you such strong covenant protection it would create problems for us with our other creditors"*
- Trustee's position as a quasi-creditor
  - Analysis of level of protection accorded to others
  - Context is important (e.g. re-financing)
  - Engagement with / co-ordination between creditors
  - Risk of insolvency and position of s75 debt

How companies are responding

Understanding corporate drivers as the basis for mitigation / recovery plan negotiations:

- *"Give us some headroom and we will see you right once we are out of this downturn"*
  - Pace of contributions and duration of recovery plan
  - Assessment requires transparency
    - Management projections: affordability, cash flow generation
    - How reasonable are assumptions?
    - Are problems related credit / financial structure, the macro economic environment, or fundamental business / competitive risks?
  - Position of other stakeholders (banks, shareholders)
  - Contingent asset structures to protect downside risk

How companies are responding

Case study:

- Company situation:
  - Listed; business turnaround and re-financing
  - Legacy pension liabilities
  - Cash available from disposals but company absorbing cash
- Recovery Plan
  - Contributions moratorium backed by escrow fund and negative pledge structure; agreed de-risking path

How companies are responding

Understanding corporate drivers as the basis for mitigation / recovery plan negotiations:

- *"All we are doing is re-arranging company assets; the covenant is not affected"*
- Typical contexts: multinationals, takeover, financial restructuring
  - Principal / participating employer structure divorced from central treasury management or organisational structure
  - Need to protect balance sheets and profit base
  - Legal framework is important in mitigation (e.g. guarantees)

How companies are responding

Understanding corporate drivers as the basis for mitigation / recovery plan negotiations:

- *"Don't lock us into a deficit by de-risking the assets"*
- Drivers and factors
  - A timing point or a strategic objection?
  - "Cult of the equity"
  - Ability of covenant to support investment under-performance
- Governance and value issues
  - Ownership of investment policy
  - Ownership of de-risking paths

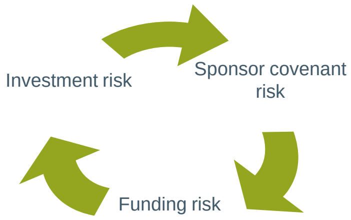
Sponsor covenant risk framework

The Sponsor Covenant

- Sponsor's willingness and ability to support the scheme
  - Cash generation for ongoing funding and deficit repair
  - Ability to secure benefits in an insolvency
- All schemes have some exposure to the sponsor covenant
- The sponsor covenant operates in lieu of solvency capital

Sponsor covenant risk framework

Sponsor covenant strength informs both investment and funding strategies



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Sponsor covenant risk framework

Setting objectives

- Preserving the status quo?
- Improving the funding position?
- Reducing the downside / insolvency exposure?
- Risk sharing / transfer options?

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Mitigation tool-kit

Preserving the status quo:

- Negative pledge
- Early warnings:
- Information undertakings
  - (e.g. financial health metrics, changes to capital structure)
- Information sharing: equivalence with bank creditors
  - (e.g. terms of major loan facility)
- Event risk triggers

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Mitigation tool-kit

Improving the funding position

- Cash injection / increased contributions
- Escrow funding
- Use of performance triggers

Mitigation tool-kit

Reducing downside or insolvency exposure

- Security over assets
- Improvement in scheme creditor position
  - (fixed or floating, pari passu or prior)
- Prospects for credit based insurance structures?
- Contingent assets

Mitigation tool-kit

Case studies: contingent assets

- Property (sale and leaseback arrangements)
- “Known unknowns” – contingent funding arrangements to address changes in risk profile

Mitigation tool-kit

Risk sharing / transfer options

- Selective de-risking of investments
- Underwriting investment underperformance / escrow
- Liability risk sharing
- Support related to financial performance
  - (e.g. security release contingent on performance targets)
- Buy-out or buy-in

Annuity buy-in and buyouts

A layering of risk exposure and mitigation

- Provider's covenant
  - should compare favourably with the sponsor's
- FSA solvency requirements
  - but levels and availability of further capital as yet untested
- Financial Services Compensation Scheme underpinning
  - but could this survive systemic failure?
- Continuing employer covenant
  - For buy-in as an investment of the scheme