Managing the Financial Subsidiary

August 24, 2006

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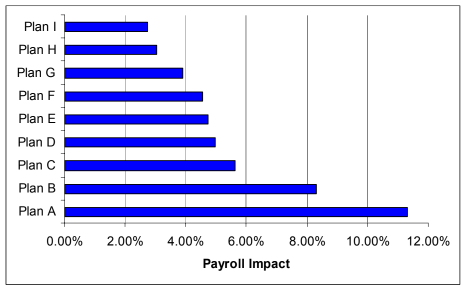
Background

- Corporate plan sponsors increasingly forced to consider pension plan as if it is an operating subsidiary
  - Establish income statement, free cash flow and balance sheet metrics within which it must operate
  - Develop more sophisticated tools to help manage it within required metrics
- Reflects:
  - Increasing size of pension plan relative to sponsoring organization
  - Increasing maturity of the plan's membership
- Plan sponsors attempt to balance a key trade-off:
  - Assets must generate sufficient return to make the plan sustainable in the long term
  - Assets must behave sufficiently like the "liabilities" that the volatility in the key financial metrics (from year-to-year) is within tolerable bounds

Context on the Problem

- Examined the financial leverage that exists within a number of large public sector plans
  - Impact of a 10% experience loss (asset and/or liability)
  - Amortized loss over 15 years
  - Expressed contribution increase as percentage of payroll



- Mature corporate plans display similar financial leverage

Public Sector Plans

- Two basic categories:
  - Risk shared plans: Member contributions and sponsor contributions are directly linked by a formula
  - Employer sponsored plans: Members typically required to contribute but deficits are primarily funded by the employer

- Employer sponsored plans should be considered under the same terms as corporate plans
  - Ultimate stakeholder is the taxpayer
  - To fund cost increases, plan sponsor must:
    - Generate additional cash (raise taxes)
    - Take money from other cash expenditures
    - Borrow

Risk-Shared Plans

- Unique characteristics must be recognized in “risk-shared” plans
- Member and sponsor contributions are linked together using a formula
  - Deficits are financed by both parties
  - Surpluses result in contribution reductions/holidays for both parties or in benefit improvements
- Intergenerational transfer is a key issue
  - Contribution changes only affect active members
  - Benefit improvements can affect both active and retired members
  - Benefit reductions typically only applied prospectively
  - Both upward/downward movements can be problematic
- Contribution volatility is the key issue to manage
- Can use similar approach to corporate plans in developing metrics (adjusted for obvious differences)

Corporate Plans – Financial Framework

- Understand the financial metrics that are being used by external stakeholders to assess the company
  - Financial analysts
  - Lenders
  - Rating agencies
- Ensure that any performance commitments that have been made to external stakeholders are recognized
- For a subsidiary of a foreign parent, understand:
  - Financial metrics used to assess subsidiary performance
  - Potential consequences of underperformance

Corporate Plans – Financial Framework

- Strategic and financial goals (short and long term)
  - Profit implications
  - Free cash flow implications
- Understand key factors that could prevent company for achieving these strategic and financial goals
  - Which can the company control or mitigate through conscious action?
  - How do they affect the Canadian subsidiary (if applicable)?
- Understand the debt structure of the corporate balance sheet (short vs. long term, variable vs. fixed)

Corporate Plans – Financial Framework

- Consolidate pension financials into the company financials to understand materiality and potential ability to swing:
  - Free cash flow
  - Operating profit
  - Employment costs
- Understand degree to which economic factors that drive pension costs also drive the company's results
  - Interest rates
  - Price inflation
  - Economic cycle
  - Currency exchange rates (and which ones)
- If pension expense or contributions were to increase, where would the money come from?

Pension Financial Management Metrics

- Should now have a framework to develop acceptable:
  - Level and variability of pension contributions
  - Level and variability of pension expense
  - Balance sheet metrics

- Need to manage all elements of the investment strategy to improve likelihood of meeting objectives
  - Proportion of matching vs. financially risky assets
  - Pattern of returns from financially risky assets
  - Ways to improve return within each category of asset
  - Ways to improve risk profile of financially risky assets