Financial Crisis

"It ain't over 'til it's over"

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"In a 2008 survey Towers Watson conducted with CFO Research Services shortly after Lehman Brothers' collapse, finance executives anticipated moderate to severe harm to their near-term financial prospects, and most of their concern centered on access to financing and risk management."

A year later, with green shoots poking up in some corners of the U.S. economy, a new Towers Watson survey finds that the worst may be over, but finance executives continue to worry about a number of crucial financing and risk management issues, as well as their ability to carry out acquisitions and other strategic plans. Analysis of the findings suggest the following:

- Cash is king — and that's not going to change in the near future.
- Despite lingering credit concerns, most executives are shifting their focus to longer-term issues, such as strategy and risk management.
- Some major issues, such as pension plan volatility and operational risk, seem to defy an easy solution and are not being adequately addressed.

Towers Watson's latest survey of corporate finance executives, conducted in October 2009, also sheds light on the impact of the deep recession, with more than two-thirds of respondents reporting lower revenues — and 42% reporting that revenues plunged 10% or more.

Most respondents also seem to have a somewhat gloomy economic outlook, with nearly half predicting the recession will not end until the second half of 2010 or even in 2011. Shortly after this survey was conducted, the U.S. government reported third quarter 2009 GDP growth of 3.5% — the first increase in a year. But to quote the homespun philosopher, Yogi Berra, finance executives seem to be saying, "It ain't over 'til it's over."

Respondents taking the most pessimistic view of when the recession would end tended, unsurprisingly, to be companies that reported the sharpest drops in revenue. The same companies worry most about their access to funding. The findings suggest that credit conditions have eased more for some companies than others, and that the great majority of companies are going to great lengths to conserve cash. In fact, *The Wall Street Journal* reported in November 2009 that companies were conserving cash at rates that haven't been matched in 40 years.

When respondents were asked to identify issues for which their level of concern has risen since the height of the financial crisis, there were some changes since our 2008 survey:

- More than half cited pension plan volatility as a major concern, putting it at number one (see page 7). In 2008, "ability to carry out strategic plans" ranked first.
- The ability to carry out strategic plans fell to second from its top 2008 rating.
- Concern about the effectiveness of their risk management function rounded out the top three issues, holding the same spot it did in 2008.

In a nutshell, executives believe that the worst of the financial crisis may be over, but we are a long way from what might be considered a "normal" economy.

Attention Shifts to Longer-Term Issues

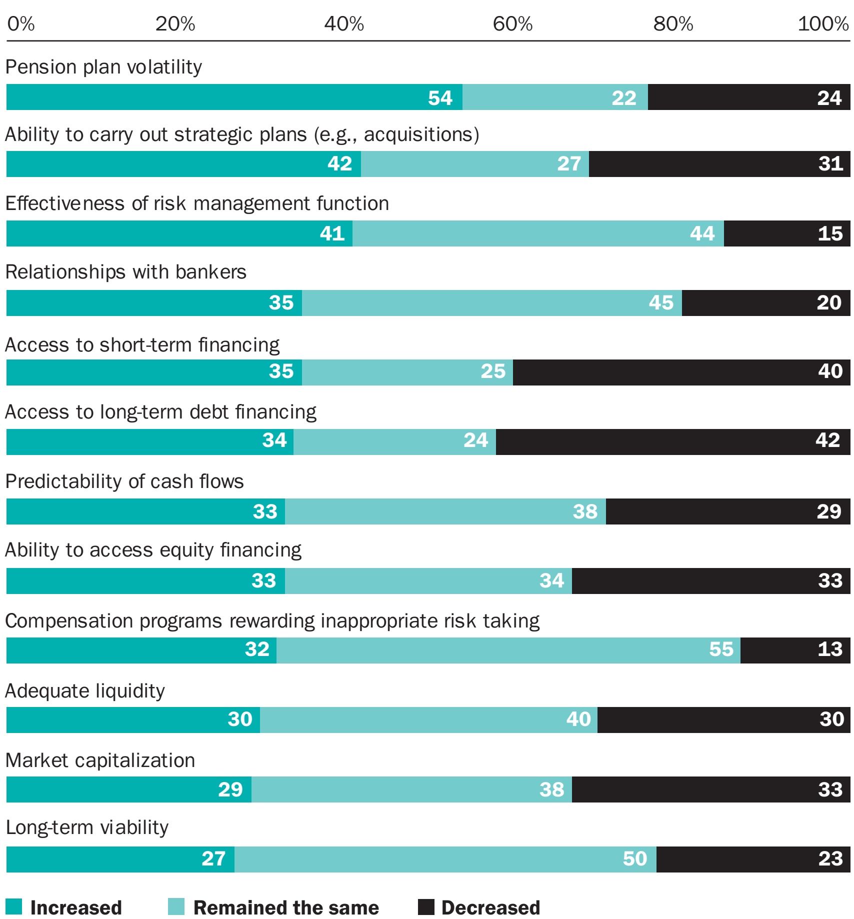
Although credit concerns have not vanished, finance executives today are more likely to give priority to longer-term problems, such as their ability to carry out strategic plans and concerns about risk management and pension plan volatility. The decline in credit concerns is revealing: 42% said that access to long-term financing was less of a concern, and a similar percentage said the same of short-term financing *(Exhibit 1)*.

“Now that the credit crisis is subsiding, finance executives are becoming more focused on bigger long-term problems,” said Prakash Shimpi, Managing Principal and head of Towers Watson’s Enterprise Risk Management (ERM) practice. “You might say they put out the fire and are now dealing with the longer-term consequences of the credit crunch.”

When asked if their companies had made changes as a result of the crisis, finance executives said they are cutting budgets and managing cash more carefully. These actions were taken more frequently than had been anticipated when respondents in last year’s survey were asked to look forward. Long-term investment plans also have been pared back, again suggesting a broad focus on cash management and cash preservation.

However, compensation programs, often cited as a cause of the excessive risk taking that led to the crisis, were of increased concern to less than a third of the respondents, with more than two-thirds saying their level of concern had remained the same or declined since the height of the crisis.

Exhibit 01. A year later, pension plan volatility joins strategy and risk management as a key issue, while financing concerns have declined



Risk management practices, which ranked among the top three concerns in both 2008 and 2009, have also been affected, with more than one-third of respondents saying they have changed the level of board and employee engagement with risk management activities. Despite these efforts, only 15% of respondents say they are less concerned with the effectiveness of their company's risk management function than they were at the height of the financial crisis. While the urgency surrounding risk management improvements has been overshadowed by cash-flow and liquidity concerns, companies' senior management still have a long way to go to reassure financial executives that risks are being managed properly.

It's All About Cash and Cash Flow

Although finance executives are lifting their eyes to look at the longer term, their intense focus on cash and cash flow is likely to extend into the future. When asked to rank the importance of certain activities over the next six to 12 months, a lopsided 81% identified cash flow as very important or essential. More than three-fourths of respondents listed earnings, followed by revenue, liquidity and market share growth *(Exhibit 2)*.

"You can make the argument that top-line revenue isn't as important as you might expect," said Arun Bansal, a Principal with Towers Watson's ERM practice. "It's all about earnings, liquidity and cash flow."

Most respondents still expect to be focusing on capital and liquidity a year from now. A long-term need to optimize liquidity levels was expected by 53% of respondents, followed by the need for capital to invest in businesses to create growth (50%) and a reduction in cash-flow volatility.

Fewer respondents ranked as important the need to aggregate risks on a common platform (16%), or creating or revising policies to handle counterparty credit risk (14%). Only 7% believed corporate hedging policy changes would be important a year from now, and a majority (59%) say they have made no recent changes in hedging policies. Of those companies that have changed hedging policies, interest-rate hedging was cited by 46%, followed by pension plan (29%), commodities (27%), foreign exchange (26%) and equities (15%).

When cash-flow issues were examined in more detail, 41% identified receivables and credit risk as being of high concern, although a similar percentage

Exhibit 02. Cash flow is also cited as the most essential key business performance measure over the next six to 12 months

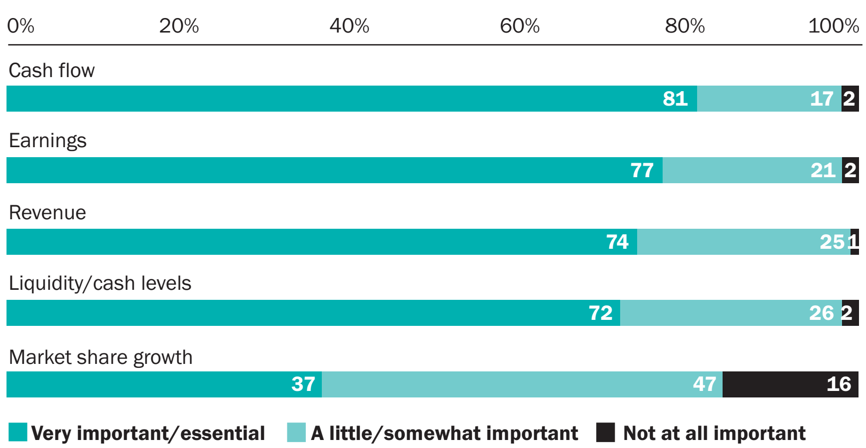
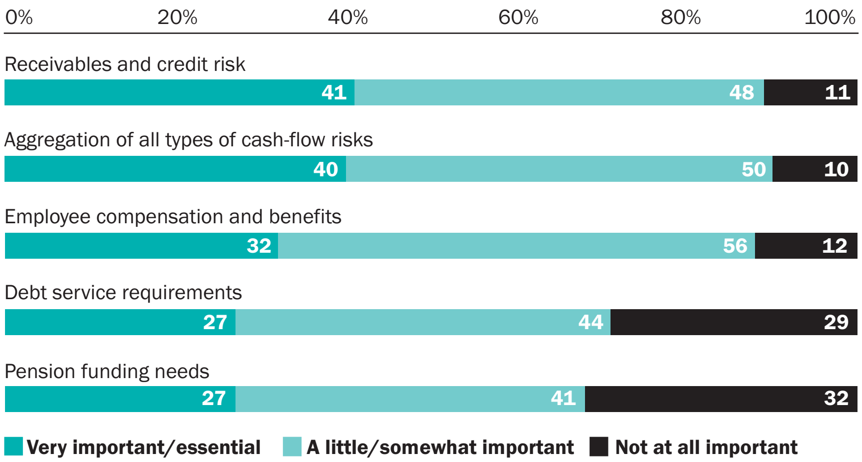


Exhibit 03. Receivables and related credit risks top list of issues pertaining to cash-flow management over the next six to 12 months



cited the aggregation of all types of cash-flow risks, including debt service, pension funding and compensation, together with receivables and credit risk. Still, ranked individually, respondents assigned somewhat lower levels of importance to compensation, debt service and pension funding *(Exhibit 3)*.

"Companies are most concerned with managing the parts of cash flow that they can't control — that is, the parts for which they have less information and depend on other parties for success," said Bansal. He pointed to the "very important/essential" rating given by many survey respondents for receivables and credit risk, and suggested three reasons:

- Receivables and credit risk impact cash flow for nearly any business.
- The credit quality of customers and suppliers — something the survey respondents cannot directly control — has been affected significantly by the recent recession.
- It is not easy to replace customers and suppliers, especially the ones that have been working with a company for a long time.

Compensation and benefits, on the other hand, form a category that companies can control and manage more readily. They know how much they're going to pay the workforce. They know how much they're going to increase or decrease benefits. And they have fewer decision points, transactions and other moving pieces.

Most companies are faced with a different problem as the economic recovery gets under way: the need to balance their continuing emphasis on cost management with growing concerns about the potential for losing key talent. Other Towers Watson research* suggests that companies are more concerned about talent retention than they were a year ago, and many are thinking about how to use rewards (e.g., targeted pay increases, 401(k) enhancements) to address talent concerns, retain good people and begin mending the recession-induced hole in their "deal" with employees.

Debt service and pension funding can also be managed and controlled more readily than receivables and credit risks. Debt service and pension funding payments can be massive and somewhat volatile, but their magnitude often can be quantified in the short term.

The survey also asked respondents to indicate a level of concern about issues related to investment portfolios greater than $1 billion. Market risk is seen to have increased the most over the last 12 months, followed by overall portfolio performance, credit risk and the robustness of current investment policy.

*"Compensation in Recovery Pulse Survey," October-November 2009 survey of more than 500 HR and compensation executives in North America and Europe, Towers Watson

Risk Management Issues Persist

Finance executives were also asked to characterize the state of their company's risk management tools and processes, particularly since risk management shortcomings are often cited as a cause of the financial crisis.

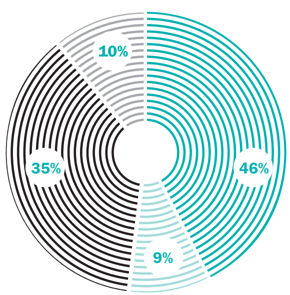
The majority of finance executives (54%) believe there are shortcomings in either their risk management tools and processes, or their deployment. Of these, almost two-thirds (35% of all respondents) said that they have adequate risk management tools and processes, but have not deployed them widely enough. Another 9% feel that management sometimes ignores messages they do not wish to hear. A surprisingly high 10% say that risk management tools and processes are inadequate or do not exist *(Exhibit 4).*

Of the risk management areas most in need of improvement, 22% cited operational risk, followed by market risk, liquidity risk, pension risk, credit risk and hazard risk.

"Operational risk, in poll after poll, surfaces as a big concern at many companies," noted Shimpi. "I think part of the concern is found in the difficulty people have in defining and measuring operational risk. In my experience, it's very closely related to the quality of employees, how they are managed, the risk-reflective performance metrics, and the policies and procedures that surround them. It's hard for many companies to get their arms around what can be a fairly amorphous challenge."

In the survey, Towers Watson gathered responses from 133 U.S. corporate finance executives polled between October 6 and October 26.

Exhibit 04. Most respondents see flaws in risk management tools and processes — and some feel that management ignores recommendations



- Available risk management tools and processes are adequate, and management follows risk management recommendations
- Risk management tools and processes are both adequate and broadly deployed, but management ignores messages they do not want to hear
- Adequate risk management tools and processes are available, but they are not deployed broadly enough
- Risk management tools and processes are inadequate or do not exist

Defined Benefit Pension Plan Volatility

Defined benefit pension plan volatility rose to the top when finance executives were asked by Towers Perrin to indicate their level of concern about a number of financial issues affected by the deep financial crisis.

With more than half of our respondents (54%) indicating an increased level of concern, pension plan volatility was ranked higher in the October 2009 survey than the much-publicized issues regarding risk management, access to short- and long-term financing, and even executive compensation.

But identifying the problem and dealing with it are two different things.

Findings in the same survey reveal that only about one-third of the respondents have changed their pension plan investment strategy as a result of the financial turmoil, and even fewer (12%) have changed pension plan hedging policies.

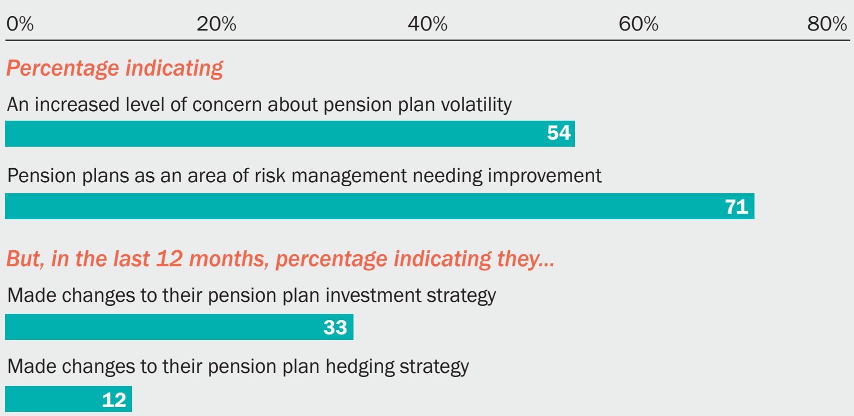
“In looking at all of the issues a finance executive faces, pension plan volatility is one of the more complex challenges executives have to address,” noted Dave Suchsland, an Executive Towers Watson’s Retirement practice. “Part of the issue is that you have diverse stakeholders as well as a risk with a long tail. They know it’s a big problem, but they are focusing on issues they can own and control, and deferring issues such as pension plan volatility that require a cross-functional team to address.”

Cash-flow concerns are somewhat higher because of the minimum funding requirements mandated by the U.S. Pension Protection Act. Nearly 70% of respondents attached some degree of importance to managing pension-related funding needs over the next six to 12 months, with more than one-quarter saying it was very important or essential.

“It’s easy to understand increasing concern around funding levels,” Suchsland added. “Plan sponsors have been watching asset values increase this year. However, the funding levels haven’t moved all that much in light of declining corporate bond yields, variations of which are used to discount pension cash flows to calculate the obligation. The funding positions have not substantively improved in many plans, and large contributions are going to have to be made.”

From a risk management perspective, 61% of respondents said pension risk management needs at least a little improvement, and another 10% think a lot of improvement is needed.

Exhibit 05. The level of concern rises for pension risk volatility, but comparatively few respondents have changed investment and hedging strategies



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