

Cash Flow at Risk: Time to Focus Is Now

- Is your company prepared for a steep increase in inflation?
- Is your debt service sufficiently laddered to protect your organization from a sudden increase in interest rates?
- Is your floating-rate exposure manageable?
- How would the unfunded pension obligations hold up to changes in interest rates and equity prices?
- Do you have the ability to consolidate the impact of changes in many factors together, such as interest rates, foreign exchange, inflation, equity prices and commodities, on your company's aggregated cash flows?

Overview

Unforeseen volatility in financial markets is creating havoc for chief risk officers, treasurers and chief financial officers. Companies in all sectors have been buffeted by a significant slowdown in demand and the unprecedented levels of volatility in the financial markets.

The risks, just to name some, are serious:

- A potential upturn in inflation, with higher interest rates
- Underperforming pension assets
- Declining revenues
- Deteriorating credit quality of buyers and suppliers

Any of these risks could threaten your corporation's ability to fund necessary expenses such as debt service and pension obligations.

False Hope of Diversification

In the past, a manager relied on diversification to minimize risk to cash flows, based on the idea that it would be unlikely for all asset classes to decline in value at the same time. However, the last two years have taught us that there may be a significant gap between what was expected and what happens in a global financial crisis. Fear and chaos can cause all asset classes to collapse at the same time.

What Could Go Wrong?

Senior managers of many companies are unsure of their ability to handle exposure to additional adverse changes in the financial markets. Can you service your company's debt if interest rates rise to the levels seen in the late '80s and early '90s? Can you support pension obligations if the equity and debt markets continue to perform poorly? Should your company commit to future investments or put them on hold for now? What about dividends — can you support paying a cash dividend over the next few years?

Potential Solutions

Your company can take many steps today to prepare itself for uncertain future cash flows. For example, it can start looking at its debt service requirements in a highly inflationary environment and hedge its risk at a relatively low cost. Commodity, foreign exchange and interest-rate hedging could protect against extreme fluctuations in cash flows. Similarly, pension assets could be moved from equities to fixed income to reduce cash-flow risk, although some level of inflation protection would be required in the portfolio.

Regardless of what solutions your organization chooses to adopt, it is critical to analyze the overall risk to cash flows in the light of changes in key market variables.

How Towers Watson Analyzes Cash Flow at Risk

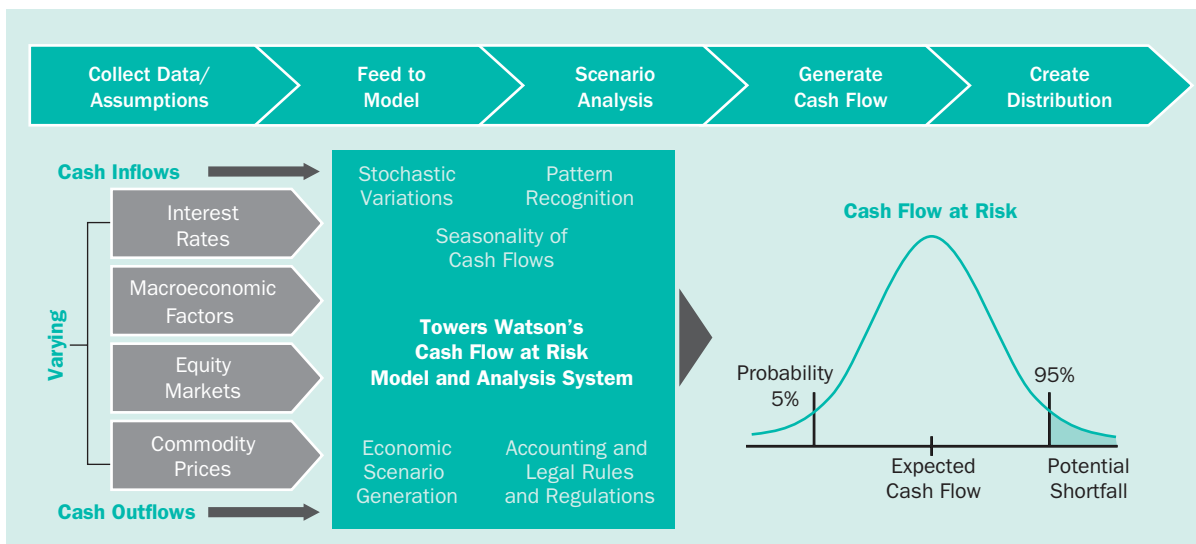
Towers Watson's Cash Flow at Risk analysis begins with an inventory of all cash-flow items subject to changes in interest rates, foreign exchange rates, equity and commodity prices, as well as macroeconomic factors such as inflation.

Next, we feed this information into our Cash Flow at Risk Model and Analysis System, which combines our analytical and risk management capabilities with our well-established pension expertise. We simulate all cash flows under extreme movements in financial and macroeconomic factors. We then evaluate the net exposure to a company's cash flows under expected and worst-case conditions. We also calculate the expected cash-flow shortage if extreme market conditions are realized.

Finally, we identify the biggest contributors to this cash shortfall and recommend hedging or other strategies that can control at least some of this exposure.

Towers Watson's Cash Flow at Risk Model and Analysis System provides an objective evaluation of the potential impact of the macroeconomic environment on a company's cash flow.

For more information or to contact a Towers Watson consultant, please visit www.towerswatson.com.



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