May 2012

Report under s89 of the Pensions Act 2004

Issued by The Pensions Regulator (the 'regulator') in relation to the British Midland Airways Limited Pension and Life Assurance Scheme (the 'Scheme').

This report sets out the regulator's position in respect of events relating to the Scheme and resulting regulatory action taken. The regulator's consideration and approach to individual cases is informed by the specific circumstances presented by a case.

The Pensions Regulator

Background

The Scheme is a defined benefit (DB) occupational pension scheme. It has approximately 3,700 members.

Clearance was sought in respect of a proposed transaction, the details of which are outlined below. At that time, the Scheme's sole statutory employer was British Midland Airways Limited ('BMAL') which was part of British Midland Limited and its subsidiaries (together the 'BMI Group'). The BMI Group was a wholly owned subsidiary group of Deutsche Lufthansa AG ('Lufthansa') following the exercise of a put option in November 2009 by a previous major shareholder which led to Lufthansa becoming the 100% shareholder.

BMAL has been significantly loss-making over the last four years and has experienced significant cash outflows. In 2010, BMAL made an operating loss of £124 million on turnover of £782 million. Lufthansa has provided significant financial support to the BMI Group since 2009; the date at which it became the sole shareholder.

Following a strategic business review, Lufthansa concluded that (due to the BMI Group's ongoing financial difficulties), if a sale could not be achieved in the near future then, in the absence of any other options, the insolvency of the BMI Group appeared inevitable, as Lufthansa would not continue to lend its support. The Scheme's trustees (the 'Trustees') and their advisers were also of the view that in the absence of support from Lufthansa the BMI Group could not continue to operate as a going concern.

Although Lufthansa has never had any direct legal obligation to fund the Scheme, it was prepared to provide, voluntarily, a limited level of funding on a conditional basis.

In December 2011, a potential purchaser for the BMI Group was found and a share purchase agreement was entered into subject to certain conditions precedent (including competition clearance and clearance from the regulator).

A draft clearance application was submitted to the regulator in January 2012 requesting clearance in respect of a Contribution Notice and/or a Financial Support Direction. The events giving rise to the application for clearance involved a proposal to substitute LHBD Holding Limited, a shell company within the Lufthansa group, as the Scheme's principal and sole statutory employer, allowing responsibility for the Scheme to pass in full to the Lufthansa group and away from the BMI Group. The BMI Group was to be fully discharged of all pension scheme liabilities via a Scheme Apportionment Arrangement or Flexible Apportionment Arrangement, and also by discharge under the Scheme's trust deed and rules.

The Scheme had a funding deficit. This can be measured on a number of bases. However, the most recent figures available at the date of the application showed an estimated deficit on a 'buy-out' basis (ie the amount it would cost to secure members' benefits by purchasing annuities) of approximately £450 million and a deficit on the Pension Protection Fund's ('PPF') section 179 measure in the region of £230 million.

Regulatory action

The Trustees, with the assistance of their professional advisers, explored a range of funding assumptions and recovery plans within the parameters of the support that Lufthansa was prepared to provide.

In light of the above analysis, the Trustees and Lufthansa reached an agreement in principle on the proposed funding arrangements for the Scheme. Lufthansa was prepared to provide, voluntarily, a limited level of funding on a conditional basis. This resulted in a 25 year recovery plan which would have required a significant degree of investment out-performance above the Trustees' proposed funding basis. Consequently, a sizeable proportion of the Scheme's assets were required to be invested in non-hedged asset classes over that period.

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When considering schemes in similar circumstances, one of the regulator's primary objectives is to help trustees and employers identify whether the scheme and its associated funding agreement are viable without a strong enough employer covenant to cope with the risk of the scheme's funding performance. Excessive funding or investment risk exposes all members (especially the younger scheme members) and the PPF.

Lufthansa was prepared to give a non-legally binding undertaking to the Trustees to discuss in good faith, in certain circumstances, any reasonable request in relation to additional funding. In keeping with its published guidance, the regulator was of the view that such a non-legally binding assurance might not protect the position of the Scheme.

Is the recovery plan viable?

The regulator worked with the parties, including the PPF, to understand the corresponding level of funding and investment performance, and related risk, implicit within the proposals explored.

This further work highlighted that the proposed future contributions were insufficient in isolation to prevent the deterioration in the Scheme's funding position. This meant that the proposed funding agreement was almost wholly reliant on achieving investment out-performance to reduce the existing funding deficit and limit further deterioration. Furthermore, under a significant number of scenarios it was shown that the Scheme would not have sufficient assets to pay benefits in full to all members and in a number of extreme scenarios the Scheme would run out of money completely at an earlier stage.

The analysis also indicated that the value of future contributions was expected to do no more than broadly meet the additional PPF liabilities which would have arisen as a result of the Scheme continuing to operate as a going concern. This meant that the PPF would be solely reliant on the Scheme's investment performance to reduce the PPF deficit. Given that the PPF has no influence on the investment strategy, the PPF levy payers would effectively be underwriting the investment risk being run by the Scheme. In a significant number of scenarios PPF entry was inevitable but at a higher cost to the PPF.

Based on this information the regulator concluded that, in view of the funding and investment risk associated with the proposal, and in the absence of a legal commitment to contribute beyond the prescribed conditional and capped amount, the continuation of the Scheme would not be in the interests of the generality of the members or the PPF.

Are moral hazard powers available?

Having considered the specific circumstances, the regulator came to the view that its 'moral hazard' powers[1] (ie Financial Support Direction and/or Contribution Notice) were not available. This view was informed by the fact that, in the regulator's opinion, not all of the relevant legal tests were met. An important factor in the regulator's consideration in this case was the benefit received by BMAL in view of the significant funding that Lufthansa provided during the period of its ownership, which enabled BMAL to continue as a going concern and pay contributions to the Scheme.

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[1] See sections 38-51 of the Pensions Act 2004

Outcome

The regulator wrote to Lufthansa and the Trustees in March 2012 to confirm that the regulator would not be providing clearance in relation to the original draft application received due to the risks inherent in the proposal.

However, the regulator confirmed that it would be willing to consider alternative approaches which would assist Lufthansa in its objective of providing members with benefits in excess of those available following an insolvency event.

Following a period of dialogue between the regulator, the PPF, the parties and their advisers, it was established that Lufthansa was not prepared to increase its level of support above that proposed in the original application. A number of alternative options were explored. However, in the absence of any change in the level of legally binding support Lufthansa was prepared to provide, the regulator concluded that no viable scheme funding solution could be found with an acceptable level of funding and investment risk. Lufthansa and the Trustees therefore sought to reach an agreement under which the Scheme's position would be crystallised.

This resulted in the Trustees and Lufthansa reaching an agreement in principle to a revised proposal under which the Scheme's liabilities would fall to the PPF via a Regulated Apportionment Arrangement[2] (RAA), in return for appropriate mitigation being received by the PPF. As part of the overall proposal, an additional amount of £84 million will be paid by Lufthansa on a voluntary basis, in order to provide members with additional benefits to help address the reduced benefits they will receive as a result of joining the PPF. This will be provided through an arrangement outside of the PPF. Whilst the regulator was aware of the proposed voluntary payment, it did not form part of the regulator's consideration as to whether approval of the RAA was appropriate.

The regulator will only approve a RAA if it believes it would be reasonable to do so. In the specific circumstances of this case consideration was given to:

- whether insolvency of the employer would be otherwise inevitable or whether there could be other solutions (including funding options for the scheme) which would avoid insolvency
- whether the scheme might receive more from an insolvency
- whether a better outcome might otherwise be attained for the scheme by other means (including through the use of the regulator's powers where relevant)
- the circumstances of the rest of the employer group, and
- the outcome of the proposal for other creditors.

RAAs are extremely uncommon. However, in the specific circumstances of this case, the regulator concluded that a RAA was an appropriate and reasonable course of action. The regulator and the PPF worked closely together to form a common view of whether the proposed level of mitigation was appropriate.

On 20 March 2012, the regulator issued a clearance statement to facilitate the revised proposal and determined to approve a RAA. As a result, the Scheme (and ultimately the PPF) received £16 million, which was significantly more than it would have done in an insolvency of BMAL.

The regulator was only able to approve these arrangements in view of the fact that in the regulator's opinion its 'moral hazard' powers were not available and that the regulator was of the view that the proposed transaction represented the best possible outcome in the circumstances.

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[2] See regulation 7A of the Occupational Pension Schemes (Employer Debt) Regulations 2005 (as amended)