MARCH OF THE ZOMBIES (OR THE CHALLENGES OF FINANCIALLY LESS SUPPORTED SCHEMES)

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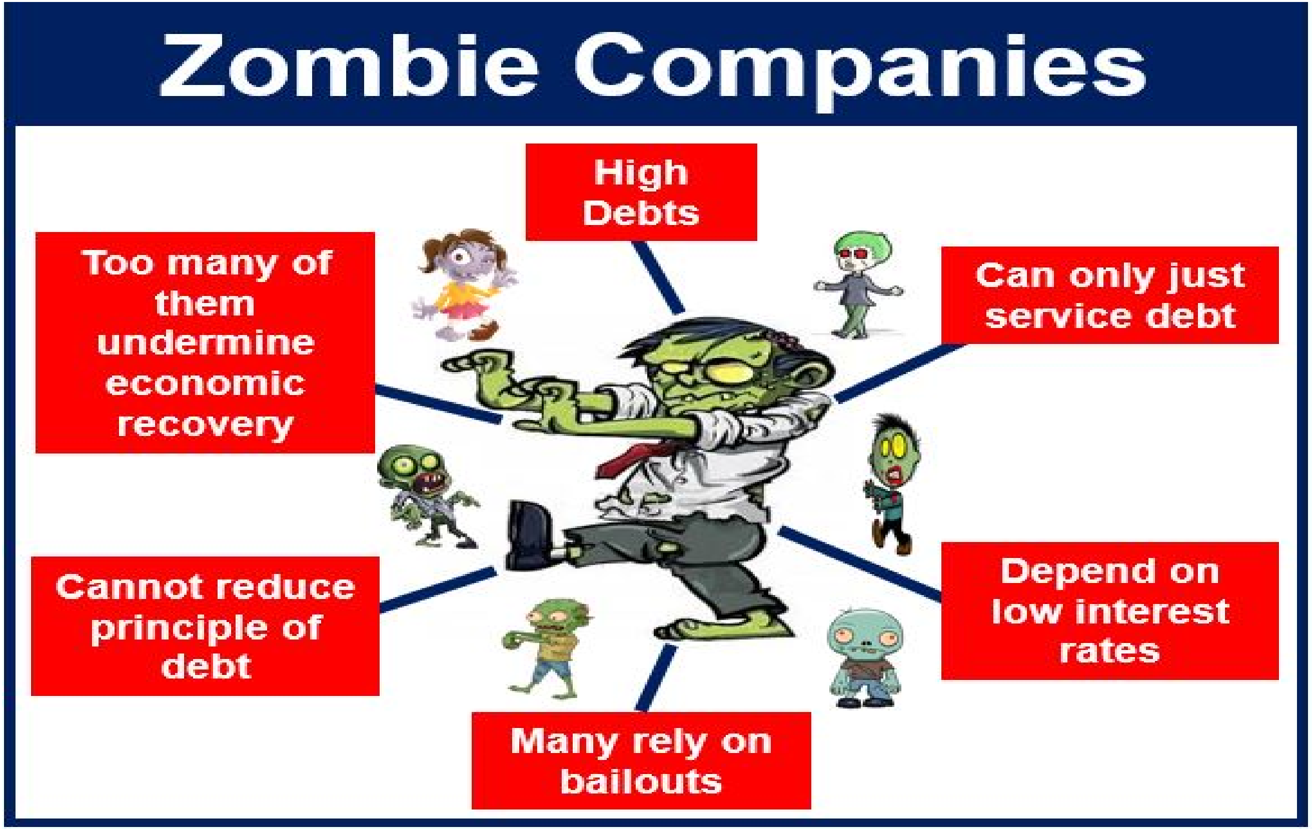
ZOMBIE COMPANIES BEHIND ZOMBIE SCHEMES

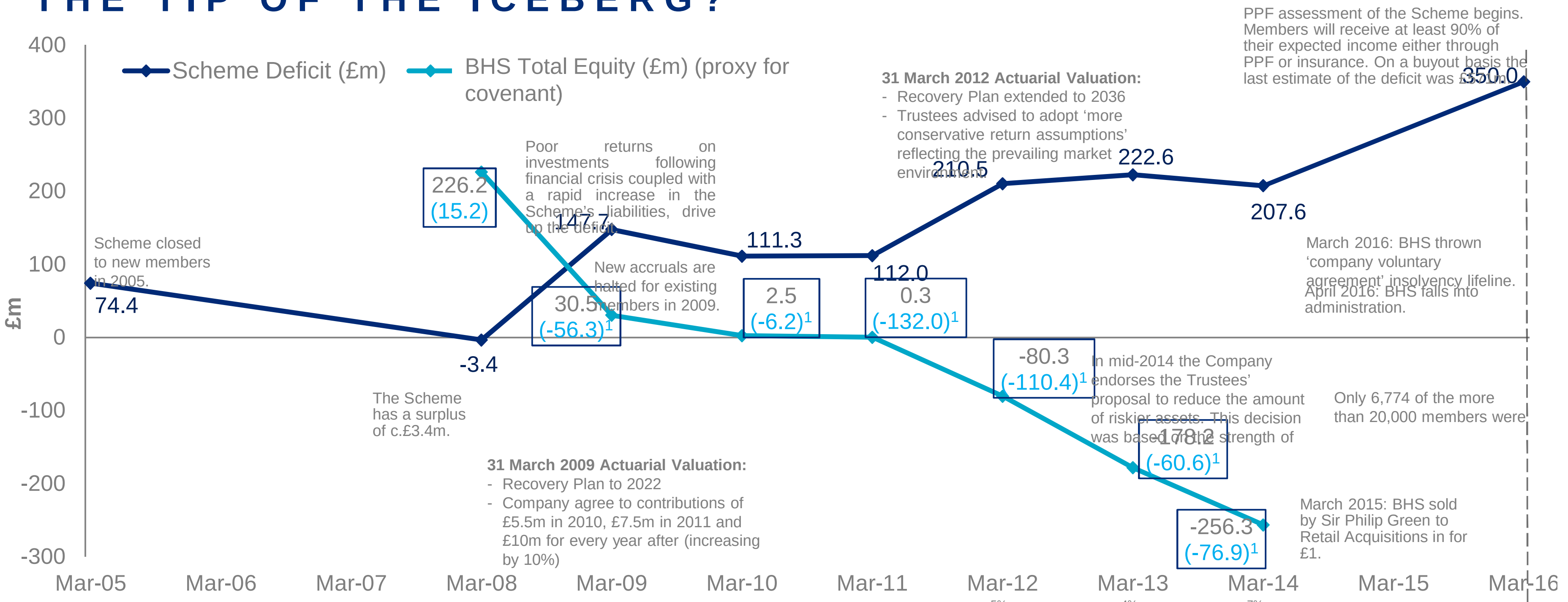


ZOMBIE SCHEMES

"Analysis of all the remaining DB schemes suggests that there may be many hundred 'zombie' schemes. These are schemes where there is no realistic chance of the pensions promises being met"

Steve Webb – written evidence to the joint Work and Pensions Select Committee and Business Select Committee in relation to BHS

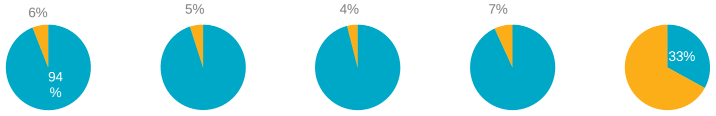
BHS PENSION SCHEME
THE TIP OF THE ICEBERG?



PENSION SCHEME ASSET ALLOCATION

MATCHING ASSETS

GROWTH ASSETS



SCALE OF THE PROBLEM

- Pensions Institute study suggested up to 1,000 schemes are stressed, including around 25 schemes with liabilities greater than £1.2bn
- Of those c.600 schemes estimated to never be able to pay full benefits
- Figures supported by comments from Alan Rubenstein, CEO of the PPF
- But:
  - Numbers of schemes at risk based on 2013 publication by TPR analysing schemes by Covenant Groups
  - Schemes estimated to be stressed were those in Covenant Group 4 – Weak
  - TPR bespoke covenant assessment based on publicly available information focussed on legal obligations to schemes
  - Rates of insolvency currently low for PPF universe fallen sharply since the second quarter of 2013, reaching 0.32 per cent (four-quarter moving average basis) in the second quarter of 2015 (*Purple Book 2015*).

BINARY APPROACHES LIMITING RESOLUTION
PPF ENTRY VS. DO NOTHING (1)

- PPF entry through trigger of insolvency or Regulated Apportionment Arrangement
- Issues with insolvency approach
  - Business will have to be actively marketed even if pre-packed
  - Third-party buyer(s) could emerge and business could be split up
  - Competitors may get access to books
  - Current owners/managers need to find funding for acquisition
  - Ransom payments usually necessary for essential trade creditors
  - Risk of contract terminations
  - Reputational damage
  - Moral hazard remains
- Does not rule out “scheme rescue”, but examples are very rare

BINARY APPROACHES LIMITING RESOLUTION
PPF ENTRY VS. DO NOTHING (2)

- RAA only possible where:
  - Sponsor insolvency inevitable
  - The scheme must receive “significantly better” value than under insolvency
  - Value offered to the scheme under the RAA is fair alongside other creditors and shareholders
  - The scheme must be given an anti-embarrassment stake in the employer
  - TPR’s moral hazard powers must not be expected to provide a better return
  - TPR must provide clearance for the RAA
  - PPF and trustee costs must be paid for by the party seeking the RAA
- In practice, it can be difficult to demonstrate that insolvency is inevitable
- Challenge of underlying business viability

BINARY APPROACHES LIMITING RESOLUTION
PPF ENTRY VS. DO NOTHING (3)

- If unwilling to trigger insolvency or unable to agree RAA, do nothing option is often default
- Challenges:
  - PPF drift
  - Investment strategy in light of IRM and challenge to ignore PPF when considering investment decisions– can trustees risk schemes out of deficit?
  - Deficits may get worse and end up in the PPF (assuming entry is allowed)
  - Potential for increased levy costs on ongoing schemes
- ECWG queried issue of trustee duty of care to PPF
- Pensions Regulator to drive use of IRM and ensure risk in schemes is commensurate with risk capacity (covenant)

ALTERNATIVE APPROACHES
LESSONS FROM RESTRUCTURING COMMUNITY (1)

- Consensual restructuring outside of insolvency is a common debtor and creditor lead approach in the case of zombie companies
- Aim is to make the capital and operating structure viable – business viability is critical
- Approaches used include:
  - Debt forgiveness
  - Debt for equity swaps
  - Standalone Company Voluntary Arrangement process (typically used in retail cases to deal with property lease commitments)

ALTERNATIVE APPROACHES
LESSONS FROM RESTRUCTURING COMMUNITY (2)

- Challenges in restructuring with pension debt:
  - Sacrosanct nature of past service liabilities:
    - Pension promise dilution with member consent
    - Statutory over-ride?
  - Risk of pension debt compromise negating ability to enter the PPF
  - Inflexible nature of PPF anti-embarrassment stakes

ALTERNATIVE APPROACHES
LESSONS FROM RESTRUCTURING COMMUNITY (3)

- PPF Plus Solutions
  - Recognise the nature of balance of stakeholder interests – why should existing shareholders get 67% or more of equity if “out of the money”
  - Solutions often multi-faceted:
    - For some pensioners PPF benefits pose limited risk
    - Others may suffer significant detriment
    - Combination of new scheme, plus residual entry into PPF?
  - Complex negotiations required with multiple stakeholders, often with competing agendas
  - Challenge of preserving future ability to enter PPF

RESURRECTION?
CAN FUTURE BHS LIKE SCENARIOS BE AVOIDED

- There is an inevitability that some sponsors will enter into an insolvency process
- Can pro-active use of existing TPR powers mitigate the risks
  - Imposition of valuation outcomes?
  - Aggressive challenge of IRM?
  - Moral hazard powers?
  - Replacement of trustees?
  - Forcing schemes into wind-up?
- What about future TPR powers:
  - Mandatory clearance?
  - Annual valuations for high risk schemes?
- Statutory considerations:
  - Over-ride to past service protection
  - Redress balance between Member and Company Nominated Trustees

QUESTIONS AND ANSWERS

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