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The liquidity kink revisited

Illiquid assets and buy-out transactions

In 2022, we wrote about a feature of the pensions risk transfer market we termed 'the liquidity kink'.

A year on, many pension schemes can now afford to buy-out with an insurer, yet schemes still hold illiquid assets. The liquidity kink is therefore a reality for many. We discuss how the market is evolving and revisit our checklist for dealing with illiquid assets.

In brief, the liquidity kink relates to the observation that a buy-out transaction typically requires a pension scheme to sell illiquid assets prior to transacting with an insurance company.

The insurer in turn, is likely to use the cash or Gilt assets transferred to buy very similar assets to those that were recently sold by the pension scheme. This can be especially true for assets that provide long-dated, inflation-linked income and an attractive illiquidity premium.

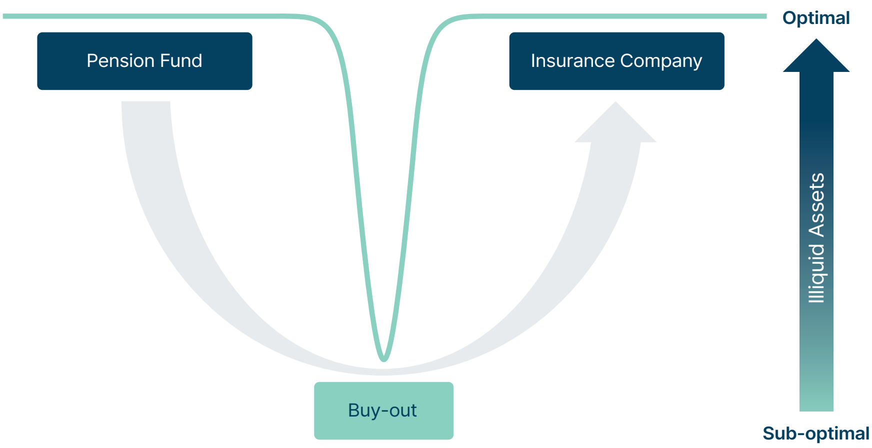
This paper looks at

- Pension scheme funding improvements and the demand for buy-out transactions.
- The evolving appetite from insurers to hold illiquid assets.
- What this means for pension schemes, especially those wanting to buy-out with an insurer and holding illiquid assets. We revisit a checklist of ways schemes can deal with illiquid assets.

This diagram illustrates the phenomenon we term the liquidity kink.

The liquidity kink can result in pension funds holding sub-optimal asset portfolios and/or higher transaction costs for holders of long-term liabilities.

This seems inefficient from all viewpoints. If only the assets could simply be transferred across in-specie as part of buy-out transactions.



The rapid reversal in 2022 of a decades long fall in interest rates has left many schemes well-funded and looking to buy-out, however many of these schemes are still holding illiquid assets.

The liquidity kink is therefore a very relevant phenomenon that schemes are contending with now.

This is all the more important as in a world where insurers are increasingly capacity constrained, it is imperative that a scheme is buy-out ready and hence an attractive prospect for insurers.

To help schemes facing the liquidity kink, we revisit our checklist of approaches a scheme could use if it holds illiquid assets and a buy-out transaction is on the horizon. It is evident that the mechanisms we discussed a year ago are happening in practice.

This is being driven by parties to a transaction taking a pragmatic approach to dealing with illiquid assets and regulatory and competitive pressures widening the set of illiquid assets insurers will consider.

We are seeing the industry working together to evolve, and innovating to solve problems that will ultimately benefit pension scheme members.

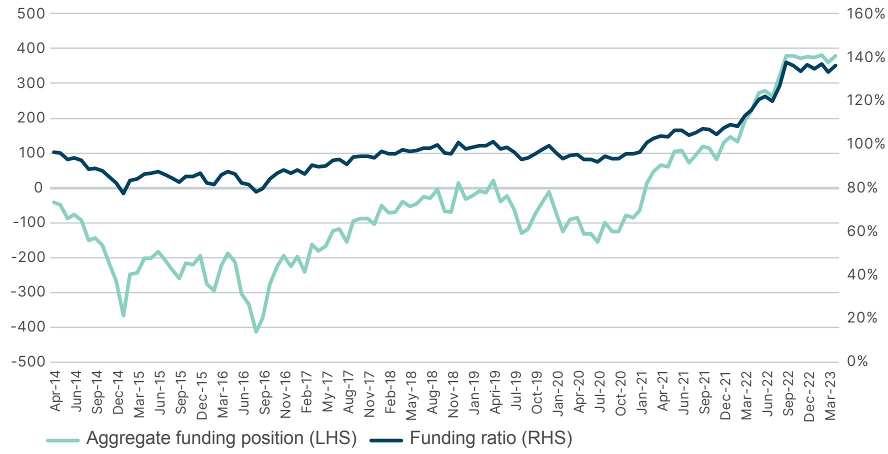
What a difference a year makes

A significant proportion of schemes can afford to buy-out with an insurer. Buy-out activity is projected to be record high with demand outstripping insurer capacity.

Schemes are further along their journey plan and much closer to buy-out than previously anticipated.

The statistics here are eye-opening. Funding levels have improved dramatically as can be seen in this chart from the PPF reproduced here.

Aggregate funding position (assets less s179 liabilities) and funding ratio of schemes in the PPF universe

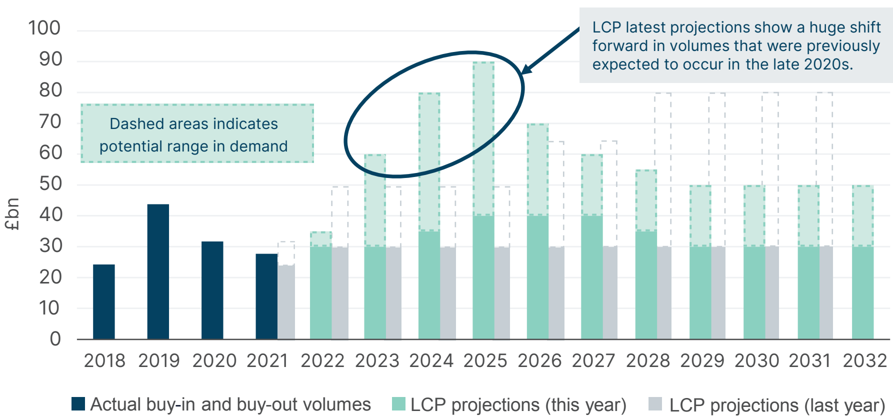


Source: PPF

- In its latest annual funding statement (2023), The Pension Regulator estimates that 25% of schemes now have sufficient assets to buy-out their liabilities with an insurer.
- LCP estimates that almost 18% of schemes are fully funded on a buy-out basis, and 45% of schemes are at least 90% funded on a buy-out basis.

Healthier pension scheme funding levels, means buy-out activity is projected to beat the previous 2019 high-water mark of £45 billion by some margin in each of the next few years, reaching upwards of £70 billion a year over the next three years.

Projected buy-in and buy-out volumes over the next decade



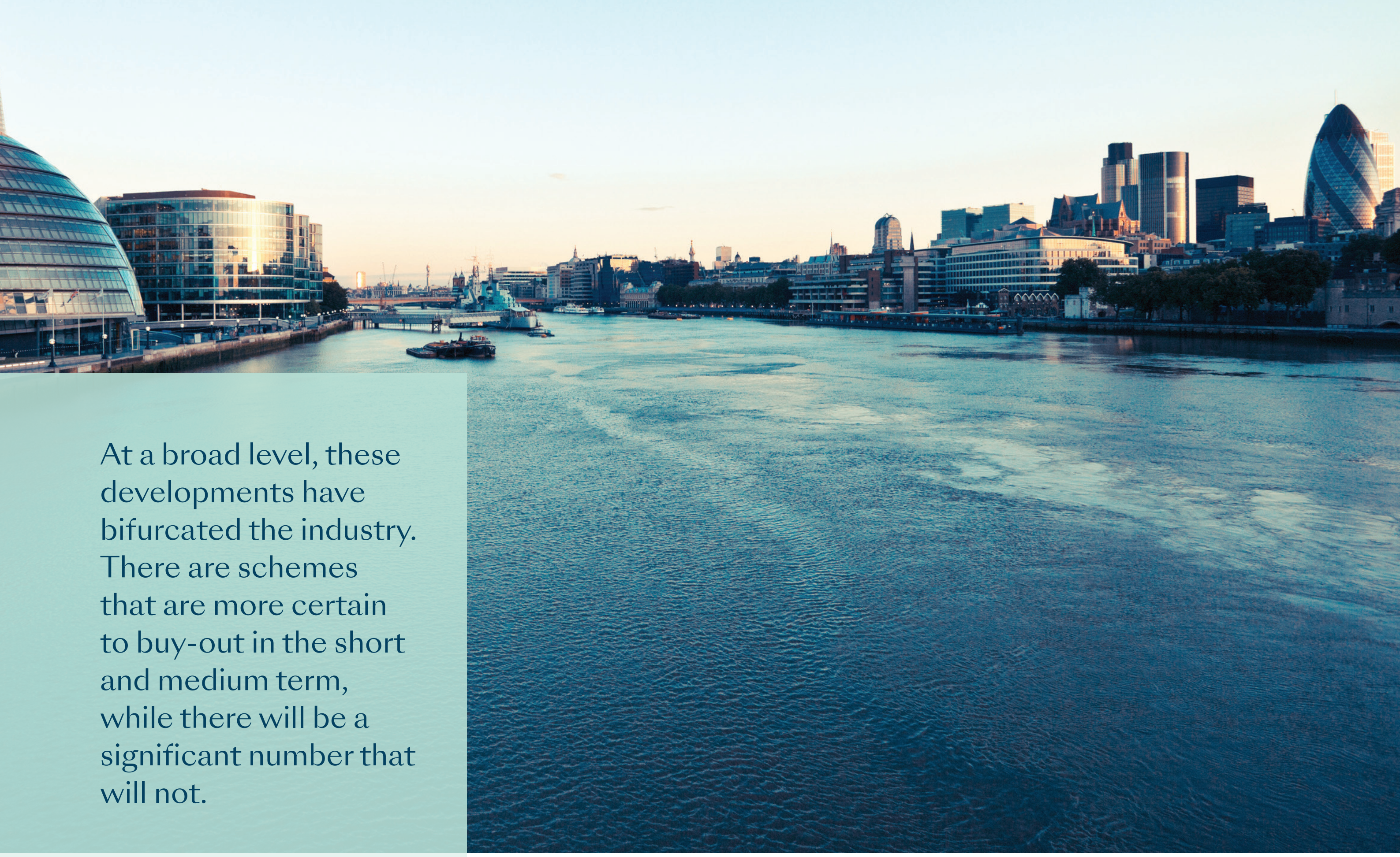
Source: LCP analysis May 2023

These projections from the consultant LCP translates to circa £200 billion of buy-out transactions over the next 3 years.

Furthermore, the consultant Hymans Robertson estimates that:

- Over the last year, the average time to buy-out has halved from 10 years to just over 5 years
- Approximately 50% of schemes will transact to buy-out by 2030

Interestingly, LCP estimates that insurer capacity runs at around £45bn for 2023, and envisages that 2023 may be the first year that pension scheme demand outstrips supply. Key constraints to capacity cited by LCP include operational resource constraints, and sourcing the right type of assets to invest in.



At a broad level, these developments have bifurcated the industry. There are schemes that are more certain to buy-out in the short and medium term, while there will be a significant number that will not.

The challenge for these schemes is to get 'buy-out ready' in order to be attractive prospects to insurers.

This will involve ensuring their data and legal documentation is up to date and de-risking their investment strategies to fluctuations in insurer pricing. Importantly for our present discussion, ensuring there is a plan to address illiquid asset holdings.

While buy-out is the topic du jour, we note that there will still be a substantial number of schemes not buying-out in the next few years. This could be schemes that intend to run the scheme off either because the premium payable to the insurer can be better spent or the scheme size means buying out is impractical. There are also likely to be many schemes that involuntarily fall into this category, due to insurer capacity extending the time to buy-out.

These schemes may be in a position to take advantage of the illiquidity premium, as featured in our previous paper [link to previous paper – 'Are pension schemes missing out on the illiquidity premium'].

Evolving appetite from insurers to hold illiquid assets

As demand is set to outstrip insurer capacity, appetite for illiquid assets continues to rise, underpinned by competitive pressures and regulatory changes.

- According to the Bank of England Insurer appetite for illiquid assets continues to rise - from backing 25% of liabilities in 2017 to around 40% in 2022.
- The types of illiquid assets insurers hold include infrastructure assets, commercial real estate loans and social housing. These assets are attractive for their matching characteristics, the illiquidity premium and the diversification benefits they offer. Indeed, Commercial Ground Rents are a case in point, an asset class for which a growing number of insurers have recently gained regulatory approvals and are now investing.
- All of which helps with pricing in a competitive market where new players are set to enter the market in coming months and years.
- Upcoming solvency II reforms will potentially mean a wider set of illiquid assets will be looked at by insurers. The reforms are set to streamline asset approval processes and make investing less capital intensive.

Insurer's approach to schemes with illiquid assets is changing due to these factors. We are seeing pragmatism and a willingness to be flexible. An example is a recent large buy-out transaction where the insurer accepted an in-specie transfer of units in a pooled fund holding illiquid assets (commercial ground rents) as part of the premium payment.

The insurer found the underlying assets in the pooled fund attractive and saw the transaction as a way to gain exposure to the asset class. Given the difficulty of originating the right type of assets, this indicates that schemes with the right types of illiquid assets may (at the margin at least) hold some attraction for insurers.

Buy-out transactions and illiquid assets
Dealing with the liquidity kink

Last year's spike in government bond yields required some schemes to sell their more liquid assets to meet collateral requirements from their LDI portfolios. Many schemes have been left with a higher than intended proportion of their portfolio in illiquid assets.

How are schemes dealing with the liquidity kink?
Below are the approaches we discussed in 2022, which are now becoming more widespread.

1

Redemption of units in normal timeframes

For example, a 6-to-12-month timeframe can be enough given how long buy-out transactions take.

2

Premium payment

It is common for insurers to allow a small amount (up to 5%) of the premium to be paid at the end of the post-transaction data cleansing period, typically a 12-to-18-month process. Combined with the time it takes to plan and implement a transaction, a scheme could have up to two years to make good the last 5% of the premium, which provides considerable additional flexibility to sell illiquid assets.

3

Deferred premium

Where schemes need further flexibility, some insurers offer the ability to defer more of the premium for longer. For example, it might be possible to defer up to 10% of the premium for five years. Some insurers also offer lots of flexibility around when the deferred amount is paid, for example making good the whole amount deferred only at the end of the deferral period. There would likely be an interest charge for premium deferral, but it is then straightforward to undertake a cost-benefit analysis of the deferral.

4

Deferred start

Under this option, a scheme only ensures its future benefit payments starting N years from transacting. As the first N years' cash flows remain a liability of the scheme, the buy-out premium payable is lower, and this could be structured so the premium is at a level that avoids the need to sell illiquid assets. However, the scheme does still need to meet benefit cash flows in the first N years. If the scheme's illiquid assets provide income, this could be used to meet those cash flows. There may be other options such as short-term finance or borrowing from the sponsoring employer that could bridge the gap to fund those cash flows and avoid selling illiquid assets. Deferred start solutions are typically more suitable to more mature schemes with a decent proportion of their liabilities relating to retired members.

5

Financing

Where a deferred premium or deferred start are not feasible or desirable options, a scheme could look to borrow against the illiquid assets to provide the liquidity so that the buy-out premium can be met in full, but without the scheme having to sell illiquid assets with a haircut.

6

Sponsor asset transfer

A scheme's trustees and sponsor would need to take appropriate advice, but it may be an option for the sponsor to agree to take any illiquid assets, to avoid the need to sell them. In return, the sponsor would provide the scheme with the funds to meet the insurance premium. This is likely only to be an option for larger employers and where the illiquid asset is material enough to make the effort and receive the advice needed to make this worthwhile.

Key takeaways

- The liquidity kink is a live phenomenon for many schemes.
- The industry is actively innovating to accommodate illiquid assets in buy-out transactions. This is underpinned by the growing appetite from insurers to hold illiquid assets.
- This bodes well for schemes with a longer investment horizon, as they can more confidently take advantage of the illiquidity premium knowing that insurers are becoming more open to taking on the right kind of assets as part of a buy-out transaction.

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