

Finance & investment briefing

September 2024

Sackers finance and investment experts take a look at current issues of interest to pension scheme investors



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In this issue

Illiquids and risk transfer	3
Legal update	5

Abbreviations

- DB:** Defined Benefit
- DC:** Defined Contribution
- ESG:** Environmental, social and corporate governance
- FCA:** Financial Conduct Authority
- FRC:** Financial Reporting Council
- IGC:** Independent Governance Committee
- LDI:** Liability Driven Investment
- LGPS:** Local Government Pension Scheme
- OTC:** Over the counter
- SIP:** Statement of Investment Principles
- SPP:** The Society of Pension Professionals
- VFM:** Value for Money

Finance & investment focus

“Welcome to the September edition of our finance & investment briefing.

Even without the recent excitement of the Euros, the Olympics and the small matter of a General Election, this is the time of year when many of us have a back-to-school feeling. The new term looks like it will be no less busy, or interesting, for the pensions industry than the last. The King’s Speech in July included a “surprise” Pension Schemes Bill and the new Government appears committed to looking at ways to increase the productive investment of pension capital in the UK. No doubt there will be more to say on this later in the year.

In the meantime, the risk transfer market continues to be busy, and in this issue, as well as the usual update on recent developments, we focus on illiquid assets and the options available to trustees where such assets present a potential obstacle to completing a risk transfer transaction. This is something which is an increasing feature of the risk transfer market where schemes achieve full funding on a buy-out basis more quickly than anticipated.

As ever, if you have any questions about any matters covered in this briefing, please speak to your usual Sackers contact.”



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Illiquids and risk transfer



Illiquid assets: those that cannot be easily or quickly sold. Typically, interests in real estate, private equity and infrastructure.

Illiquid assets

With increasing numbers of schemes looking to buy in earlier than anticipated, residual illiquid assets are becoming a common theme in risk transfer transactions of all sizes.

The 2022 liquidity crisis was in some ways a boon to pension schemes, which found themselves, in very short order, in favourable funding positions for buy out. At the same time, illiquid asset classes (typically less sensitive to short term yield changes) became a relatively larger proportion of schemes' overall asset allocation, just at the time when buy in pricing was within reach.

It is this increase in the proportion of illiquid assets that is causing a roadblock when it comes to risk transfer transactions. With recent increases in interest rates and changes in the market, more schemes are finding themselves in a position to look seriously at their risk transfer options. For many schemes, risk transfer transactions are the final step in securing member benefits in the long term. But in order to undertake such transactions, schemes need to be "transaction ready" with a portfolio of assets that are both highly liquid and low risk, as well as aligned with insurer prices. Schemes with even quite modest proportions of illiquid assets can find themselves faced with an "illiquidity barrier" that can cause problems and delays in transactions across the market.

How do you offload an illiquid asset?

Pension schemes need to carefully assess the options available to them when relying on illiquid assets (eg private equity or credit) or semi-liquid assets (eg hedge funds) to fund risk transfer transactions. In practice, there is often no appetite from the insurer to take on illiquid assets and other solutions need to be considered.

Insurers are very much aware of this "illiquidity barrier" and innovative solutions are now being seen in the market to tackle the issue (however, often these will only be available for the larger transactions). Below we discuss a few possible options that might be available.

Deferred premiums



The insurer may agree that an amount of the insurance premium is payable at a later date. In effect, a percentage of premium is "loaned" to the trustee that can be paid down gradually as the cashflow from the illiquid asset(s) is realised. The loan is typically a percentage of the premium price and will be duration limited. This can be a relatively straightforward approach and one that is increasingly prevalent in the current market. It can give trustees time to consider the sale of the illiquid asset(s) and may avoid the need to take any "haircuts" on their value. Some insurers are now working with third party finance providers to offer these facilities, though from a trustee perspective this is unlikely to make much difference to the end product.

However, it can be a costly option for trustees (particularly given the rise in interest rates). If trustees have alternative access to bridging finance from another source, this may be commercially more attractive.

Loan from a company entity



A loan from a willing company entity can help provide a bridge to the pension trustees to progress the risk transfer transaction whilst the illiquid asset(s) are realised. This option could reduce the need for a deferred payment solution (as set out above). A further advantage of this route is that the terms of the loan can be flexible and may be relatively quick to put in place. Numerous such facilities were used during the liquidity crisis.

Loans of this sort can also manage the risk of trapped surplus, which may be reason enough for some schemes to put the facility in place. In any event, regulatory and tax rules will need to be adhered to, and negotiations will be required with the company entity, who will need to understand the risks associated with the arrangement. We have had much success with establishing liquidity facilities, particularly where the trustees have engaged early with the relevant company stakeholders.

Secondary sales



A secondary sale in its simplest form is the transfer of an interest held by an investor in a private equity, credit or hedge fund before the end of the fund's term. As private funds of this sort are commonly established as limited partnerships, the interests being transferred will be an interest in the partnership, with the buyer assuming the liabilities attached to those interests. In relation to liquidity, a secondary sale results in both a reduction in the investor's outstanding commitment and, to the extent that the sale generates cash proceeds, an immediate improvement in its liquidity situation.

Secondary sales typically involve a third party broker. Brokers are generally very experienced and commercially minded, however their involvement with the actual management of the sale will differ in each case. Secondary sales can be expensive and complex transactions and almost invariably (certainly at present) incur a significant haircut to the current value of the illiquid asset(s). In addition, issues in relation to legacy scheme documentation, valuation dates and timing, and underlying manager consent should be factored in early in the process.

Taxation is also a point to address early in the transaction. Changes in US tax policy impose income tax on a gain realised by a non-US person that sells or otherwise transfers an interest in a partnership to the extent that gain is considered effectively connected to a US trade or business of the partnership. The tax is collected by the purchaser by withholding the requisite amount. This can be complex and, as ever, early engagement and preparation may pay dividends in delivering the transaction on time and within budget.

These are not the only options available to trustees and larger schemes may have the opportunity to engage with more structured solutions to share the risks associated with liquidation of illiquid assets. In every case the process and approach will be bespoke and nuanced for the particular scheme.

New solvency regulations for insurers that come into force this year may provide more scope for insurers to take on illiquid assets. However, it remains to be seen how impactful these will be in relation to the sorts of legacy assets trustees typically hold. With many schemes facing issues with liquidity we can expect more creative approaches to the problem. As ever, preparation is key and engaging early with insurers can be extremely beneficial.

New Pension Schemes Bill announced

Pension Schemes Bill announced in the King's Speech

The [King's Speech](#) on 17 July 2024 set out the new Government's legislative agenda for the current Parliamentary session. This includes a new Pension Schemes Bill intended to encourage consolidation and focus on value and outcomes for members, to "enable security in retirement, but also enable pension schemes to invest in a wider range of assets, driving growth".

Continuing some of the "[Mansion House](#)" policy proposals of the previous Government, the Pension Schemes Bill is expected to include measures to introduce:

- automatic consolidation of deferred small DC pension pots
- a new VFM framework for trust-based DC schemes to demonstrate they deliver value. This is expected to apply consistently across the whole pensions market, with the FCA introducing rules for contract-based schemes
- new duties for trustees to offer a retirement income solution or range of solutions, including default investment options, and
- a framework for commercial DB superfunds.

No timing is given for the measures to come into force.

Government launches pensions review

Following its [election manifesto](#) commitment to review the pensions landscape, the Government has [announced](#) the launch of a review to "boost investment, increase pension pots and tackle waste in the pensions system".

The first phase, led by the Pensions Minister, Emma Reynolds, will focus on actions to support greater productive investment and better retirement outcomes, including through consolidation and "encouraging at-scale schemes to increase returns through broader investment strategies". This phase is expected to be reported on "in the next few months" and will consider further measures to support the new Pension Schemes Bill.

The next phase, expected later this year, will look at "further steps to improve pension outcomes and increase investment in UK markets, including assessing retirement adequacy". The review will also consider "how to unlock the investment potential" of the LGPS.

Pensions landscape under review

FRC announces update to the Stewardship Code

On 22 July 2024, the FRC [announced](#) "significant revisions" to the UK Stewardship Code ("the Code") application process, and gave an update on its ongoing review of the Code. Some "immediate changes" are intended to reduce the burden on signatories, for example by enabling cross-references to previous reports to reduce the volume of reporting. These changes to the Code will apply for the next application window (31 October 2024) and the FRC intends to write to signatories individually to inform them of how the changes impact them.

The FRC expects to launch a public consultation on the revised Code later this year.

Revisions to the UK Stewardship Code

SPP publishes practical ESG guide for trustees

On 19 June 2024, the SPP published a [practical guide for trustees](#) on engaging with asset managers on ESG, which aims to provide "a comprehensive outline" of the various ESG disclosure requirements. It includes information about the role of an investment consultant, case studies, and checklists of the information that trustees need from their asset managers in relation to:

- climate reporting
- SIPs and implementation statements, and
- optional additional information on stewardship.

New guide published

Contact

Sackers is the UK's leading commercial law firm for pension scheme trustees, employers and providers. Over 70 lawyers focus on pensions and its related areas, including Sackers finance and investment group, a team of lawyers who provide cutting-edge advice on all aspects of pension scheme finance and investment.



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