Innovations to stem tide of DB pension fund selling only go so far

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New ideas have sprung up to allow pension schemes to hold on to illiquid assets - but not everyone is convinced they will make a big difference

Just over a year after the UK's biggest property funds for institutional investors were hit with a wave of redemption requests, many are still under pressure.

Last month, for example, *React News* revealed that Lothbury Investment Management had suspended trading in its £1bn Lothbury Property Trust follow a spike in redemptions during the second quarter.

Much of the initial selling last year was driven by the so-called "denominator effect", whereby pension funds found themselves overweight to real estate as a result of falling bond and share prices. However, the changing financial market backdrop also accelerated a trend that has been building for some time of defined benefit pension schemes selling out of real estate in preparation for buyout by an insurer.

This is because higher bond yields massively increased the number of pension funds that are fully funded and ready for buyout.

However, there are those who question whether pension schemes really need to sell their real estate before going down the buyout route. Schemes can find themselves struggling to offload properties in a difficult market, only for the insurer to then use the cash or gilt assets transferred to buy very similar assets.

Alternatives

AlphaReal calls this a "liquidity kink" that it claims leads to inefficiency and higher costs that are ultimately borne by pension scheme members. In a recent paper, the real estate investment manager laid out various alternatives including "deferred premium" transactions, whereby pension schemes can defer part of their premium due to an insurer, or borrowing against illiquid assets to provide liquidity so the buyout premium can be met in full without selling.

Phillip Rose, chief executive of AlphaReal, says: “AlphaReal sees increasing opportunities for secure income assets to transit between pension funds and insurers as part of the buy-out process.”

The fund manager clearly has a vested interest in promoting these alternatives. There is a lot of money at stake. A survey of the size and structure of the UK market by the Investment Property Forum estimated in 2020 that direct and indirect property investment by UK private defined benefit schemes totalled about £80bn.

However, these ideas are not just being touted by the property industry. They are being given serious consideration in the pensions industry.

Consultancy firm LCP recently flagged how innovation was helping overcome the challenge of dealing with illiquid assets, citing deferred premium structures and the transfer of assets to insurers as premium payment.

“We have had real success in this area in recent months, including transferring property to an insurer as part of a buy-in,” it said.

Reform to Solvency II should help broaden the range of illiquid assets insurers can take on, it added.

At the same time, there is a question over how many pension schemes will want to pursue these alternatives.

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>
> SIMEON WILLIS, XPS

Simeon Willis, chief investment officer at XPS Pensions, argues that most pension schemes will find that selling their illiquid assets is the best way forward.

“Although there are ways of incorporating illiquid assets in buy-out transactions, where it is an option, pension schemes will usually be better off selling early in the process of embarking on a buy-out. Holding on to illiquid assets carries with it risk and there are additional costs that come with some of the workarounds.”

He also questions whether pension funds will get best value if they look to cut deals to sell their illiquid assets to an insurer. They can end up losing some of their bargaining power.

“We are seeing some insurers now say they are prepared to buy a fund’s illiquid assets but this often doesn’t involve an upfront commitment to a price. The danger is that it becomes very difficult for the pension scheme to ascertain whether it is getting value for money overall because the price that you sell the illiquids for contributes to the overall price of the deal. With this uncertainty it is difficult to assess how competitive quotes are.”

Government proposals

Longer term, other options could be developed that make it easier for pension schemes to hold on to illiquid assets.

The government is currently reviewing responses to a call for evidence on defined benefit pension fund reform that proposes making the Pension Protection Fund a consolidator of schemes. This would provide schemes with an alternative to the insurance market that would make it easier for them to keep hold of illiquid assets.

However, independent consultant John Forbes argues that it may be too little too late.

“I think they want there to be more investment in private assets that benefit the economy, but if defined benefit schemes are in terminal decline, I’m not sure you’re going to achieve a lot,” he says.

“Not only has the horse bolted long ago, it is currently dying of old age out on the moors.”