Illiquid assets and bulk annuities: Overcoming the challenge

Standard Life explores the considerations for trustees around managing illiquid assets ahead of a bulk purchase annuity transaction

In the bulk purchase annuity (BPA) market, managing illiquid assets was the hottest topic of 2023.

Over the past 18 months, many schemes have enjoyed significant improvements to their funding levels, primarily driven by higher interest rates. This has brought forward de-risking plans for many schemes.

As a result, many schemes' assets are not in the shape they expected at this stage of their journey. In particular, illiquid assets represent a much larger proportion of asset holdings than expected for schemes reaching buy-out affordability.

So while many schemes can afford to buyout on paper, lots of them are holding illiquid assets that are generally not a good fit for insurers' annuity portfolios, due to their regulatory requirements. In fact, according to Standard Life data, around 40 per cent of schemes approaching the market over the past year confirmed they had illiquid assets to manage.

The majority of consultants and professional trustees who participated in our research said illiquids had delayed a transaction – highlighting the need for trustees to plan carefully for dealing with their illiquid assets before approaching the insurance market[1].

In this article, Standard Life summarises key points from its *Thinking Forward* report – *Managing illiquid assets during a bulk purchase annuity transaction* – which explores the challenges being posed by illiquid assets, and how trustees can navigate towards a successful transaction.

Trustee and consultant views

We surveyed professional trustees and pensions consultants to understand how illiquid assets are viewed by the schemes they support. Some key observations include:

- All survey respondents noted that some clients believed holding illiquids would prevent them from doing a buy-in
- Half of respondents noted that deferred premiums are considered the only viable solution to deal with illiquid asset holdings

We also found that deferred premiums and secondary market sales are the actions schemes most commonly consider in order to manage illiquid assets.

Taking action

For schemes looking to secure a BPA, below are some of the broad options they are considering for managing their illiquid assets:

1. Using illiquid assets as premium payment
2. Arranging a deferred premium with an insurer
3. Selling illiquid assets on the secondary market
4. Obtaining a company loan (legal advice should be taken)
5. Obtaining an investment bank solution (legal advice should be taken)
6. Delaying the time to buy out

There is no 'one-size-fits-all' approach, and in some cases a combination of these options could be suitable. Trustees will need to carefully consider the pros and cons of each option to craft the solution that best suits the requirements of their scheme.

Let's explore in more detail two of these options: Deferred premiums and secondary market sales.

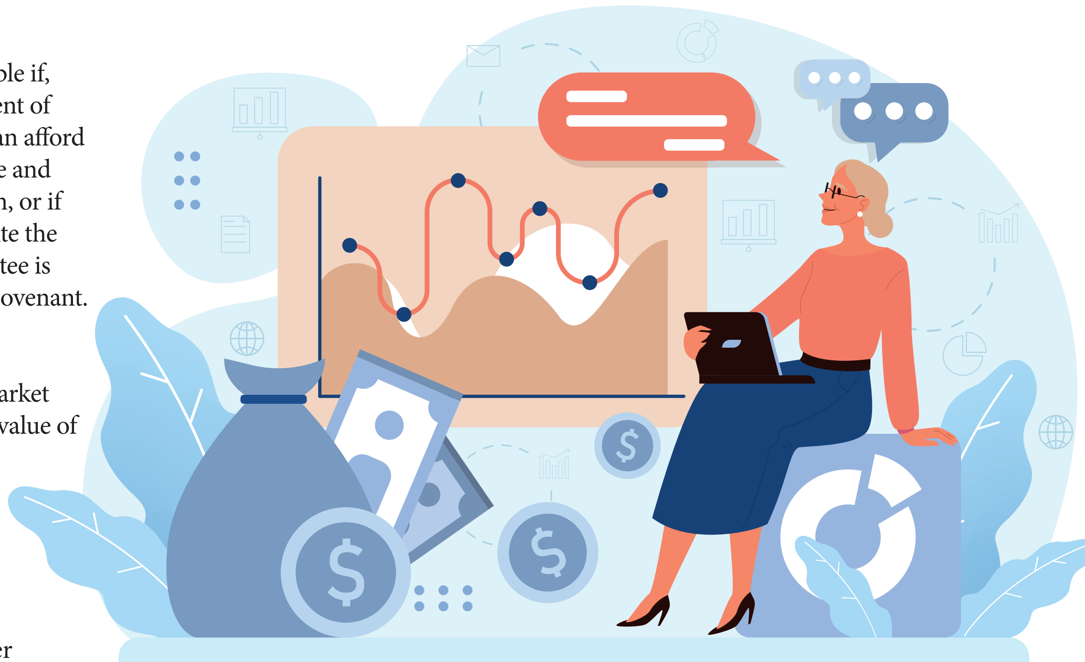
Deferred premium

Where a scheme expects illiquid assets to run-off over the short to medium term, or has line-of-sight to a secondary market sale, deferring a portion of the premium can buy time to either allow the asset to run-off or complete a more measured sale.

The idea is simple: For example, pay 90 per cent of the buy-in premium today and 10 per cent over the next two years, with the 10 per cent met from proceeds from the remaining illiquid asset distributions or sales proceeds.

While this is a neat solution in some respects, trustees and sponsors should be alive to the associated risks. What happens if the illiquid assets don't pay out when you expect them to, or don't pay the amount expected, or the secondary market sale price is lower than expected? When the deferred premium becomes due, the scheme would then be reliant on any other residual assets and potentially a sponsor contribution to avoid defaulting on the deferred premium payment requirements.

This would be a magnification of the liquidity risk that the scheme always had when holding illiquids, as we saw play out in the LDI (liability-driven investment) crisis when some schemes ran short of liquid assets to meet collateral calls.



These risks may be acceptable if, for example, you hold 20 per cent of the premium in illiquids and can afford for these assets to halve in value and still meet the deferred premium, or if the sponsor agrees to underwrite the deferred premium and the trustee is comfortable with the sponsor covenant.

The secondary market

By engaging with secondary market brokers to understand the sale value of their illiquids, schemes will be better placed to assess the true affordability of a BPA transaction.

Secondary market sales take time. It's therefore important to carefully consider all options for managing illiquid assets as early as practicable, and far ahead of a BPA transaction. Then, if a secondary market sale is the preferred route, the scheme has sufficient time to appoint a broker and conduct the sale alongside the fast-paced execution of a BPA.

An insurer perspective

Insurers and pension scheme operate in different regulatory regimes. For insurers, there are strict requirements regarding the assets they can use to back their annuity liabilities. As a result, insurers are rarely a natural buyer for illiquids held by pension schemes.

Although it may be possible for an insurer to accept these assets, this may not be the most economically efficient outcome. The price at which insurers would accept an illiquid asset may be materially lower than the price that could be obtained in the secondary market.

That said, where there is a compelling need to secure an annuity in a short timeframe, with certainty being a priority for both the sponsor and the trustee, insurers taking on illiquid assets can help meet scheme objectives.

For trustees heading towards a BPA transaction while holding illiquid assets, we would recommend making the following considerations:

- Engage early – an insurer should be happy to discuss how it sees your specific assets at an early stage, giving you time to plan
- Understand the full suite of options
- Ensure there is a clear, realistic plan for illiquid assets before formally requesting quotes. Insurers now see this as a key part of market preparation, just as much as preparing the data or a benefit specification

Ultimately, for most pension schemes the guiding principle is this: the best value for illiquids will be provided by running them off or selling them to the highest bidder – which may or may not be the insurer they ultimately select.

Where next?

Managing illiquid assets will remain a key focus for schemes aiming to execute insurance transactions for some time.

In due course, we expect schemes to manage their position more actively in the lead up to a transaction, engaging earlier with insurers about potential options, and having a clearer strategy heading into a broking process and eventual transaction. We expect this will lead to better outcomes for schemes, reducing the frictional cost of execution.

This analysis is from our report, *Managing illiquid assets during a bulk purchase annuity transaction*, which can be found at: *standardlife.co.uk/managingilliquids-bpa*

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[1] Standard Life surveyed 12 EBCs and five professional trustee firms via an email questionnaire between 9 and 30 October 2023